Tax Exempt & Government Entities

TE/GE

Advisory Committee on

Tax Exempt and Government Entities (ACT)

2014 Report of Recommendations

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2013-2014 Member Biographies

EMPLOYEE PLANS

Alison Cohen, Atlanta, GA

Cohen is a benefits lawyer working for Transamerica Retirement Solutions, specializing in the Employee Plans Compliance Resolution System (EPCRS) corrections. She has 18 years of experience working with retirement plans. From plan operations to presentation and sales, to resolution of complex legal issues, Cohen has broad experience and knowledge of the real world of retirement plan law. Cohen received a B.A. in Political Science from Rice University, Houston and a Juris Doctorate from the University of San Diego School of Law, San Diego.

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 his Bachelor of Arts from Boston University.

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, Employee Stock Ownership Plan (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 Master's degree in Actuarial Science from the University of Nebraska and a Bachelor of Science degree in Mathematics from the State University of New York.

Donna M. Mueller, Des Moines, IA

Ms. Mueller is CEO of the Iowa Public Employees Retirement System—a state-wide public defined-benefit retirement system that has 300,000 members and 2,200 public employers, collects $942 million in contributions, pays $1.4 billion in benefits, and invests $24.5 billion in trust fund assets. She is Past-President of the National Association of State Retirement Administrators and a member of the National Council on Teacher Retirement. Ms. Mueller received a Bachelor of Arts in Political Science at the University of Minnesota, Duluth and a Juris Doctorate from Washington and Lee University, Lexington, Virginia.

David A. Mustone, McLean, VA

Mr. Mustone is partner at Hunton & Williams LLP advising employers on tax, ERISA and labor law aspects of employee benefits law. His clients include for-profit employers (both publicly traded and privately held) and a variety of nonprofit and governmental employers. He is co-chair for separate IRS liaison groups on determination letter and correction programs for tax qualified plans. He served as a senior attorney in the IRS Office of Chief Counsel. Mr. Mustone received a Bachelor of Arts in Government from the University of Notre Dame, Notre Dame, Ind.; and a Juris Doctorate and LL.M in

Taxation from the National Law Center, George Washington University, Washington, D.C.

Stuart A. Sirkin, Washington, D.C.
Sirkin is a benefits lawyer with The Segal Company. He gained vast experience on employee plans while working at the IRS, the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC), the Senate Finance Committee, as well as consulting and law firms and through his involvement with interagency task forces, American Bar Association subcommittees and other groups. Sirkin received a B.A. in Economics from George Washington University, Washington, D.C.; a Masters in Labor Economics from Cornell University, Ithaca, N.Y.; a Juris Doctorate from Columbia University Law School, New York, and a Masters in Tax Law from the Georgetown University Law Center, Washington, D.C.

EXEMPT ORGANIZATIONS

Eric B. Carriker, Boston, MA

Mr. Carriker is an assistant attorney general in the Non-Profit Organizations/Public Charity Division of the Massachusetts office of the Attorney General. He conducts investigations and litigation that cover 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 president of the National Association of State Charities Officials. He is a graduate of Harvard College and Boston University Law School.

Milton Cerny, Washington, D.C. and Richmond, VA

Mr. Cerny is counsel at McGuireWoods representing nonprofit organizations (hospitals, private foundations, universities, and U.S. affiliates of foreign charities). He advises on tax planning and legal representation on large case and team audits regarding tax controversies before the IRS and compliance with federal requirements on governance and private foundations. He was technical advisor to the IRS Assistant Commissioner, Employee Benefits and Tax Exempt Organizations. Mr. Cerny received a Bachelor of Science in International Relations at American University, Washington, D.C., and a Juris Doctorate from American University, Washington College of Law.

Virginia Gross, Kansas City, MO

Ms. Gross is a shareholder in the law firm of Polsinelli PC and has been a tax attorney for more than 22 years. Her practice is devoted to advising and counseling tax-exempt and governmental organizations on federal tax law and governance matters, including reporting, compliance and structural issues. Gross has extensive experience working with private foundations and other grant-making entities, healthcare organizations,

colleges and universities, supporting organizations and other public charities, social clubs, and associations. She also works with many nonprofit boards of directors on governance matters and writes and presents extensively on legal matters for tax-exempt organizations, including Form 990 reporting, governance issues, and private foundation law. Gross received a B.S. in Civil Engineering from Texas A&M University, College Station, and a Juris Doctor from the University of Texas School of Law, Austin.

Marty Martin, Raleigh, NC

Mr. Martin established the 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 program and is affiliated with the North Carolina State University Institute for Nonprofits. He authors The Nonprofit Mentor blog and frequently speaks on issues related to nonprofit organizations. Mr. Martin received a Master's Degree Public Administration 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.

David Moja, Orlando, FL

Moja is a Partner and National Director of Not-for-Profit Tax Services at Capin Crouse LLP. With 26 years of accounting experience, he has worked both inside not-for-profit organizations and for public accounting firms. Moja has extensive experience serving colleges and universities, associations, global missions organizations, churches, chambers of commerce, children's advocacy groups and environmental organizations. Moja has spoken extensively on tax-exempt organization issues to a wide variety of groups and conducts regular webcasts on exempt organizations issues. Moja is a licensed CPA in Florida, Georgia and Colorado and received a B.S. in Accounting from Florida State University, Tallahassee.

Gary J. Young, Boston, MA

Mr. Young is director of the Northeastern University Center for Health Policy and Healthcare Research and professor of Strategic Management and Healthcare Systems at the D'Amore-McKim School of Business and the Bouvé College of Health Sciences, Northeastern University. Previously, he was professor and chair of the Department of Health Policy and Management, Boston University School of Public Health, senior associate with the Lewin Group, and also served as a health care attorney and analyst within the U.S. government. Mr. Young received a Juris Doctorate and a Ph.D. in Management from the State University of New York.

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 University 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, Comptrollers and Treasurers. Mr. Jaros received his Juris Doctorate from the University of Detroit School of Law, his Master's 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 Deputy Director for the State of Alaska, Department of Administration, Division of Finance. She is the state liaison with the IRS for all tax matters including return filing and overall tax compliance. She oversees the accounting services, payroll, systems administration, and programmers for the Division. She is directly involved in implementing new tax provisions and 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, Comptrollers 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 has served 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, Comptrollers and Treasurers.

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

Holly Easterling, Ada, OK

Ms. Easterling is Secretary of the Department of Treasury for the Chickasaw Nation in Ada, OK, where she works 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 worldwide. Ms. Easterling graduated from Oklahoma State University with a Bachelor's degree in accounting and became a CPA in 1990.

Diane M. Gange, Sequim, WA

Ms. Gange is CFO of Jamestown S'Klallam Tribe and is responsible for fiscal oversight of the Tribe's operations and all of its enterprises. She is responsible for the analysis and interpretation of financial information pertaining to the Tribe and its operation's performance. She makes recommendations concerning business policy, resource allocation, and business operations to improve financial performance. She is also responsible for analyzing and determining tax strategies relating to tribal business programs, advising Tribal Council on tax consequences of programs affecting its citizens, and developing policies and plans for company relations with outside firms. She has conducted training in accounting principles and governmental accounting. Ms. Gange received a Bachelor of Science in Accounting from Central Washington University, Ellensburg, WA, and an Associate of Arts in Accounting at Peninsula College, Port Angeles, WA.

William "Yaan Yaan Eesh" Micklin, Alpine, CA

Mr. Micklin is 1st Vice President of the Central Council of Tlingit & Haida Indian Tribes of Alaska, representing over 28,000 tribal citizens. He is CEO for the Ewiiaapaayp Band

of Kumeyaay Indians and Executive Director of the California Association of Tribal Governments. He is appointed to tribal advisory committees for the Internal Revenue Service, Department of Interior, and Department of Energy. Mr. Micklin graduated with a Bachelor of Arts in English Literature from the University of Washington.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

Katherine A. Newell, Princeton, NJ
Ms. Newell is Director of Risk Management and Ethics Liaison Officer at the New Jersey Educational Facilities Authority (NJEFA) responsible for developing and implementing post-issuance tax compliance policies and procedures. As a Government Finance Officers Association member, she worked with the National Association of Bond Lawyers on the GFOA-NABL Post Issuance Compliance Checklist and is a member of the GFOA's Debt Committee. Prior to joining NJEFA, she engaged in the private practice of law, specializing in financing for governmental entities and conduit borrowers. Ms. Newell received her LL.M in Taxation from Georgetown University School of Law, Washington, D.C.; a Juris Doctorate from Villanova University School of Law, Villanova, PA; and a Bachelor of Arts in Mathematics from Temple University, Philadelphia, PA.

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 $9.1 billion. She is responsible for the issuance of over $4 billion in debt financing. Prior to joining Providence, she served as the Treasurer of the Public Utility District of Clark County. In that role 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 a Master's of Business Administration from the University of Portland and a Bachelor of Science in Business Admin/Finance from Portland State University, OR.

Lorraine Tyson, Chicago, IL
Ms. Tyson is a tax partner in Pugh, Jones & Johnson, P.C.'s Public Finance Practice Group and advises clients on federal tax and securities law issues that arise in public

finance and privatization transactions. She also serves as tax controversy counsel to issuers or other participants on bond deals audited by the IRS. Ms. Tyson is a member of the Tax Exempt Financing Committee of the American Bar Association and the Tax Committee of the National Association of Bond Lawyers (NABL). She has served as a panelist at NABL's Tax and Securities Law Institute and is a member of the Steering Committee for NABL's Bond Attorneys' Workshop from 2011-2013. Ms. Tyson received an LL.M in Taxation from Northwestern University School of Law, a Juris Doctorate from the University of Illinois College of Law, and a Bachelor of Arts from Northwestern University. She is a member of the Governors State University Board of Trustees and is also a member of Women in Public Finance's Board of Directors.

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

This General Report is presented in connection with the 13th annual public meeting of the IRS Advisory Committee on Tax Exempt and Governmental 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 Governmental Entities Division (TE/GE) 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 Pre-Approved and Determination Letter Programs

- **Exempt Organizations:** Analysis and Recommendations Regarding Unrelated Business Income Tax Compliance of Colleges and Universities

- **Federal, State and Local Governments:** The Affordable Care Act and Government Employees

- **Indian Tribal Governments:** IRS Tribal Consultation: A Compliance Audit and Recommendations for Improvement

- **Tax-Exempt Bonds:** Today's Reality: The Increased Reliance on the "Facts and Circumstances" Test in Analyzing Management Contracts for Private Business Use

The cooperation between the ACT members, the Service, and the numerous constituent groups was evident throughout this year's projects which culminated in these reports.

This year's ACT shared in the many challenges that the IRS and the Federal Government, as a whole, is facing due to much tighter budgets and fiscal restraints that have been imposed by Congress. Despite these limitations, the TE/GE leadership has provided the necessary cooperation and access to its personnel and resources to ensure the ACT can present meaningful insight and recommendations to the Service.

The individual reports of the ACT and the recommendations contained therein have consistently, over the prior 12 years since its inception, been considered by the Service in evaluating processes, guidance and myriad tax administration and compliance projects. While not every recommendation or report has been adopted by the Service, the reports have opened up dialogues and even assisted the Service in examining existing guidance or examination projects.

Special Thanks

As each year passes, we have a number of our members who complete their term. This year, we thank the following members for their contributions to the ACT:

- Eric B. Carriker
- Milton Cerny
- Holly Easterling
- Stephen L. Ferszt
- Robert E. Jaros
- Marty Martin
- Joan E. McCabe
- William "Yaan Yaan Eesh" Micklin
- J. Sue Painter

- Lisa M. Pusich
- Kathy Sheppard

Each member has made significant contributions to the ACT. I would like to thank each of these members, as well as those continuing, for their support, service and their friendship.

On behalf of the ACT, I would like to thank Commissioner John Koskinen and his staff for their continued interest. The Service's leadership has continually offered its ongoing support for our service and we have seen firsthand the dedication of its personnel to collaborate with the ACT in furtherance of its projects.

Lastly, I would personally like to thank the members of the ACT and the IRS leadership with whom I have enjoyed serving with over the last three years. In particular, Robert Choi has provided invaluable leadership to my EP subcommittee and I am grateful for his guidance. I congratulate Katherine A. Newell as the incoming Chair for the 2014-2015 year. Finally, I would like to thank Mark Kirbabas for stepping in as the Acting Designated Federal Officer to succeed Bobby Zarin and her team and helping to make this year successful. I hope that our input is helpful to the Service and to the constituent groups we serve.

Stephen L. Ferszt
Chair

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Employee Plans:
Analysis and Recommendations
Regarding the Pre-Approved and Determination Letter Programs

Alison J. Cohen, Esq.

Stephen L. Ferszt, Esq.

Joan E. McCabe, ASA, EA

Donna Mueller, Esq.

David Mustone, Esq.

Stuart A. Sirkin, Esq.

June 11, 2014

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on Tax (ACT) Practitioner Survey on Pre Approved Plans

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I. Executive Summary

The Employee Plans subgroup of the ACT ("EP Subcommittee") elected to undertake a review of the pre-approved Master and Prototype (M&P) and Volume Submitter (VS) programs and the relationship of these programs to the IRS determination letter program for individually drafted plans.

Our goal was to identify recommendations for the pre-approved and determination letter programs which would help these programs better complement each other and be meaningful in assisting plan sponsors and practitioners in complying with the document requirements of the Internal Revenue Code ("Code"). Our recommendations were also aimed at easing some important challenges faced by the IRS including limited budgets, retirements of experienced staff, new focus on inventory control and the desire to facilitate timely closure of individual determination letter requests.

Our strong interest in reviewing this aspect of the Employee Plan's work was rooted in the EP Subcommittee's belief that a successful determination, opinion and advisory letter program is a key element in good plan governance and tax compliance. While the content of a plan document does not assure the plan's operational compliance, the EP Subcommittee believes that plan documents which properly include the Code requirements are more likely to operate in accordance with those requirements.

Section III of the report describes the evolution of the pre-approved and determination letter programs as well as the current status of those programs. Section IV describes the process we undertook to study and understand these programs for our project. Section V contains a detailed description of the Subcommittee's recommendations which fall into the following general categories:

EMPLOYEE PLANS

- Changes to the pre-approved plan program
- Expansion of the pre-approved plan program
- Changes to the determination letter program

A summary of the Subcommittee's recommendations is described in Section VI.

Appendix A provides U.S. Department of Labor statistics which demonstrate the significant growth in small cash balance plans in recent years. Appendix B provides statistics on recent determination letter applications for Employee Stock Ownership (ESOP) plans. These statistics show the significance of ESOPs as a source of determination letters filings. Appendix C includes a summary of the results of the Practitioner Survey that the Subcommittee conducted with the practitioner community.

This year's project was supported and encouraged by the management and staff of Employee Plans. In particular, the EP Subcommittee would like to acknowledge the support and leadership provided by Rob Choi, Director of Employee Plans. Throughout the year, EP management and staff shared their time generously and provided the EP Subcommittee with valuable insight and feedback that facilitated our work and recommendations and we are grateful for their assistance.

II. Introduction

Employers sponsoring retirement plans (including plans for self-employed individuals) and the employees participating in those plans may enjoy certain tax benefits provided that the retirement plan complies with the requirements of Internal Revenue Code ("Code") §§401(a) and 501(a). These sections are implemented through a complex set of rules, regulations, and other guidance, such as revenue procedures, issued by the Internal Revenue Service ("IRS"). A retirement plan meeting the Code and related guidance is considered a qualified plan.

A plan sponsor may obtain assurance of the qualified status of the plan and related trust document through the determination letter process for plans that are individually designed. An adopter of pre-approved plans may receive assurance through an advisory or opinion letter issued to the sponsor of the pre-approved plans. A favorable determination letter expresses the IRS' opinion that the terms of the plan, as presented in the plan document, meet the requirements of the Code and applicable guidance. However, a plan must also operate in accordance with the plan document and the relevant Code sections and applicable guidance in order to maintain its qualified status.

Assuring the qualified status of a plan document is a critical first step for plan sponsors and adopters. The EP Subcommittee chose as its project this year to review the determination letter processes and pre-approved plan program with a primary focus on expanding the pre-approved plan program to lower the demand on the determination letter program and the IRS agents. The Employee Plans Division (EP) of TE/GE is simultaneously engaged in examining these programs.

III. History

In lieu of an individually-designed plan with its particular determination letter, an employer may adopt a pre-approved plan for which the IRS has issued an advisory or opinion letter. These letters state that the pre-approved plan document meets the legal requirements of the Code and applicable regulations. There are two categories of pre-approved plans, Master and Prototype (M&P) and Volume Submitter (VS).

Master and Prototype[1]

An M&P plan consists of a basic plan document containing non-elective provisions and an adoption agreement in which the adopting employer may select elective provisions. An M&P mass submitter or an M&P sponsor develops an M&P plan and submits it to the IRS to obtain an opinion letter that the plan document meets all the tax requirements. An employer adopting an M&P plan of a sponsor that has received an opinion letter may rely on that opinion letter.[2]

An M&P sponsor must be a U.S. business and have at least 30 employer-clients that are expected to timely adopt the sponsor's basic plan document. A sponsor may request opinion letters for any number of basic plan document types and adoption agreements, provided that the 30-employer requirement is met with respect to at least one basic plan document.[3]

An M&P mass submitter must also be a U.S. business. It must submit a lead plan document for an opinion letter. To be a mass submitter, the business must have at least 30 unaffiliated sponsors that are expected to adopt plans that are "word-for-word

[1] Rev. Proc. 2011-49, Part I.
[2] See id. at §19.
[3] See id. at §4.07.

identical" to the mass submitter's lead plan document.[4]

An M&P sponsor or mass submitter may request an opinion letter on either a master plan or a prototype plan. The request for either plan must include a basic plan document containing non-elective provisions, an adoption agreement containing elective provisions that an adopting employer may select, and a trust document or custodial account document. The primary difference between the two is that a master plan utilizes a trust or custodial account that is jointly used by all employers adopting the particular master plan, whereas, each adopting employer of a prototype plan maintains a separate trust or custodial account.[5]

An M&P plan may be designated as a standardized plan or a non-standardized plan.[6] A standardized plan is designed to meet tax qualification requirements based solely on the plans terms. An adopting employer may rely on the opinion letter issued to the pre-approved plan sponsor to the same extent as an individually issued determination letter, except in limited circumstances.[7] A non-standardized plan allows the adopting employer more plan design choices and elective provisions than a standardized plan. As with the standardized plan, an adopting employer may rely on an opinion letter issued to the M&P sponsor, except under limited conditions.[8]

Volume Submitter[9]

A VS plan is a specimen or sample plan offered to employers by a VS practitioner for adoption on an identical or substantially identical basis. To obtain an advisory letter as to the qualification of the VS plan, the practitioner must submit a basic plan document that may have choice over plan terms (or, if it wishes, a separate adoption agreement

[4] See id. at §4.08.
[5] See id. at §§ 4.01 and 4.02.
[6] See id. at §§ 4.09 and 4.10.
[7] Rev. Proc. 2011-49 at §19.01(1)-(3).
[8] See id. at Part II.
[9] See id. at Part II.

that offers choices over elective provisions). The VS practitioner must also submit a trust document or custodial account document. VS plans provide an adopting employer with more options and greater flexibility than an M&P plan. An employer adopting an identical VS plan (including elections contained in the submitted VS plan) may rely on the advisory letter issued to the VS practitioner.[10]

A VS plan may be submitted by a VS practitioner or a VS mass submitter. As with an M&P sponsor or M&P mass submitter, each must meet a 30 client threshold. A VS practitioner must be a U.S. business with at least 30 employer-clients expected to adopt a plan substantially similar to the VS practitioner's specimen plan.[11] A VS mass submitter must be a U.S. business that is submitting a specimen plan on behalf of 30 unaffiliated practitioners who are sponsoring, on a word-for-word identical basis, the same specimen plan. The VS mass submitter must meet the 30-practitioner rule for each specimen plan, which is more stringent than the rule for an M&P mass submitter.[12]

Determination Letter Program

The determination letter program has a long history, both as to its importance to the industry, and as to the growing volume of applications filed with the IRS.[13] However, the IRS has continued to struggle with a significant backlog of applications and a large volume of new determination letter applications each cycle.

Individually designed retirement plans may be submitted to the IRS for a determination that the plan and trust document meet the tax qualification requirements of the Code. The application for a determination letter is submitted on a five- year cycle based generally on the plan sponsor's employer identification number (EIN). Certain types of

[10] See id. at §19.02.
[11] See id. at §13.05 (only 10 employer-clients are required in the case of a money purchase specimen plan).
[12] Rev. Proc. 2011-49 at §13.06.
[13] A summary of the variations and growth in the process from 1954 through the initial implementation of Revenue Procedure 2005-66 is recounted in the 2010 Report of the Advisory Committee on Tax Exempt and Government Entities (ACT), Employee Plan Section III.

plans – governmental plans, multiple employer plans and multiemployer plans – are clustered by type of plan for cycle filing purposes.[14] The application package must include a copy of the plan and all plan amendments. While there is no legal requirement that a plan sponsor obtain a determination letter, most plan sponsors seek a letter to avail themselves of the protections provided under Code Section 7805(b).

In 2001 and again in 2003, the IRS issued White Papers exploring alternatives to the determination letter program and seeking comments in response thereto.[15] As a result, major revisions to the program were instituted through Revenue Procedure 2005-66.[16] This Procedure established a five-year staggered determination letter application process for individually designed plans, commonly referred to as the "cycle" process.

While the cycle process may have had a positive effect in managing the volume of applications each year, the IRS still experiences a significant peak in the number of applications during the year as the great majority of submissions are filed at the end of each cycle. This creates an instant backlog as a new inventory of applications comes in all at once. While the number of applications has remained relatively constant over time, the IRS' staffing has been depleted due to hiring freezes, staffing cutbacks, retirement and routine attrition, which makes it difficult for the IRS to handle the backlog and new applications timely. Moreover, the retirement and attrition of experienced agents has left the IRS with a decreasing number of more senior staff, the only personnel generally allowed to review (within the current collective bargaining agreement guidelines) complex determination applications on a full-time basis.

When the 2014 ACT project first began, the EP Subcommittee met with leaders of EP to examine the determination letter backlog issue and means to address it. In the interim, the TE/GE Employee Plans Division began a Lean Six Sigma exercise to examine

[14] Rev. Proc. 2014-1; Rev. Proc. 2007-44.
[15] Announcement 2001-83, 2001-2 C.B. 205; Announcement 2003-32, 2003-1 C.B. 933.
[16] Further refinements to the program made by Rev. Proc. 2007-44.

processes or means to improve the processing of both individual and pre-approved plan applications. The EP Subcommittee supports this endeavor. In light of time constraints, the EP Subcommittee focused its efforts more on the pre-approved program. Nevertheless, this report makes some significant recommendations with respect to the determination letter program.

IV. Due Diligence

This project examines ways to address the large on-going demand for individual determination letters in an era of continuously shrinking staff and resources, with a focus on exploring ways to encourage more employers to make use of pre-approved plans.

The EP Subcommittee developed a survey that it made available through numerous channels in an attempt to reach a broad cross-section of the practitioner community. The results of the practitioner survey are shown in Appendix C. In addition, the EP Subcommittee conducted interviews with a group of prominent pre-approved plan document providers, ESOP industry experts, ESOP plan sponsors and the professionals who assist in the adoption process and administration of such plans. There was strong participation from all facets of these practitioner communities, and we thank them for their valuable insights and comments.

Finally, the EP Subcommittee solicited the views of the Employee Plans personnel. Rob Choi, Director, Employee Plans, generously made himself and his staff available so that the EP Subcommittee was able to conduct in-depth in-person and telephone interviews with, among others, senior members of the EP leadership team, the leadership of the EP Determinations Group, and EP staff. The EP Subcommittee was also provided with pertinent statistical data, which provided valuable insight into the nature and volume of determination letter application filings from year-to-year, the various types of plans submitted, the status of IRS case processing and related statistical information.

Our research resulted in recommendations that are related to changes to the current pre-approved program, expansion of the pre-approved program to include additional plan types and changes to the determination letter process. Those specific recommendations are discussed in the remainder of this report.

V. Recommendations

a. Changes to the current Pre-Approved Program

The IRS pre-approved program is well utilized and popular with plan sponsors and practitioners alike. Given the limited resources that are expected to be available within the IRS, the EP Subcommittee believes it is desirable to implement changes to the pre-approved program to encourage expanded use of the program with the hope of reducing the number of employers seeking individual determination letters, which require extensive IRS resources.

The EP Subcommittee recommends the following changes to the pre-approved plan program in order to increase its popularity and expand its utilization:

i. Consolidation of M&P and VS status

The pre-approved program currently includes both M&P and VS components. In addition, the M&P component includes standardized and non-standardized plan types. The separate components and plan types that are defined by the pre-approved program share many common procedural and substantive requirements. The IRS has made changes to the pre-approved program over time that has virtually eliminated the distinction between these various components and plan types. The distinct requirements for M&P and VS plans now vary so little that the EP Subcommittee believes the differences do not warrant the duplicative efforts required to maintain both categories for pre-approved plans.

The EP Subcommittee recommends consolidation of the pre-approved program, by combining the M&P and VS components into a single pre-approved program. Consolidation of the programs will benefit the IRS, plan sponsors and practitioners.

The IRS will benefit from consolidation and resulting simplification of the program. It will also reduce the number of pre-approved plans that would have to be reviewed, thereby saving the agency substantial resources and man hours. Because many mass submitter sponsors maintain both M&P and VS plans that are substantially identical, consolidation should significantly reduce such duplication. The consolidation will also eliminate small differences in process and substantive requirements, resulting in less work to administer the program, fix filing errors and correct plan provisions that may not be eligible for the separate components of the program. Simplification and flexibility should help to reduce the number of pre-approved plans that would need to be submitted for approval.

Plan practitioners will be able to provide an improved and more cost effective service without having to sponsor multiple documents to serve a varied clientele. Plan sponsors who are largely unaware of the intricate details of the program's different components, and find such components confusing, will also benefit from simplicity.

ii. Procedural Requirements for Consolidated Pre-Approved Program

Simplified and flexible procedural requirements can reduce confusion and maximize the efficiency and utilization of the consolidated pre-approved program.

The current M&P and VS components of the pre-approved program have unique procedural requirements. In order to avoid losing the flexibility currently available under the pre-approved program, the consolidated pre-approved program should continue the use of the procedural requirements already in place.

Specifically, the procedural requirements for the consolidated program should provide that:

1. **Pre-approved plan format**. Pre-approved plan drafters should be able to use either an individually drafted format (which does not include a separate adoption agreement for optional provisions), or an adoption agreement format that includes a base document and a separate adoption agreement for optional provisions. Further, under either of these formats, the pre-approved plan drafter should have flexibility to designate optional provisions that can either be included or deleted in the plan document executed by the plan sponsor.

2. **Mass submitter/sponsor status**. Requirements for mass submitter and plan sponsor/VS practitioner status for certain plan types that have a narrower (or are new to the) market should be reduced. This includes cash balance plans, which the IRS has recently committed[17] to incorporating into the pre-approved defined benefit plan program (and discussed in Section B below), and ESOPs, which are discussed in Section C below. It should also include government plans and multiple employer plans to encourage greater use of pre-approved plan documents for these arrangements as well.

   The current pre-approved program generally requires M&P/VS mass submitters to submit applications on behalf of at least 30 unaffiliated pre-approved sponsors. There is a similar requirement for sponsor/VS practitioner status as well for adopting employers that will utilize their documents. The Service has reduced this number to 15 for money purchase and 403(b) plans to encourage the use of pre-approved plan documents for these plan types. We believe that a similar reduction for cash balance, ESOP, governmental and multiple employer plan sponsors is essential to making pre-approved program workable for these plan types.

[17] Announcement 2014-14.

While reducing the number of required sponsors could increase the number of plans submitted by mass submitters and sponsor/VS practitioners for pre-approved status, it should also reduce over the long term the number of employers that apply for individual determination letters.

Further, if a pre-approved plan uses an adoption agreement format, each unique adoption agreement (with different optional provisions), that is paired with a common base document, should be considered a unique pre-approved plan and all plan sponsors that utilize an adoption agreement that is paired with the common base document should be eligible to be included in the qualifying number required for mass submitter or VS practitioner status.

3. **Mass submitters with minor modifications**. The consolidated pre-approved program should contain simplified procedures for applications from mass submitters of pre-approved plans that contain only insignificant changes to a previously approved document. Plans submitted with minor modifications should be reviewed on a limited basis with reduced user fees. This minor modification process is currently available for M&P plan documents but not for VS plan documents.

4. **Governmental plans**. Generally, governmental plans may utilize a VS document but are not permitted to sponsor M&P plans under the current pre-approved program. Plans that satisfy the overall qualification requirements for governmental plans should be allowed to utilize either type of pre-approved document to the extent that the M&P program continues to be separately maintained.

   Given that the majority of governmental agencies sponsor qualified plans, the IRS should engage in targeted customer outreach to promote increased

awareness of a pre-approved document among the federal, state and local governmental agencies. This should be particularly worthwhile with the recent addition of the pre-approved cash balance plan program, as this type of plan has become increasingly popular among governmental agencies.

iii. Substantive Requirements for Consolidated Pre-Approved Program

Substantive requirements for the consolidated pre-approved program should allow maximum flexibility so that a broad range of plan designs may be accommodated within a single pre-approved plan document. It is important that any consolidated program not be any more restrictive than the current pre-approved program. Therefore, the best features and most liberal requirements from the current program's M&P and VS components should be incorporated within the parameters of the consolidated program.

The specific substantive requirements should include:

- Both integrated and non-integrated plan benefit (or contribution) formulas should be permitted within any single pre-approved defined benefit or defined contribution plan. This is currently permitted for defined contribution M&P plans, but not for defined benefit M&P plans.
- Hardship withdrawal provisions that fit the 401(k) safe harbor hardship requirements, and those that do not, should be available within any pre-approved plan as long as they are conditioned on nondiscriminatory and objective criteria.
- After-tax employee contributions should be available as an option in any pre-approved plan.

iv. Approval for Separate Trust Agreements that are used with Pre-Approved Plans

Under the current pre-approved program procedures, mass submitters must submit all custom trust documents that may be used with its pre-approved plan documents.[18] Therefore, each employer that utilizes a separate trust agreement with a pre-approved plan must, to obtain full reliance, use a trust agreement that has been approved for use with the plan.

The stand-alone trust agreements used by a trust company may be submitted with a number of different pre-approved documents. This often results in duplicative efforts as the same trust agreement will be reviewed by the IRS multiple times.

This problem could be addressed by the establishment of a separate program for approval of trust agreements, so that an organization utilizing a separate trust agreement could obtain approval for its use with any pre-approved plan document. However, the EP Subcommittee recognizes that limited IRS resources might make it difficult to establish such a program. Therefore, the EP Subcommittee recommends alternatively that the IRS establish a formalized internal process to avoid duplication of stand-alone trust reviews.

Avoiding such duplicative efforts could easily be accomplished by assigning each trust agreement with a unique identifying code. After receiving unique identifiers, approved trust agreements could be placed on a list. Adopters of that trust would be able to utilize it with any pre-approved plan, eliminating the need to re-file the trust and plan with the IRS.

[18] Rev. Proc. 2011-49 at §19.03.

To further reduce the resources that are currently devoted to reviewing stand-alone trust agreements, the IRS should limit its review of trust agreements to tax qualification compliance, and not extend to issues related to Title I of the Employee Retirement Income Security Act (ERISA). To this end, we also recommend that it include language in its advisory and opinion letters to clarify that its review and approval of any trust provisions only pertains to such terms as they relate to qualification under Code Section 401(a) and does not cover Title I of ERISA.

v. Clarification of Reliance on Advisory and Opinion Letters for Tax-Qualified Status

The EP Subcommittee recommends that the IRS initiate efforts to reduce confusion related to plan sponsor reliance on IRS advisory and opinion letters in order to reduce unnecessary determination letter filings. In general, employers adopting an M&P or VS plan may rely on the plan's advisory or opinion letter if the employer has not amended the plan's terms other than to choose options provided under the approved plan and has not otherwise made impermissible changes to the document.[19] Despite the availability of this reliance, a determination letter is often viewed as more beneficial to plan sponsors in certain situations such as bankruptcy, mergers, acquisitions, and ESOP financing transactions. For example, certain bankruptcy rules related to protection of assets in an employer's retirement plan are only applicable if the plan is considered to be qualified. An advisory or opinion letter is considered insufficient in these cases in some bankruptcy courts.

This misperception results in the use of individually drafted plans in many cases where a pre-approved plan would be adequate and appropriate for the particular plan sponsor. Clarification of this misperception may therefore reduce the number of unnecessary individual determination letter applications. To avoid confusion related to the reliance that a plan sponsor can enjoy, the EP Subcommittee recommends that the IRS include

[19] See id. at §19

additional wording in each advisory or opinion letter that cites the guidance set forth in Revenue Procedure 2011-49. The advisory or opinion letter should state that pursuant to that revenue procedure, the employer may rely on the advisory or opinion letter and that letter is the equivalent to a determination letter.

b. Creation of a Pre-Approved Cash Balance Plan

Much of the pension universe has moved from defined benefit plans to defined contribution plans and many of the employers still sponsoring defined benefit plans have moved from traditional final-average pay pension plans to cash balance plans. With respect to new defined benefit plans, as shown by the latest available information from the U.S. Department of Labor (DOL), virtually all of the new cash balance plans are sponsored by small employers. See Appendix A for data regarding cash balance plans.

i. Benefits of Having a Pre-Approved Cash Balance Plan

On January 23, 2014, the IRS issued Announcement 2014-4. The Announcement extended the deadline for submission of pre-approved defined benefit plans from January 31, 2014 to February 2, 2015. According to the Announcement, the purpose of the extension is to provide time to permit plans with certain cash balance provisions to be included in the current pre-approved defined benefit plan submission cycle.

The EP Subcommittee worked with the IRS and encouraged its consideration and decision to create a pre-approved cash balance plan program. In deciding that our project this year would be an analysis of how to reduce the volume of individually designed plans by moving more plans to the pre-approved programs, we identified cash balance plans as a key component.

As a result of IRS' own internal discussions and a push from pre-approved plan sponsors for the IRS to include a cash balance component to the defined benefit pre-

approved program in the Economic Growth Tax Relief Reconciliation Act (EGTRRA) cycle, matters have proceeded very rapidly from the time we started addressing this issue. During this time period, we shared our preliminary survey findings with the IRS, our view that the IRS should establish a cash balance pre-approved program, and our view that it would work best as a component of the overall defined benefit plan pre-approved program rather than as a stand-alone program.

Our survey of practitioners supports the notion that the majority of them either strongly desire the IRS to create a pre-approved program, or have no opinion either way. Many of those practitioners who want the pre-approved program are already using or adapting form documents prepared by others and submitting them under the more time consuming and costly individually designed plan program. However, it is worth noting that some of the surveyed practitioners are concerned that given the complexity of cash balance plans, the IRS is inviting operational problems by implementing a pre-approved program. While the IRS has made the decision to create the cash balance pre-approved program, the IRS has not yet determined the permissible features that will be covered under the program.

ii. Make the Pre-Approved Cash Balance Plan Program as Flexible as Possible

Based on the comments received from our survey, and discussions with practitioners, the IRS will not be able to maximize the move from individually designed cash balance plans to pre-approved cash balance plans unless the program accommodates a variety of plan designs.

The key questions hinge upon what limits on design options are necessary and the factors that support such limits. The EP Subcommittee recommends that in designing the cash balance pre-approved program, the IRS incorporate language that allows for

maximum flexibility and ban design components only if there is an identifiable and measurable risk in allowing that design component in the pre-approved program.

It is widely recognized among the practitioner community that EP now functions, and will continue to function, in a world with increasingly limited resources. The IRS' willingness to take certain risks in the pre-approved program should reflect such change.

a) **Permissible Interest Credits**. At the time we were writing this paper, Treasury and the IRS have not published the final cash balance regulations on permissible interest credits. The regulations that Treasury has issued take the approach that the only permitted interest crediting rates are the rates specifically permitted in the regulations. (Some of the comments submitted on the already published regulations have argued that the regulations' list should only be a safe harbor list with other rates not specifically prohibited if they are market rates of interest.)

   Regardless of how the final regulations resolve this issue, the EP Subcommittee appreciates why the IRS might favor limiting the usable interest crediting rates in the pre-approved program to such a narrow list. This approach keeps the plans in the pre-approved program within the confines of certainty while not overly limiting flexibility. However, within that context, we believe that the IRS should consider allowing the full range of permitted market rates including flat rates, variable rates and variable rates with a floor.

b) **Pay Credits**. The other component of the benefit formula is the pay credit. Survey participants and others we discussed this issue with believe it is important to provide for flexible design. For example, the pre-approved design should allow both flat dollar pay credits and percentage-of-compensation pay credits.

c) **Rate Groups**. Many small employer cash balance plans use varying pay and/or flat dollar credits for plan participants based on their job classification, service,

age or other criteria. Frequently, these plans test for nondiscrimination in combination with the employer's defined contribution plan. If the IRS were to place limitations on the number or type of rate groups allowable within the pre-approved program, practitioner comments indicated that the IRS would significantly reduce the number of plans that would choose the pre-approved route.

d) **Other Hybrid Plans Such as PEPs**. It is our understanding that final cash balance plan regulations are anticipated shortly. We also understand that pension equity plan (PEP) regulations when issued are likely to be issued in proposed form. Therefore, PEPs and other hybrid designs not covered by the currently planned final regulations should be excluded from the pre-approved program for now.

e) **Conversions to Cash Balance Formulas**. If the IRS seeks to maximize use of the pre-approved plan program, it should allow existing plans into the pre-approved program that were converted from a final average pay plan to a cash balance plan. However, to avoid unnecessary complications, the program should be limited to "A+B" conversions (i.e., the program should not cover conversions that use the greater of "A or B").[20]

iii. Publish the LRMs for Public Comment Before Adopting

Pre-approved plan practitioners have tremendous insight as to what is practical to include in a pre-approved document. Likewise, individually designed plan practitioners possess the insight necessary to know what will be required in making the switch from an individually designed plan to a pre-approved plan. The IRS should make this proposed design open for comment by the practitioner community – similar to what it did

[20] "A" is the benefit under the final pay portion of the plan; "B" is the benefit under the cash balance portion.

when it proposed the Section 403(b) plan pre-approved program. In that case, the IRS received numerous, valuable comments. The EP Subcommittee believes this would avoid having resources used to create a program that has only a limited number of adopters.

c. Create a Pre-Approved Employee Stock Ownership (ESOP) Plan

i. Benefits of a Pre-Approved ESOP Plan

Dealing with ESOPs as individually designed plans places a burden on the IRS determination letter program. See Appendix B for data on the IRS's processing efforts in connection with ESOPs.

As of July 31, 2013, the IRS ESOP backlog consisted of more than 4,300 plans. While the IRS has completed the majority of ESOP submissions from the first Cycle D, as of July 31, 2013, it had closed very few ESOP submissions from the first Cycle E. That is, many Cycle E sponsors have been waiting three or more years for determination letters. Considering the staffing challenges that the IRS is currently facing, this backlog will not be alleviated in the near future and the waiting period for ESOP sponsors is not likely to change.

One approach the IRS has been considering to address the problem long term is the development of a pre-approved ESOP program.

Based on comments received from our survey, practitioners were split on the creation of a pre-approved ESOP program. A substantial group of practitioners, in essence, said "no way." They believe that most ESOPs are structured during leveraged financial transactions, involved Subchapter S corporations, and have complex operational rules. Appendix B shows a relatively even divide between leveraged and non-leveraged ESOPs, but there are clearly more ESOPs with under 100 participants (although we do

not have data on whether they are Subchapter S corporations). Respondents consistently expressed their view that ESOP expertise was required every step of the way for Subchapter S corporations and leveraged ESOPs because the intricacies of plan design placed a heavy burden on plan administration.

They also pointed out the lack of regulatory answers on many questions as final regulations appear to be outdated. It is our understanding that a new ESOP regulation project is in its preliminary stages at Treasury and IRS' Chief Counsel. Such a project is likely to take some time and there is a concern that until the regulations are issued in final form, the IRS might be compelled to take a narrow position in any pre-approved program.

The EP Subcommittee recognizes that legal fees for designing ESOPs are a valuable source of revenue for some practitioners and may serve to prejudice views. However, there are many practitioners who believe that employers might rely upon their legal professionals less for administrative guidance if the ESOP is a pre-approved document, which will result in increased violations. This appears to be a pointed concern with respect to Subchapter S ESOPs that must comply with the complex distribution rules of Code Section 409(p).

Another group of practitioners in our survey believed that while the concerns regarding complexity in operation were justified, a pre-approved plan document would be an attractive alternative as long as the pre-approved plan provided sufficient certainty and flexibility.

ii. The IRS Should Develop a Pre-approved ESOP Program

The EP Subcommittee supports the development of an ESOP pre-approved program because of the heavy burden ESOP determination letters place on EP's diminishing resources. In our survey, we asked practitioners what provisions would be important in

a pre-approved ESOP program. The answers, based on the generality of the question, were so varied that it would be difficult to categorize, much less narrow, in this report. It is our understanding that the IRS has been talking informally with ESOP practitioners, ESOP document providers, and ESOP sponsors and associations, and will continue to do so. The EP Subcommittee recommends that the IRS should continue that outreach so that a workable ESOP program can be developed that will meet the needs of the ESOP community.

iii. Consider Whether a Partial Pre-Approved Program Would Work

Even in the most complex ESOP, a significant portion of the language may be considered "boilerplate." The EP Subcommittee recommends that the IRS examine whether implementing an ESOP program that uses a base pre-approved defined contribution plan document would accelerate IRS review. Employers could then modify the base document for relevant ESOP provisions and only the modifications would be subject to IRS review.

d. Changes to the Current Determination Letter Program

The determination letter program continues to be an invaluable resource for employers sponsoring individually designed plans to ensure that plan documents are compliant with the applicable tax qualification requirements. Because of the myriad of qualification requirements and the differing views as to what should be contained in a plan document for compliance purposes, determination letters provide reasonable assurance to diligent plan sponsors that the tax qualification of the submitted plan documents will pass muster upon audit or other IRS compliance review. At the same time, the ability of the IRS to review and approve individually designed plan documents on an ongoing basis plays a critical role in overseeing and policing qualification compliance as these documents are central to plan administration and operations. While up-front review does not assure operational compliance, plan documents that follow the requirements of

the Code increase the likelihood that the sponsor will operate the plan in accordance with those requirements. The EP Subcommittee believes that a well-run determination letter program is a key element to an efficient compliance program.

In 2005, the IRS established a staggered five-year determination letter program to provide a more predictable workflow and allow for a better balance of IRS personnel and resources between plan document review and audit enforcement.[21] However, given the significant backlog in determination letter application processing, it is evident that the continued contraction of IRS staffing and resources has strained EP's' ability to process and review the current flow of determination letter applications on a timely basis. Short of an infusion of significant additional funding and resources, there is no one easily identifiable solution to the IRS's current predicament. In the EP Subcommittee's view, however, there are some steps that the IRS could implement now that would enable the IRS to better control and manage its determination letter application workflow in a fair and sensible way. The EP Subcommittee also believes that over the longer term, the IRS should develop a more efficient and targeted determination letter review process that takes into account its reduced resources while remaining cognizant of the most critical risk areas.

The EP Subcommittee's recommendations regarding the current determination letter process relate to (i) delaying the start of new five-year cycles to provide time to catch up with backlogs; (ii) narrowing the availability of "off-cycle" filings; (iii) limiting multiple employer plans (MEPs) submissions by participating employers and (iv) considering varying user fees so as to encourage submission of pre-approved plans and reduce unnecessary determination letter applications. The EP Subcommittee also has longer-term recommendations regarding the determination letter application review process.

[21] This program was originally established in Rev. Proc. 2005-66. The program is now set out in Rev. Proc. 2007-44.

1. Determination Letter Program Changes

a) Delay the Start of New Five-Year Remedial Amendment Cycles

Under the current determination letter process, individually-designed plans generally must be submitted once every five years in order to maintain a current determination letter,[22] and the year in which a plan must be submitted (to keep the remedial amendment period open and maintain reliance) is generally based on the last number of the plan sponsor's EIN.[23] In contrast, pre-approved plans are subject to a six-year cycle,[24] during which the document providers must submit the documents for an advisory or opinion letter (depending on the type of pre-approved plan involved) and adopting employers must thereafter adopt the approved plan documents within the required timeframe.

Given the continuing contraction of IRS funding and resources, the EP Subcommittee submits that it would be reasonable and appropriate for the IRS to delay the start of each five-year cycle subsequent to the PPA five-year cycle -- something that the IRS would appear to have the authority to do under Rev. Proc. 2007-44.[25] This would give the IRS additional time to catch up on the inventory backlog without unnecessary disruption or constriction of the determination letter process.

A delay would also mean that when the submission is made it will be made using a more up-to-date cumulative list and there will be a shorter time in which the submission "sits" with the IRS. This should be welcomed by both practitioners and the IRS because

[22] See Rev. Proc. 2007-44 at § 9.
[23] See id. at § 9.03. However, there are a number of special rules and exceptions. See §§ 10 & 11. For example, all multiemployer, multiemployer and government plans must be submitted with a designated annual cycle within the 5-year process. See §§ 10.02-10.04.
[24] See id. at § 15.
[25] See §13.03, which gives the IRS the authority extend the expiration date of outstanding determination letters for one or more cycle years through published guidance.

there will be fewer plan amendments being drafted between the time of submission and the time the determination letter is issued.

While the EP Subcommittee recommends that the per-cycle extension generally be one year, we also recommend that the IRS reserve the discretion to provide for a longer period should the current inventory backlog require additional time. In making this recommendation, the EP Subcommittee is not suggesting that any fundamental changes be made to the structure and processes of the five -year cycle and we are not recommending that critical off-cycle submissions (e.g., for terminations) be subject to the moratorium. Instead, we would envision the cycle moratorium as a period during which no new on-cycle applications would generally be permitted and during which the IRS' determination letter group could devote full time and attention to the existing backlog.

The EP Subcommittee does not believe such a moratorium would create undue hardship or burden for individually designed plan sponsors and their service providers. By providing ample advance notice and guidance, the adverse impact of any extension should be minimal. Moreover, we believe that the extension would generally be welcomed by the benefits community as a sensible, responsible step to alleviating the substantial backlog and providing a shorter, more predictable turnaround of determination letter applications, and based on more current cumulative lists.

If it is determined that a complete moratorium is unnecessary because it is only the higher-graded cases causing the major backlog, the IRS may want to consider applying the moratorium only to plans that tend to have a greater percentage of higher- graded cases, such as defined benefit plans and ESOPs. This in essence would create two separate sub-cycles for individually designed plans that do not coincide – one cycle for defined benefit plans and ESOPs and another cycle for other defined contribution plans. While this would add some complexity to the cycle structure, the EP Subcommittee does not believe that this would ultimately create a burden if the revenue procedure

made this clear (e.g., non-ESOP defined contribution plans continue using Cycles A – E, and defined benefit plans and ESOPs use new Cycles V-Z).

b) Narrower Availability of "Off-Cycle" Filings

Revenue Procedure 2007-44 currently permits a determination letter application to be filed for individually designed plans outside of the plan's on-cycle year, called an "off-cycle" filing.[26] Except for terminating plans (which are reviewed under the Cumulative List in effect on the termination date), these filings are reviewed under the Cumulative List in effect for the year in which the filing is submitted.[27] Because an off-cycle filing is not treated as an "on-cycle" filing, a second, separate on-cycle determination letter application is needed to preserve the extended remedial amendment period and continued reliance from cycle to cycle.[28]

In general, the Revenue Procedure provides that off-cycle filings will not be reviewed until all on-cycle filings have been reviewed.[29] Exceptions are provided for –

- Terminating plans;[30]
- A newly adopted plan (where the on-cycle filing period is at least two years away);[31]
- An off-cycle filing that is made in accordance with IRS guidance requiring a determination letter application filing;[32] and
- A filing for which there is an "urgent business need," which the Revenue Procedure makes clear will occur "only in limited cases where exceptional circumstances exist."[33]

[26] See § 14.
[27] Id. at § 14.01.
[28] Id. at § 14.01.
[29] Id. at §§ 14.01 & 14.02.
[30] Id. at § 14.02(1).
[31] See id. at § 14.02(2).
[32] See id. at § 14.02(3).

Off-cycle applications must go through the same intake, screening and review process as on-cycle filings and, therefore, generally require the same time and effort as other application filings. The EP Subcommittee understands that because of the significant application backlog, the IRS has been unable to review off-cycle filings that are not eligible for priority processing. As a result, these applications are typically closed and returned to the plan sponsor without review during the plan's subsequent on-cycle year.

Despite the on-going backlog for non-priority eligible off-cycle filings, we understand that the determination letter staff is continually surprised by the number of applications the IRS receives each year. These applications must still go through initial processing and tracking, which ultimately involve (in our view) an unnecessary expenditure of the IRS' limited resources and staffing. Therefore, the EP Subcommittee recommends that off-cycle filings only be permitted in circumstances under which priority review is allowed (as outlined above), with the exception of newly adopted plans. As set forth in Revenue Procedure 2007-44, while an off-cycle application filing for such a plan is eligible for priority status, it is not needed to preserve reliance, as the plan's remedial amendment period is automatically extended to the end of the new plan's otherwise applicable first on-cycle year. [34] In these circumstances, providing off-cycle filing priority for new plans no longer makes sense with the continued attrition of staff and resources. Therefore, we believe that eliminating this priority would be a fair and appropriate cutback to the current determination letter program.

c) Limit Multiple Employer Plan (MEP) Review Submissions by Participating Employers

Under current IRS procedures, a determination letter application may be submitted by the entity controlling the MEP and, if desired, by each separate participating employer in

[33] See id. at § 14.03.
[34] See §14.04.

that plan.[35] Where participating employers opt to file separate determination letter applications, those applications must be filed in one submission with the lead application of the controlling entity (and a higher user fee is required).[36] However, regardless whether a participating employer files a separate determination letter application, the participating employer can rely on the principal participating employer's determination letter, except for certain qualification requirements (specifically, §§ 401(a)(4), 401(a)(26), 401(l), 410(b), 414(s) and, if the employer maintains or has ever maintained another plan, §§ 415 and 416).[37]

In the past, the primary advantage to obtaining a separate determination letter for a participating employer of a MEP was separate reliance as to compliance with the nondiscrimination rules under §§ 401(a)(4), 401(a)(26) and 410(b) for any special plan features applicable to that employer. However, now that determination letters addressing such nondiscrimination compliance are generally no longer available,[38] the value of separate letters for participating employers is greatly diminished.

In these circumstances, the EP Subcommittee believes that the elimination of separate determination letters for MEP participating employers would be a fair and appropriate cutback to the current program to conserve resources. In general, this would put participating employers in much the same position reliance-wise, as an employer that has adopted a non-standardized M&P or VS plan.[39] However, to put MEP participating employers on closer footing to such pre-approved plan adopters, the EP Subcommittee recommends that the IRS also allow for additional reliance for such employers along the lines permitted under Sections 19.02(2), (3) and (4) of Revenue Procedure 2011-49,[40]

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[35] See Rev. Proc. 2014-6 § 10.02.
[36] See id. at §§10.02(2) & 10.03; see also Rev. Proc. 2014-8 § 6.05(d).
[37] See Rev. Proc. 2014-6 § 10.02(1).
[38] See id. at §5.03.
[39] See Rev. Proc. 2011-49 § 19.02(1).
[40] These Sections generally allow for additional reliance in the following circumstances:
(1) For §§410(b) and 401(a)(26), when 100 percent of all nonexcludable employees are covered under a nonstandardized plan (Section 19.02(2));

as applicable, because these are issues that would ordinarily be considered and ruled on in reviewing the controlling entity's determination letter application. We believe that this can be accomplished without unduly complicating the MEP determination letter process or undermining IRS compliance and enforcement efforts in this context.

We recommend that the IRS include language in its determination letters for MEPs that states that an employer maintaining a MEP can rely on a determination letter issued for the plan except with respect to the requirements of §§401(a)(4), 401(a)(26), 401(l), 410(b) and 414(s), and whether the employer maintains or has ever maintained another plan, §§415 and 416. Such language may lead more participating employers to feel that they do not need a separate letter if the IRS decides it cannot eliminate all such letters.

Additional outreach efforts by the IRS to practitioners, plan auditors and plan sponsors would also help clarify the misperception concerning the benefits of a participating employer's determination letter request and thereby reduce unnecessary determination letter applications.

d) User Fee Changes

Under Code Section 7528(a), the Secretary of Treasury has the authority to require the payment of user fees for individual letters and rulings. These fees can vary by categories (or subcategories) established by the Secretary and are to be determined taking into account the average time for complying with the request and its difficulty.[41]

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(2) For §401(a)(4) amounts testing, when a safe harbor allocation/benefit formula and compensation definition is used under a nonstandardized plan (Sections 19.02(3) & (4));

(3) For §§401(k)(3) and 401(m)(2) (in form), when a compensation definition is used under a nonstandardized M&P plan (Sections 19.02(3)); and

(4) For §§401(k)(11) and 401(m)(12), for an adopted safe harbor plan unless safe harbor contributions are provided in another plan (Sections 19.02(3)).

[41] See §§7528(b)(1)(A) & (B) of the Code.

In addition, the Secretary has the discretion to provide for reduced fees in appropriate circumstances.[42]

Indeed, Code Section 7528 can be read as giving the Secretary the flexibility in the determination letter application context, to charge higher or lower fees by application or plan type (or any reasonable subcategory thereof). Based on this, we submit that in this era of constricting resources and staffing, it would be reasonable and appropriate for the IRS to implement user fee changes that could discourage unnecessary or duplicative determination letter filings in circumstances where the plan sponsor is already entitled to reliance. For example, implementing a higher per participating employer fee for MEP applications may discourage unnecessary usage where reliance on the controlling entity's letter would suffice. Similarly, a higher fee for Form 5307 filings could discourage adopting employers who make only minor, inconsequential changes to a volume submitter plan from automatically submitting an application without considering the necessity for doing so. In addition, instituting higher user fees for plans that could be maintained on a pre-approved plan document might encourage more employers sponsoring individually-designed plans to migrate to a pre-approved document.

In sum, the EP Subcommittee recommends that the IRS study whether there are appropriate circumstances in which the determination letter application user fee structure could be changed in a fair and meaningful way to encourage usage of pre-approved plans and reduce unnecessary determination letter application filings.

2. Revamping of the Determination Letter Application Process

It is evident that with the continued dwindling of EP personnel and resources, the IRS must take a critical look at the current application process and be open to "new ways of doing business," with an eye to maintaining a viable, useful and effective determination

[42] See id. at §7528(b)(2)(A).

letter program. We believe that this will require a combination of actions aimed at both improving operational efficiencies and streamlining the current application process. We applaud the steps EP has already taken in this regard, as it has initiated a thorough top-to-bottom review of the determination letter program using the well-recognized "lean six sigma" management review process.

In engaging in this process, the EP Subcommittee encourages the IRS to give consideration to the following:

a) Improving operational efficiencies through –
   - Re-evaluation of the determination letter application case-grading criteria.[43] The ultimate goal here would be to reduce the current ongoing Grade 13 case backlog by allowing for a more flexible, balanced approach to the grade assignment for plans having technical or other appropriate characteristics similar to plans otherwise assigned to lower grades (which we recognize may require union agreement and, therefore, may take time to accomplish).
   - Implementation of a team concept for reviewing Grade 13 (or other higher) graded cases, under which lower-graded personnel would do a preliminary review and case workup (of some or all aspects of the application) to facilitate ultimate review by higher-graded personnel. In our view, this could (if properly designed and managed) significantly reduce the time needed by higher-graded personnel to review a case and, at the same time, have the added benefit of providing additional hands-on training opportunities for the lower grades.
   - Implementation of a voluntary or mandatory electronic filing system for determination letter applications. While we recognize that a full-fledged electronic filing program may not be feasible absent the allocation of additional funding/resources, there may be reasonable alternatives (such as submission by pdf or similar electronic file) that may, upon further study, be a

[43] These are set out in Internal Revenue Manual 7.11.2.5.

viable option for eliminating/reducing paper submissions (and the corresponding recordkeeping requirements for the IRS).

- Increased customer outreach and education on common determination letter application deficiencies and problematic plan provisions to improve the overall quality of application and document content.

b) Streamlining the determination application review process through –
   - The development/improvement of risk assessment tools to better identify the plan universe for which a more intensive document review may be appropriate in the future, taking into account existing enforcement and compliance concerns.
   - Expanded use of the auto and merit closure processes to eliminate or reduce review of plans with modest risk characteristics.
   - A more uniform, structured approach to the review and processing of plans of the same type, under which (i) unnecessary processing inconsistencies are eliminated and (ii) prior experience with, and the characteristics of, the plan type are taken into account in determining the appropriate level of review.
   - A more uniform, structured approach to modified pre-approved plans and individually designed plans with an existing determination letter, under which review would generally be confined to intervening plan document and law changes.

c) A reevaluation of the allocation of resources between the examination and determination letter functions and reconsideration whether it may again make sense to use examination personnel on a temporary basis to assist in reviewing determination letter applications (at least during periods of extreme backlogs).

Most significantly, the EP Subcommittee would like to emphasize its commitment to the importance of the determination letter program. Whatever actions the IRS takes in this

regard, we urge that it avoid employing measures that will undermine the critical role determination letters play in the qualification compliance process.

VI. Conclusion

This year the EP Subcommittee reviewed the determination letter processes and the advisory opinion letters issued to pre-approved plans. The EP Subcommittee's focus was on the pre-approved program with particular emphasis on expanding the program to lower the demand on IRS agents and reduce the significant backlog requiring extensive IRS resources.

After evaluating the collective results of feedback received from the practitioner community and IRS personnel, the EP Subcommittee has compiled the recommendations set forth below:

I. Changes to the Pre-Approved Plan Program

- Consolidation of the pre-approved program to combine the M&P and VS components into a single pre-approved document.
- Liberalization of pre-approved plan formats to allow any pre-approved document to use either an individually drafted format, or an adoption agreement, which includes a base document and separate adoption agreement for optional provisions.
- Reduce requirements for mass submitter/ VS practitioner status for certain plan types popular in narrow markets including cash balance plans and ESOPs.
- Simplified procedures for applications from mass submitters of pre-approved plans that contain only insignificant changes to a previously approved document, including reduced user fees for minor modifications.
- Availability of pre-approved documents for governmental plans with targeted customer outreach to promote awareness among the federal, state and local agencies.

- Enhanced procedures for approval for separate trust agreements that can be used with preapproved plans.
- Clarification of reliance on advisory and opinion letters for tax-qualified status.

II. Expansion of the Pre-Approved Plan Program

- Expansion of the pre-approved defined benefit plan program to allow cash balance provisions. Parameters for cash balance provisions should allow for maximum plan design flexibility.
- Expansion of the pre-approved defined contribution plan program to allow ESOP provisions.

III. Changes to the Determination Letter Program

- Delay the start of the next the five-year remedial amendment cycle.
- Narrow the availability of off-cycle filings.
- Limit MEP review by limiting the ability of each participating employer to come in for a separate determination letter.
- Examine whether there are appropriate circumstances in which the determination letter application user fee structure may be changed to encourage usage of pre-approved plans and reduce unnecessary determination letter application filings.
- Improve operational efficiencies of the determination letter process.
    - Re-evaluate the determination letter application case-grading criteria to reduce ongoing Grade 13 backlog and allow for a more flexible approach to the grade assignment for plans.
    - Implement a team concept for reviewing Grade 13 (or higher) cases, under which lower-graded personnel would conduct a preliminary review.
    - Implement a voluntary or mandatory electronic filing system for determination letter applications.

  - Increase IRS customer outreach and education on common determination letter application deficiencies.
- Streamline the determination application review process.
  - Develop and/or improve risk assessment tools.
  - Expand use of the auto and merit closure processes to eliminate or reduce review of plans with modest risk characteristics.
  - Implement a more uniform approach to the review and processing of plans of the same type.
  - Implement a more uniform approach to modified pre-approved plans and individually designed plans with an existing determination letter.
- Re-evaluate the allocation of resources between the examination and determination letter functions to reconsider whether examination personnel should assist on a temporary basis to alleviate backlog.

EMPLOYEE PLANS – APPENDIX A
DOL Statistics on Cash Balance Plans

The DOL compiles data from the Form 5500 filings. The most recent compilation is of the 2011 Form 5500 data. For 2011, the data shows 8,417cash balance plans, of which 7,147 were plans with fewer than 100 participants (leaving 1270 plans with 100 or more participants).[44] Comparable numbers for the 2010 data set were 7,635 plans, 6,371 plans with fewer than 100 participants, and 1,264 plans with 100 or more participants.[45]

Assuming no plan terminations, 782 new cash balance plans were established between 2010 and 2011, of which only six had 100 or more participants.

Year/Size	Number of Plans	Cash Balance	Other DB
≥100 participants			
2011	9,839	1,270	8.569
2010	10,155	1,264	8,891
<100 participants			
2011	35,418	7,147	28,271
2010	36,388	6,371	30,017

Difference (2010 to 2011)	≥100 participants	<100 participants
Number of Plans	(316)	(970)
Cash Balance	6	776
Other DB	(322)	(1,746)

[44] (Tables A1, A1(a), and A1(b))
[45] (Tables A1, A1(a), and A1(b))

EMPLOYEE PLANS - APPENDIX B

IRS and DOL Statistics on ESOPs

ESOP Receipts and Closings per Cycle (2/1/2006 – 7/10/2013)[46]

Cycle	A	B	C	D	E	A2	B2	C2
Receipts	1,582	1,579	1,374	1,468	2,474	1,443	1,300	108
Closed	1,574	1,559	1,349	1,028	88	402	166	4
Open	8	20	25	440	1,593	1,041	1134	104

Determination Letters Issued[47]

2013	Leveraged	Non-Leveraged
Total	1,534	824
Initial	351	175
Amendment	1,134	579
Termination	49	70
2012		
Total	460	926
Initial	108	145
Amendment	328	700
Termination	24	81

[46] IRS
[47] SOI Tax Stats IRS Data Book

2011

Total	73	325
Initial	13	37
Amendment	25	221
Termination	35	67

Number of ESOPs – Leveraged and Non-Leveraged[48]

	Total	Leveraged	Non-Leveraged
2011	6,801	2,976	3,825
2010	6,968	3,069	3,899

Number of Plans by Size

	<25 Participants	25 – 99 Participants	100 – 249 Participants	250 – 999 Participants	1,000 – 4,999 Participants	≥5000 Participants
2011	1,018	2,647	1,317	863	363	333
2010	1,052	2,689	1,348	876	346	328

ESOP With and Without 401(k)

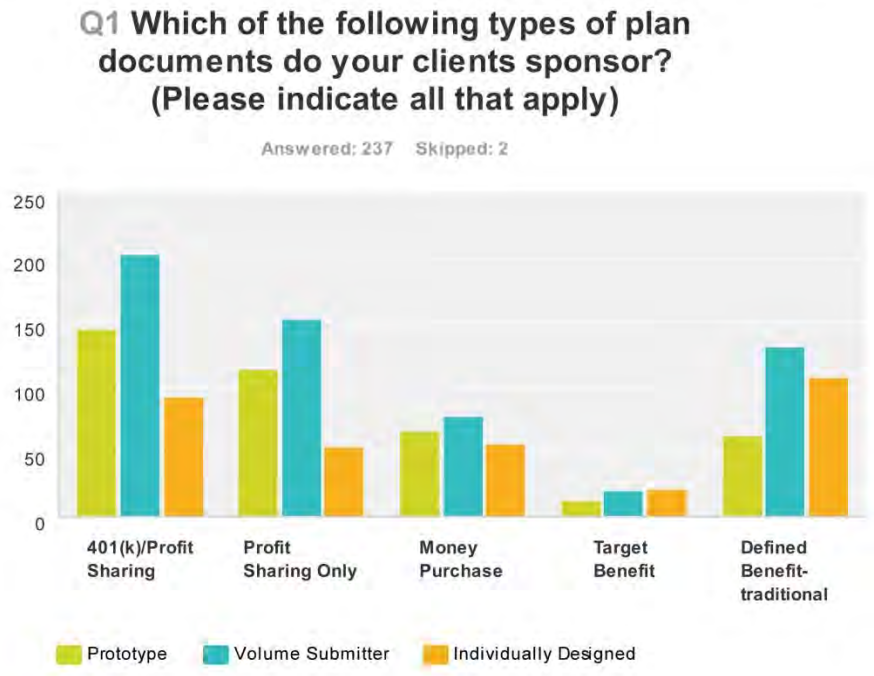
	ESOP, Not 401(k)	401(k) and ESOP
2011	5,515	1,286
2010	5,675	1,293

[48] Table D12 and Table D12

EMPLOYEE PLANS - APPENDIX C

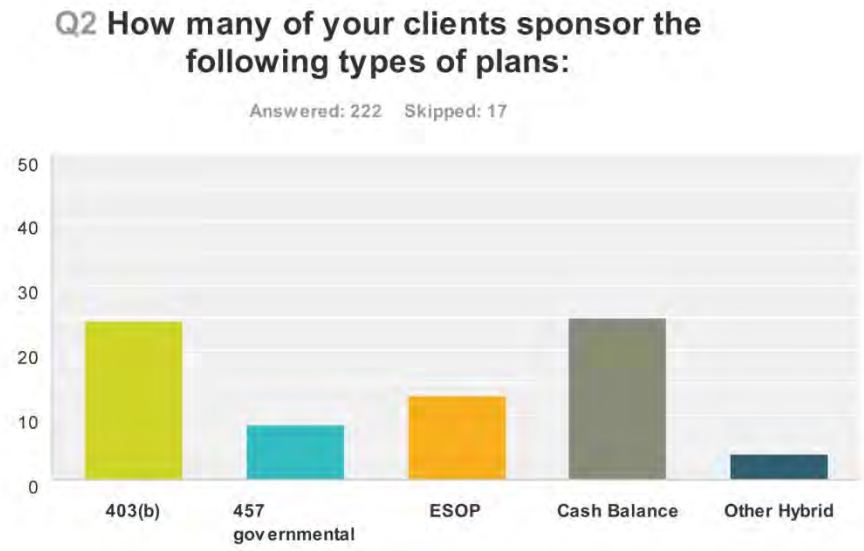
Practitioner Survey Results

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans



	Prototype	Volume Submitter	Individually Designed	Total Respondents
401(k)/Profit Sharing	**61.70%** 145	**85.96%** 202	**39.57%** 93	235
Profit Sharing Only	**56.72%** 114	**75.62%** 152	**26.87%** 54	201
Money Purchase	**47.48%** 66	**55.40%** 77	**40.29%** 56	139
Target Benefit	**30.77%** 12	**51.28%** 20	**53.85%** 21	39
Defined Benefit- traditional	**31.63%** 62	**66.84%** 131	**54.59%** 107	196

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

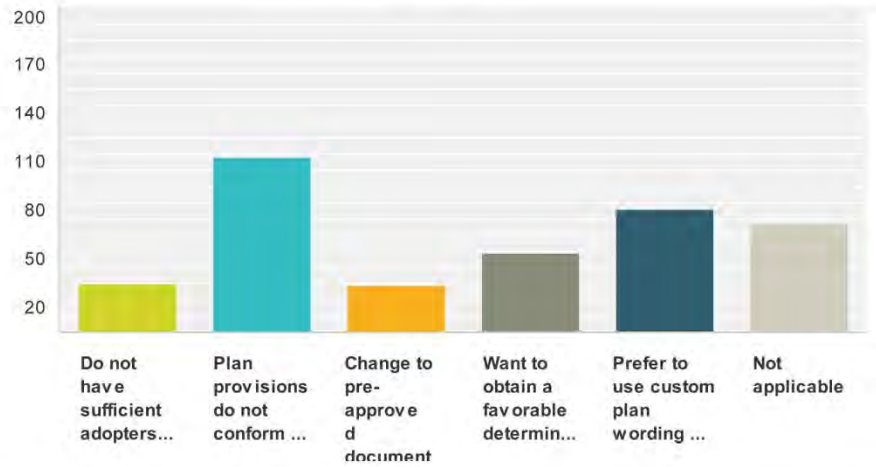


Answer Choices	Average Number	Total Number	Responses
403(b)	25	4,785	195
457 governmental	9	1,501	175
ESOP	13	2,390	184
Cash Balance	25	4,979	200
Other Hybrid	4	472	121
Total Respondents: 222			

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q3 If you utilize individually drafted plan documents, which of the following explains the reason(s) for using an individually designed plan? (check all that apply)

Answered: 206 Skipped: 33

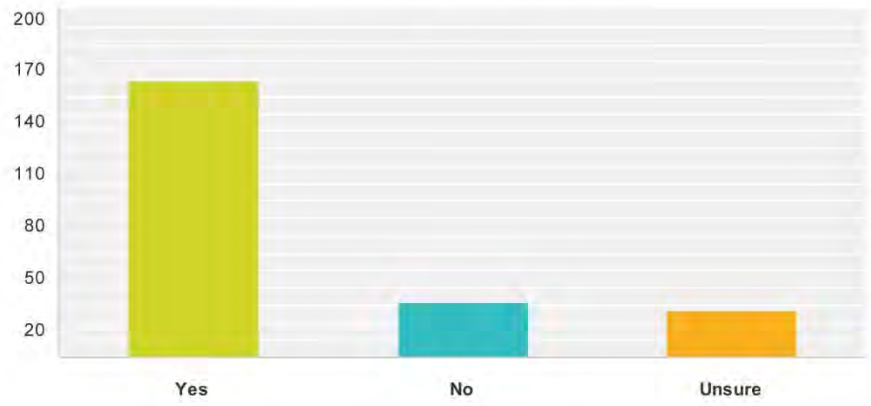


Answer Choices	Responses	
Do not have sufficient adopters to sponsor a pre-approved plan	14.56%	30
Plan provisions do not conform to mass submitter	52.43%	108
Change to pre-approved document could pose anti-cut back issues	14.08%	29
Want to obtain a favorable determination letter in the name of the plan	23.79%	49
Prefer to use custom plan wording to describe plan provisions	36.89%	76
Not applicable	32.52%	67
Total Respondents: 206		

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q4 If the pre-approved plan program was expanded so that your client's individually designed plan(s) became eligible for the program, would you be inclined to utilize the pre-approved plan(s)?

Answered: 218 Skipped: 21

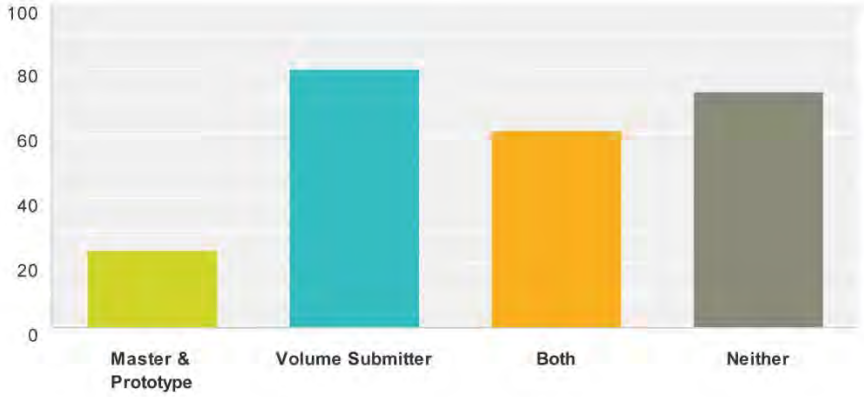


Answer Choices	Responses	
Yes	72.94%	159
No	14.68%	32
Unsure	12.39%	27
Total		218

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q5 Does your organization currently sponsor an IRS pre-approved (Master & Prototype or Volume Submitter) plan document?

Answered: 238 Skipped: 1

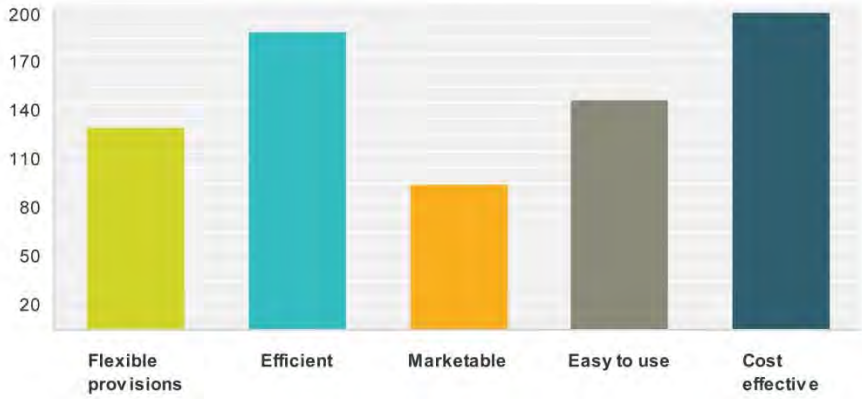


Answer Choices	Responses	
Master & Prototype	10.08%	24
Volume Submitter	33.61%	80
Both	25.63%	61
Neither	30.67%	73
Total		238

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q6 What do you consider to be the most positive aspects of the pre-approved document program? (check all that apply)

Answered: 229 Skipped: 10



Answer Choices	Responses	
Flexible provisions	54.59%	125
Efficient	80.35%	184
Marketable	39.30%	90
Easy to use	62.01%	142
Cost effective	85.59%	196
Total Respondents: 229		

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q7 List up to 3 drawbacks to, or problems with, using pre-approved plan documents?

Answered: 173 Skipped: 66

Answer Choices	Responses	
1	100.00%	173
2	52.60%	91
3	28.90%	50

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q8 List up to 3 changes to the pre-approved program that would enhance the use of pre-approved plan documents?

Answered: 146 Skipped: 93

Answer Choices	Responses	
1	100.00%	146
2	34.93%	51
3	9.59%	14

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q9 If the pre-approved plan program was expanded to include ESOP plans, what are the most important plan provision options you would like to see included?

Answered: 88 Skipped: 151

Answer Choices	Responses	
1	100.00%	88
2	29.55%	26
3	15.91%	14

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q10 If the pre-approved plan program was expanded to include Cash Balance plans, what are the most important plan provision options you would like to see included?

Answered: 84 Skipped: 155

Answer Choices	Responses	
1	100.00%	84
2	38.10%	32
3	14.29%	12

IRS Advisory Committee on Tax (ACT) Practitioner Survey on Pre Approved Plans

Q11 Would you be interested in speaking confidentially to a member of the Advisory Committee on Tax (ACT) about your experience with the IRS pre-approved plan program?

Answered: 227 Skipped: 12

Answer Choices	Responses	
Yes - Please provide your contact information below. Your name will not be used in our confidential survey.	20.70%	47
No	79.30%	180
Total		227

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Exempt Organizations:
Analysis and Recommendations Regarding Unrelated Business Income Tax Compliance of Colleges and Universities

Milton Cerny, Co-Leader

Gary J. Young, Co-Leader

Eric Carriker

Virginia Gross

Marty Martin

David Moja

June 11, 2014

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I. Executive Summary and Introduction

On April 25, 2013, the IRS released its final report on the tax law compliance activities of 400 colleges and universities across the country, *Colleges and Universities Compliance Project Final Report*. In 2010, the IRS had released an Interim Report summarizing the responses to a questionnaire sent by the IRS to 400 randomly selected colleges and universities in October 2008. In that questionnaire, the 400 colleges and universities were asked to submit information in a number of areas based on their tax years ending in 2006. Based on the questionnaire responses, the IRS opened examinations of 34 colleges and universities and focused on issues of unrelated business taxable income, executive compensation and employment tax. The IRS has completed 90 percent of those examinations and published its Final Report, which provides a comprehensive view of both the questionnaire responses and the examinations.

The examinations resulted in more than 180 adjustments to the examined institutions' returns, resulting in an aggregate increase to unrelated business taxable income (UBTI) of approximately $90 million, spread among 90 percent of the examined institutions.

The primary reasons for this increase were (i) improper reporting of certain losses as connected to unrelated business activities when they were not; (ii) errors in computation or substantiation regarding net operating losses (resulting in the disallowance of nearly $19 million in Net Operating Losses); and (iii) misclassification of certain activities as exempt or otherwise not reportable that the IRS found to be unrelated activities.

As a result of the examinations summarized in the Final Report, the IRS has stated that it plans to look at UBTI reporting "more broadly," focusing on recurring losses and the allocation of expenses. Additionally, the IRS plans to use examinations and education resources to make tax-exempt organizations aware of the rules regarding the

application of the tax to unrelated business activity. This increased focus will have impact on the entire nonprofit sector and not just colleges and universities.

In light of the IRS' intention to increase its focus on UBTI reporting for tax exempt organizations, the IRS Advisory Committee on Tax Exempt and Government Entities (hereafter ACT) selected this topic for its annual project for calendar year 2014. The focus of our project was to review the existing rules, regulations and reporting to find the reasons for the significant under reporting of unrelated business income and to recommend specific changes as to the reporting of such income and additional guidance to the sector and to the revenue agents who must administer this important area.

The ACT's specific recommendations are the following:

1. **The IRS Exempt Organizations Division should recommend that Chief Counsel and Treasury open a regulation project so that profits from a substantial commercial activity will not preclude exemption under I.R.C. § 501(c)(3) as long as an organization's income and its financial resources are used commensurate in scope with its charitable program**.

The IRS should open a regulation project to: (1) formalize the commensurate test articulated in Rev. Rul. 64-182; and (2) to reject application of the commerciality test. Recent court cases and IRS rulings have been applying a "commerciality test" to determine: (1) when certain business activity conducted by a Section 501(c)(3) organization will preclude tax exemption; and (2) what constitutes unrelated business generating taxable income. Neither the tax law nor the implementing regulations provide support for a commerciality test.

2. **The Exempt Organizations Division should work with Chief Counsel and the Treasury Department to provide formal guidance to the field regarding proper methods for allocating indirect costs where facilities and/ or personnel are used to carry on exempt activities and to conduct unrelated trade or business.**

The IRS should develop guidance that has several elements. One is to identify methods that will be given safe harbor treatment. Another element is to identify allocation methods that are per se unreasonable. Allocation methods that are not designated for safe harbor treatment or as per se unreasonable may come under increased scrutiny and ultimately be rejected as unreasonable subject to facts and circumstances.

3. **The Exempt Organizations Division should work with the Chief Counsel and the Treasury Department to publish a comprehensive revenue ruling on a range of UBI issues. The ruling should provide categories of activities that will be considered related and unrelated, guidance on preparatory time spent on activities, and scenarios of situations involving the activities frequently reported on the college and university questionnaire, such as facility rentals and dual use properties.**

The ruling should provide categories of activities that will be considered related and unrelated, guidance on the use of losses, and scenarios of situations involving the activities frequently reported on the college and university questionnaire, such as facility rentals and dual use properties. The ACT has put forth a proposed revenue ruling.

4. **The Exempt Organizations Division should expeditiously formalize and adopt a new Form 990-T based upon the proposed format enumerated in this report.**

The new form will be web-based and have as its centerpiece activity-by-activity reporting on "Checklist A". This checklist - which would not be open to public disclosure - includes links to education and outreach materials; activity-specific worksheets that provide step-by-step processes for calculating revenues and expenses; and flow-through to a new, streamlined Form 990-T.

5. **The Exempt Organizations Division should continue to leverage its use of its electronic database and web based resources to include communication, education, and training. The IRS should continue to improve, update and enhance the public and tax professional's access to the IRS materials and information available on its website.**

Specific recommendations include: enhance the Exempt Organization's Update listserv, require the submission of an electronic email address on the IRS Forms 1023 and 990, and establish and use an "EO Box" which is linked to nonprofit organizations as its primary means of electronic communications to exempt organizations; establish an "EO Tax Professional" webpage which provides direct links to the relevant statutes, regulations, revenue rulings and procedures, private letter rulings, CPE, EO-related IRM, and other IRS information, and enhance the current "A-Z Index" on the IRS website and improve its file naming conventions.

II. Scope of Project

On April 25, 2013, the IRS released its final report on the tax law compliance activities of 400 colleges and universities across the country.[1] In 2010, the IRS had released an Interim Report summarizing the responses to a questionnaire sent by the IRS to 400 randomly selected colleges and universities in October 2008. In that questionnaire, the 400 colleges and universities were asked to submit information in a number of areas based on their tax years ending in 2006. Based on the questionnaire responses, the IRS opened examinations of 34 colleges and universities and focused on issues of unrelated business taxable income, executive compensation and employment tax. The IRS has completed 90 percent of those examinations and published its Final Report, which provides a comprehensive view of both the questionnaire responses and the examinations.

The examinations resulted in more than 180 adjustments to the examined institutions' returns, resulting in an aggregate increase to unrelated business taxable income (UBTI) of approximately $90 million, spread among 90 percent of the examined institutions. The primary reasons for this increase were (i) improper reporting of certain losses as connected to unrelated business activities when they were not; (ii) errors in computation or substantiation regarding net operating losses (resulting in the disallowance of nearly $19 million in NOLs); and (iii) misclassification of certain activities as exempt or otherwise not reportable that the IRS found to be unrelated activities.

The improper reporting of certain losses as connected to unrelated business activities occurred in two ways. First, the IRS found that institutions were claiming losses from activities that did not qualify as a "trade or business" because the institutions failed to show a profit motive for the activities. Because of this issue, the IRS disallowed losses on 75 percent of the returns examined, resulting in the aggregate disallowance of more

[1] Internal Revenue Service, *Colleges and Universities Compliance Project Final Report*, (hereafer "Final Report").

than $150 million in losses and NOLs. Second, the IRS found that approximately 60 percent of the examined institutions had misallocated expenses between exempt and unrelated business activities, resulting in claimed expenses that were not connected to the unrelated business activity.

More than 30 different activities were connected to more than 180 adjustments made to the UBTI reporting of the examined institutions. In order of frequency, the following activities accounted for more than half of the adjustments: (i) fitness and recreation centers and sports camps; (ii) advertising; (iii) facility rentals; (iv) arenas; and (v) golf course. In particular, adjustments related to advertising and facility rentals resulted in changes in UBTI for almost half of the examined institutions. Adjustments related to fitness and recreation centers, sports, camps, arenas and golf courses resulted in changes to UBTI for about one-third of the examined institutions.

As a result of the examinations summarized in the Final Report, the IRS has stated that it plans to look at UBTI reporting “more broadly,” focusing on recurring losses and the allocation of expenses. Additionally, the IRS plans to use examinations and education resources to make tax-exempt organizations aware of the rules regarding the application of the tax to unrelated business activity. This increased focus will have impact on the entire nonprofit sector and not just colleges and universities.

In light of the IRS’ intention to increase its focus on UBTI reporting for tax exempt organizations, the ACT selected this topic for its annual project for calendar year 2014. The focus of our project was to review the existing rules, regulations and reporting to find the reasons for the significant under reporting of unrelated business income and to recommend specific changes as to the reporting of such income and additional guidance to the sector and to the revenue agents who must administer this important area. We also conducted interviews with representatives from various stakeholder groups to obtain opinions and suggestions pertinent to the unrelated business income

tax (UBIT) issue.[2] The ACT interviewed members of the IRS as well as tax professionals and policy analysts who have expertise in UBIT.

[2] The ACT gratefully acknowledges and thanks the individuals who were interviewed and contributed information to this report.

III. Overview of UBIT

A. History

The Corporation Excise Tax Act of 1909 granted tax exemption to "any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual." The Act was quite obviously a tax on the privilege of doing business. Because of the Act's limited applicability, there were many who felt that no specific provision was necessary to protect charitable organizations.[3] In a colloquy between Senator Bacon of Georgia, and Senator Flint of Wyoming, Senator Bacon's intent was to exempt the business income of charitable organizations that were 'organized to make a profit but not organized for individual profit. The example he gave was the Methodist Book Concern.[4] Congress made it clear that they were aware of the fact that these organizations earned "profits" and that the making of such profits was consistent with the grant of tax exemption. What remained unclear was the scope and nature of the profits that could be earned.

In 1924 the Supreme Court, interpreting what it means to "operate exclusively" for an exempt purpose, created what became known as the "destination-of-income test." *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas*, 263 U.S. 578 (1924). Under the destination-of-income test, as long as the profits derived from commercial activities were used to support an exempt purpose (i.e., charity, education, religion, etc.) organizations could engage in unlimited amounts of commercial activity. Thus, the "exclusivity" requirement of the Revenue Act applied to the "purpose" of the organization, but not every aspect of its activities. The government argued that the organization was not operated "exclusively" for religious purposes because it used its properties to produce income and traded in wine, chocolate and

[3] See Senator Bacon, Congressional Record 4151 (1909).
[4] Congressional Record 4151 (1909), Last accessed April 9, 2014.

other articles.[5] Thus, the government contended that an organization could only engage in limited commercial activity that was necessary to make its properties productive.[6]

Based on the reading of the Trinidad Case, the Third Circuit, applying the destination-of-income test, ruled that the profits of the Mueller Macaroni Company, a commercial pasta company, wholly owned by New York University, was immune from taxation.[7] Support for this destination of income test came in the case of *Roche's Beach, Inc. v. Comm'r,* 96 F.2d 776 (1938). The organization, a charitable trust, operated a bathing beach and concession stand. All of its profits were paid over to charity. On appeal, the court ruled in favor of the taxpayer as exempt on the destination of income theory, though never addressed the issue of any business limitation regarding the organization's activities.[8]

1. Purpose vs. Activity

The courts split into two camps on this issue. The majority led by the Second, Third, Fifth, Sixth and Eighth Circuits and the Court of Claims applied the "exclusive purpose" requirement of the exemption provision. When the funds arising from the business activity were used to accomplish an exempt purpose was the controlling issue to these courts and the fact that the funds came from an unrelated business activity was not relevant. On the other side, the minority of courts led by the Tax Court viewed business as a purpose and interpreted exclusively to mean primarily equating business to a purpose allowing only a limited amount of business activity to be conducted. An interesting Sixth Circuit case which has relevance to our discussion is *Comm'r v. Orton*, 173 F.2d 483 (6th Cir. 1949). There the court presented the distinction cited by Senator Bacon in the creation of the exemption from the corporate income tax. The Court said "A business does not operate in vacuo—it is related to some objective. With the

[5] *Trinidad v. Segrada Orden de Predicadores*, 263 U.S. 578 (1924).
[6] Government brief pages 6 & 7, Trinidad, supra.
[7] *C.F. Mueller Co. v. Comm'r,* 190 F.2d 120, 124 (3rd Cir. 1951).
[8] *Roche's Beach, Inc. v. Comm'r*, 96 F.2nd 776 (2nd Cir. 1938).

ordinary business man, it is run for profit and the profits serve his needs. Here the business which in itself Orton deemed basic for good ceramics, produced profits to be placed back into the furtherance of research and study in that field".

In response to the *C.F. Mueller* decision, the Congress in 1950 enacted two changes to the law of exempt organizations. First, it added the unrelated business income tax ("UBIT") that subjects profits derived from activities that are unrelated to an organization's exempt purpose to income tax. I.R.C. §§ 511-513. Second, it disqualified from exemption "feeder organizations," that is, businesses whose only claim to exemption is that all of their profits are payable to an exempt organization (e.g., the Mueller Macaroni Company). I.R.C. § 502.

By 1950, charities were heavily involved in business activities. Congress in enacting the unrelated business income tax and the feeder provision did not require charitable organizations to abandon all commercial activities. The 1950 Act, struck a balance between the two objectives of encouraging benevolent enterprise but restraining unfair competition by imposing a tax on the unrelated business income of tax-exempt organizations.[9]

The Revenue Act of 1950 made clear that tax exempt organizations (i.e., organizations whose exclusive and primary purposes are charitable, religious, or educational) could engage in substantial commercial ventures. However, revenue from such ventures, if not related to the organization's exempt purposes would be subject to taxation. Accordingly, the extent of a charitable organization's unrelated commercial activities impacted its potential tax liability, but not its entitlement to exemption.

The second change to the law of exempt organizations enacted in 1950 referred to as the "feeder" provision under section 502 which states as follows: "An organization operated for the *primary purpose* of carrying on a trade or business for profit shall not

[9] *See United States v. American College of Physicians*, 475 U .S. 834, 838 (1986)(emphasis added).

be exempt from taxation under section 501 *on the ground that* all of its profits are payable to one or more organizations exempt from taxation under section 501." (Emphasis added.).

In 1959, the Department of Treasury in drafting the new regulations for charitable organizations attempted to reconcile the primary purpose test and the presence of substantial business activity. Section l.501(c)(3)-1(c)(1) addressed the *organizational test* by clearly requiring that an organization's purposes and powers must be exclusively for one or more exempt purposes. Section 1.501(c)(3)-1(e)(1) expressly addressed an *operational test* for charitable organizations conducting "a trade or business." This language also incorporates a primary purpose test in determining whether engaging in business activities as a substantial part of a charitable organization's activities precludes tax exempt status. Section 1.501(c)(3)-1(e)(1) specifically addresses the business activities of exempt organizations. These new regulations raised a number of issues and problems including what is "substantial" and what does "in furtherance of" mean.

2. Section 1.501(c)(3)-1(e)(1) sets forth a two-prong test:

An organization may meet the requirements of Section 501(c)(3) although it operates a trade or business as a substantial part of its activities, [1] if the operation of such trade or business is *in furtherance* of the organization's exempt purpose or purposes and [2] if the organization is not organized or operated for the *primary purpose* of carrying on an *unrelated trade or business*, as defined in Section 513.[10]

A number of actions were taken by the IRS following the publication of the new regulations in an attempt to harmonize these provisions. The first was the issuance of a

[10] It is interesting to compare the final regulation with the proposed regulation: "An organization does not meet the requirements of section 501 (c)(3) if it is organized for the purpose of engaging in a trade or business as a substantial part of its activities." 21 Fed. Reg. 1423 (1959).

Report by the Exempt Organizations Council regarding business activities carried on by charities.[11] The Council, composed of representatives of the Assistant Commissioner Technical and the Office of Chief Counsel, studied various issues pending at the IRS regarding the interpretation of the Code and the regulations. Paper Number One dealt with the question of business activities conducted by tax exempt entities (See GCM 32689 dated October 9, 1963 and GCM 34682 dated November 17, 1971). The paper reached two discrete conclusions. First, the amount of charitable expenditures of an organization must be taken into consideration in equating business activities with charitable activities under the primary purpose test of Section 1.501(c)(3)-1(c). Second, if an organization in fact carries on a real and substantial charitable program reasonably commensurate in financial scope with is financial resources and its income from its business activities and other sources, it would be considered to have a primary charitable purpose. Following on the heels of the adoption of new regulations issued in 1959, the IRS was faced with the question of the quantum of business activities that could be carried on and the application of the primary purpose test of Section 502 and the primary activities test under Section I.501(c)(3)-1(e)(1). The Council reached the conclusion that an otherwise charitable organization is deemed to have met the primary purpose test of Section 1.501(c)(3)-1(e)(1) and is entitled to exemption under Section 501(c)(3) where it is shown that such business income was used to carry out its primary charitable purposes "commensurate in scope with its financial resources." (See GCM 32689, GCM 34682 and EO/Op 1964-1).

This position was confirmed in Revenue Ruling 64-182,C.B.186 (1964). The importance of this revenue ruling was that in determining charitable purpose one looked to the size and extent of the charitable program rather than the operation of the business to determine its purpose. Accordingly, the IRS must look to whether such income from business activities is used commensurate in scope with its financial resources or whether the income is plowed back into its business operation which would change its charitable purpose and subject the income to the unrelated trade or business income

[11] See the appendix to Gen. Couns. Mem. 34682 dated November 17, 1971.

tax or deny the organization's claim to exemption by virtue of Section 502 as a feeder organization.[12]

While the regulation promulgated by Treasury in 1959 attempted to address the specific test to be applied to organizations carrying on substantial unrelated business activity, the juxtaposition of these two regulations has raised confusion on which controls for determining tax exemption. In recent years the IRS and the courts have been leaning toward the adoption of a "commerciality doctrine" even though neither the Congressional history nor subsequent action by Congress regarding Sections 502 and 511-14 would indicate that the primary purpose testhas been replaced by a "commerciality test" in determining the extent of business activity conducted by a charitable organization. However, in analyzing the amount of business activities carried on we must look to some of the following factors exhibiting commerciality:

- The organization sold goods and services to the public.
- The organization was in direct competition with for profit businesses.
- The prices set by the organization were based upon pricing formulas common in retail food businesses.
- The organization utilized promotional material and "Commercial catch phrases" to enhance sales.
- The organization advertised its services and food.
- The organization did not receive any charitable contributions.

The commerciality doctrine is not only unsupported by the Internal Code or its implementing regulations, the doctrine is also inconsistent with the common law of charitable trusts, upon which the 1959 regulations issued by the Department of Treasury were based. In *Eastern Kentucky Welfare Rights Organization v. Simon*,[13],

[12] See Gen. Couns. Mem. 32689 *supra* indicates (1) that in determining "primary purpose" there is no mathematical comparison of size based on number of employees space utilized, or limit on unrelated business activities; (2) that the dedication of net revenues from an unrelated business for charity is a necessary part of the analysis and evidence that the organization's primary purpose is charitable.
[13] 506 F. 2d 1278 (D.C. Cir.1974), vacated on other grounds, 426 U.S. 26, 46 (1975).

the D.C. Circuit Court of Appeals upheld the validity of Revenue Ruling 69-545, C.B. 117 (1969), which allowed exemption for a hospital which promoted the health of class of persons broadly enough to benefit a community, as not inconsistent with I.R.C. § 501(c)(3). The court rejected plaintiffs' argument that Revenue Ruling 69-545 unlawfully replaced an earlier revenue ruling[14] which had required for exemption that a health care organization provide a substantial portion of its health care services without cost or on a reduced cost basis. The court held that "charity" can be defined as far broader than merely relief of the poor, because the 1959 regulations interpreting I.R.C. § 501(c)(3)[15] used the term "charitable" in its generally accepted legal sense, and those regulations could be interpreted using the common law of charitable trusts. [16] The commerciality doctrine interpreting the 1959 regulations should similarly be measured against the common law of charitable trusts.

Development of the common law of charities was not initially smooth in the United States. Most states adopted England's common law and statutes regarding charities, or enacted legislation specifically upholding charitable trusts.[17] However, because of an erroneous holding by the Supreme Court in *Trustees of Philadelphia Baptist Association v. Hart's Executors*[18] that the charitable trust doctrine had its origin in England's 1601 Statute of Charitable Uses, seven states rejected the charitable trust doctrine, so that the only method of devoting funds to charitable purposes was through gifts.[19] The Supreme Court reversed itself twenty-five years later in *Vidal v. Girard's Executors*[20], holding that charitable trusts should be recognized in the United States because equity jurisdiction existed in England independent of the Statute of Charitable Uses.[21]

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[14] Revenue Ruling 56-185, C.B. 202 (1956).
[15] Sec. 1.501(c)(3)-1(d)(2).
[16] *Eastern Kentucky Welfare Rights Organization v. Simon* , *supra*, 506 F.2d at 1287.
[17] Marion R. Fremont-Smith, *Governing Nonprofit Organizations* 44 (2004).
[18] 17 U.S. (4 Wheat.) 1 (1819).
[19] Fremont-Smith, supra at 44.
[20] 43 U.S. (2 How.) 127 (1844).
[21] Fremont-Smith, supra at 45. At the time of the Supreme Court's *Hart's Executors* decision, records had not clearly shown that charitable trusts had been enforced before the 1601 Statute of Charitable Uses. Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, *Scott and Ascher on Trusts* §37.1.3 (5th ed. Supp. 2013).

Nonetheless, the rationale of *Hart's Executors* that no charities could exist without the 1601 Statute of Charitable Uses was followed in Virginia, Maryland and West Virginia[22] for nearly 100 years, and the decision influenced the development of charitable trusts in New York, Michigan, Wisconsin and Minnesota.[23] Today all states recognize charitable trusts, though they differ on the extent to which the *cy pres* doctrine will save a trust which is impossible to perform.[24]

Perhaps feeding the seeds of the commerciality doctrine, during the late nineteenth and early twentieth centuries, state courts around the country "grappled with whether organizations like schools and hospitals that accepted or demanded fees from the beneficiaries of their services could be considered charitable". [25] This uncertainty may have been reinforced by the need for gifts to create a charitable fund in those seven states which did not recognize charitable trusts because of the *Hart's Executors* case.[26]

However, the common law of charitable trusts in the United States had well overcome any shaky origins traceable to the *Hart's Executor's* case and undercut any rationale for the commerciality doctrine by the time the Department of Treasury issued its regulations

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[22] George Gleason Bogert & and George Taylor Bogert, *The Law of Trusts and Trustees* § 322 (2d ed. Supp. 2013).

[23] Fremont-Smith, supra at 45. The 1828 New York code had been copied in Michigan, Wisconsin, and Minnesota, which did not generally recognize charitable trust validity until the early 20th century. Fremont-Smith supra at 47. However, each of the seven original states which followed the Supreme Court's Hart decision now has a statute validating charitable trusts. Scott and Ascher, *supra*, at §37.1.3 Bogert & Bogert, *supra*, at §322 details how the remaining states did not become embroiled by the *Hart's Executors* case, because they adopted the 1601 Statute of Charitable Uses or reenacted it as part of local statute, or they enforced charitable trusts through their inherent equity or chancery powers.

[24] Scott and Ascher, *supra*, at §37.1.3. See Restatement (Third) of Trusts § 28 clause (a) (2003)(validity of charitable trusts in the United States is not dependent on a statute to that effect or upon the reception of the state to the statute of charitable uses). Only Alaska, North Dakota, and South Carolina do not recognize the *cy pres* doctrine. Fremont-Smith, *supra,* at Table 2.

[25] Thomas A. Kelly, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2468-70 (2005).

[26] See Scott and Ascher, *supra*, at § 38.10, n. 3, citing *Retirement Homes of Detroit Annual Conference of United Methodist Church v. System Township*, 330 NW 2d 682, 686 (Mich. 1982)("While it does not appear that the apartments are operated for profit, neither does it appear that the residents receive any significant benefit that they do not pay for. There is no "gift" to the residents")

in 1959. The 1959 Restatement of Trusts[27] explicitly provided that schools, hospitals, or poor person homes could charge their beneficiaries fees or contributions to expenses if the income was used for a charitable purpose.[28] It further provided that a charity could be profitable if the resulting profit was used for charitable purposes rather than for personal profit,[29] even if that profit was derived from non-charitable businesses.[30]

[27] Restatement (Second) of Trusts § 376 (1959), cmt c. charging fees.
[28] See many state case citations in accord at Scott and Ascher, *supra,* at §38.10, n.3 and Bogert & Bogert, *supra,* at §364. Similar language was adopted at Restatement (Third) of Trusts § 28 clause (a) (2003), Restatement (Third) of Trusts § 28 cmt a(1) (2003) and Restatement (Third) of Trusts § 28, cmt h on clause (b) (2003)
[29] Restatement (Second) of Trusts § 376 (1959), comment d. profitable enterprises. Accord Scott and Ascher, *supra,* at §38.10. Similar language was adopted at Restatement (Third) of Trusts § 28 cmt h on clause (b) (2003) and Restatement (Third) of Trusts Sec. 28, cmt j on clause (d) (2003)
[30] Restatement (Second) of Trusts Section 376 (1959), cmt d. profitable enterprises.

IV. Application of UBIT Rules to Colleges and Universities

Generally, private colleges and universities that are described in Internal Revenue Code section 501(c)(3) are exempt from federal income tax, and public colleges and universities that are state instrumentalities are exempt from federal income tax under Internal Revenue Code section 115. Internal Revenue Code section 511, however, imposes a tax on the UBTI of both colleges and universities that are exempt under Internal Revenue Code section 501(c)(3) and public colleges and universities. Broadly defined, UBTI is income an otherwise tax-exempt organization receives from a trade or business that is unrelated to the tax-exempt organization's exempt purpose.

Unfortunately, many tax-exempt organizations do not fully understand the rules for determining whether income is UBTI requiring the filing of a Form 990-T and the payment of UBIT. As a result, many organizations likely underreport their UBTI and underpay their UBIT. Not only does this increase the organization's audit risk, it also may require the payment of back taxes with interest, as well as penalties for failure to file and failure to pay.

The UBIT rules are not complex. They are, however, very detailed. Tax administrative officials, as well as outside tax advisors, for colleges and universities must know and understand these rules in order to report the institution's revenues properly to avoid an underpayment of tax, with interest and penalties. Business activities of interest to the IRS typically conducted by colleges and universities include (but are by no means limited to) college book stores,[31] travel programs,[32] athletic programs,[33] alumni use of

[31] Related items include sales of course books, supplies, tapes, compact discs, athletic ware necessary for participation in athletic and physical education programs, computer hardware and software, and items to induce school spirit. There is also an exception for convenience items used by students such as sundry articles, cards, film, etc. The IRS will tax sales of such items to the general public.

[32] Regulations on travel and tour activities (under Treas. Reg. § 1.513-7) were issued by the IRS on February 4, 2000. The regulation contains only a brief statement of the UBIT general rule and two examples pertaining to universities.

> Example 1 states that income from an alumni association program open to its members and their guests and arranged by a travel agency which pays a per-person fee to the association is UBTI; although a faculty member is present, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited.

university facilities, such as a golf course,[34] rental of university facilities,[35] corporate sponsorships,[36] bartering,[37] and telecommunication rentals.[38]

A. Definition of Unrelated Trade of Business

In order for an activity to constitute an unrelated trade or business, three requirements must be met. First, the activity must constitute a trade or business. Second, the trade or business must be regularly carried on. Third, the activity must not be substantially related to the exempt purposes of the college or university.[39]

> Example 2 states that there is no UBIT where there is a "substantial amount of required study, lectures, report preparation, examinations, and [the tours] qualify for academic credit" in a program, sponsored by an organization whose purpose is education about the geography and culture of the U.S., consisting of tours of parks and other locations in the U.S. and conducted by education professionals where participants agree to participate in the required study program, including five or six hours per day devoted to study.

See also, Bertrand M. Harding, Jr. *The Tax Law of Colleges and Universities*, 3rd Ed., § 3.6 (2008) (discussing other examples of travel tours).

[33] Revenue generated from entrance charges to college and university athletic events is considered income from a related trade or business. Similarly, income generated by the telecasting and radio broadcasting of the athletic event, including the sale of exclusive television and radio rights, is related. *See* Rev. Rul. 80-295, 1980-2 C.B. 194; Rev. Rul. 80-296, 1980-2 C.B. 195.

[34] In Tech. Adv. Mem. 9645004, the IRS concluded that the alumni use of a university's golf course or ski facility does not contribute importantly to the accomplishment of the university's exempt purposes. The IRS rejected the argument that by making a golf course available the university is providing an "inducement" for alumni to make financial contributions or otherwise be involved in the university. *See* Priv. Ltr. Rul. 8020010; *but see* Priv. Ltr. Rul. 8340101; *see also Oakland Univ. v. Comm'r*, No. 2570-97 (T.C. stipulated decision entered May 27, 1998).

[35] Generally, the income from the rental of university athletic facilities, dormitories, and facilities to other than students would be considered as passive rental income and not taxable as long as collateral services such as meals or services beyond ordinary maintenance is not provided. *See* I.R.C. § 512(b)(3); *see also* Gen. Couns. Mem. 38060 (concluding that operation of a hotel and restaurant for the general public adjacent to a college campus was UBTI).

[36] A qualified sponsorship payment is not UBTI even when the payment is based on a contingent level of attendance or broadcast rating indicating a degree of public exposure. *See* I.R.C. § 513(i)(2)(A). Congress added Internal Revenue Code section 513(i) in order to reduce any uncertainty on payment to nonprofit organizations, including universities. A "qualified" payment received by either a private or public state college or university is not subject to UBIT even if there is a complimentary receipt of tickets or receptions for the donor corporate sponsor.

[37] Bartering activities are considered income for services rendered. *See* Treas. Reg. § 1.61-2(d)(1).

[38] Telecommunication rentals can take several forms, from the passive rental of telephone poles to carrying other utility lines. *See* Priv. Ltr. Rul. 7828001.

[39] I.R.C. § 513.

1. Trade or Business

A "trade or business" includes any activity carried on for the production of income from the sale of goods or the performance of services.[40] In general, the regulations under Internal Revenue Code section 513 provide some guidance as to what activities constitute a trade or business for purpose of the UBIT rules, including activities which are carried on for the production of income and which have the characteristics of a trade or business under Internal Revenue Code section 162; a trade or business that is carried on to produce income from the sale of goods or performance of services; and activities that do not contribute importantly to accomplishment of the organization's tax exempt purposes.

Although a primary purpose for adoption of the UBIT rules in 1950 was to eliminate "unfair" competition when nonprofits engaged in commercial endeavors, the case law does not require an actual showing of competitive effect.[41] Competition with for profit businesses is a consideration under the Treasury Regulations to determine whether there is a "trade or business."[42] However, it is not necessary to establish evidence of actual competition to have unrelated trade or business income.[43] The IRS and the courts have used this factor in determining how the organization conducts an activity to negate the organization's argument that the business is substantially related to its exempt purpose.

It is difficult to distinguish between tests for UBIT and tests for compliance with the requirement that an exempt organization must "operate" for its exempt purposes. Determining the existence or absence of a commercial purpose in exemption cases is a "facts and circumstances" determination in the view of the Tax Court.[44] Although the Internal Revenue Code and Treasury Regulations do not make the presence or

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[40] *See* I.R.C. § 513; Treas. Reg. § 1.513-1(b).
[41] *See U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).
[42] *See* Rev. Rul. 68-505, 1968-2 C.B. 248.
[43] *See Disabled American Veterans v. U.S.*, 693 F.2d 525 (5th Cir. 1982).
[44] *See Redlands Surgical Services v. Comm'r*, 113 T.C. 47, 72 (1999); *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 357-8 (1978).

absence of profits a factor in determining the existence of a trade or business, several federal courts have held that a trade or business exists if the activity was entered into to "realize a profit."[45] The accumulation of profits has been considered by various courts, but the ultimate decision of exemption rests on the purpose for the accumulation.[46] The appearance of "commercialism" is also important to some courts.[47] The courts also recognize that passive activities do not constitute a "trade or business." Investing is not normally a trade or business, nor is a covenant not to compete.[48]

2. Regularly Carried On

Whether a trade or business is "regularly carried on" is determined by reference to the "frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued […] in light of the purpose […] to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete."[49] Relevant factors include the typical time span of activities and whether the activities are engaged in only discontinuously or periodically without the competitive and promotional efforts typical of commercial endeavors.[50] The Internal Revenue Service generally views preparatory activity as part of the business activity for purposes of determining whether a trade or business is regularly carried on.[51] Advertising in programs for the three-week NCAA basketball tournament did not produce income from an activity regularly carried on and

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[45] *U.S. v. American Bar Endowment*, 477 U.S. 105, at 110 n. 1 (1986); *American Postal Workers Union v. U.S.*, 925 F.2d 480 (D.C. Cir. 1991); *Fraternal Order of Police v. Comm'r*, 87 T.C. 747, *aff'd*, 833 F.2d 717 (7th Cir. 1987); *L.A. Credit Union League v. U.S.*, 693 F.2d 525 (5th Cir. 1982); *Carolinas Farm & Power Equipment Dealers v. U.S.*, 699 F.2d 167, 169 (4th Cir. 1983); *Professional Insurance Agents of Michigan v. Comm'r*, 726 F.2d 1097, 1102 (6th Cir. 1984).

[46] *See Presbyterian and Reformed Publishing Co. v. Comm'r*, 743 F.2d 148 (3rd Cir. 1984); *Scripture Press Foundation v. U.S.*, 285 F.2d 800 (Ct. Cl. 1961), *cert. den.*, 368 U.S. 985 (1962).

[47] *See Estate of Hawaii v. Comm'r*, 71 T.C. 1067 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981).

[48] *See San Antonio District Dental Society v. U.S.*, 340 F. Supp. 11 (W.D. Tex. 1972); *see also Ohio Farm Bureau Federation, Inc. v. Comm'r*, 106 T.C. 222 (1996).

[49] Treas. Reg. § 1.513-1(c)(1).

[50] Treas. Reg. § 1.513-1(c)(2)(i), (ii). *See, e.g., National Collegiate Athletic Association v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990); *see also* Rev. Rul. 68-505, 1968-2 C.B. 248 (holding that the conduct of an activity for all or a significant portion of the season satisfied the regularly carried on test).

[51] Rev. Rul. 73-424, 1973-2 C.B. 190. The courts that have been called upon to address this issue have rejected the preparatory time argument. *See, e.g., Suffolk County Patrolmen's Benevolent Association v. Commissioner*, 77 T.C. 1314, 1323 (1981).

the fact that year-round sales of advertising occurred was considered by the court as merely in the nature of "preparation time."[52] The courts have held that preparation time should not be taken into account to determine "regularity," but the IRS disagrees with this position and continues to litigate this issue. Moreover, the activities of those acting on the organization's behalf can be attributed to the organization on an "agency" theory.[53]

3. Substantially Related

An "unrelated" trade or business is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of the purpose or function constituting the basis for the organization's exemption.[54] An activity that is a trade or business is "related" to the tax-exempt purpose of the organization if the activity is "causally related" to the achievement of the organization's exempt purpose. The causal relationship must be "substantial" and "contribute importantly" to the exempt purpose.[55] If the activity is carried on more extensively than necessary, income from the excess activity is treated as unrelated.[56] Thus, where income is realized from activities which are related but are conducted on a scale that is not reasonably necessary to accomplish the tax-exempt purpose, the excess income will be UBTI.

Because the determination of whether a trade or business is substantially related to an organization's exempt purposes depends upon the facts and circumstances of each case, the numerous IRS pronouncements and judicial decisions offer limited comfort in connection with a particular organization carrying on a particular activity. But, there are

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[52] *Nat. Collegiate Athletic Assn v. Comm'r*, 914 F.2d 1417 (10th Cir. 1990), *nonacq. recom'd*, AOD 191-015 (March 22, 1984).
[53] *State Police Association of Massachusetts v. Comm'r*, T.C. Memo. 1996-407 (September 4, 1996), *aff'd* No. 97-1319 (1st Cir. 1997).
[54] I.R.C. § 513(a). In the case of state colleges and universities, the educational purpose or function described in Internal Revenue Code section 501(c)(3) is controlling.
[55] Treas. Reg. § 1.513-1(d)(2).
[56] *See* Treas. Reg. § 1.513-1(d)(3).; *see also* Rev. Rul. 76-94, 1976- 1 C.B. 171.

a number of factors that the IRS and the courts have relied on in concluding that an activity is not substantially related. These factors include:

- Fees charged to the general public are comparable to commercial facilities;
- Only those that purchase the goods or services are benefited and the benefits are in direct proportion to the fees charged;
- The organization furnishes and operates the facilities through its own employees who perform substantial services in providing the activity; and
- Maximization of profit is a predominant element in the exempt organization's conduct of the activity.[57]

4. Convenience Exceptions

UBTI does not include income from any trade or business in which substantially all the work is performed without compensation;[58] or which is the selling of merchandise substantially all of which has been received as gifts or contributions; or which is carried on, in the case of a Section 501(c)(3) or a state college or university, primarily for the convenience of its students, officers or employees.[59]

The convenience exception can be applied to certain goods and services provided and sold by colleges and universities, including articles that are of a recurrent demand and do not have a useful life of more than one year. Such articles would include clothing with the college or university insignia used in university sports and low cost wearing

[57] Gen. Couns. Mem. 39863 (Nov. 26, 1991); Tech. Adv. Mem. 9147008 (Aug. 19, 1991).
[58] "Substantially all" has not been defined by the IRS except in limited situations. In Priv. Ltr. Rul. 9544029, the IRS concluded that the test was met where a religious organization used volunteers supervised by paid staff in a ratio of 10 to 1 to sell clothing apparel and other items including crosses, buttons, key chains, flags, and bumper stickers containing inscriptions or artwork with a Biblical message or theme. *See also Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Comm'r*, 42 T.C.M. 1202 (1981), *aff'd in part and rev'd in part*, 696 F.2d 372 (9th Cir. 1982) (bingo taxable when bartender and caller constituted 23.1% of the total man-hours); *St. Joseph Farms of Indiana Brothers of the Congregation of the Holy Cross v. Comm'r*, 95 T.C. 9 (1985) (test met where uncompensated workers constituted 91% of the farm labor force and 94% of the total hours worked on the farm); *Greene Cty. Medical Society Foundation v. U.S.*, 345 F. Supp. 900 (W.D. Mo. 1972) (where the reimbursement of volunteer expenses is not considered compensation).
[59] *See* Treas. Reg. § 1.513-1(e); Rev. Rul. 55-67, 1955-2 C.B. 266 (convenience rule applies to on-campus laundry and dry cleaning services for university students).

apparel, novelty items such as jewelry, cups, and pillows imprinted with the school's logo or name, and items such as film, cards, candy, newspapers, and magazines.[60]

As a general rule, items do not fall into the above categories if they have a useful life of more than one year. Items such as cameras, tape recorders, radios, record players, television sets, and small appliances would be subject to UBIT.[61] Exceptions have been made if a school demonstrates that its campus is located a considerable distance from commercial retail facilities.[62] The IRS has held, however, that revenues from the sale of multiple computers to students, faculty and nonstudents is UBTI.

Dormitory rentals to students during the school year, as well as the provision of food, laundry, and similar services, come within the convenience exception. Questions have been raised, however, regarding the provision of similar services to students during the summer months and to for-profit companies conducting educational programs using the school's facilities. [63] The IRS ruled that such rental activities were related to the school's tax-exempt purpose.[64] In another ruling, a theological school had rented out dormitory quarters to family members of students and faculty, potential students, and their parents, guest speakers, guests of other nonprofit organizations, and members of the general public.[65] There, the IRS expanded the convenience exception to include the first four cited categories but held that the rental income from the general public was UBTI.[66]

5. Special Rules Relating to Unrelated Trade or Business

Special rules apply under Internal Revenue Code section 513 for qualified convention and trade show activity, certain hospital services, certain bingo games, certain

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[60] *See Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951); Gen. Couns. Mem. 33323.
[61] *See* Gen. Couns. Mem. 35811.
[62] *Id*.
[63] *See* Priv. Ltr. Rul. 9014069.
[64] *Id*.
[65] *See* Priv. Ltr. Rul. 200625035.
[66] *Id*.

distributions of low cost articles, certain exchanges and rentals of member lists, certain travel and tour activities, and certain sponsorship payments.[67]

a. Income Excluded from UBTI

Certain Investment Income. Dividends, interest, payments with respect to securities loans, annuities, and other substantially similar income for routine and ordinary investments, and all deductions directly connected with any of such types of investment income, are excluded in determining unrelated business taxable income.[68]

Royalties. Royalties and all deductions connected with royalties are excluded from UBIT except in the case of debt-financed income and receipts from controlled organizations. Royalties (including overriding royalties) whether measured by production or by gross are excluded from UBTI.[69] Generally, a royalty is a payment for the use of a valuable right such as a trademark, trade name, service mark, or copyright, regardless of whether the property represented by the right is used.[70] If the payment for such rights is coupled with a duty to perform services by the grantor, however, it is not treated as a royalty for tax purposes. But, if a licensor retains quality control rights with respect to the licensed product, it does not cause payments to the licensor to lose their character as royalties.[71] The IRS has held that payments received for the personal endorsements by an athletic organization's members of products or services are payments for personal services and not royalties.[72] Royalties may be received from books, plays, copyrights, trade names, patents, and the exploitation of natural resources.

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[67] *See* I.R.C. § 513; Treas. Reg. § 1.513-3.
[68] I.R.C. § 512(b)(1); Treas. Reg. § 1.512(b)-1(a)(1).
[69] I.R.C. § 512(b)(2); Treas. Reg. § 512(b)-1(b). Working interests in oil and gas leases are not considered a royalty, and the income is taxable where the organization is liable for the operating expenses associated with the interest. *See* Rev. Rul. 69-179, 1969-1 C.B. 158.
[70] *See National Well Water Ass'n, Inc. v. Comm'r*, 92 T.C. 75 (1989); *Comm'r v. Affiliated Enterprises, Inc.*, 123 F.2d 665 (10th Cir. 1941), *cert den*. 315 U.S. 812 (1942); *Comm'r v. Wodenhouse*, 337 U.S. 369 (1949); *Rohmer v. Comm'r*, 153 F.2d 61 (2nd Cir. 1946); *Sabatini v. Comm'r*, 98 F.2d 753 (2nd Cir. 1938).
[71] *Lemp Brewing Co. v. Comm'r*, 18 T.C. 586 (1952), *acq*. 1952-2 C.B. 2; Rev. Rul. 81-78, 1981-1 C.B. 135 (situation 1); Priv. Ltr. Rul. 9436001; Priv. Ltr. Rul. 200601033.
[72] Rev. Rul. 81-178, 1981-1 C.B. 135 (situation 2).

Mailing list rentals, affinity cards, and similar arrangements are often used by colleges and universities and their affiliates to generate revenue. The IRS held that the rental of mailing lists to organizations marketing their affinity cards to members was subject to UBIT. However after the loss of several court decisions,[73] the IRS has conceded the issue based in large part on the decision in *Oregon State University Alumni Association, Inc.* where the court said that the organization's activity in the program was insubstantial. In Private Letter Rulings 199938041 and 200149043, the IRS held that under certain circumstances, a subsidiary organization's activities of marketing and licensing for its exempt parent will not be attributed to the parent for purposes of determining the parent's continued qualification for exempt status or liability for tax on UBTI. There, the IRS allowed the tax exempt organization to bifurcate payments under a licensing agreement where one part was a royalty to the parent for use of the intellectual property and the other was a payment to the taxable subsidiary for services.

Rents. Except in the case of debt-financed income and receipts from controlled organizations, rents from real property and incidental rents from personal property leased with real property are also excluded in the computation of UBTI. Rents from personal property are "incidental" only if they do not exceed 10 percent of the total rents from all the property leased. However, if rents from personal property exceed 50 percent of the total rents, all rents (including the rent from real property) are UBTI. Also, rents are UBTI if the determination depends in whole or in part on the income or profits derived from the property leased (other than an amount based on a fixed percentage of receipts or sales).[74]

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[73] *Sierra Club v. Comm'r*, 103 T.C. Memo, 1993-199, aff'd, 86 F.3d 1526 (9th Cir. 1996); *Common Cause v. Comm'r*, 112 T.C. 3 (1999); *Planned Parenthood, Fed. of America, Inc. v. Comm'r*, T.C. Memo. 1999-2006 (1999); *Oregon State University Alumni Association, Inc*., *and Alumni Association of the University of Oregon, Inc.*, CA-9, 99-2 U.S.T.C. ¶ 50, 879; *Mississippi State University Alumni, Inc. v. Comm'r*, T.C. Memo 1997-397. *See also* Rev. Rul. 69-179, 1969-1 C.B.158 for a detailed discussion of this issue. *See* Lloyd Hitoshi. Mayer, *Tax Court Rules (Again) on Sierra Club Affinity Card Income*, 24 EXEMPT ORG. TAX REV. 311 (May 1999).

[74] I.R.C. § 512(b)(3); Treas. Reg. § 1.512(b)(2); *see* Priv. Ltr. Rul. 9551019.

The IRS has ruled that payments to a university for the use of excess radio frequency were non taxable royalties.[75] Payments for the use of the university broadcast tower, however, were taxable where the IRS later held that such income was not rents under Internal Revenue Code section 512(b)(3) because under Internal Revenue Code section 1.48-4(a) broadcasting towers are treated as tangible personal property rather than real property.[76]

Rent loses its characterization as passive and excluded income if the organization provides substantial services to occupants. Parking lot revenues at a university football stadium are generally regarded by the IRS as income from rent because they are considered related under the convenience exception. The furnishing of heat and light, the cleaning of public entrances to university facilities, parking lots, and the collection of trash are not considered services rendered to the occupant.[77] Income from valet or maid services to particular occupants would be considered income from services.

Similarly, the rental of a university facility to corporate business patrons for special events where the university provides food service would be subject to UBIT.[78] The IRS has ruled that the income from the lease of a university football stadium to a professional football team for several weeks during the summer months was subject to UBIT because services such as maintenance, security, and linen services were provided to the team.[79]

Sales or Other Dispositions of Property; Options; Forfeiture of Deposits; Short Sales, etc. Except in the case of debt-financed property, gains or losses from the sale, exchange, or other disposition of property are excluded in the computation of UBTI, except for inventory-type property or property held primarily for sale to customers in

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[75] *See* Priv. Ltr. Rul. 9816027.
[76] *See* Priv. Ltr. Rul. 200104031.
[77] Treas. Reg. § 1.512(b)-1(c)(5).
[78] In Tech. Adv. Mem. 9702003, the IRS determined that a museum's activities in renting its facilities to corporate and business patrons for special events was not sufficiently related to the museum's educational purposes. The rent exclusion did not apply because the museum provided substantial services primarily for the convenience of the patrons including food and liquor. The same rationale would be applied to the rental of university facilities including hotels.
[79] Rev. Rul. 80-298, 1980-2 CB.197.

ordinary course of business.[80] There is no UBTI from gains or losses on the lapse or termination of options to buy or sell securities in connection with the organization's investment activities or from gains or losses from options on real property or from the forfeiture of good-faith deposits (consistent with established business practices) for the purchase, sale, or lease of real property.[81] There is no UBTI from the short sale of stock through a broker.[82]

Income from Scientific Research. Income (and all related deductions) from research is excluded in the calculation of UBTI in the following situations: income derived from research for (a) the United States, or any of its agencies or instrumentalities, or (b) any state or political subdivision thereof;[83] in the case of a college, university or hospital, income derived from research performed for any person;[84] and in the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, all income derived from research for any person.[85]

Technology transfer is an area that has caught the attention of the IRS. In 1982, the IRS held that a university foundation formed to transfer technology from nonprofit research institutions to private industry by obtaining patents, copyrights, and rights from researchers licensing them to third parties was not a tax-exempt activity.[86] Since then

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[80] *See generally* I.R.C. §§ 512(b)(5). *See, e.g.*, Priv. Ltr. Rul. 9619069 (no UBTI where a tax-exempt organization, whose purpose was to support the endowment of a school, subdivided and sold unimproved farm land to unrelated third parties at fair market value); Priv. Ltr. Rul. 9704010 (no UBTI where school participated directly or indirectly in partnerships created to finance infrastructure improvements and subdivide large land parcels with the hope of selling such parcels to real estate developers); Priv. Ltr. Rul. 9745025 (sale of an apartment building).

[81] I.R.C. §§ 512(b)(1), 512(b)(5). However, the Senate Finance Committee and the IRS are looking into alternative investments including offshore hedge funds and equity funds. In a recent inquiry, the Senate Finance Committee questioned the $100 million of investments by the Boys and Girls Clubs of America in offshore and private equity funds registered in foreign countries investing in U.S. stocks and bonds for tax advantages.

[82] *See* I.R.C. § 512(b).

[83] I.R.C. § 512(b)(7).

[84] I.R.C. § 512(b)(8).

[85] I.R.C. § 512(b)(9).

[86] *See Washington Research Foundation v. Comm'r*, TCM 1985-570. For a broad discussion of the tax issues regarding technology transfers by universities and their tax-exempt foundations, *see* Milton Cerny

the IRS has not provided much guidance on the taxation of technology transfer and its commercialization. The IRS has held in several private letter rulings that the transfer of technology from laboratory to public use was a tax-exempt activity and thus would not be subject to UBIT.[87] Universities also have used taxable subsidiaries to transfer research conducted at the institution that may have applied uses in the marketplace.[88]

b. Unrelated Debt-Financed Income

Until the introduction of the unrelated trade or business income tax, tax-exempt organizations enjoyed a full exemption from the payment of federal income tax. The Revenue Act of 1950 subjected charities to tax on their unrelated trade or business income but excluded from the tax certain forms of passive income. Charities could acquire property on credit with all financing provided by the seller and then lease the property back to the seller under a long-term lease and service the loan with tax-free rental income from the lease.[89] Over the years, the IRS found that many tax-exempt organizations were making debt-financed acquisitions of going businesses. The IRS attempted to revoke the tax-exempt status of these organizations and require sellers to report their gain as ordinary income, but the courts ruled against the IRS on these issues.[90]

& Kelly Hellmuth, *Economic Crisis: Technology Transfer to the Rescue*, TAX'N OF EXEMPTS (May/June 2010).

[87] *See* Priv. Ltr. Rul. 8512084 (holding that a university assignment of a copyright to specialized research software for a percentage of gross income was not taxable); Priv. Ltr. Rul. 9243008 (holding that an organization's transfer of communication technology amongst public and private sectors lessened the burdens of government under section 501(c)(3) and such commercialization was not taxable); Priv. Ltr. Rul. 9316052 (holding that a governmental instrumentality conducting research in the public interest creating marketable technologies to develop industries to aid the economies of surrounding states was a charitable activity).

[88] *See* Priv. Ltr. Rul. 9604019 (examining a 501(c)(3) supporting organization that exchanged all of its intellectual property rights in software technology for stock in a for-profit subsidiary); Priv. Ltr. Rul. 9705028; Priv. Ltr. Rul. 9720031; Priv. Ltr. Rul. 200602039; Priv. Ltr. Rul. 20060240; Priv. Ltr. Rul. 200602041.

[89] In a famous case involving the New York University School of Law, a corporation that purchased and operated a macaroni company was held to be a tax exempt organization. *C.F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3rd Cir. 1951). Congress enacted the feeder provision to deny exemption to such transactions.

[90] *See*, *e.g.*, *Comm'r v. Brown*, 380 U.S. 563 (1965); *but see University Hill Foundation, etc. v. Comm'r*, 446 F.2d 701 (9th Cir. 1971).

Fearing an erosion of the tax base, Congress expanded Internal Revenue Code section 514 in 1969 to include UBTI from any passive investment income to the extent that the property generating income was acquired directly or indirectly with borrowed funds. Today, income from investments subject to acquisition indebtedness purchased by the exempt organization in addition to investments subject to acquisition indebtedness contributed to the organization, are subject to UBIT under Internal Revenue Code section 514(b).

The general rules excluding dividends, interest, royalties, rent, and proceeds from dispositions of certain property do not apply if the income is from "debt-financed" property, i.e., property subject to acquisition indebtedness.[91] "Acquisition indebtedness" is defined as debt incurred by an exempt organization to acquire or improve property that was either incurred before the purchase of the property or debt incurred after the property is acquired if the debt would not have been incurred but for the acquisition of the property.[92] The amount of income reported as UBTI is generally determined by a ratio of the average amount of acquisition indebtedness during the taxable year to the property's average adjusted basis (including straight-line depreciation) during such taxable year.[93] An important exemption from the debt-financed income rules is provided for certain indebtedness incurred in connection with the acquisition or improvement of real property by universities and their affiliated support foundations, pension plans, title-holding companies described in Internal Revenue Code section 501(c)(25), or partnerships all of whose partners are one of the foregoing or which meets rigid profit and loss allocation rules.[94] Property "substantially related" to the organization's exempt purpose is not subject to the debt-financed property rules. Debt-financed property rules do not apply to real property used by colleges and universities to carry out their tax-

[91] I.R.C. §§ 512(b),(c), 514. *See Henry E. and Nancy Horton Bartels Trust v. U.S.*, 209 F.3d 147 (2nd Cir. 2000), *cert. denied*, 531 U.S. 978 (2000) (holding that the purchase of securities on margin gave rise to UBTI).
[92] I.R.C. § 514(c).
[93] I.R.C. § 514(a)(1); Treas. Reg. §§ 1.514(a)-1(a)(1), 1.514(a)-1(b)(2)(ii). As an example, a building with an adjusted basis of $100,000 and acquisition indebtedness of $50,000 receives $10,000 in rent. The debt/basis ratio is 50% ($50,000/$100,000); $5,000 of the $10,000 income is taxable.
[94] I.R.C. § 514(c)(9); Treas. Reg. § 1.514(c)-2; see Priv. Ltr. Rul. 9510040.

exempt functions.[95] If an exempt organization uses 85% or more of the debt financed property for tax-exempt related purposes, the property will not be treated as debt-financed.[96]

[95] *See* Rev. Rul. 55-676, 1955-2 C.B. 266; Rev. Rul. 81-19, 1981 C.B. 533; *see also* I.R.C. § 514(c)(9) (special exception for debt-financed real estate of schools).

[96] This exception also applies to certain activities that are exempt from UBIT such as research under I.R.C. §§ 512(b)(7) and (9) and under the voluntary work and thrift store exceptions under I.R.C. § 514(b)(1)(D).

V. Key UBIT Issues to be Resolved

A. Internet and Catalogue Sales

The extensive use of the internet by colleges and universities and other tax-exempt organizations has raised a number of issues with the IRS, but to date there has been a paucity of guidance from the IRS. It was anticipated that the final sponsorship regulations under Treasury Regulation section 1.513-4 would include guidance on internet and catalogue sales. However, those issues were reserved for further consideration.[97] The regulations, as discussed previously, did provide useful guidance on other issues of advertising and incidental benefit. However, guidance on internet and catalogue sales has not been forthcoming since the IRS raised a series of questions that were to be incorporated into Treasury Regulation section 1.513-4 regarding sponsorships and unrelated trade or business.[98] The FY 2000 Exempt Organizations Technical Training Program article, "Tax Exempt Organizations and World Wide Web Fund Raising and Advertising on The Internet," raised a number of red flags in this area.[99] The IRS in Private Letter Ruling 9723046 caused further confusion regarding the parameters allowed to a sponsor's page, converting what would be an acknowledgement of a sponsor into potential taxable advertising.

If a website is being used to create a periodical, there is a question of whether the exception for an acknowledgement of a sponsor that is not subject to UBIT in "printed material" that is distributed in connection with a specific event under Internal Revenue Code section 513(i) would also apply to an acknowledgement on a website. It would appear that this restriction should not apply to a website acknowledgement of a sponsor. Thus, the determination of UBIT derived from the sale of advertising in exempt organization periodicals under Treasury Regulation section 1.512(a)-1(f) would

[97] *See* T.D. 8991, (4/24/2002).
[98] *Id*.
[99] *See* Cheryl Chasin, Susan Roth, Robert Harper, *Technical Instruction Program* (2000).

also seemingly not apply.[100] Therefore, while the IRS has not ruled on this matter, websites should not be seen as periodicals coming under the restrictions imposed by Internal Revenue Code section 513(i) on acknowledgements.[101] A hyperlink from a section 501(c)(3) organization's website to a for profit business without advertising, posting the name and address of the business, was a "qualified sponsorship" and not subject to UBIT.[102] Where, instead, a tax-exempt organization "endorses" the business sponsor's product, such endorsement is advertising and not a qualified acknowledgement of the sponsorship.[103]

Providing a link to a business vendor on the educational organization's website for a fee may be unrelated business taxable income depending on whether or not the sale of goods or services are related to the organization's tax-exempt purposes. If the services or products are not related, then the question might be whether the fee comes under the exception for the exploitation of an intangible such as the royalty exception from UBIT under Internal Revenue Code section 512(b)(2). The IRS has not ruled on whether the sale of educational courses on the internet is a related activity. However, there should be not be a reason to treat fees from these sales any differently from those fees derived from providing educational programs under Treasury Regulation section 1.501(c)(3)-1(d)(3). Similarly, e-mail list rentals would be treated in the same way as those under Internal Revenue Code section 513(1)(b) and not subject to UBIT.

Finally, there is some uncertainty on the question of when an institution serves as an internet service provider and what tax effect it will have. This issue appears to be a factual issue that depends on the group of end users being served and the context in which the services are offered. This issue arises when "electronic strips" or "charity malls" serve as a third-party website hosting a collection of hyperlinks to online vendors. The charity mall encourages shoppers to purchase goods and services from featured

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[100] *See* Priv. Ltr. Rul. 200303062 where an agricultural organization sold banner advertisements on its website. The IRS stated that Treas. Reg. § 1.512(a)-1(f) did not apply.
[101] *See* Treas. Reg. § 1.513-4(e).Also see Treas. Reg. § 1.513-4(f), Examples 11 and 12 treated the EOs' websites in those examples as not periodicals. Compare Priv. Ltr. Rul. 201405029 (Nov. 8. 2013).
[102] Treas. Reg. § 1.513-4(f), Ex. 11.
[103] Treas. Reg. § 1.513-4(f), Ex. 12.

vendors and agrees to pay a portion of the sales income to the exempt organization selected by the purchaser. In some instances, the payment over the fair market value of the articles is considered a contribution to the tax-exempt organization.[104] The IRS has issued private letter rulings that permit an income tax charitable deduction for the donation where the entity acts as the agent for the charity.[105] In either case, the income received by the exempt organization should be treated as an exploitation of tax-exempt function resulting in a royalty payment that is exempt from UBTI.

The IRS included several questions on the compliance questionnaire for colleges and universities regarding internet activities. Possibly, the information that is gathered through the questionnaire or the pending audits will lead to some additional guidance that will shed some light on these issues.

B. Partnerships and Limited Liability Companies

Exempt organizations are permitted to be either general or limited partners in partnerships or members in a limited liability companies ("LLCs").[106] If an exempt organization is a member of a partnership that regularly carries on a trade or business that is unrelated, it must include the unrelated taxable income of its partnership share and the deductions directly connected with the included income.[107] The IRS has required an exempt organization that participates in a general partnership to show that the tax-exempt purposes of the organization are served and that its interests are properly protected through guarantees, indemnities, and penalties. Additionally, the IRS considers "control" of the substantive functions of the partnership to be an important factor for assessing the relatedness of the partnership activities where the exempt organization or its affiliate is a general partner.[108]

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[104] *See, e.g.,* Rev. Rul. 85-184, 1985-2 C.B. 8.
[105] *See* Priv. Ltr. Rul. 200228001; Priv. Ltr. Rul. 200142019.
[106] I.R.C. § 512(c)(1); *see also* Treas. Reg. § 1.512(c)-1 regarding income and expenses includible in UBTI.
[107] I.R.C. § 512(c)(1), as amended by P.L. 103-66, § 13145(a)(1)-(3).
[108] Rev. Rul. 98-15, 1998-1 C.B. 718; *Redlands Surgical Services v. Comm'r*, 113 T.C. 3 (1999) (declaratory judgment of exempt status of the subsidiary of a parent of a typically reorganized hospital

S corporation stock owned by an exempt organization is treated as an interest in an unrelated trade or business, regardless of whether it is related or unrelated to the organization's tax-exempt purpose.[109] All pass-through income, including dividends, interest, and other passive income attributable to the exempt organization's shareholdings in the S corporation, is subject to UBIT as well as any gains from the organization's sale of the S corporation stock.[110]

C. Controlled Organizations

A tax-exempt organization may own a for-profit subsidiary with an independent business purpose.[111] The exclusions from UBIT of interest, annuities, royalties, and rents (in the absence of acquisition indebtedness) do not apply to such income received from a "controlled organization." During the last 30 years, many large tax-exempt entities, namely universities and hospitals, have diversified into commercial activities through controlled organizations. Universities have taken controlling interests in a wide range of commercial enterprises including energy production, transportation services, and the production of consumer goods such as food and clothing.[112] Such diversification has attracted criticism from commentators who point to a "corporatization" of tax exempts that is inconsistent with their mission.

Control of stock corporations means ownership by vote or value of more than 50 percent of the corporation's stock. For partnerships or other entities, control means ownership of more than 50 percent of the profits, capital, or beneficial interests. Control

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system in California); *cf. Plumstead Theatre Society, Inc. v. Comm'r*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) (limited partners had no control over partnership of charitable general partner); *Housing Pioneers v. Comm'r*, 65 T.C.M. (CCH) 2191 (1993), *aff'd*, 49 F.3d 1395 (9th Cir. 1995) (activities of co-general partner were so narrowly framed that for-profit partner was in a position of control with inappropriate private benefit). *See St. David's Health System v. U.S.*, 349 F.3d 232 (5th Cir. 2003); Priv. Ltr. Rul. 200548026; Priv. Ltr. Rul. 200448048 (control of partnership that owns and operates an MRI facility).

[109] I.R.C. § 512(e)(1)(A).

[110] I.R.C. § 512(3)(1)(B).

[111] *See*, *e.g.*, Priv. Ltr. Rul. 9720036 (section 509(a)(2) charity established two for-profit subsidiaries); Priv. Ltr. Rul. 9722032 (spin-off of a for-profit affiliate and transfer of technology and employees to commercialize pharmaceutical products).

[112] See, "Unfair Competition and Corporate Income Taxation." Susan Rose-Ackerman. 34 Stanford Law Review 1017. 1982.

of nonstock corporations presumably will mean that more than 50 percent of the directors of trustees of the organization are representatives of, or directly or indirectly, controlled by, an exempt organization. Under Treasury Regulation section 1.512(b)-1(1)(4)(i)(b), a trustee, director, agent, or employee of an exempt organization is a "representative" of that organization; the same regulations provide that an exempt organization controls any trustee or director that it has the power to remove and replace. Constructive ownership rules apply to determine whether the requesting control test is met.

The UBIT rules apply to second-tier subsidiaries under Internal Revenue Code section 512(b)(13) by providing that the constructive ownership rules of Internal Revenue Code section 318 apply to determine control and ownership of interests. Thus, a parent entity is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Internal Revenue Code section 512(b)(13) also provides the method for determining how much of an annuity, interest, rent, or royalty payment made by a controlled subsidiary to a university parent is includible in the latter's UBTI. The payments are subject to UBIT to the extent the payment reduces the net unrelated income or increases the net loss of the subsidiary. This control test is based on the vote or value and the application of the constructive ownership rules under Internal Revenue Code section 318.

Congress further modified Internal Revenue Code section 512(b)(13) in 2006, to add an exception for payments from controlled organizations that meet the requirements of Internal Revenue Code section 482. This exception, made at the urging of the college and university community, applies only to payments made pursuant to a binding written contract in effect on the date of enactment (which was August 17, 2006). This special provision expired on December 31, 2013, and a one-year extension is currently pending as part of the package of "extenders" being considered by Congress.

D. Allocation of Expenses

The Internal Revenue Code allows deduction of expenses from UBTI for all ordinary and necessary expenses incurred in carrying out the unrelated trade or business if the expense is directly connected with carrying out the business.[113] The expense must be an allowable deduction under one of the business deductions allowed to businesses, and the expense must be directly connected to carrying on the unrelated trade or business.[114] If the expense item satisfies both tests and it is attributable solely to the conduct of a trade or business, then it is fully deductible in calculating UBTI.

Dual Use Expenses. Dual use expenses are expenses incurred for both related and unrelated activities. An exempt organization must make a "reasonable" allocation of the expenses between those activities.[115] This is an important issue for universities and other exempt entities that rent out their facilities to the public.

Treasury Regulation section 1.512(a)-1(c) provides that if assets or personnel of an exempt organization are employed both in an unrelated trade or business and in an exempt activity, there must be a reasonable allocation with regard to the deduction attributable to such assets or personnel between the two uses. The determination of what constitutes a reasonable basis depends on the facts of the individual case. In *Disabled American Veterans v. U.S.*, the court directed that allocations should be based

[113] *See* I.R.C. § 512(a)(1); Treas. Reg. § 1.512(a)(1); *see also* I.R.C. § 162; Treas. Reg. § 1.162.
[114] For example, I.R.C. § 162 defines ordinary and necessary business expenses. I.R.C. § 165 allows deductions for losses and §§ 167 and 168 for depreciation deductions. *See also Amer. Medical Assn. v. U.S.*, 887 F.2d 760 (7th Cir. 1989) (holding that the directly connected test is met if the dominant reason for incurring the expense was to engage in an unrelated trade or business).
[115] *See* Treas. Reg. § 1.512(a)-1(c). *Rensselaer Polytechnic Institute v. Comm'r*, 732 F.2d 1058 (2nd Cir. 1983) is the leading case in the area. The college operated a field house for both its educational uses and commercial uses. In determining the expenses against the commercial use, the college used a three-part methodology of (a) direct expense, (b) variable expense dependent on the percentage of commercial use, and (c) fixed expenses that did not vary on actual use. The IRS argued that fixed expense percentage should be calculated on the proportion of time that commercial use has to total time available. The court agreed with the college's methodology and held that allocating fixed expenses on the basis of time of actual use (disregarding time of non-use) was a reasonable allocation method. While the IRS has never acquiesced in this decision, it is generally followed by the university community in allocating expenses for dual use facilities.

on gross receipts.[116] In *Rensselaer Polytechnic Institute v. Commissioner*, the court held that the allocation should be based on actual time of use.[117]

Direct or Indirect Expenses. The issue of "direct" and "indirect" cost allocations has been at issue in several court cases, including *Rensselaer*, where the IRS attempted to assert its position that indirect expenses for dual use facilities must be directly connected to the unrelated activity to which it is allocated and the dual use expense would not have been incurred but for that activity.[118] The IRS announced in 2006 that it was developing a project to review the treatment and allocation of income and expenses for colleges and universities.[119] The IRS completed this project in 2013 and issued its Final Report on April 25, 2013.[120]

Aggregation of Deductions from Multiple Trades or Businesses. UBTI is calculated by aggregating the income and deductions attributable to all unrelated trade or businesses of an exempt organization.[121] Thus, a loss resulting from a deduction from one unrelated trade or business can be used to offset income from another trade or business. However, if a particular business continually operates at a loss, the IRS in most cases will challenge the deduction of the losses under Internal Revenue Code section 165 because the activity is not engaged in to make a profit.[122] Net operating loss deductions are available in computing UBIT. These losses can be carried back two years immediately preceding the loss year and, if not used up, can be carried forward 20 years.[123] Under a special rule, net operating losses for any year, including carry back or forward losses to another taxable year, are determined regardless of whether or not they were taken into account in determining income or deduction for UBTI purposes.

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[116] *Disabled Am. Veterans v. U.S.*, 704 F.2d 1570 (Fed. Cir. 1983).
[117] *Rensselaer Polytechnic Inst. v. Comm'r*, 732 F.2d 1058 (2d Cir. 1984).
[118] The government's reasoning did not prevail in *Rennselaer*.
[119] IRS 2007 Exempt Organizations Workplan, available at http://www.irs.gov/pub/irs-tege/fy07_teb_workplan.pdf.
[120] Id. at 1.
[121] Treas. Reg. § 1.512(a)-1(a).
[122] *See West Virginia State Medical Assn. v. Comm'r*, 882 F.2d 123 (4th Cir. 1989); Tech. Adv. Mem. 9719002.
[123] *See* I.R.C. § 172.

E. Advertising

Advertising income is taxable as UBIT if it is in a publication that promotes an advertiser's services or products and is regularly carried on.[124] Advertising in a publication circulated to members "exploits" the exempt function of the organization, which exempt function is furthered by the circulation and distribution of the "readership content" of the publication.[125] If expenses of the exempt and non-exempt activities exceed the income of the exempt activity, some exempt expenses may be allocated to the non-exempt (advertising) activity, but a loss may not be created for carryforward or carryback purposes.[126]

If the advertising is profitable after taking into account the direct costs of the advertising, the profit may be reduced (but to no more than zero) by the amount which "readership costs" (the cost of producing and distributing the exempt activity readership content) exceed "circulation income" (the subscription income and/or portion of dues attributable to receiving the periodical).

Colleges and universities may sell commercial advertising (as described in Internal Revenue Code section 513 rather than sponsorship acknowledgements under Section 513(i)) in a variety of formats including advertising in student newspapers, professional journals, athletic programs, and the sponsorship or exclusive use of a business corporation's products. Because the advertising is included in an otherwise related activity, the IRS will "fragment" a particular business activity like a school newspaper or journal into its component parts, some of which are related like the editorial content, and others like product advertising that may be taxed as UBTI.[127] An example of advertising

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[124] *See* I.R.C. § 512; *National Collegiate Athletic Association*, *supra* note 32, where the activity was not regularly carried on. *See also* Rev. Rul. 68-505, 1968-2 C.B. 248 (where the conduct of an activity for all or a significant portion of the season satisfied the regularly carried on requirement).

[125] *U.S. v. American College of Physicians*, 475 U.S. 834 (1986) (holding that revenues from advertising in a scholarly journal were unrelated trade or business income because such advertising was not substantially related to the organization's exempt purposes).

[126] Treas. Reg. § 1.512(a)-1(f)(3)(iii).

[127] Treas. Reg. § 1.513-1(b). An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of activities or endeavors which may or may not be related to the organization's tax exempt purpose.

in a university campus newspaper operated by students is presented in Treasury Regulation section 1.513-1(d)(4)(iv), example 5. There, the students solicited, sold, and published paid advertising in the campus newspapers under the instruction of the university.[128] While the services rendered to the advertisers normally would have constituted commercial advertising, the preparation and publication of the advertising contributed importantly to the university's educational program, and the income was not from an unrelated trade or business.[129]

Both the IRS and the courts require substantiation rather than estimates of expenses. In Private Letter Ruling 9324002, the IRS denied an allocated overhead deduction because the organization failed to justify a 50% allocation rate. Colleges and universities should take note that, in connection with an audit of the University of Michigan resulting from a compliance audit, the IRS disallowed virtually all of the direct expenses claimed by the University against its UBTI because the University could not prove that the amounts were expended for designated purposes and the indirect cost deductions were disallowed because they were not based on a reasonable method.[130]

Colleges and universities are also allowed to take charitable contributions as deductions, but not to exceed 10% of the institution's UBIT as computed without regard to the charitable contribution deduction.[131] A specific deduction of $1,000 is also allowed in computing UBTI.[132]

F. Investment Structures to Avoid Unrelated Business Income Tax

There are two primary ways in which certain investments, typically those in some type of investment partnership such as a hedge fund, a fund of funds, or private equity fund,

[128] Treas. Reg. § 1.513-1(d)(4)(iv), Ex. 5.
[129] *Id*. In an interesting, related decision, the IRS held in Tech. Adv. Mem. 19994035 that even a separately incorporated organization publishing a university daily news paper that had student journalists and faculty that solicited and published advertising was not subject to UBTI.
[130] *Regents of Univ. of Mich. v, Comm'r*, No. 4625-95 (T.C. filed Mar. 21, 1995) (this case was settled prior to trial, and all of the expenses in question were allowed); for further discussion of this case, *see* Bertrand M. Harding, Jr. *The Tax Law of Colleges and Universities*, p.64, 3rd Ed. (2008).
[131] I.R.C. § 512(b)(10).
[132] I.R.C. § 512(b)(12).

can generate UBTI. First, UBTI includes debt-financed income. If the charitable organization invests in a fund that is a partnership for federal tax purposes and the fund borrows to make investments and generates income (i.e., is leveraged), the charitable organization will have to pay tax on its share of the income attributable to the debt-financed property under the unrelated business income tax rules. Second, if the fund is a pass-through entity and invests directly in a business that is operated as a pass-through entity, the income received by the fund from this operating business will be unrelated business taxable income that will pass through to the charitable organization for federal income tax purposes.[133]

When considering these investments, a college or university must consider the effect of these possible taxes on the projected returns from the investment and must also determine what protections or options, if any, may be available to avoid or minimize any adverse tax consequences from UBTI. The agreements for some investment partnerships will prohibit the fund manager from making investments that could generate UBTI or require the manager to use its "best efforts" to avoid or minimize UBTI.

Many funds are structured in a manner specifically designed to address the UBTI concerns of tax-exempt organizations. These are generally funds that invest in a manner likely to generate significant unrelated business taxable income. These funds typically use a "blocker corporation," often created offshore in a jurisdiction that does not impose income taxes on corporations so that a corporate-level tax is avoided, for its tax-exempt investors.[134] The tax-exempt investors invest in the blocker corporation, instead of the partnership vehicle, and the blocker corporation then invests in the investment partnership. This blocker corporation will distribute dividends and the sale of the interest will generate gains, neither of which are UBTI to a tax-exempt organization

[133] I.R.C. § 512(c)(1).
[134] In some instances a domestic blocker is utilized. While a domestic blocker does not typically serve to reduce UBIT, it may help an exempt organization avoid the filing of a Form 990-T to report flow through UBI.

(assuming no borrowing by the charitable organization to acquire the investment).[135] The IRS has ruled favorably on the use of such an arrangement to avoid UBTI.[136]

The tax consequences of these types of investments, however, must be carefully considered as these structures can also cause the organization to incur taxes on income that would otherwise be exempt. While the blocker corporation is an effective method of eliminating UBTI for tax-exempt investors, the taxes could potentially be greater for a tax-exempt entity investing through a blocker corporation. Foreign corporations are generally subject to U.S. federal income tax on income that is "effectively connected" with the conduct of a trade or business in the U.S.[137] Foreign corporations that are partners in a partnership are considered as being engaged in a trade or business within the U.S. if the partnership is so engaged.[138] A foreign corporation is subject to U.S. federal income tax on its effectively connected income at the regular graduated rates applicable to U.S. corporations. In addition, a foreign corporation may be subject to the branch profits tax at a rate of 30 percent.[139] The branch profits tax is basically a tax on the amount of the foreign corporation's effectively connected income that is not reinvested in the U.S. If the foreign corporation is subject to the branch profits tax, the effective tax rate on the effectively connected income can be as high as 54.5 percent. Additionally, a U.S. private investment fund is required to withhold tax at the highest applicable marginal rate on the effectively connected income, including U.S. source interest and dividends, allocable to each foreign partner.[140]

A tax-exempt investor that invests directly in a U.S. partnership would only be taxed on the portion of effectively connected income that constitutes UBTI, and that tax is substantially lower than the 54.5 percent that a blocker corporation may have to pay.

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[135] *See* I.R.C. § 512(b)(1) & (5).
[136] *See, e.g.,* Priv. Ltr. Rul. 200315028; Priv. Ltr. Rul. 200315035.
[137] I.R.C. § 882.
[138] I.R.C. § 875.
[139] I.R.C. § 884.
[140] I.R.C. § 1446.

Furthermore, the tax-exempt investor would not be subject to any tax on non-debt-financed U.S. source interest and dividends.[141]

The United States' four-year, post-secondary educational institutions collectively held more than $400 billion in endowments in 2008. [142] The United States Senate Finance Committee has expressed concern about investments of college and university endowments in overseas hedge funds, offshore tax shelters, and potential risky investments. Before the market crash in 2008-2009, endowment managers were putting a larger percentage of their endowment funds into hedge funds and other alternative investments. The National Association of College and University Business Officers ("NACUBO") estimated that in 2000 three unidentified colleges had invested 40 to 60 percent of their endowments in hedge funds. The hedge fund craze continued to build when stock prices declined.[143]

That trend continued into 2008-2009 when we saw the collapse of the stock market that resulted in the fall of major investment houses and banks that had invested in risky products composed of credit default swaps and other exotic products that were rolled into bonds from real estate mortgage and other investments that required fund managers to cover "shorted" stock positions resulting in unlimited potential losses. Congress, the IRS, and the public have been concerned about the growth of college and university endowments and whether these institutions are engaged in charitable activities commensurate with their resources.

The Senate Finance Committee and the IRS began taking a closer look at college and university endowments and offshore investments that avoid federal taxes. Senator

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[141] In a letter dated August 16, 2010 to the House Ways and Means Committee, Senate Finance Committee, Treasury, and the IRS, the New York State Bar Association Tax Section recommended that Congress and Treasury undertake a review of Internal Revenue Code section 514 in order to determine whether the tax policy rationale for subjecting leveraged investments in securities and commodities to UBTI is appropriate today.

[142] For a current discussion of the growth of college and university endowment, see *College and University Endowments Have Shown Long-Term Growth, While Size Restrictions, and Distributions Vary*, *supra*, note 13.

[143] *See* John L. Pulley, *Betting the Endowment on Risky Investments*, THE CHRONICLE OF HIGHER EDUCATION, January 18, 2002.

Grassley continues to express concern about these investments, and the college and university questionnaire specifically focused on these types of investments.[144] Investments by college and university endowments through offshore hedge funds and private equity funds can be quite profitable, but they should only be engaged in with full knowledge that Congress is reviewing these relatively tax-free investments in their continuing search for funds to finance the U.S. Treasury. What Congress grants, it can also take away.

The primary objective of the UBIT rules was to eliminate a source of unfair competition by placing the unrelated business activities upon the same tax basis as that of a for profit business endeavor. Since 1950, when the UBIT rules were originally introduced, it has not really accomplished its statutory purpose. The small business community over the years, led by a consortium of trade associations, has urged Congress to expand the scope of the UBIT rules and improve its enforcement at the IRS. However, Congress has not, up to this point, been willing to take on the challenge to restructure the UBIT rules either through lack of political will or more importantly the lack of empirical data.

Now that the IRS has completed its study of college and university business activities, some of the analysis and information will provide useful substance for future legislation. But Congress will still have the same tax policy issues to deal with, that is, should taxpayers with equal income pay the same amount of tax? Is it unfair for the tax system to favor one competitor over another?

There has been a plethora of suggested Congressional modifications to the UBIT rules. Recently, Rep. Camp, Chairman of the House Ways & Means Committee, released a discussion draft of the "Tax Reform ACT of 2014" on February 26, 2014. The draft includes a number of proposed UBIT changes including the following:

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[144] C. Grassley, *Wealthy Universities Must Make Themselves More Affordable*, THE CHRONICLE OF HIGHER EDUCATION, May 30, 2008 (directing comments at universities with large endowments).

- *Conducting Multiple Unrelated Trade or Business Activities*. The Draft eliminates an organization's ability to offset unrelated business taxable income from one trade or business with losses from another unrelated trade or business. Under the proposed provisions, organizations will have to compute their unrelated business taxable income separately for each trade or business activity and would no longer be able to aggregate their income and losses derived from such activities. Although this change will affect only organizations conducting multiple unrelated trades or businesses, the Draft will significantly impact such organizations' UBIT calculations and tax liabilities.
    - *Corporate Sponsorships*. The Draft makes significant changes to the treatment of corporate sponsorships for UBIT purposes. As proposed, if an organization uses or acknowledges the name or logo of a sponsor's product line, the sponsor's payment will be treated as per se unrelated trade or business income. Additionally, if an organization receives more than $25,000 of qualified sponsorship payments for any one event, the use or acknowledgement of the sponsor's name or logo must appear with the names of a "significant portion" of the other donors to the event.

- *Miscellaneous Changes*.
    - Organizations that may be exempt from tax under provisions of the I.R.C. other than Section 501(a) would be subject to UBIT (such as organizations exempt under Section 115).
    - The sale or licensing of a name or logo of an exempt organization would be treated per se as an unrelated trade or business, and any income derived from such licensing would be indeed in the organization's unrelated business taxable income.
    - Income derived from a research trade or business would be excluded from UBIT only if the results of the research are freely available to the public.

- Gain or loss resulting from the sale of distressed property would be included in UBIT calculations.[145]

However, there has not been a comprehensive analysis of the formulation of UBIT since the House Ways and Means Draft Report in 1988. The following recommendations in the Draft Report could affect colleges and universities:

- Income from the sale of goods from mail order and catalog sales of book stores would be treated as UBIT subject to certain exceptions that included sales of mementoes, T-shirts, and other items with the exempt organization's logo costing less than $15.00.
- Special exemptions for sales of goods to students with a retail price of $15.00 or less, and for items with higher prices if the sales furthered educational programs and the articles were not common consumer goods. Books and computer software would be exempted but not appliances, cameras, television sets, VCRs, and recreational sports equipment. Exemptions for computer sales would be granted on the condition that the faculty member approved the purchase. (With the widespread use of computers, such sales with or without faculty approval would appear to be related).
- Health, fitness, exercise, and similar health promotion activities for a special fee would be subjected to UBIT.
- Income derived by a college or university from travel or tours conducted by the students and faculty would be subject to UBIT except where travel is related to a degree program curriculum.
- Income derived from food sale by a university for students, faculty, or employees would be subject to UBIT unless provided on the institution's premises.

[145] Joint Committee on Taxation "Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V – Tax Exempt Entities" February 26, 2014. See Appendix E for report.

- Lodging facilities income would be treated as UBIT except in the case of college and universities only when such facilities are used as dormitories, or fraternity, or sorority housing used by students, faculty, or staff but not to facilities patronized by the public.
- Affinity credit card income or catalog and endorsement activities would be treated as UBTI. A number of these items were included in the college and university questionnaire issued by the IRS.
- Advertising income subject to UBIT could only be reduced by deductions associated with direct advertising costs.

The Draft Report also recommended that the convenience exception to UBTI under Internal Revenue Code section 513(a)(2) should be repealed except for limited exceptions applicable to university dining halls and dormitories. The Draft Report went on to indicate that royalty income would be subject to UBIT whether measured by net or taxable income. There would be an exception for the licensing of a trademark or logo fostering name recognition and for certain non-property working interests and products directly related to the organization's tax- exempt function.

The IRS is seeking more data in the current compliance review on two more significant recommendations that would apply to controlled subsidiaries of colleges and universities. The oversight subcommittee would have taxed the income of a nonexempt controlled taxable subsidiary as UBTI if the tax on such income would have been less than if the activity was carried on directly by the tax-exempt parent. This recommendation would have required the charity's taxable subsidiaries to pay tax at the level of the greater of (1) the amount computed under the normal corporate rates, or (2) the amount of UBIT that would have been paid if the activity was conducted in the parent charity.

Finally, the 1988 Draft Report focused on the allocation of expenses and recommendations in the case of dual use facilities. The IRS allows any reasonable allocation. The draft report would have limited the deductibility of marginal costs if the

facility was used 25 percent or less of the time for a taxable activity. If the taxable activity use percentage exceeded 25 percent and up to 75 percent of the time, costs (including depreciation and general administrative costs) would have been allowable to the taxable activity based on a percentage of actual use. Over 75 percent of time used by a taxable activity would result in all costs being deductible except for marginal costs.

VI. IRS Fact Finding and Colleges and Universities Compliance Project

The IRS study of colleges and universities commenced in 2008. Prior to this time, colleges and universities had stayed mostly out of the limelight with respect to the attention of the IRS, Department of Treasury and Congress for several decades. Focus was instead on hospitals, credit counseling organizations, down payment assistance entities, and other rapidly growing industries within the nonprofit sector. This changed during the 2000's when there was attention by certain members of Congress to the increasing costs of tuition at institutions of higher learning and suspected lack of spending from their endowments to assist with these costs. This coincided with the IRS studying various aspects of the unrelated business income, including the frequency with which unrelated business income activities were being reported with few corresponding Forms 990-T being filed. Nonprofit governance and executive compensation were also hot topics of the day, with colleges and universities being significant players with respect to these matters as well. All of these matters were the subject of the college and university compliance project.

1. College and University Questionnaire

The IRS began its compliance check of colleges and universities by sending a questionnaire (Form 14018) to 400 public and private college and universities. Of the 33-page questionnaire, 13 pages were devoted to the activities of the colleges and universities and the form requested information on 47 different activities that could potentially result in UBTI[146] As a result of the compliance check, 34 of the 400 colleges and universities were examined.

[146] It is important to note that beginning in 1951, public colleges and universities became subject to UBI under the current IRC Section 511(a)(2)(B).

2. Interim Report

The IRS published the Colleges and Universities Compliance Project Interim Report ("Interim Report") on May 7, 2010. The Interim Report focused on the results from the questionnaire. The results contained in the Interim Report did not include data provided for certain questions and because the responses were not weighted, the findings could not be extrapolated beyond those institutions initially surveyed to all tax-exempt colleges and universities, both private or public.

With respect to reporting UBTI, the Interim Report notes that nearly half of the small colleges and universities reported never filing a Form 990-T, with 29% of the medium institutions and 4% of the large institutions reporting not filing a Form 990-T.

Rental activity was the most frequently reported activity across all institutions – small (67%), medium (88%) and large (96%) – and included facility and arena rental, recreation center usage, athletic facilities usage, personal property rental, and telecommunications-related or broadcast tower rental. Advertising and corporate sponsorships were the next two highest reported activities. Other categories receiving noteworthy volumes of reporting included logo usage, catering and other food services, royalties, intellectual property income, conference center operations, parking lot operations, and bookstore operations.

Regarding UBTI reported on a Form 990-T, the highest percentage of colleges and universities reported unrelated business activity in advertising (53% of large institutions, 21% of medium-sized, and 6% of small), facility rental (41% of large institutions, 22% of medium-sized, and 11% of small), and "other" (54% of large institutions, 31% of medium-sized, and 14% of small). The IRS notes that "other" likely included a number of separate activities that would be analyzed in its final report.

A higher percentage of the colleges and universities generally reported that they engage in a certain activity than reported the activity on the Form 990-T. For example,

while 23% of small universities reported that they engaged in advertising, only 6% (roughly one-fourth) reported the activity on a Form 990-T. Regarding the large universities, the discrepancy was smaller, but still present, with 82% reporting advertising as an activity and only 53% reporting it on the Form 990-T.

The questionnaire requested that the colleges and universities report direct and indirect expenses for their Form 990-T reported activities. The majority of colleges and universities reported having indirect expenses associated with their unrelated business activities. When questioned about whether they paid or accrued expenses to a related organization, a much smaller number of colleges and universities reported that they engaged in this practice.

Regarding the use of an outside accountant or counsel, the highest percentage of affirmative responses was for use of an outside advisor to determine if an activity was related or unrelated, with far fewer positive responses regarding use of an outside advisor for expense allocation and intercompany pricing matters. At least 60% of all colleges and universities in all size categories reported that they did not rely on advice from their independent accountants or counsel for any of these determinations regarding their UBTI.[147]

3. Final Report

The IRS released the *Colleges and Universities Compliance Project Final Report* (previously defined as "Final Report") on April 25, 2013. The Final Report's Executive Summary was revised on May 2, 2013. The Final Report presents the findings of the 34 examinations conducted by the IRS as a result of responses to the questionnaire. It also included (in an appendix) additional data gathered from the questionnaire not included in the interim report. For example, the appendix lists these activities as the top related revenue-generating activities at most of the colleges and universities: bookstore sales, food services, facility rentals, parking lot income, tuition and fees, sponsorship

[147] Even when outside guidance was sought, the IRS, upon examination, still found errors in a significant number of situations.

income and gifts and grants. Investments were also listed as a top-ranking income-generating activity for the small and medium educational institutions. Some of the top loss-generating activities included facility rental, advertising, recreation centers, conference centers, arena rentals, catering and food services, golf courses, and athletic facility rentals.

In the Final Report, the IRS stated that the examinations of the 34 audited institutions resulted to increases to UBTI for 90% of the colleges and universities examined, which totaled about $90 million. The examinations also resulted in the disallowance of more than $170 million in losses and net operating losses, which the IRS notes "could amount to more than $60 million in assessed taxes."

The report disclosed these three primary reasons for increases to UBTI:

1. Disallowing losses and expenses that were not connected to unrelated business activities, primarily due to a lack of profit motive and improper expense allocation. A lack of profit motive was evidenced by a pattern of recurring losses, with over $150 million in NOLs disallowed and 70% of returns examined having losses and NOLs disallowed. Nearly 60% of the Forms 990-T examined by the IRS reflected improper expense allocations used to offset UBTI. In many instances, the IRS found that the claimed expenses, which generated losses for the unrelated business activity, were not connected to the unrelated business activity.

2. Errors in computation or substantiation of NOLs (nearly $19 million in NOLs disallowed).[148]

3. Reclassifying activities reported as related as unrelated (nearly 40% of the examined institutions misclassified certain activities as exempt or otherwise not reportable on Form 990-T, with most of these activities resulting in net income.)

[148] Under I.R.C. § 170(b), an organization may generally carry an NOL back up to two years and forward for up to 20 years. With such a long carry forward period, records lacking sufficient detail and staff turnover can make substantiation of NOLs difficult.

Most adjustments came from fitness, recreation and sports camps, advertising activities, facility rentals, arenas and golf activities. For the most part, expense allocation methods were not challenged by the examining agents, in large part due to other errors being found and a lack of particularly sanctioned or unsanctioned methods for determining expense allocations.

In the Final Report, the IRS states that the most common reason, by far, for the disallowance of losses and NOLs in the exams was that a claimed loss related to an activity for which the institution lacked a profit motive, "as evidenced by years of sustained losses." Because exempt organizations can use losses from one unrelated business activity to offset another, the disallowance of these losses for which profit motive could not be demonstrated resulted in the disallowance of $150 million in total losses of the 34 institutions examined. The misallocation of expenses attributable to exempt activities to unrelated business activities contributed to the disallowance of expense deductions on a sizeable number (60%) of the returns examined. These were often indirect expenses that were determined to not have a proximate and primary relationship to the activities to which they were attributed.

More than one-third of the returns under exam reflected net operating losses that were either improperly calculated or unsubstantiated. In addition, more than 40% of colleges and universities examined were treating activities as related that were determined, upon examination, to be unrelated activities that were reportable on the Form 990-T. In the vast majority of cases, these activities resulted in a net profit and therefore increase the institution's UBTI.

4. Difficulty with UBTI Reporting

Why were there so many errors discovered by the IRS in reporting the UBTI of the examined colleges and universities? It appears there were a number of contributing factors including, (a) the lack of guidance involving the allocation of expenses to unrelated activities, (b) concepts such as profit motive that are neither clear in the tax laws nor set forth in sufficient detail in IRS materials, including the instructions to the 990-T, and (c) an absence of contemporary guidance on the related and unrelated nature of the various activities in which colleges and universities are involved.

Certain aspects of determining UBTI and the calculation UBIT are admittedly subjective. Of the three-part test for UBTI, both the “trade or business’ and “related” aspects of potential UBTI activities leave room for judgment calls. While on the one hand, there is a tendency to classify any income that creates revenue for an organization as a “trade or business,” can it really be the case if the activity, once its associated expenses are properly allocated to it, results in a net loss year after year? And while any activity that provides experiences and opportunities for a college or university’s students may arguably be related, there needs to be guidance in this era of ever-increasing growth by colleges and universities regarding their undertakings and non-traditional activities.

Even though colleges and universities may have incentive to reduce their UBIT through aggressive classification of activities as either related (if producing a profit) or unrelated (if producing a loss that could offset UBTI from another activity), our discussions with the IRS, the industry, and practitioners do not reveal an intentional disregard of the rules. Instead, they reveal a lack of clarity and guidance that often does not provide enough direction to those individuals (typically the in-house financial staff of the institutions) making the reporting decisions on potential UBTI activities.

When the prevailing rulings in this area were written decades ago, the types of activities in which colleges and universities are now engaging were not a reality. The current opportunities and funding for research, the variety and scale of college and university

facilities, and the interaction between colleges and universities, for-profit businesses, and members of the public were not contemplated in the 1960's and 1970's when much of the unrelated business income guidance was published. Today, a university's arena, daycare center, recreational facility, catering services, golf course, and conference center may all be open to the public. In addition, colleges and universities are becoming more entrepreneurial with their research and intellectual property to generate additional funds for the institution, offer educational opportunities for their students, and provide incentives to faculty and researchers regarding their developments. The absence of contemporary IRS guidance on these issues leaves colleges and universities, as well as the IRS upon examining these institutions, relying, at least in part, on conjecture and guesswork to calculate their UBTI and corresponding UBIT.

While many aspects of the unrelated business income law could benefit from more clarity and guidance, certain areas appear to need more immediate attention, based on the findings of the college and university study. These areas are reflected in the recommendations set forth in this report.

VII. Reporting and 990T Redesign

Current Form 990-T

As mentioned above, profit motive, cost allocations, and other concepts are not set forth in sufficient detail in IRS materials, including the instructions to Form 990-T. This, along with the lay out of the form, creates confusion for organizations with regard to reporting unrelated business activities.

Form 990-T, Exempt Organization Business Income Tax Return (and Proxy Tax under Section 6033(e)), is the reporting instrument for exempt organizations that have income from unrelated business activities. The purpose of the form is to report unrelated business income, figure and report unrelated business income tax liability, report proxy tax liability, claim a refund of income tax paid by a regulated investment company (RIC) or a real estate investment trust (REIT) on undistributed long-term capital gain, and request a credit for certain federal excise taxes paid or for small employer health insurance premiums paid. Also, the form is used to report unrelated business income tax on reinsurance entities.[149]

The form first appeared in 1951 and has remained substantially the same for 63 years. In addition, the "specific deduction" (Internal Revenue Code section 512(b)(12)) has remained at $1,000 since the form was introduced in 1951.

Conversely, Form 990 – Return of Organization Exempt from Income Tax - was substantially redesigned for the 2008 filing year. The interplay between Form 990 and Form 990-T has generally been constrained to a two-line query. Prior to 2008, Form 990 (2007) asked "Yes/No" questions on lines 78a and 78b. These questions asked, "Did the organization have unrelated business gross income of $1,000 or more during the year covered by this return?" and "If 'Yes,' has it filed a tax return on Form 990-T for this year?"

[149] 2013 Form 990-T, Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)), Instructions, Page 1.

On the "new" Form 990 (introduced in 2008), the two questions (with slightly altered wording) are included in Part V, Lines 3a and 3b. Line 3a states, "Did the organization have unrelated business gross income of $1,000 or more during the year?" Then, line 3b follows up with, "If 'Yes,' has it filed Form 990-T for this year? If 'No' to line 3b, provide an explanation in Schedule O."

One source of "990-T confusion" begins here. Many organizations have trouble understanding the concept of "unrelated business gross income." The instructions to Form 990, Part V, Line 3a state, "Check "Yes" on line 3a if the organization's total gross income from all of its **unrelated trades or businesses** is $1,000 or more for the year. See Pub. 598, Tax on Unrelated Business Income of Exempt Organizations, for a description of **unrelated business income** and the Form 990-T filing requirements for organizations having such income."

The Form 990 Glossary defines "Unrelated business gross income" as, "Gross income from an unrelated trade or business as defined in Section 513."

In addition, the Form 990 glossary states that "Unrelated business income" is, "Income from an unrelated trade or business as defined in Section 513."

That glossary gives the definition of "Unrelated trade or business" as, "Any trade or business, the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. See Pub. 598 and the instructions for Form 990-T for a discussion of what is an unrelated trade or business."[150]

After 63 years, the time has come to redesign Form 990-T. We envision a new form that would heighten education and outreach, simplify the form 990-T process for the tax-exempt sector, provide better statistical data, and if possible minimize the size of the form.

[150] IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations is a key source of UBIT information for exempt organizations.

VIII. IRS Communication with the Public

IRS EXEMPT ORGANIZATIONS' CUSTOMER EDUCATION AND OUTREACH

Education, communication and training are an integral part of how the IRS Exempt Organizations ("EO") division seeks to fulfill this mission. While this report focuses on issues related to unrelated business income and its related tax ("UBIT"), information about UBIT comprises only a small percentage of the information for which the Customer Education and Outreach (CE&O) function is responsible. As one of EO's three primary divisions, CE&O is responsible for providing information to diverse and growing numbers of exempt organizations, taxpayers, consumers, professionals and practitioners, and the public.[151] Each acquires and uses IRS information to inform and understand their tax obligations and responsibilities.

During the course of a year CE&O will produce or modify significant numbers of publications, websites, videos, and other resources.

EO's Customer Education and Outreach ("CE&O") division has two primary external customers.[152] Their primary external customers are small and mid-sized nonprofit organizations and the public many of whom do not engage in UBI activities and do not need to know about it beyond just the mere basics. Yet, UBI web pages represent the many areas of EO guidance and assistance for which easy and ready access to web-based IRS information will advance the IRS mission and goals. For these small and mid-sized organizations IRS web information is likely to be their main, if not their only source for accurate and current information IRS requirements. While larger nonprofits may have staff and/or tax professionals to assist them, for those smaller organizations without these professional resources, access to IRS information may be their primary

[151] See, "Organizational Chart for IRS Exempt Organizations." Last accessed January 16, 2014.
[152] CE&O also has a significant internal customer, i.e. its own IRS EO agents and personnel, who access and use the web. Indeed, many of these web-based resources reflect an internal IRS focus in their use of terminology and descriptions that, while readily familiar to these agents who may work with them frequently, are not readily known or understood by the public whose access is infrequent. Implicit in our discussion is potential for IRS personnel also to benefit from these recommendations.

resource. Reaching these customers present significant challenges and will require the IRS to commit significant resources to serve them.[153]

Their second external customers are tax professionals or practitioners who render services to and on behalf of nonprofit and tax-exempt organizations. These customers include lawyers, CPAs, and enrolled agents. When working with nonprofit organizations about UBI and UBIT or other issues, this group requires detailed information to address their clients' specific legal, tax, and accounting needs. This is particularly the case for practitioners in small firms or with only intermittent needs to access IRS information. [154]

RESOURCES

Resources are always a concern. EO personnel do the best they can with what they have. They will point out when ACT's recommendations may be "resource challenged." Prior ACT reports have spoken to "challenging times", "resource constraints", or similar language which reference EO budgetary constraints. In some instances this may mean "not this year"; in other instances, not now and likely never.

Budgetary constraints arise from two primary sources. First there are the Executive and Congressional priorities, legislation, budgets, and action or inaction. When addressing these resource constraints the ACT generally can advocate on behalf of EO and the IRS for securing the resources needed to serve the growing and vibrant nonprofit

[153] See generally, "Leveraging Limited IRS Resources in the Tax Administration of Small Tax-Exempt Organizations", Advisory Committee on Tax Exempt and Government Entities (ACT) 2013 Report of Recommendations, beginning at page 75. Last accessed March 8, 2014. One recommendation in this report was to create a direct link from the IRS main web landing page (www.irs.gov) to the Exempt Organizations' main landing web page "Charities & Nonprofits" (http://www.irs.gov/Charities-&-Non-Profits). The "Help for Tax Exempts" tab which now resides on IRS' main landing page (www.irs.gov) was established within several hours after the 2013 ACT report's oral presentation of its report and recommendations. The ACT acknowledges and thanks the IRS leadership and personnel responsible for this rapid response to this specific recommendation.

[154] While tax professionals may have access to external publications and resources to include online databases and subscriptions, the subscription costs for these services can run to several hundred dollars or more per month. In many instances the cost places them beyond the ability of many of the smaller tax professionals to obtain or use them, especially if only required on an infrequent basis. The information created by the IRS is funded through taxpayers' dollars and should be easily accessible and available without additional cost to the public and professional alike.

sector. Externally, the ACT can bring to the attention EO needs and encourage the sector to serve as advocates on behalf of EO.

The second constraints are the management decisions made by the Department of the Treasury and IRS leadership when making their discretionary decisions and allocation of resources that affect EO. These efforts are easiest when a specific need or resource can be identified and brought to their attention. In some instances the ACT may disagree with their allocations.

The IRS and EO have a new leadership team which only has come together in recent weeks. They are operating in response to recent events which brought attention and resources to some issues about which the ACT had previously written.[155] Because many of their management decisions and resource allocations are still unfolding, their full impact has not yet been realized.

In making discretionary allocations it is easy to consider education and outreach services as peripheral activities. Because they may not appear essential to the IRS core mission of tax collection and enforcement, it can be easy to diminish or otherwise constrain their resources. In some instances this may be appropriate. But if their cost is the primary criteria, then the IRS can simply post the applicable statutes, regulations, revenue procedures, and other required documents on their website and take no further action. Clearly, neither the IRS nor the ACT considers this to be an appropriate course of action.

ACT members see daily both the need for and the desire by the sector to use and learn from CE&O educational and outreach services. First, this means investment in IRS personnel and their training, access to IRS resources, and the public's access to these IRS resources. Waiting for an hour to talk with IRS personnel, as has happened to ACT

[155] See, for example, "Exempt Organizations Form 1023: Updating It For the Future." 2012 Advisory Committee on Tax Exempt and Government Entities (ACT) Report of Recommendations. Pg. 69 et. seq. Last accessed April 5, 2014. The silver lining in these events is the IRS is committing significant "human, financial, and technological" resources to the application process which we believe will yield long term positive results to the nonprofit sector and the IRS.

members, simply is not good customer service, especially if that person then does not have the training and ready and easy access to the information needed answer a caller's question.

There is little doubt the most efficient means to provide this information is through leveraging their web-based technology. To meet these needs will require consistent, if not increasing, investments in technology capacity combined with smart application and use of the technology. Today web access is ubiquitous, mobile, and accessible through smartphones. The IRS simply needs the capacity and ability to provide access to its web resources through many different media simultaneously. Significantly, technology will require significant upfront expenditure before this investment begins to yield efficiencies and effectiveness over time. The latter items do not appear as a line item budget savings, but are significant over time.

Competition for IRS IT resources operates as a significant constraint for EO. For example, the IRS Content Management System (CMS) or Online Services "own" these resources and may have priorities or objectives which supersede or override EO's needs. ACT members and the nonprofit sector experienced CE&O efforts to upgrade and improve its web pages. In the process their efforts were overridden by IRS system-wide "upgrades and improvements" which adversely affected access to EO web pages.

On the other hand, the ACT also experienced the speed at which change can be made. Within hours after the 2013 public meeting the IRS.gov home page was modified to include "Help for Tax Exempt" tab on the main page which provided a direct link to EO's homepage. This was a symbolic, but significant reminder that IRS leadership can redirect sufficient IT resources to bring EO up to speed and to maintain it.

In those instances when EO "owns" the resources and means by which this information is produced and distributed, they have greater ability, capacity, and flexibility to provide relevant and timely information to the exempt organization community. In other instances EO must share and compete, or are otherwise dependent upon other components of the IRS to provide the needed information and resources (e.g., web

resources and publications). At a minimum, both CMS and EO may require closer coordination and cooperation to assure IT and web-based resources match the needs for both the larger IRS' (i.e. non-EO) and EO's shared goals and responsibilities to serve the public.

In the ACT's experience, CE&O seeks creative and innovative means to leverage their resources and offset their deficits. But at some point, even their good faith efforts to leverage their resources will reach diminishing returns without timely access or an increase in needed resources.

COMMUNICATIONS, TRAINING, AND PUBLIC EDUCATION

CE&O's primary and most cost effective strategy is to provide access to information for and about exempt organizations through its website. As noted in previous ACT reports, the web provides EO with its most significant leveraging resource available to fulfill this component of the IRS mission. Paradoxically, as experienced when seeking UBI and UBIT web information and indicated in some of the following sections, the IRS web site may challenge users for reasons of its accessibility, quantity, complexity and change.

CHALLENGES TO CURRENT EO ELECTRONIC COMMUNICATIONS

Small and mid-size organizations are receptive to EO information and the training opportunities provided by IRS. Currently, EO provides information and educational materials through its website, training programs, videos, and, in particular, the EO Update email listserv.

CE&O has two central challenges in their education and communication strategies. While they offer timely and useful information, they can't compel recipients to access this information or apply it correctly. This challenge is present in every strategy. When nonprofits do not avail themselves of IRS information then it becomes a more resource intensive compliance function including IRS audits, compliance checks, and other tools for those nonprofits which fail to comply with applicable law.

Their second challenge is to provide their information directly to nonprofit organizations which want or need it. The ACT believes this can be addressed through better use of technology.

EO LISTSERV AND CREATION OF "EO BOX"

CE&O provides the EO Update email listserv which is effective means to distribute current information to individual recipient. It has three limitations beyond email overload which nearly everyone endures. First, a listserv requires voluntary participation and significant ongoing commitment of IT resources to keep this list current. Given the churn among nonprofit leadership, members, and volunteers nonprofits database management will always be a challenge and require ongoing commitment of significant resources.

Second, CE&O doesn't know if, when, or how an individual subscriber may provide EO Update information to a specific organization(s).[156] For example, EO may presume ACT members who subscribe will provide the listserv information to the nonprofits we serve. But they have no way to know whether we do. Because of the volume of information which is forthcoming from EO, providing this information is a challenge even for professionals serving the nonprofit sector.

Finally and most significantly, these emails are not linked or delivered directly to registered nonprofit organizations, especially those who do not have professional advisors. Currently there is no indication that CE&O efforts directly reach most nonprofit organizations. A more effective and efficient use of electronic communications will link delivery of EO Update information directly to the nonprofit organizations filing the IRS 1023 and 990 forms.

Most nonprofit organizations have a web site which contains a "contact us" email address (e.g. info@nonprofit.org). This is the email address by which they want the public to communicate with them directly. This email address is the functional and

[156] This is analogous to the marketing saying that "Half of the marketing budget is wasted; the problem is you don't know which half is wasted."

electronic equivalent to an organization's "street address or mailing address." Currently, this information cannot be captured by the current IRS IT systems, but could be as part of ongoing IRS and EO IT system upgrades to include IRS 1023 and 990 electronic filings.

Currently, the IRS Form 1023 application makes submission of this email address optional (See Line 9b). It does not require an organization to submit an "email address" unlike an organization's street address or PO Box mailing address which is required.[157] Similarly, the current IRS Form 990 does not capture this information on an annual basis.[158] Neither form captures an email address for an organization's "responsible party" which is also required to be provided.[159]

As an interim step the IRS could require nonprofit organizations to submit a current email address on its initial IRS Form 1023 application and annually through its IRS Form 990 filings. This will permit CE&O to add this email address to its EO Update listserv and thereby assure delivery of this email to a majority of the registered nonprofit organizations which use an email address. While this doesn't solve the first challenge (i.e. delivery, but without reading or using), it at least assures EO that a nonprofit organization will receive direct information through its own email address and/or through a responsible individual associated with the nonprofit.

There is a second alternative which will not rely upon email delivery to an individual or an organization's "contact us" email address. Sometimes "old" ideas can be adapted to new times effectively and efficiently.

Since its inception the U.S. Postal Service used post office boxes as a cost effective means to deliver the mail to individual PO Box recipients. What if EO adapted this "old" communication tool to the electronic age by creating the equivalent of a web-based electronic mailbox for every nonprofit organization, i.e. an individual "EO Box"?

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[157] See, "IRS Form 1023." Last accessed April 4, 2014.
[158] See, "IRS Form 990." Last accessed April 4, 2014.
[159] See, "Responsible Parties and Nominees." Last accessed April 4, 2014.
See also, "Form SS-4." Last accessed April 4, 2014.

An "EO Box" provides continuity and one source for current IRS information as long as the nonprofit is in existence. The box will survive leadership and management change of personnel which is particularly relevant for those small and mid-sized organizations. Recipients could create their own login and password to access this information. Because it will become known as "their source" for IRS information, it is reasonable to expect most nonprofits will come rely upon their "EO Box" for this information.

An "EO Box" will address the EO's central underlying challenge to insure that EO communications reach every nonprofit organization in their efforts to fulfill their mission to assure compliance with tax law in the most effective and cost efficient means.

Significantly, it can provide them with a potential methodology to test and refine their effectiveness for delivering relevant IRS information to nonprofits. In some instances smart adaptation of this technology over time may permit the IRS to customize the information sent to an organization by matching their specific needs or profile with IRS information.

Having established one central point of contact for a nonprofit, the responsibility, as it always has been, will be upon their leadership to review and use this information appropriately if they choose to access the "EO Box" created for their organization. EO could also establish a similar EO Box for tax professionals who are registered on PTIN or who opt-in in addition to its listserv. An "EO Box" will provide the opportunity for increased IT efficiencies and effectiveness by the ability to deliver this information to a single electronic repository for the nonprofit.

TAX LAW

If a user finds it, the IRS webpage "Understanding IRS Guidance – A Brief Primer" provides a brief overview on the IRS and related tax law, but notes both "may seem, well, a little puzzling at first glance."[160] This page provides a brief introduction to regulation, revenue rulings, revenue procedures, private letter rulings, notices, and

[160] "Understanding IRS Guidance – A Brief Primer". Last accessed January 16, 2014.

announcements. However, this page does not provide direct hypertext links which easily could take a user to the specific sections referenced on this page. These sources will provide information on issues related to tax law involving UBIT or any other area affecting exempt organizations.

TAX CODE, REGULATIONS AND OFFICIAL GUIDANCE

Access to the statutes, regulations, and the Internal Revenue Bulletin ("IRB") may be found on the IRS website "Tax Code, Regulations, and Official Guidance." [161] For information related to statutes and regulations a user is redirected by hypertext links respectively to a Cornell Law School site or to a U.S. Government Printing Office website, neither of which are maintained by the IRS.[162] To access these primary sources for tax-related law, a user must learn to navigate these disparate sites.

The IRS regularly publishes official tax guidance through publication of the IRB. While rulings and procedures reported in the IRB "do not have the force and effect of Treasury tax regulations, they may be used as precedents."[163] Yet the user cannot access either a searchable format or a printer friendly PDF format of the IRB directly from the "Tax Code, Regulations and Official Guidance" webpage.

A user can link to a webpage which contains an IRB master list in both an HTML and a PDF format.[164] But this page does not contain an index or searchable format for information which will assist a user in finding information related to a specific topic or IRB. Finally, the "Tax Code, Regulations and Official Guidance" page provides access to the IRS GuideWire service. This allows a user to receive email notification of guidance issued by the IRS. [165]

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[161] See, "Tax Code, Regulations, and Official Guidance." Last access January 16, 2014.
[162] See "Legal Information Institute". Cornell University Law School. Last accessed January 16, 2014. See also, "U.S. Government Printing Office". Last accessed January 16, 2014.
[163] See, "Tax Code, Regulations, and Official Guidance." ibid.
[164] See, "IRB Title and Publication Date." Last accessed January 16, 2014.
[165] See, "Subscribe to IRS GuideWire." Last accessed January 16, 2014.

The EO Division publishes an email listserv titled "EO Update" which provides current information on issues of tax policy, services, and current information to its subscribers. The update will provide links to news releases, new forms and guidance, changes to the IRS Charities and Nonprofits web site, and information regarding upcoming IRS training and outreach.[166] The updates are archived by year with each year's archived listing subject matter by each EO Update.[167]

TAX PROFESSIONALS

Tax professionals are CE&O's second primary customer. They include lawyers, CPA, and enrolled agents who typically have greater need on a consistent basis to access the detailed and specific information to advise and guide nonprofit organizations. Currently, there is not an EO tax professional web page which will provide easier web-based access to more detailed and extensive legal and tax information which these practitioners, as well as the public on occasion, may require. Establishing an "EO Practitioner Home Page" could provide them with clear links to the relevant statutes, regulations, revenue rulings and procedures, private letter rulings, CPE, and other IRS information which these professionals require. It would also add others who also seek to information on an infrequent basis. Consistent with this report's other recommendations, the overarching goal should be to provide this information through improved access, indexing, and search functions.

On the main IRS.gov web pages there is a tab "for Tax Pros". Currently, this page does not provide direct access to "Tax Pro" information for EO practitioners. We recommend creating a direct hypertext link from center portion of this page to an "EO Practitioner Page." A second alternative is to provide a link under its "More Topics for Tax Pros" category.

[166] See, "Subscribe to Exempt Organization Update." Last accessed January 16, 2014.
[167] See, "Exempt Organizations Update Archive." . Last accessed January 16, 2014.

FORMS AND PUBLICATIONS

The IRS educates and communicates through the forms and publications which it publishes and updates in response to changes in the law. For UBI and related matters for exempt organizations, these publications include:

PUBLICATION 598 – Last revised in March 2012, Publication 598 is a 22-page document which is accessible on the web.[168] It can be found through the "Current Forms and Publications" webpage and its related search page accessible through a hypertext link. [169] Using the search feature from the IRS main landing page (www.IRS.gov), a user will find Publication 598 listed as the sixth reference to unrelated business income. A comparable Google search for "IRS unrelated business income" lists this publication as the third entry behind two entries located on the IRS website pages titled "Unrelated Business Income Defined" and "Unrelated Business Income Tax."[170]

IRS FORM 990 and 990 EZ – Exempt organizations which are engaged in unrelated business activities typically will file either an IRS Form 990 or a Form 990 EZ. The instructions for an IRS Form 990 are contained within a 99-page downloadable PDF file.[171] Instructions for the IRS Form 990 EZ are similarly available as a 48-page downloadable PDF file.[172] Both contain references to UBIT.

IRS FORM 990 T. – For organizations with UBI, the IRS requires they file a Form 990 T. The instructions for this form are comprised in a 28-page downloadable PDF file.[173] The current IRS Form 990-T is available as a four-page downloadable PDF file.[174]

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[168] See, "Publication 598 (Rev. March 2012) Tax on Unrelated Business Income of Exempt Organizations." Last accessed January 16, 2014.
[169] See, "Current Forms and Publications" as well as this resource. Last accessed January 16, 2014.
[170] Unrelated Business Income Defined and Unrelated Business Income Tax. Last accessed January 16, 2014.
[171] See, "2013 Instructions for Form 990 Return of Organization Exempt From Income Tax." Last accessed January 16, 2014.
[172] See, "2013 Instructions for Form 990-EZ." Last accessed January 16, 2014.
[173] See, "2013 Instructions for Form 990-T." Last accessed January 16, 2014.

WEB PAGES

EO provides web pages devoted to UBI related issues with alternate ways to access them. When "unrelated business income" is entered into the IRS website search engine, the first two entries are for information for the "SOI Tax Stats – Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics" and "SOI Tax Stats – Exempt Organizations' Unrelated Business Income #UBI# Tax Study Metadata".[175] These pages provide access to statistical data on unrelated business income which is not generally information useful to the public or practitioners.

The third and fourth entries on an IRS web search take a user to the IRS website page titled "Unrelated Business Income Defined" and "Unrelated Business Income Tax."[176] By contrast, a Google search using the same terms lists these latter two pages as the top entry. These pages provide high-level information about UBI.

As a result of the 2012 ACT report, the IRS main web page (www.IRS.gov) has a direct link to the main webpage for Charities & Non-Profits.[177] The "Charities & Non-Profits" page is the main landing page for EO. On the left side it contains an "A-Z" index. As noted below, this index is not complete in its references to all of the IRS materials on UBI.

A second way to access information on UBI from the "Charities & Non-Profits" webpage is to click on the several tabs, including "Charitable Organizations", "Churches & Religious Organizations", "Private Foundations", and "Other Non-Profits". Each hypertext tab links to a page which will contain a hypertext link to UBI information.[178] The various UBI webpages, as is the case with most IRS webpages, can be printed out,

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[174] See, "Form 990-T Exempt Organization Business Income Tax Return (and proxy tax under section 6033 (e)." Last accessed January 16, 2014.
[175] See, "SOI Tax Stats – Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics." and "SOI Tax Stats – Exempt Organizations' Unrelated Business Income #UBI# Tax Study Metadata." Last accessed January 16, 2014.
[176] See, "Unrelated Business Income Defined" and "Unrelated Business Income Tax." Last accessed January 16, 2014.
[177] See, "Charities & Non-Profits." Last accessed January 16, 2014.
[178] See for example, "Tax Information for Charitable Organizations. Last accessed January 16, 2014.

added as a “favorite” on the user’s web browser, or added to a variety of social media, e.g., Facebook, email, Twitter, Gmail, StumbleUpon, etc. However, none of pages contain direct links that enable a user to access a downloadable electronic PDF file.

WEB SEARCH

The current IRS website has a search function. When searching for information, this search function generally does not work as well as an external search engine. It does not yield as productive a ranking as an external search engine like Google generally will do. For a practitioner who accesses the site frequently or goes to a particular webpage repeatedly, they may already know a phrase which will enable them to access the page. For others unfamiliar with shortcuts phrases, they will find the IRS search function challenging to use.

The IRS should consider outsourcing this search function and/or continue to identify and use search engine optimization tools and techniques, including the use of key words, to improve the site’s current search capabilities. Finally, a thorough review and editing of the total number of web pages may help to improve the search functions by limiting the number of pages on which key information is located.

WEB INDEXING AND FILE NAMES

As indicated, the IRS provides a significant amount of information on its website. However, the information is often difficult to find. Generally it is not well organized, lacks good indexing and cross referencing, and, in some instances, simply is not current. In a worst case scenario, the information may be inaccurate or not up to date because the information is not being maintained and is on the web for archival purposes. The UBIT CPE texts are a clear example of the latter. Because of the reorganization and transfer of IRS EO technical personnel to the Treasury’s Office of Chief Counsel, that office should be mindful of the need for coordinated maintenance of website information in the future. Because of the reorganization and transfer of IRS EO technical personnel to the Treasury’s Office of Chief Counsel, this is an issue which they will consider. Current

and accurate CPE serves a highly useful educational purpose for IRS personnel, tax professionals, and the public. As part of their professional responsibilities, the ACT strongly encourages this office to update and maintain this resource as part of a continuing education process for IRS personnel which will also benefit the public and tax professionals. This information likely is already contained in their legal and memo databanks and over time could be migrated into CPE texts.

EO's web pages contain an A-Z subject matter index. This index can provide an easy means of search for both the public and professional alike if it is more inclusive. The key is to create an index which provides easily understood references to all relevant subject matter.

For example, the UBIT index currently lists only the following entries:

Unrelated Business Income Tax (UBIT)

- Tax on Unrelated Business Income of Tax Exempt Organizations - Pub. 598, *Tax on Unrelated Business Income of Tax Exempt Organizations*
- Unrelated Business Income Module of StayExempt Workshop
- Unrelated Business Income Tax Exception and Exclusions[179]

To find any additional information one must use the site's search function or already be familiar with a webpage link.

Because this UBIT index contains only limited UBI related entries, it does not provide a one stop subject matter index to provide ready access to all of the UBI and UBIT information located on the website. It should. This index might easily be expanded to provide access information through the use of well-designed hypertext links. For example, this index might provide the following:

[179] See, "Charities and Nonprofits A-Z site index (U-Z)." Last accessed January 16, 2014.

Unrelated Business Income Tax (UBIT)

- Cases – UBIT
- Continuing Professional Education (CPE) articles – UBIT
- Definition - UBIT
- EO Listserv – UBIT
- Exceptions and Exclusions – UBIT
- Internal Revenue Manual (IRM) – UBIT
- Publications
    - Publication 598 Tax on Unrelated Business Income of Tax Exempt Organizations – UBIT
    - Other publications - UBIT
- Regulations - UBIT
- Revenue Rulings -UBIT
- Revenue Procedures – UBIT
- Statistics of Income (SOI) Tax Stats - UBIT
- Statutes -UBIT
- Video workshop –UBIT
- StayExempt - Unrelated Business Income Module of StayExempt
- Workshop – UBIT

This UBIT index should be considered as an example. There are other topics and areas in which a thoughtful analysis of available web materials and index design will prove invaluable as means of accessing IRS materials. CE&O could convene outside volunteers as a means for their input as frequent consumers and users of this IRS resource. This group may also be useful in offering “keywords” for the search function. Alternatively, the IRS might include on its web pages a “suggestion box” for additional terms to use as key words.

There exists a similar problem with indexing and file names for the IRM. If users find their way to "Internal Revenue Manual" or the "IRM Source Files – Directory List of File, Names-Expert Interface Pages", pages are not well indexed and do not have file names which clearly indicate what is contained within a given file.

WEB PAGE AND PDF FILES

Web pages and files are not available as a downloadable and searchable PDF file. Having this information as a PDF file enables a user to read, email, search, store, and print copies in an electronic page format and provides them with ready access, easy reading, and the ability to save and reuse IRS information. For resources that are analogous to a book with multiple chapters, e.g. the IRM, a user should be able to download either the entire volume and by relevant chapter or segment.

In many instances a single web page may contain extensive information. The print function for a lengthy page may only print a portion of a page and will not print the remainder of the page. The print function should print the entire web page.

EDUCATION, WORKSHOPS, AND SEMINARS

CE&O provides many different opportunities to educate the public through live workshops, virtual training, and educational resources and programs. Easy access to a listing for these programs is through the hypertext link "Education, Workshops, Seminars" contained on the "Charities & Non-Profits" webpage.[180] The user is taken to the webpage "Education, Workshops, Seminars" which contains hypertext links to four categories of training. These categories are: live training, virtual training, educational resources, and other educational products and programs.[181]

As noted in the 2013 ACT report, the IRS Academic Institution Initiative is a highly successful in-person workshop that provides basic information primarily for small and mid-sized nonprofits. Information on UBI is included in this basic workshop training and

[180] See, "Charities & Non-Profits." Last accessed January 18, 2014.
[181] See, "Education, Workshops, Seminars.". Last accessed January 18, 2014.

text.[182] The "Exempt Organizations Participant Text" used in this course provides the participants with a hard copy of the workshop's curriculum. As noted in the 2013 ACT report, this document and related materials still remain unavailable as a downloadable PDF file.[183]

The ACT continues to endorse these workshops as an invaluable educational tool and resource. While an online version will lose the intimacy of the in-person presentation, CE&O should adapt this workshop for an online version.

As the Colleges and University Compliance Project Final Report stated, larger institutions had difficulty with UBI.[184] UBI and UBIT represent some of EO's more sophisticated and challenging issues, in addition to emerging areas of law and regulation, which may benefit from an educational initiative(s) focused on issues which affect these larger nonprofits. These address more complex issues and emerging areas.

As with so many of their educational efforts, this is an area which can be delivered over the web in a cost effective manner. Information in this format can be captured and reused through technology like Adobe Captivate which enables the IRS to display both the presenter and their Microsoft PowerPoint presentations simultaneously.

Emerging opportunities and interactive learning in higher education, e.g. Massive Open Online Courses can serve as an example to guide IRS efforts or as an opportunity to work with outside providers and state regulators to provide cost efficient and effective use of IRS training resources.

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[182] "Chapter 4 Unrelated Business Income (UBI)." *Exempt Organizations: Participant Text.* Training 4325-002 (Rev. 10-2008). Catalog Number 88908P.

[183] See, "Leveraging Limited IRS Resources in the Tax Administration of Small Tax-Exempt Organizations." Footnote 58, pg. 14. Last accessed January 18, 2014. Footnote 58, 2013 ACT report, , pg. 108.

[184] For example, the report noted: "The IRS found that about 20 percent of colleges and universities examined sought outside advice about the tax treatment of specific potentially unrelated business activities. In about 40 percent of those cases where an institution had obtained an outside opinion, the IRS did not agree with the opinion when the issue came up on examination." See, "Colleges and University Compliance Project Final Report," pg. 14. Last accessed March 9, 2014.

Finally, we recognize the value of in-person training. In addition to current IRS workshops, there are many educational workshops nationwide which annually attract advanced tax practitioners. CE&O should continue to provide speakers for these workshops as a means of leveraging its resources.

Nationwide Tax Forums – Clicking on the hypertext link for "Nationwide Tax Forums" the user is taken to a non-IRS website.[185] The 2014 schedule has not been posted yet. A cursory search of the hypertext links for "IRS PowerPoint Presentations from 2007-2013 Nationwide Tax Forums" accessible on the IRS website did not indicate presentations with UBI in their titles.[186]

Virtual Training – CE&O provides virtual training through a combination of webinars, online courses at www.StayExempt.irs.gov, and life cycles of exempt organizations. A review of the "Webinars for Exempt Organizations" webpage indicates there are no currently scheduled webinars.[187] There were no listings for UBI training. There is a hypertext link to the "IRS Video Portal" which takes the user to a non-IRS video website that contains hypertext links to video presentations on: "Churches; Disability Awareness; Disaster Information; Filing Returns; Fundraising & Donations; Gaming; Help & Resources; International Activities; New Non-Profits; and State Tuition Orgs."[188]

Clicking on the link "Online courses at stayexempt.irs.gov" takes a user to the "StayExempt online courses" webpage.[189] On this page, there is an "Unrelated Business Income" link which takes the user to the CE&O "Unrelated Business Income" course.[190] This 30-minute course was published in August 7, 2009.

Taught through audio and the web-based inanimate cartoon characters Tim and the Coach, a user is provided with relatively simple and high level information about UBI on

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[185] See, "IRS Nationwide TaxForum." Last accessed January 18, 2014.
[186] See, "IRS Nationwide Tax Forum Information." Last accessed January 18, 2014.
[187] See, "Webinars for Exempt Organizations." Last accessed January 18, 2014.
[188] See, "IRS Video Portal." Last accessed January 18, 2014. Other videos topics on this page include: Individuals, Businesses, Tax professionals, Governments, and Espanola. A cursory review of the links to these video presentations indicate they were produced anywhere from several months to several years.
[189] See, "StayExempt online courses." Last accessed January 18, 2014.
[190] See, "Unrelated Business Income." Last access January 18, 2014.

31 webpages. The topics covered include: the UBI test; exceptions, exclusions, & deductions; filing Form 990-T; charitable gaming conclusion; and conclusion. On the last page, the user can access a two-page downloadable PDF file which provides only simple summary information about UBI. [191] If one does not want to take the course, this PDF file also is accessible directly on the webpage "Existing Organizations: Maintaining your tax-exempt status". [192] The course concludes with an evaluation survey which provides CE&O with feedback from users who take the time to complete it.[193]

On the section "Educational Resources" and "Other Educational Products and Programs" contained on the web page "Education, Workshops, Seminars," a user is not provided with direct links for information on UBI, but is guided to a variety of educational information and guidance provided by CE&O. Often these link back to information which a user may access through other means on the IRS website.

CPE and IRM – There are two other resources regarding UBI, as well as other topics, which primarily are known to tax professionals but not the general public. These resources are Continuing Professional Education ("CPE") articles and the Internal Revenue Manual ("IRM"). CPEs are available through a link on the CE&O "Education, Workshop, Seminars" webpage. The user is taken to the webpage "Exempt Organizations continuing professional education technical instruction program" which were written and published by IRS technical specialists between 1979 and 2004.[194] On this page one can access these articles either by fiscal year or through the link "Exempt Organizations CPE Topical Index" which will take a user to a 29-page PDF file posted on September 6, 2013.[195] They are not readily or easily accessible through the IRS search function. Indeed, it is likely only a tax practitioner would know of their existence.

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[191] See, "Course 2 Summary: Unrelated Business Income." Last accessed May 1, 2014.
[192] See, "Existing Organizations: Maintaining your tax-exempt status." Last accessed January 18, 2014.
[193] The ACT reviewed a summary of the evaluations for 2013 which is not publicly available. While not a statistically valid survey, it indicated a relatively high degree of satisfaction with the format and information provided by this online course.
[194] See, "Exempt Organizations continuing professional education technical instruction program." Last accessed January 18, 2014.
[195] See, "Index of Topics." Last accessed January 18, 2014.

A comparable Google search "irs cpe" takes the user directly to the IRS webpage "Exempt Organizations continuing professional education technical instruction program" which contains a list of CPE by fiscal year only. From this page a user can access the "Exempt Organizations CPE Topical Index".

Once the CPE "Index of Topics" is located, it contains listings on UBI topics with links to the corresponding CPE text.[196] Clicking on the links associated with these various topics will take the user to a page titled "CPE for FY (year)".[197] The representative page will contain a hypertext link and brief description of the CPE associated with the link. The user will then be able to access a downloadable PDF CPE text. The last CPE on UBI appears to have been published in 2002.

The Internal Revenue Manual ("IRM") represents a second source of information on many different topics.[198] While it may provide an excellent resource for practitioners, it is not easily accessible for them, much less the general public. The IRM table of contents is not indexed in a manner that makes finding a particular topic easy. The challenge is in finding the IRM number. The "IRM Source Files – Directory List of File Names – Expert Interface" webpage notes "(t)his page provides a direct link to the IRM source file directory on our FTP server. There's not much assistance there, just a directory listing of the files that can be sorted by the file name or the date posted."[199] Indeed, when this page is accessed, the user is confronted with a naming format that defies any ease of access unless one knows the specific Zip file name. A representative file name is: "irm 01-001-004.zip" followed by the "last modified" date and file size.

[196] For a complete list of CPE texts on the IRS website, see Appendix D.
[197] See, for example, "CPE for FY 1980." Last accessed January 18, 2014.
[198] See, "Internal Revenue Manual (IRM)." Last accessed January 18, 2014.
[199] See, "IRM Source Files – Directory List of File Names – Expert Interface." Last accessed January 18, 2014.

Efforts to locate IRMs for UBI on the "Forms & Publications" page were not successful.[200] This included trying to use the IRM search function and term "unrelated business income."

A Google search for "Internal Revenue Manual" and "unrelated business income" takes a user to the IRS webpage "Part 7. Rulings and Agreements. Chapter 27. Exempt Organizations Tax Manual. Section 4. Taxation of Unrelated Business Income."[201] This webpage, like many IRS webpages, does not contain a "Print" button function nor direct access to a downloadable PDF file. Printing directly from the webpage yields a four-page document that appears to have been last updated on or about February 23, 1999 and defines the term "small print."

From this search, a user might learn they can access "Chapter 7 Rulings and Agreement" from IRM index and then toggle down to "Section 7.27 Exempt Organizations Tax Manual" to find more information on UBI.[202] From their titles Subsection 7.27.3 through 7.27.10 appear to address UBI issues. The links take the user to a webpage that details more information, but which does not contain a "Print" function button or downloadable PDF files.

The Internal Revenue Manual (IRM) is accessible through EO's general A-Z index. This appears to be the easiest means to access this resource. This index may benefit by adding index topics for subsections. Currently, these pages are available only as a web page. EO specific manual sections should be available as a downloadable PDF file by both the entire IRM as a manual and individual chapters or sections.

Because these documents provide significant information and understanding regarding IRS activities and operations, they should indexed and made available easily accessible from an EO Practitioner's web page as well.

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[200] See, "Forms & Publications." Last accessed January 18, 2014.
[201] See, "Part 7. Rulings and Agreements. Chapter 27. Exempt Organizations Tax Manual. Section 4. Taxation of Unrelated Business Income." Last accessed January 18, 2014.
[202] See, "Part 7. Rulings and Agreements." Last accessed January 18, 2014.

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The IRM does not seem to be indexed well by the site's search function. It is difficult to locate a specific section through the search function. To improve access to specific sections by a search function likely will require more key words.

When you can find them on the website, CPE articles have provided an excellent resource for IRS personnel, the public, and practitioners.[203] CPE provide well-written and easily understandable explanations for many different facets of exempt organizations. They focus on a particular topic or issue, set forth IRS policy and practice, and provide references to legal precedent and analysis which guide the IRS. Interestingly, they indicate the article's author which provides the author with keen sense of their professional obligation, responsibility, and accountability for their quality and accuracy.

Currently, CPE articles are being archived, but now are not updated due to resource considerations. A recently announced reorganization will transfer EO technical and legal staff to the Office of Chief Counsel. This may provide an opportunity for this office to create and update CPE texts as an integral part of their ongoing professional activities. Because CPE texts provide a significant leveraging of legal knowledge and resources for educational and professional use by the IRS, public, and tax professionals alike, the IRS should encourage this office to resume issuing CPE texts and update those which have not been updated.

[203] See Appendix B.

IX. Recommendations

Based on the ACT's review of the *College and Universities Compliance Project Final Report* and its own independent study of the UBIT issue, which as noted includes interviews with IRS personnel and tax practitioners representing colleges and universities, the committee puts forth the following recommendations.

1. **The IRS Exempt Organizations Division should recommend that Chief Counsel and Treasury open a regulation project so that profits from a substantial commercial activity will not preclude exemption under I.R.C. § 501(c)(3) as long as an organization's income and its financial resources are used commensurate in scope with its charitable program**.

There is an apparent inconsistency in IRS regulations for determining exempt status under I.R.C. § 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1) holds that an organization will not qualify for tax exemption if more than an insubstantial part of its activities are not in furtherance of an exempt purpose. However, Treas. Reg. § 1.501(c)(3)-1(e) goes on to say that an organization may qualify for tax exemption even if it operates a trade or business as a substantial part of its activities if such operation is in furtherance of its exempt purpose and it is not organized and operated for the "primary purpose" of carrying on a trade or business. Revenue Ruling 64-182 harmonized those two provisions with the "commensurate rule" which determines whether a charitable purpose is present by examining the size and extent to which business income is used for charitable activities rather than to fund the underlying business operation.

However, the IRS never formalized Revenue Ruling 64-182 as a regulation and confusion has arisen. Courts have been led astray in crafting a "commerciality test" in an attempt to harmonize these two apparently inconsistent regulations by imposing greater business limitations than do the statutory provisions themselves. Recent court cases and IRS rulings have been applying a commerciality test to determine: (1) when

certain business activity conducted by a Section 501(c)(3) organization will preclude tax exemption; and (2) what constitutes unrelated business generating taxable income.

Neither the tax law nor the implementing regulations provide support for a commerciality test. To the contrary, the evidence is clear that the imposition of tax under the Corporation Excise Tax Act of 1909, from which the present income tax exemptions are derived, does not indicate any intention to limit the tax exemption of charities engaged in business or to limit the quantum of business activity, but rather indicates an intention to assure exemption of certain charities engaged in businesses. To the extent that Congress has since acted it was to tax the unrelated commercial activity of an organization that had an otherwise charitable purpose. Similarly, to the extent that law denied exemption to feeder organizations obligated to pay over all their commercial income to a specific charity, it was in the recognition that such income, like the income from unrelated commercial activities of an exempt organization, should be taxed unless feeder organizations were otherwise exempt.

Thus, the ACT recommends that the IRS open a regulation project to: (1) formalize the commensurate test articulated in Rev. Rul. 64-182; and (2) to reject application of the commerciality test.

2. **The Exempt Organizations Division should work with Chief Counsel and the Treasury Department to provide formal guidance to the field regarding proper methods for allocating indirect costs where facilities and/ or personnel are used to carry on exempt activities and to conduct unrelated trade or business.**

The ACT advances this recommendation based on the findings contained in the IRS' Final Report and its own fact finding through interviews with IRS staff and professionals in accounting and tax law who represent college and universities. The Final Report refers to improper expense allocation as one of the primary reasons for underpayment of UBTI by college and universities. According to the Report, for nearly 60% of the Form

990-Ts examined, colleges and universities had misallocated expenses to offset UBI for specific activities.

At the same time, the ACT finds that current IRS regulations and published guidelines do not offer the field clear guidance for determining what constitutes improper methods of cost allocation. Currently, IRS rules state that the cost allocation method must be reasonable. Additionally, the "method must allocate to unrelated trade or business activity only that portion of any item of deduction that is proximate and primarily related to the business activity…"[204] Based on interviews and a review of guidance materials, the ACT concludes that current IRS guidelines regarding cost allocation methods do not adequately distinguish between reasonable and unreasonable methods.

The ACT recommends that the IRS develop guidance in the form of a revenue ruling that has several elements. One is to identify methods that will be given safe harbor treatment. These are methods that the IRS will consider under most circumstances to be reasonable for allocating indirect costs where dual use assets are involved. These may include, for example, a unit-based methodology (e.g., unrelated rounds of golf/total rounds of golf) or a space-based methodology (square footage used for unrelated activities/total square footage). Exempt organizations that apply such methods consistently and with appropriate documentation will not likely be subject to further scrutiny including an audit. Another element is to identify allocation methods that are per se unreasonable. This may include the use of combinations of methods such that the exempt organization does not allocate costs consistently. Allocation methods that are not designated for safe harbor treatment or as per se unreasonable may come under increased scrutiny and ultimately be rejected as unreasonable subject to facts and circumstances.

[204] Treas. Reg. § 1.512(a)-(1)(a); §1.512(a)-1(c).

3. **The Exempt Organizations Division should work with the Chief Counsel and the Treasury Department to publish a comprehensive revenue ruling on a range of UBI issues. The ruling should provide categories of activities that will be considered related and unrelated, guidance on preparatory time spent on activities, and scenarios of situations involving the activities frequently reported on the college and university questionnaire, such as facility rentals and dual use properties.**

The ACT advances this recommendation in light of the significant adjustments to UBI made by the IRS as a result of its examination of colleges and universities in connection with the college and university compliance project and the lack of formal UBI guidance issued in the past several decades. The ACT has drafted a proposed revenue ruling that addresses these issues, which is attached as Appendix A. The ACT believes that clarity and guidance to the nonprofit sector in the form of a formal revenue ruling are needed regarding these UBI topics. The IRS should update Publication 578 and its website materials to reflect the situations and outcomes set forth in the proposed revenue ruling. The IRS should also consider publishing a fact sheet that sets forth the information in the proposed revenue ruling.

4. **The IRS should expeditiously formalize and adopt a new Form 990-T based upon the proposed format enumerated in this report. The new form will be web-based and have as its centerpiece activity-by-activity reporting on "Checklist A". This checklist - which would not be open to public disclosure - includes links to education and outreach materials; activity-specific worksheets that provide step-by-step processes for calculating revenues and expenses; and flow-through to a new, streamlined Form 990-T (see Appendices B and C).**

Proposed Form 990-T Redesign

As we have interviewed members of the U.S. exempt organizations community, there appears to be a wide range of opinions regarding Form 990-T. Many tax attorneys tend to like the current, somewhat nebulous unrelated business income arena, while Chief Financial Officers at small and medium-sized nonprofits voiced their frustration at being confused by (and losing sleep over) the lack of clarity and guidance with regard to unrelated business income and activities.

Most interviewees voiced a desire for a "completely electronic Form 990-T" with "no paper." Many intimated that the current Form 990-T does not adequately address the nuances of income from alternative investments, partnerships (Schedule K-1, Form 1065), or S corporations (Schedule K-1, Form 1120-S).

Further, as we spoke with representatives from the IRS' Exempt Organizations division, we consistently heard that the Service is frustrated by the lack of information that they receive regarding exempt organizations from the current Form 990-T.

New Form 990-T Vision

The vision of the redesigned form would be to:

A. Heighten education and outreach in the UBIT arena
B. Simplify Form 990-T for those organizations required to file
C. Minimize the size of the return – if possible
D. Provide IRS-requested Yes/No questions to provide overall UBIT data

Heighten Education and Outreach in the UBIT Arena

By expanding the instructions to the form in a manner that included verbiage and examples from IRS Publication 598 and "classifying" all known types of UBIT income into the eleven lines of Form 990, Part VIII, the instructions to the new form could be laid out in such a way as to help organizations navigate the stormy waters of unrelated

business activities recognition and reporting. Part of this design would include worksheets (akin to those included in the Form 1040 instructions for reporting Social Security income) that could walk the organization through the process of recognizing and reporting unrelated business income that they may be generating. These worksheets would not be part of the new form (thus not open to public disclosure for 501(c)(3) organizations) but would be kept in the organization's records.

Simplify Form 990-T for Those Organizations Required to File

Related to our discussion above regarding heightened education and outreach, the "simplification" goal includes creating a symbiotic, user-friendly relationship between the new form and the new instructions. Central to making things simple would be an "Unrelated Business Activities Checklist" that operates as a "flow-chart" or "decision tree" that walks organizations through the three steps of "qualifying" an activity as an unrelated business (Trade or business? Regularly carried on? Not related to exempt purpose?). By providing plainly worded narrative, usable examples, and step-by-step worksheets that link to each of the eleven functional lines/sub-lines of the new form, organizations should be empowered to more readily understand, recognize, and report items of unrelated business income generated from the activities they are carrying on.

Minimize the Size of the Return

With the suggested central checklist and "worksheet" format, we believe the form could be only 2-3 pages long. Page one could contain Part I – Unrelated Business Income (three column for Gross income, Expenses, Net Income - which would result in Total net unrelated business income in Part I, Line 12, Column C).

The instructions to Form 990, Part VIII, Column C state, "In column (C), report any unrelated business revenue received by the organization during the tax year from an unrelated trade or business, unless that revenue is reportable in Part VIII, column (D). See Pub. 598 and Instructions for Form 990-T for more information." And then, a "tip" that says, "A section 501(c)(3) organization that is an S corporation shareholder must treat all allocations of income from the S corporation as unrelated business income.

Gain on the disposition of stock is also treated as unrelated business income. See section 512(e)."

Provide IRS-requested Yes/No questions to provide overall UBIT data

A new Form 990-T could include a section (proposed as Part IV) that would include IRS questions requiring Yes/No answers. The format and "look-and-feel" could be much like Form 990, Part V. The IRS has provided us with questions they would like to see asked (see below under "Proposed New Form 990-T").

Form 990-T Redesign "Packet"

We put together a summary description – based on the "Form 990-T Redesign Vision" above in a Form 990-T Redesign Packet. In that packet, we floated a draft "2015 Form 990-T" to over 300 interested parties (practitioners and exempt organization insiders) and asked for comments. Included in this packet with the draft form were the Unrelated Business Activities Checklist and associated guide sheets and worksheets. The comments received were overwhelmingly positive, especially with regard to the Checklist concept and its focus on education and outreach.

Specifically, most comments centered upon making sure that the new form instructions would be clear and ensuring that the list of activities on the Unrelated Business Activities Checklist was comprehensive and complete. The plan is to seek input from across the exempt organization sector on both these matters. With these requests for comments, we are confident that these issues will be well covered.

Components of the new Form 990-T "process"[205]

- Unrelated Business Activities Checklist[206]
- Guide sheets
- Form 990-T (new)
    - Part I – Revenues and Expenses
    - Part II – Signature
    - Part III – Tax Computation & Payments
    - Part IV – Other Information Regarding Unrelated Business Activities
- Worksheets[207]
    1. Periodical Advertising (Worksheet 1b)
    2. Unrelated Debt-financed Rental (Worksheet 6a)

Unrelated Business Activities Checklist (not open to public disclosure) (See Appendix C)

The flagship of this "educational redesign" would be an interactive "Unrelated Business Activities Checklist" which would allow organizations to work through their analysis of various activities and intelligently ascertain whether or not they have reportable unrelated business income. We want to be ever mindful of small and medium-sized organizations that may have few resources to utilize on understanding UBIT issues and exposures – while accommodating the needs and activities of the largest universities and hospitals.

The Checklist lists/describes 60-70 typical unrelated business activities. With a click on a chevron (⌂), it links users to "Guide sheets" which refer to specific sections of IRS Publication 598 (expanded) and other written guidance to give narrative and educational

[205] Please note that Unrelated Business Activities Checklist and Worksheets would not be open to public disclosure.
[206] This listing of "activities" is somewhat based upon the College & University Compliance Project Questionnaire – Section II – Activities – pages 16 and 17.
[207] We expect to have 20-30 Worksheets modeled after the various worksheets in the Form 1040 instructions (e.g.

assistance to organizations about the law and what examples are included in the "activity."

For purposes of the attached draft, we simply alphabetized the 32 activities that were listed in the College and University Compliance Project questionnaire. Many of the people who reviewed the Form 990 Redesign "Packet" suggested additional line items for the Checklist including: auctions, gaming, captive insurance, non-patient labs, pharmacies, various alternative investments, sports concessions, event parking, parking lots/garages, restaurant operations, and several other items. Certainly, the "final list" of activities will take some work and collaboration.

The plan would be to educate organizations to proceed down the checklist, checking the "Yes" column (Column B) for any activities that they currently conduct. If needed, they may click on the "chevron" for further information. Then – using that further information – they would ascertain whether the activity falls under an exclusion from UBIT (Column C). If Column B is checked "Yes" and there is not applicable exclusion, the organization should enter the revenues from the activity in Column E. If a worksheet exists for the activity (Column D) the organization will be able to compute/calculate the Revenues (Column E), Expenses (Column F), and Net Income (Column G) from the specified worksheet. (In an interactive environment, the columns would automatically fill from the worksheets – and flow to Form 990-T, Part I.)

The "Activity" line numbers from Column A (adjacent to the Name) of the Unrelated Business Activities Checklist would always be brought forward to Form 990-T Part I, Column A (for Lines 2 through 14). These are brought forward to Form 990-T, Part I, Column (a) in the event that multiple activities on the Checklist are to be reported on a single line of Part I. This way, readers will be able to discern which activities (from the Checklist line numbers) make up the amounts on the "combined" line reporting of Income (Column (b)), Expenses (Column (c)), and Net unrelated business income (Column (d)) on Form 990-T, Part I.

The Checklist would be on-line, interactive and unique to each exempt organization. It should be electronically filed with the IRS, but not open to public inspection. An issue that the ACT has carefully considered is whether the Checklist should ultimately be a multi-use, on-line "index" that users could go to in order to find information on "all things UBIT"? The ACT does not believe the checklist should be open to public inspection. First, the "spirit" of the Checklist is all about education and outreach. The IRS and the filing organization should be able to utilize information provided to work together to ascertain whether or not activities engaged in are, in fact, unrelated business activities. This "dialog" should not be carried out publicly. Second, the Checklist represents an unprecedented amount of information being provided by exempt organizations and this level of specific information could put organizations at an economic disadvantage with competitors – both exempt and for-profit. Next, for-profit corporations are not required to provide this amount of financial information on their Form 1120-series returns - which are not open to public inspection. Additionally, there is precedent for having schedules of forms redacted or not made public. For example, Schedule B (Form 990) may be redacted from the public inspection copy of the Form 990 of a public charity. Finally, at this time of this writing, the IRS was in the process of introducing a new Form 1023-EZ which includes an "Eligibility Checklist" in the instructions that is not open to public disclosure.

Guide sheets

By clicking on a chevron (⌂) in the Checklist, users are taken to "Guide sheets." These one to five page resources give details from IRS Publication 598 and other written documents concerning the Checklist, Column A "Activity" (e.g. Advertising, Telecom Related Rentals, Travel Tours, etc.) The Guide sheets are organized as follows:

- Title
- Executive summary
- Exclusions
- Narrative

The goal is to provide clear definitions, education, and guidelines – especially for small and mid-sized exempt organizations - with regard to unrelated business activities.

Worksheets

By clicking on "worksheet links" in the Checklist (Column D), the user is taken to the applicable Worksheet for step-by-step computation of revenues and expenses. The worksheets provide guidance and "mapping" to inclusion of amounts on Unrelated Business Activities Checklist and Form 990-T, Part I. The various worksheets would be designed as supporting documentation for data entered on the new Form 990-T, Part I.

Examples would be:

- Debt-financed property
- Periodical advertising
- Schedule K-1, Form 1065

Proposed New Form 990-T (See Appendix B)

In response to some of the interview comments above, we set about re-designing the Form 990-T. The initial plan was to design the form to "link" to Form 990, Part VIII (Statement of Revenue), Column C which is where an organization reports its items of unrelated business income among the eleven lines of that part (Form 990, Part VIII, Line 12 is a "totals" line). The eleven lines of Form 990, Part VIII are denoted:

1. Contributions
2. Program service revenue
3. Investment income (including dividends, interest, and similar accounts)
4. Income from investment of tax-exempt bond proceeds
5. Royalties
6. Rents
7. Sales of assets other than inventory (i Securities, ii Other)

8. Income from fundraising events
9. Income from gaming activities
10. Sales of inventory (less returns and allowances)
11. Miscellaneous revenue

Line 12 would be a “Totals” line.

In our survey and various meetings, there was moderate amount of support for this “linking” of Form 990, Part VIII with Form 990-T concept. However, after much discussion, and input from several parties (including the IRS and the NACUBO Tax Committee) we moved away from the concept of linking the Form 990-T redesign Part I to the 11 line items of Form 990, Part VIII.

Next, we needed to rethink the Form 990-T (redesign) Part I line items. First, we turned to the IRS SOI (Statistics of Income) UBIT statistics for the years 2008, 2009, and 2010 to see which activities generated the top amounts for “Table 6. Unrelated Business Income Tax Returns: Sources of Gross Unrelated Business Income (UBI), by Size of Gross UBI”. We found those activities to be (in order of dollar amounts):

1. Gross profit (less loss) from sales and services
2. Advertising income
3. Other income (less loss)
4. Unrelated debt-financed income
5. Income (less loss) from partnerships and S corporations
6. Net capital gain income
7. Investment income (less loss)
8. Rental income
9. Exploited exempt activity income, except advertising
10. Income from controlled organizations

Then we spoke to several parties about possible, logical line items for Form 990-T (redesign) Part I. These conversations resulted in the expansion of the activities as follows:

1. Income from unrelated sales of goods
2. Income from unrelated services
3. Capital gain income
4. Income from partnerships and S corporations
5. Income from real property (including dual-use)
6. Income from personal property leased with real property
7. Unrelated debt-financed income
8. Investment income
9. Investment income from section 501(c)(7), section 501(c)(9), and section 501(c)(17) organizations
10. Income from controlled organizations
11. Exploited exempt activity income (except advertising)
12. Advertising income
13. Periodical advertising income
14. Other income

It should be mentioned that the 2014 House Ways and Means Committee (Republican) Tax Reform proposal includes a codicil that, "Tax-exempt organizations would be required to calculate separately the net unrelated taxable income of each unrelated trade or business." We believe the proposed lines of Form 990-T (redesign) Part I would facilitate this proposal – if it is voted into law.

We envision a new Form 990-T, Part I containing the fourteen lines of descriptions with four columns for:

(A) Line item number from Unrelated Business Activities Checklist
(B) Gross unrelated business income

(C) Expenses

(D) Net unrelated business income

Form 990-T, Part I, Line 15, Column D would contain "total net unrelated business income" for the organization for the reporting year.

Form 990-T, Part I, Lines 16 (Taxable income) and 17 (Tax due) would bring the amounts from Part III, Tax Computation and Payments.

Form 990-T, Part II (bottom of Page 1) would contain a signature section that is identical to the current Form 990-T, Part II.

Form 990-T, Part III (top of Page 2) would be "Tax and Payments" to include the computations of tax at the corporate rates (with the "schedule" for the "group" organization's share of the corporate income tax brackets). One question we have is whether the various excise taxes should be moved off of this schedule – possibly to a new "Schedule X" (X is for excise!)

Form 990-T, Part IV (remainder of Page 2) would include IRS questions (much like Form 990, Part V). The IRS has provided sample questions as follows:

- Is there any unrelated business income activities reported on this return involving dual use of facilities?
- What allocation method have you used in allocating expenses between related and unrelated use?
- Do you intend on using this same allocation method in future years?
- Was the Circular A-21 method used? If so what was the amount allocated for indirect expenses for overhead & repair and maintenance?
- List your organization's top five unrelated business activities and the gross income amount and gain or loss reported for each.
- Has any unrelated business activity reported on this return experienced losses for five or more years? If so, has the organization implemented material changes

in the activity to produce a profit?

- Do you conduct an annual review to determine if there are activities that should be reported on Form 990-T? If not, when was the last time a review was conducted?

"Consolidated" Form 990?

Finally, there is an intriguing movement afoot that asks whether all exempt organization reporting might be accomplished on one form. Form 990 could be used to replace Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code); Form 1024 (Application for Recognition of Exemption Under Section 501(a); Form 990-EZ (Short Form Return of Organization Exempt from Income Tax) – by requiring smaller organizations to fill out only certain parts of Form 990; Form 990-PF (Return of Private Foundation and Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation) – maybe by having private foundations file select parts of the current Form 990 and instituting a "Schedule P" for items specific to private foundations; and "Schedule T" could replace the current Form 990-T (Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)). Who knows what the future might hold?

5. **The IRS should continue to leverage its use of its electronic database and web based resources to improve and enhance its communication, education, and training. The IRS should continue to improve, update and enhance the public and tax professional's access to the IRS materials and information available on its website. Specific ACT recommendations include:**

1. Resources

The IRS must commit the "human, financial, and technological" resources to upgrade and modernize EO's technology capabilities in all phases of its operations and provide its data in an "open data" format to the public. Included in these efforts are closer communication and coordination among internal IT providers and resources with EO personnel.

2. Electronic communications – EO Update listserv and "EO Box"

The IRS should enhance the EO Update listserv, require the submission of an electronic email address on the IRS Forms 1023 and 990, and establish and use an "EO Box" which is linked to nonprofit organizations as its primary means of electronic communications to exempt organizations.

3. Establish and links to an "EO Tax Professional" website

The IRS should establish an "EO Tax Professional" webpage which provides direct links to the relevant statutes, regulations, revenue rulings and procedures, private letter rulings, CPE, EO-related IRM, and other IRS information. These sources of IRS law and guidance should be current, structured, and accessible through use of the index, search, and naming conventions.

The IRS should establish a direct link from www.IRS.gov's "for Tax Pros" web page to the "EO Tax Professional" webpage.

4. Index and file names

The IRS should enhance the current "A-Z Index" on its website and improve its file naming conventions particularly for the IRM.

5. Web based search capability

The IRS should enhance its website search capabilities by (a) outsourcing it to a provider for whom their core competency is in web searching and/or (b) improving the current search functions through increased search engine optimization and improvement of keywords and search algorithms. The ACT encourages the IRS to use outside volunteers to assist in improving their indexes, file names, and key word search.

6. Web pages and PDF files

The IRS web pages and files should become available as downloadable and searchable PDF files. The print function on web pages which contain extensive information should print out the entire web page.

7. Educational opportunities

The IRS should make its "Exempt Organizations Participant Text" available as a downloadable PDF file.

The IRS should established an "advanced" education initiative to address complex issues (e.g. UBI and UBIT), as well as emerging areas (e.g. ACA).

The IRS should enhance and improve their capacity to provide web-based technologies as an on-demand training and educational resource.

The IRS should collaborate with other training organizations by providing speakers and materials as a means of leveraging their resources.

8. Continuing Professional Educational Texts (CPE) and Internal Revenue Manual (IRM)

The IRS should encourage the Treasury's Office of Chief Counsel to create and update the significant legal knowledge and resources for the public and professional provided by CPE texts as an integral part of their ongoing professional education and training activities on behalf of IRS personnel and the public.

The IRS should make available as downloadable PDF files EO specific IRM manuals and sections of its manual.

EXEMPT ORGANIZATIONS – APPENDIX A

Proposed Revenue Ruling on Unrelated Business Income

The following is a proposed revenue ruling we recommend the IRS publish to provide clarity and guidance in the area of UBI. These situations may also be appropriate for publication in other, more informal guidance from the IRS, such as in Publication 598 or in a published fact sheet. Other clarity on these situations could be in the form of published regulations.

This ruling provides 23 situations illustrating the application of the rules relating to unrelated business income and the corresponding unrelated business income tax to the profit-making activities of an organization exempt from income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) of the Code. A Section 501(c)(3) charitable organization is subject to the unrelated business income tax its net income from a trade or business activity that is regularly carried on and that is not substantially related to its exempt purpose, with certain modifications.

ISSUE

In each of the 23 situations below, an organization described in Section 501(c)(3) or a public university is engaged in an activity for the production of income. For purposes of this ruling, none of the exceptions to taxable unrelated business income such as the volunteer labor exception or sale of donated goods is applicable. At issue is whether the charity's income or loss from the activity is taxable as income from an unrelated trade or business.

BACKGROUND LAW ON UNRELATED BUSINESS INCOME

Section 501(c)(3) of the Code, in part, provides for the exemption from federal income tax or organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in Section 501(c). Colleges and universities that are instrumentalities of any government or political subdivision thereof, or wholly owned or operated by a government, political subdivision, or agency or instrumentality of any one or more governments or political subdivisions are also subject to tax on their unrelated business tax income under Section 511.

Section 512(a)(1) of the Code defines "unrelated business taxable income" generally as gross income derived by any exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions, with certain modifications. A trade or business generally includes any activity carried on for the production of income from selling goods or performing services.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under Section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides guidance on what factors must be taken into account in determining whether an activity is "substantially related." Under this regulation, a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income. The regulation further provides that the activity is substantially related, for the purpose of

Section 513, only if the causal relationship is a substantial one. “Thus, for the conduct of trade or business to be substantially related to the purposes for which exemption is granted, the production of the goods or the performance of the services must contribute importantly to the accomplishment of those purposes . . . Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.”

Section 513(c) of the Code provides that the term “trade or business” includes any activity that is carried on for the production of income from the sale or goods or the performance of services.

Section 513(c) also states that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which, may or may not, be related to the exempt purpose of the organization.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to the unrelated business income tax is includable in the computation of an organization’s unrelated business income if (1) it is income from a trade or business, (2) such trade or business is regularly carried on, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization’s performance of its exempt functions. Section 1.513-1(d)(2) of the Income Tax Regulations provides that substantially related requires that the production or distribution of goods or the performance of services must contribute importantly to the accomplishment of the purposes of which exemption is granted.

Section 1.513-1(d)(3) of the Income Tax Regulations provide that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Where income is realized by an exempt organization from activities that are in part related to the

performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes unrelated business income.

ANALYSIS OF FACTUAL SITUATIONS

Facility Rental; Dual Use Property

Under Section 1.512(c)(2)(ii) of the Income Tax Regulations, all rents from real property are excluded from the calculation of taxable unrelated business income and all rents from personal property leased with real property are excluded from an organization's unrelated business income if the rents attributed to the personal property are incidental to the total rents received or accrued under the lease. For this purpose, the personal property rents are "incidental" to the total rents if the rents do not exceed 10 percent of the total rents. If more than 50 percent of the total rents are attributable to the personal property or the determination of rents depend in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentage of the gross receipts or sales, then no portion of the rental income is excluded from unrelated business income.

Rev. Rul. 80-297, 1980-2 CB 196, situation 1, provides that a school operating a tennis club through its own employees, who performed substantial services for the participants in the club, could not exclude the income received as rent from real property.

Situation 2 of Rev. Rul. 80-297 describes a school that provides its tennis facilities available to an unrelated individual for ten weeks at a fixed fee which does not depend, in whole or in part, on the income or profits from the leased property. In situation 2, the school provided the leased facilities without the provision of any services. Situation 2 provides that, unlike Situation 1, the income received from the leased property was treated as rents from real property under Section 512(b)(3) of the Code and was excludable from unrelated business income.

Rev. Rul. 80-298, 1980-2 CB 197, provides that a university leasing its stadium to a professional football team and furnishing grounds and playing field maintenance, dressing room linens, and stadium dressing rooms was furnishing substantial services for the convenience of the lessee. The provision of such substantial services for the convenience of the lessee go beyond those usually rendered in connection with the rental of space for occupancy only. Rev. 80-298 concludes that the income derived from the university's leasing of its stadium is not excluded from unrelated business taxable income as rent from real property under Section 512(b)(3) of the Code.

Rev. Rul. 78-98, 1978-1 C.B. 167, describes an exempt school which operates a ski facility for use in its physical education program and also for use, to a substantial degree, for recreational purposes by students attending the school and members of the public who are required to pay slope and ski lift fees comparable to nearby commercial facilities. The recreational use of the facility by students is substantially related to the school's exempt purposes and the income derived from the student's use of the facility is not from unrelated trade or business under I.R.C. § 513. However, the income from use of the facility by the public is from an unrelated trade or business.

Section 1.512(a)-1(c) of the Income Tax Regulations provides that where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities . . . shall be allocated between the two uses on a reasonable basis. It further provides that the portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by Section 162, Section 167, or other relevant provisions of the Code.

Section 1.513-1(d)(4)(iii) of the Income Tax Regulations provides that certain dual use assets and facilities may be employed in both related and unrelated businesses. The gross income from the use of the asset in an unrelated business is unrelated business income.

Situation 1

X is a private school. X leases its conference facility to a for-profit business for its meetings and seminars. The lease of the conference facility includes personal property such as tables, chairs and other furniture. The personal property represents 20 percent of the overall rental income received from the for-profit business. The conference facility is not debt-financed. The rental income received by X for lease of the conference center facility is not unrelated business income because the rental income does not include more than 50 percent of rental of personal property. The amount X receives for the rental of the personal property is unrelated business income.

Situation 2

Y, a state university, leases its basketball arena to a for-profit entertainment business for a concert sponsored by a for-profit promotional company. In addition to use of the arena, the Y agrees to provide utilities and security services and will operate the concession stands for the event. The concert does not contribute to the educational activities of the University. Due to the substantial services provides by the University, the rental income from this arrangement results in unrelated business income for the University.

Situation 3

X, a private university, operates a golf course. The golf course is used by the students, faculty, staff and alumni of X and is also open to the public. Students and faculty pay a fee of $D to use the golf course. Alumni and members of the public pay a fee to use the golf course that is $3D. The fee income from the student, faculty and staff use of the golf course is not income from a unrelated business activity. The fee income received from the alumni and public use of the golf course is income from an unrelated business activities.

Situation 4

The facts set forth in Situation 3 are the same, except that the X's expenses associated with the direct operation of the golf course have exceeded the income received from the operation of the golf course each year for the last five years. Due to the pattern of losses each year, X's operation of the golf course, absent other facts and circumstances to the contrary, is not a trade or business for purposes of the unrelated business income rules because it is not carried for the production of income.

Cell Tower Rentals

Situation 5

R is a private college that owns and operates a radio station whose activities are related to its exempt purpose. The transmission equipment is on a stand-alone tower on R's campus and there is no debt on the tower property. The tower is not considered real property under the laws of the state in which R is located. R rents space on the tower to a cellular phone company. The rental income from the cellular phone company is unrelated business income.

Situation 6

The facts set forth in Situation 5 are the same, except that R's radio tower is located on top of a dormitory. There is no acquisition indebtedness on the dormitory building. The tower is part of a building is and is considered real property under the laws of the state in which R is located. The rental income from the cellular company is excluded from unrelated business income.

Situation 7

L is a public university that enters into an agreement with a telecommunications company, M, to lease real property to M on which M will build a cell phone tower.

L will not provide any services and will not put any of its equipment on the tower. M will erect the tower and place a fence around the tower. M will also pay all expenses associated with the cell phone tower. The rental income to L is not unrelated business income.

Hotel Rentals and Dormitory Use

Section 1.512(b)-1(c)(5) of the Income Tax Regulations states that payments for the use or occupancy of rooms or other space where services are also provided to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels do not constitute rent from real property.

Rev. Rul. 76-402, 1976-2 C.B. 177, involved an exempt school that annually contracts with an individual who conducts a 10-week summer tennis camp with the school furnishing the tennis courts, housing, and dining facilities and the individual hiring the instructors, recruiting campers, and providing supervision. The amounts received by the school are from the dual use of facilities and personnel; therefore, an allocable portion of expenses attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under Section 512 of the Code.

Situation 8

A, a public university, operates a hotel on its campus to house visiting professors, parents of students, visiting athletes, and other guests of the university. The hotel is also open to the public. A is not located in an isolated region and there are other hotels available in the area for use by the public. Because the income received from A's operation of the hotel represents the payment for the use or occupancy of rooms where services are also provided to the occupants, the income is not rental income from the lease of real property. The income A receives from providing rooms to visiting professors, parents of students, visiting athletes, guests of the university who contribute importantly to

the university's educational and other exempt purposes is considered substantially related to A's exempt functions and is not unrelated business income to A. The income A receives from members of the public does not contribute importantly to A's exempt purposes and is therefore unrelated business income.

Situation 9

B, a public university, operatives a hotel on its campus to house visiting professors, parents, visiting athletes and other guests. The hotel is also open to the public. B offers, as one of its educational programs, a degree in hotel management. Students of B study the operations of the hotel, coordinate its activities, and participate in the day-to-day management and activities of the hotel as part of their education. The hotel offers the students the ability to receive training that would not otherwise be available to them in a university setting. The hotel is not operated on a scale than is significantly larger than needed to provide this real world experience to its students. In this instance, the operation of the hotel contributes importantly to the educational purposes of B and is therefore substantially related to the accomplishment of B's tax-exempt, educational purposes. As a result, all income B receives from the operation of the hotel is income that is related to its exempt functions.

Situation 10

X is a private university. X has several dormitories that are used to house students during the fall and spring semesters. During the summer months, X coordinates with Y, a charitable organization within the meaning of Section 501(c)(3), for Y to conduct summer sports and educational camps for youth. X leases dormitory space to the participants of the camps and for the camp's counselors. X's income from the lease of the dormitory space to the camp participants and counselors is not income from an unrelated business because the activity contributes to the educational purposes of X.

Situation 11

Same facts as Situation 10, except that during the summer months, X leases the dormitory rooms to local businesses so that the businesses' new employees can participate in the training programs offered by the businesses in locations near X. These training programs are not related to X's educational purposes. X's rental of dormitory space to these businesses is unrelated business income because the leasing of dormitory space involves the provision of services as well as the rental of space.

Catering/Food Services

Situation 12

C is a private university that contracts with an outside company, F, to provide food services to its students in various eating venues around its campus. C rents several rooms and halls on its campus to unrelated organizations for their meetings. F provides food and drink to these organizations at these meetings and events. C does not generate unrelated business income from the rental of the rooms to the organizations because the food services are provided directly to the organizations by a third party.

Situation 13

P is a private university that directly operates its own food services division providing meals to students. P rents various rooms and halls on campus to unrelated groups for meetings. P's food services division provides catering services for these meetings and events. P's income from these arrangements generates unrelated business income to P from the catering services. In addition, because the services provided by P are substantial, P generates unrelated business income from the rental of these facilities.

Exclusive Provider Arrangement

Section 1.513-4(a) of the Income Tax Regulations provides that qualified sponsorship payments received by an exemption organization are not unrelated business income. For this purpose, a "qualified sponsorship payment" is any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefits, regardless of whether the sponsored activity is related or unrelated to the recipient's exempt purposes. Substantial return benefit does not include the use or acknowledgement of the name, logo, or product lines of the payer's trade or business. Benefits include (a) advertising, (b) exclusive provider arrangements, (c) goods, facilities, services or other privileges, and (d) exclusive or nonexclusive rights to use an intangible asset of the exempt organization.

Situation 14

X, a private university, enters into a ten-year contract with a sports drink manufacturer (B), pursuant to which B will be the exclusive provider of sports drinks for X's athletic departments and the concession stands at X's sporting events. As part of the contract, X agrees to perform various services for the company such as guaranteeing that its coaches make promotional appearances on behalf of B, assisting B in developing marketing plans for its sports drink and participating in joint promotional opportunities for X and B. Due to the services to be performed by X and the exclusive provider agreement, the income received under the contract is not a royalty and is unrelated business income to X.

Website Publications

Section 1.512(a)-1(f) of the Income Tax Regulations provides that amounts realized from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity, namely the circulation and readership of the periodical developed through the production and

distribution of the readership content of the periodical. Subject to the limitations of paragraph (d)(2) of the regulation, where the circulation and readership of an exempt organization periodical are utilized in connection with the sale of advertising in the periodical, expenses, depreciation, and similar items of deductions attributable to the production and distribution of the editorial or readership content of the periodical qualify as items of deductions directly connected with the unrelated advertising activity.

Section 1.513-4 of the Income Tax Regulations provides rules for qualified sponsorship payments, and excepts from such rules the income from the sale of advertising or acknowledgements in exempt organization periodicals. A "periodical" is defined as regularly scheduled and “printed material” published by or on behalf of an exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the organization. For this purpose, printed material includes material that is published electronically.

Situation 15

X is an educational organization. X publishes an educational magazine, the content of which is exclusively on X’s website. In addition to grants and contributions, X is supported in part by advertising revenues. X employs writers, researchers, a creative director and an editorial director for its publications and also incurs expenses for website maintenance and overall administration. For purposes of the unrelated business income cost allocation rules of Section 1.512(a)-1(f) of the Income Tax Regulations, X’s website publication is a “periodical.” Accordingly, X’s expenses, depreciation and similar items of deduction attributable to the production and distribution of the website publication, including the salaries of the publication staff, qualify as items of deductions directly connected with the unrelated advertising activity and may be used as deductions against the unrelated business income attributable to the sale of advertising in the website periodical.

Bookstore Operations

Situation 16

X is a state university. X operates a bookstore on its campus that sells books, t-shirts and other clothing items imprinted with the university's name, computer hardware and software, music, and educational supplies, such as notebooks and pens. The bookstore also sells food, appliances, toiletry items, other clothing apparel, and other convenience items. The sale of all of these items by the university to its students, faculty and staff does not result in unrelated business income because all items are either related to the university's educational purposes or are for the convenience of the students, faculty and staff of the university. To the extent these items are sold to the public, the income arising from the sale of food, appliances, toiletry items, other clothing apparel and convenience items results in taxable unrelated business income to X.

Situation 17

Same facts as Situation 16, except that X does not operate the bookstore on its campus, but rents the facility to a for-profit business, Y, that operates the bookstore. Y pays X a fixed monthly rental fee for its lease of the bookstore property. Provided X is not providing services to Y in exchange for the rental fee, the rental income is not unrelated business income to X.

Youth Camps

Situation 18

G is a public university that directly operates a basketball camp for children in grades 5 through high school. This camp operation utilizes G's residence, dining, and athletic facilities and is operated to provide basketball instruction to children and is an integral part of G's educational program. Income from the

basketball camp is from an exempt activity that is substantially related to G's exempt purposes and is not unrelated business income.

Situation 19

Same facts as Situation 18, except that G employs a nationally known basketball coach, J, who runs G's basketball program. J owns a limited liability company, K, that operates a basketball camp for pre-college age children, using G's residence, dining, and athletic facilities. In addition, some of G's personnel provide services for the camp. Under a contract between G and K, G provides food, linens, and related services to K in addition to the personnel. K pays G fair market value for the various services and facilities provided by G. G's income from K is unrelated business income. Because this income is from the dual use of facilities and personnel, an allocable portion of the expenses attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under Code Section 512.

Technology Transfer

Situation 20

C is a private university that is an educational organization described in Section 501(c)(3) of the Code. C has developed healthcare software that it licenses to a for-profit business, D, in exchange for a reasonable royalty payment. C and D have entered into a technology transfer agreement setting forth the royalty that D will pay to C. C will provide services to periodically update D's effective use of the software and monitor the software for D. Both the services to be provided and the amount C will receive for these services is separately stated in the technology transfer agreement. The royalty received by C is excluded from its unrelated business income because it is royalty income within the meaning of Section 512(b)(2) of the Code. The amount C receives for its services is unrelated business income.

Situation 21

D is a private university that has developed a portfolio of intellectual property as a result of its research and development activities. D has determined to sell the portfolio and engages and outside firm, F, to market and negotiate the sale of the portfolio. D eventually sells the intellectual property to E, a for-profit company located by F. D previously engaged in very few sales involving this type of intellectual property. The income D receives from the sale of the intellectual property to E is not unrelated business income.

Preparatory Time

In National Collegiate Athletic Association v. Comm'r, 914 F. 2d147 (10th Cir. 1990), an exempt organization within the meaning of Code Section 501(c)(3) published a program for its major basketball tournament. Advertisements, some of which were placed by national companies, made up a substantial portion of the program. At issue in the case was whether the advertising activity was "regularly carried on" for purposes of the unrelated business income rules. The Court determined that in determining the normal time span of the business activity, preparatory time should not be considered. The Court held that the exempt organization's involvement in the sale of advertising space was not sufficiently long-lasting to find that it was regularly carried on by reason of the duration of the activity. In addition, the regulations require the consideration of whether an intermittent activity occurs so infrequently that neither its recurrence nor the manner of its conduct causes it to be regarded as a trade or business that is regularly carried on. The Court held that the advertising in the organization's program, which was distributed over less than a three-week span at an event occurring only once a year, was "sufficient infrequent to preclude a determining that the NCAA's advertising business was regularly carried on."

Situation 22

X is a public university that conducts an annual baseball tournament lasting five days. X spends two months prior to the tournament selling advertising space in the brochure, which is distributed at the tournament. Because the brochure is distributed only over a five-day period, the advertising for the brochure is not an unrelated business activity.

Foreign Blocker Corporation

Under Code Section 512(b)(1), dividend income earned by a tax-exempt entity is not subject to the UBI tax. Similarly, other forms of passive investment income are exempt from the UBI tax, such as interest, payments with respect to securities loans, royalties and income from the rental of real property under Code Section 512(b)(1), (2) and (3). The exclusion of passive investment income from UBI generally extends to these types of investment income and "other substantially similar income from ordinary and routine investments to the extent determined by the [Service]." Section 1.512(b)-1(a)(1) of the Income Tax Regulations. Capital gains are also excluded from treatment as unrelated business income under Code Section 512(b)(5).

The legislative history of the unrelated business income provisions indicates that passive income received by tax-exempt organizations should not be taxed as unrelated business income "where it is used for exempt purposes because investments producing incomes of these types have long been recognized as property for educational and charitable organizations." H. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950). See also S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

Investment income that would otherwise be exempt from the UBI tax, however, is taxable under Section 514 of the Code to the extent the investment generating the income is debt-financed by its tax-exempt owner, absent a specific exception. The amount of income that is taxable under these rules is proportional to the amount of the investment that is debt-financed. Under Section 512(b)(13) of the Code, specific

payments of interest, annuities, royalties and rent received from a controlled entity are treated as UBI. In the case of a corporation, "control" means ownership by vote or value of more than 50 percent of the stock in the corporation under Section 512(b)(13)(D)(i)(I) of the Code. Dividends are not included among the items covered by this rule.

Under Sections 951-964 of the Code, a United States Shareholder of a controlled foreign corporation must include in gross income the shareholder's pro rata share of the controlled foreign corporation's Subpart F income for the year even if the income is not distributed. Pursuant to Section 954(c)(1) of the Code, Subpart F income includes investment income. A "controlled foreign corporation" is a foreign corporation if more than 50 percent of the voting power of the stock of the corporation or the total value of the stock of the corporation is owned by "United States Shareholders." A United States Shareholder is defined under Sections 957 and 951(b) of the Code as any U.S. person owning as much as 10 percent of the voting stock of the foreign corporation.

In 1996, Section 512(b)(17) was added to the Code to provide that income earned by a controlled foreign corporation from insuring third-party risks is taxable as unrelated business income. The legislative history of this provision favorably discussed the Service's prior rulings characterizing Subpart F income inclusions as dividends and thus not taxable as unrelated business income. H. Rep. No. 104-586, 104th Cong., 2nd Sess. (1996).

In *Rodriguez v. Commissioner*, 137 T.C. No. 14 (2011). The Tax Court determined whether Subpart F income received by individual taxpayers was eligible for the reduced individual tax rate on qualified dividends under Section 1(h)(11) of the Code. Section 1(h)(11) of the Code states that the term "qualified dividend income," for purposes of the reduced income tax, means "dividends received during the taxable year from domestic corporations and qualified foreign corporations." The Tax Court held that Code Section 951 inclusions do not constitute actual dividends because actual dividends require a distribution by the corporation and receipt by the shareholder, and a change of

ownership of something of value, neither of which occurred in the facts of the case. The Tax Court further held that these inclusions do not constitute deemed dividends because, when Congress decides to do that, it states as much in the Code, which was not done in the law pertaining to this case. The Fifth Circuit, in *Rodriguez v. Commissioner*, 772 F. 3d. 306, 112 A.F.T.R. 2d 2013-5172 (5th Cir. 2013), affirmed the Tax Court's decision.

Situation 23

G is a private college. G forms a corporation, H, in a foreign country. G contributes cash and non-mortgaged property to H and owns 100% of H's stock. H invests in various foreign investments, receiving rents, royalties, dividends and interest from these investments. G is a United States Shareholder and H is a controlled foreign corporation within the meaning of Code Sections 951-964. The Subpart F income inclusions of G attributable to its ownership of H are excludable from G's taxable unrelated business income.

EXEMPT ORGANIZATIONS – APPENDIX B

Draft Form 990T Redesign

Form **990-T**

Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

For calendar year 2012 or other tax year beginning_____, 2012, and ending_____, 20_____ See separate instructions.

OMB No. 1545-0687

2015

Open to Public Inspection for 501(c)(3) Organizations Only

A ☐ Check box if address

B Exempt under section 501( ) ( )
☐ 408(e) ☐ 220(e)
☐ 408A ☐ 530(a)
☐ 529(a) ☐

C Book value of all assets at end of year

Print or Type

Name of organization (Check box if name changed and see instructions.) ☐

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code

D Employer identification number (Employees' trust, see instructions.)

E Unrelated business activity codes (see instructions)

F Group exemption number (see instructions) ▸

G Check organization type ▸ ☐ 501(c) corporation ☐ 501(c) trust ☐ 401(a) trust ☐ Other

H Describe the organization's primary unrelated business activity. ... ▸

I During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? . .Yes ☐ No ☐
If "Yes," enter the name and identifying number of the parent corporation. ▸

J The books are in care of ▸ Telephone number ▸

Part I Unrelated Business Activities Income & Expenses

		(a) Unrelated Business Activities Checklist Line numbers	(b) Income from activities (See Worksheets)	(c) Expenses – Direct or Indirect (See Worksheets)	(d) Net Unrelated Business Income (Loss)
1	Income from unrelated sales of goods				
2	Income from unrelated services				
3	Capital gain income				
4	Income from Partnerships and S Corps				
5	Income from unrelated real property rentals (including dual-use)				
6	Income from personal property leased with real property				
7	Unrelated debt-financed income				
8	Investment income				
9	Investment income from section 501(c)(7), 501(c)(9), and 501(c)(17) orgs				
10	Income from controlled organizations				
11	Exploited exempt activity income (except advertising)				
12	Advertising income				
13	Periodical advertising income				
14	Other income				
15	Total				
16	Taxable income (From Part III, Line 5)				
17	Tax due (From Part III, Line 13)				

Part II Signature

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Signature of officer Date Title

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-	PTIN
Firm's name ▸			Firm's EIN ▸	
Firm's address ▸			Phone no.	

For Paperwork Reduction Act Notice, see Cat. No. Form 990-T

Working Draft

Part III Tax Computation and Payments

1 Net Income from Part I, Line 12, Column (c) 1
2 Speciific deduction (Generally $1,000 – see instructions) 2
3 Net Operation Loss deduction (see instructions and "Profit Motive" below) 3
4 Charitable contribution deduction 4
5 Taxable Income (Line 1 less Lines 2, 3 and 4) 5
6 **Organizations taxable as corporations** (see instructions for tax computation). Controlled group members (sections 1561 and 1563) check here ▸ ☐ **See instructions** and:
a Enter your share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order):
(1) $ (2) $ (3) $
b Enter organization's share of: **(1)** Additional 5% tax (not more than $11,750) $
(2) Additional 3% tax (not more than $100,000). . . . . $
c Income tax on the amount on line 4 . . . . . ▸ 6c
7 **Trusts tax table at trust rates** (see instructions for tax computation). Income tax on the amount on line 34 from: Tax rate schedule or Schedule D (Form 1041) .. . . . . ▸ 7
8 **Proxy tax** (see instructions) . . . . . ▸ 8
9 Alternative minimum tax 9
10 **Total Tax.** Add lines 5c and 7 to line 8 or line 6, whichever applies 10
11 **Total credits.** (from Worksheet __) 11
12 **Payments**
a. **Estimated payments** 12a
b. **Payments with Form 8868** 12b
c. **TOTAL** 12c
13 **Tax due (refund) (Line 9 less Lines 10 plus 11c)** 13
14 **Refund** _____ **Amount applied to 2016 tax** _____

Part IV Other Information Regarding Unrelated Business Activities

		Yes/No	Yes	No
1	Is there any unrelated business income activities reported on this return involving dual use of facilities?	1		
2	Have you used _____ allocation method in allocating expenses between related and unrelated use?.	2		
3	Do you intend on using the same allocation method in future years?	3		
4	Was Circular A-21 method used? If so what was the amount allocated for indirect expenses for overhead & repair and maintenance?	4		
4a	Overhead $ _____			
4b	Repair & Maintenance $ _____			
5a	Has any unrelated business activity reported on this return experienced losses for 5 or more years?	5a		
5b	If so, has the organization implemented material changes in the activity to produce a profit? .	5b		
6	Do you conduct an annual review to determine if there are activities that should be reported on Form 990-T? . . . . . If not, when was the last time a review was conducted? Year _____. . . .	6		
7	**Lines reserved annual "hot issues" and/or "activity survey" questions**	7		
8	**Lines reserved annual "hot issues" and/or "activity survey" questions**	8		
9	**Lines reserved annual "hot issues" and/or "activity survey" questions**	9		
10	**Lines reserved annual "hot issues" and/or "activity survey" questions**	10		

Form 990-T

EXEMPT ORGANIZATIONS – APPENDIX C

990T Unrelated Business Activities Checklist

Unrelated Business Activities Checklist (UBAC)								
Form 990-T								
Activity	*	Yes	Excl	wkst	Revenues	Expenses	Net Income (Loss) to 990-T, Part I	Form 990-T, Part I, Line #
(A)		(B)	(C)	(D)	(E)	(F)	(G)	
1. Advertising	☐			1				*Line 12*
2. Arena Rental	☐			2				*Line 5*
3. Athletic Facilities Usage	☐			2				*Line 5*
4. Bookstore	☐							*Line 1*
5. Catalog Sales	☐							*Line 1*
6. Catering Services	☐							*Line 2*
7. Commercial Research	☐							*Line 14*
8. Computer Services	☐							*Line 2*
9. Conference Center Operation	☐							*Line 5*
10. Credit Card Promotions	☐							*Line 14*
11. Debt Financed Income	☐			6a				*Line 7*
12. Exclusive Use Contracts	☐							*Line 14*
13. Exploited Exempt Activity Income	☐							*Line 11*
14. Facility Rental	☐			2				*Line 5*
15. Food Services	☐							*Line 2*
16. Golf Course	☐							*Line 2*
17. Hotel Operation	☐							*Line 5*
18. Income from Controlled Orgs	☐							*Line 10*
19. Intellectual Property	☐							*Line 14*
20. Internet Sales	☐							*Line 1*
21. Parking Lot Operations	☐							*Line 2*
22. Partnership Allocations	☐							*Line 4*
23. Patents	☐							*Line 14*
24. Personal Property Rentals	☐							*Line 6*
25. Power Generations	☐							*Line 14*
26. Recreation Center Usage	☐			2				*Line 5*
27. Restaurant Operation	☐							*Line 5*
28. S-Corp Allocations	☐							*Line 4*
29. Sale of space in periodicals	☐							*Line 13*
30. Telecomm Related Rentals	☐							*Line 6*
31. Travel Tours	☐							*Line 2*
32. Working Interest in Oil, Gas, etc.	☐							*Line 14*
LIST CONTINUES...	☐							
List other UBI activities below.	☐							
71	☐							
72	☐							
73	☐							
74	☐							
75	☐							
76	☐							
77	☐							
TOTAL								

EXEMPT ORGANIZATIONS- APPENDIX D

List of the CPE texts related to UBIT which were located on the IRS website

UBIT, IRC 501(c)(19) 1999-J

UBIT, Allocations 1992-B

UBIT, Developments 2002-F

UBIT, Developments 1999-N

UBIT, Developments 1997-O

UBIT, Developments 1990-F

UBIT, Developments 1988-F

UBIT, Developments 1987-B

UBIT, Developments 1981-O

UBIT, Developments 1980-P

UBIT, Exceptions Regarding Fund-Raising 1982-L

UBIT, Foreign Organizations 1992-K

UBIT, Fund-raising 1986-G

UBIT, Health Clubs 2000-A

UBIT, Housing 1992-D

UBIT, Insurance Activities 1981-P

UBIT, IRC 501(c)(12) Electric & Telephone Co-ops 1980-I

UBIT, IRC 501(c)(2) and 501(c)(25) Organizations 1989-F

UBIT, IRC 512(c)(2) Repealed Under OBRA '93..... 1995-D

UBIT, IRC 501(c)(19) 1986-P

UBIT, Limited Member Dues Taxable 1995-G

UBIT, Marketing of Goods by Educational Institutions 1980-Q

UBIT, Museum Retailing 1979-U

UBIT, Option Premiums & Loan Commitment Fees 1995-D

UBIT, Partnerships 1987-N

UBIT, Promotion of Fine Arts 1982-P

UBIT, Published Guidelines 1992-B

UBIT, Regulations and Statutory Framework 1994-O

UBIT, Relaxed Requirements Under IRC 514(c)(9) 1995-D

UBIT, Resolution Trust Corp. Foreclosure Property 1995-D

UBIT, Royalties and Exploitation Income 1979-V

UBIT, Royalty Income and Mailing Lists 1994-I

UBIT, Sale of Land by Social Club 1994-H

UBIT, Social Clubs 1980-G

UBIT, Special Rules for Partnerships 2000-L

UBIT, Taxable Subsidiaries 1994-H

UBIT, Taxation of Passive Income 1980-R

UBIT, Title Holding Companies Allowed to Have 1995-D

UBIT, Travel Tours 1996-J

UBIT, Travel Tours 1979-T

UBIT, VEBAs 1992-J

EXEMPT ORGANIZATIONS - APPENDIX E

Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V – Tax Exempt Entities

Subtitle A – Unrelated Business Income Tax

Sec. 5001. Clarification of unrelated business income tax treatment of entities treated as exempt from taxation under section 501(a)

Current law: Under current law, income derived from a trade or business regularly carried on by an organization exempt from tax under Code section 501(a) (including pension plans) that is not substantially related to the performance of the organization's tax-exempt functions is subject to the unrelated business income tax (UBIT). The highest corporate rate is applied to unrelated business income. A college or university that is an agency or instrumentality of a State government (or political subdivision) generally is subject to UBIT on any unrelated business taxable income. It is unclear, however, whether certain State and local entities (such as public pension plans) that are exempt under Code section 115(l) as government-sponsored entities as well as section 501(a) are subject to the UBIT rules.

Provision: Under the provision, all entities exempt from tax under section 501(a), notwithstanding the entity's exemption under any other provision of the Code, would be subject to the UBIT rules. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.1 billion over 2014-2023.

Sec. 5002. Name and logo royalties treated as unrelated business taxable income

Current law: Current law designates certain activities as *per se* unrelated trades or businesses for UBIT purposes, including advertising activities and debt management plan services.

Provision: Under the provision, any sale or licensing by a tax-exempt organization of its name or logo (including any related trademark or copyright) would be treated as a *per se* unrelated trade or business, and royalties paid with respect to such licenses would be subject to UBIT. The provision would be effective for tax years beginning after 2014.
JCT estimate: According to JCT, the provision would increase revenues by $1.8 billion over 2014-2023.

Sec. 5003. Unrelated business taxable income separately computed for each trade or business activity

Current law: Under current law, income subject to UBIT is based on the gross income of any unrelated trade or business less the deductions directly connected with carrying on such activity. In cases where a tax-exempt organization conducts two or more unrelated trades or businesses, the unrelated business taxable income is the aggregate gross income of all the unrelated trades or businesses less the aggregate deductions allowed with respect to all such unrelated trades or businesses. As a result, losses generated by one unrelated trade or business may be used to offset income derived from another unrelated trade or business.

Provision: Under the provision, a tax-exempt organization would be required to calculate separately the net unrelated taxable income of each unrelated trade or business. In addition, any loss derived from an unrelated trade or business could only be used to offset income from that unrelated trade or business, with any unused loss subject to the general rules for net operating losses – i.e., such losses may be carried back two years and carried forward 20 years. Thus, losses generated by one unrelated trade or business could not be used to offset income derived from another unrelated trade or business. The provision would generally be effective for tax years beginning after 2014. However, NOLs generated prior to 2015 may be carried forward to offset income from any unrelated trade or business, but NOLs generated after 2014 may only

be carried back to offset income with respect to the unrelated trade or business from which the net operating loss arose.

JCT estimate: According to JCT, the provision would increase revenues by $3.2 billion over 2014-2023.

Sec. 5004. Exclusion of research income limited to publicly available research

Current law: Under current law, income derived from a research trade or business is exempt from UBIT in the following cases: (1) research performed for the United States (including agencies and instrumentalities) or any State (or political subdivision); (2) research performed by a college, university or hospital for any person; and (3) research performed by an organization operated primarily for the purposes of carrying on fundamental research the results of which are freely available to the general public.

Provision: Under the provision, the exception from the UBIT rules for fundamental research would be limited to income derived from the research made available to the public. Thus, income from research not made publicly available would be treated as unrelated trade or business income and subject to the UBIT rules. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.7 billion over 2014-2023.

Sec. 5005. Parity of charitable contribution limitation between trusts and corporations

Current law: Under current law, for purposes of determining unrelated business taxable income subject to UBIT, an organization may deduct contributions made to other organizations. If the contributing tax-exempt entity is organized as a corporation, the charitable contribution deduction is limited to 10 percent of the entity's unrelated business taxable income – the same limitation that applies to corporations. But, if the

contributing tax-exempt entity is organized as a trust, the deduction is limited to 50 percent of the entity's unrelated business taxable income – the same limitation that applies to individuals.

Provision: Under the provision, charitable contributions for purposes of determining UBIT would be limited to 10 percent of the unrelated business taxable income whether the contributing entity is organized as a corporation or a trust. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would have negligible revenue effect over 2014-2023.

Sec. 5006. Increased specific deduction

Current law: Under current law, UBIT is based on the gross income of any unrelated trade or business less the deductions directly connected with carrying on such activity. However, all tax-exempt organizations may claim a $1,000 deduction against gross income subject to UBIT.

Provision: Under the provision, the deduction would be increased to $10,000. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would reduce revenues by $0.3 billion over 2014-2023.

Sec. 5007. Repeal of exclusion of gain or loss from disposition of distressed property

Current law: Under current law, UBIT is based on the gross income of any unrelated trade or business, including gains or losses from the sale, exchange, or other disposition of inventory. An exception to the inclusion of such gains or losses applies to certain real property acquired by the tax-exempt organization from a bank or savings and loan association that held the property in receivership or conservatorship or as a result of a foreclosure. To qualify, the tax-exempt organization generally may not expend substantial amounts to improve or develop the distressed property and must dispose of such property within 30 months of acquisition.

Provision: Under the provision, the UBIT exception for acquisitions of distressed property would be repealed. Accordingly, a tax-exempt organization would be required to include in its unrelated trade or business income gain or loss resulting from the sale of such property to customers. The provision would be effective for property acquired after 2014.

JCT estimate: According to JCT, the provision would have negligible revenue effect over 2014-2023.

Sec. 5008. Qualified sponsorship payments

Current law: Under current law, for purposes of the UBIT rules, an unrelated trade or business does not include the activity of soliciting and receiving qualified sponsorship payments. A qualified sponsorship payment generally is any payment made by a business sponsor with respect to which the business receives no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the business in connection with the tax-exempt organization's activities. Such a use or acknowledgment does not include advertising of such sponsor's products or services (i.e., qualitative or comparative language, price information or other indications of

savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services).

Provision: Under the provision, the UBIT exception for qualified sponsorship payments would be modified in two respects. First, if the use or acknowledgement refers to any of the business sponsor's product lines, the payment would not be a qualified sponsorship payment, and, therefore, would be treated by the tax-exempt organization as income from an advertising trade or business – which is a *per se* unrelated trade or business. Second, if a tax-exempt organization receives more than $25,000 of qualified sponsorship payments for any one event, any use or acknowledgement of a sponsor's name or logo may only appear with, and, in substantially the same manner as, the names of a significant portion of the other donors to the event. Whether the number of donors is a significant portion is determined based on the total number of donors and the total contributions to the event, but in no event shall fewer than 2 other donors be treated as a significant portion of other donors. Thus, a single business could not be listed as an exclusive sponsor of an event that generates more the $25,000 in qualified sponsorship payments. Such a contribution would be treated as advertising income by the tax-exempt organization and subject to UBIT. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by less than $50 million over 2014-2023.

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Federal, State and Local Governments:
The Affordable Care Act and Government Employers

Robert E. Jaros

Lisa M. Pusich

Kathy M. Sheppard

June 11, 2014

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I. Executive Summary

Implementation of the Affordable Care Act (ACA) law is a monumental undertaking. This is not surprising. Affordable health care for all citizens encompasses resources from many sectors of federal, state, and local governments as both implementers and employers. The IRS manages the reporting and collection provisions required by the ACA. It is the communications and training actions necessary to carry out the law that the FSLG subcommittee of the ACT has focused its report on for the 2013 - 2014 year. As with any federal law, the IRS does not make any judgment on the background or purpose of a law; the IRS role is to implement any law effectively and efficiently. In that same context the ACT recommendations are based on the ACA law, as enacted, and the professional knowledge and the responses and feedback from the ACT FSLG subcommittee survey issued in February and received through April 4, 2014 (Appendix A). Some recommendations may have been clarified with recently released regulations. Graphical charts of responses are referenced throughout this report.

The IRS regulations necessary for implementation have had lengthy lead time to issuance so, even with the recent extensions granted, employers are faced with a short implementation timeline to reporting deadlines.

As all states and most regional and local governments meet the general definition of Applicable Large Employers (ALE) there are many challenges ahead for the target audience of FSLG.

In order to assure successful, compliant, reporting by employers the IRS will need a “full court press” for communications and outreach including education for employers on the various components of required ACA reporting. In terms of sequential reporting, the Patient Centered Outcomes Research Institute (PCORI) provision is the next reporting requirement. For tax year 2014 employers should define, then complete an assessment of, their entities. Reporting requirements for tax year 2015 for many entities will entail

significant data gathering of information not formerly in the realm of data fields needed or captured for tax reporting. For implementation of the upcoming ACA provisions it is imperative that the IRS prepare training and communications materials to disseminate in the current calendar year. At this writing the PCORI outreach was expected to be made available in mid-May for a July 31, 2014 reporting deadline. This is viewed as deficient for employer compliance.

Through the survey, many comments were received that identify concerns that there is not yet a complete understanding of all employer requirements or the costs to implement necessary changes. Local governments, especially, commented that they are understaffed with bare-bone budgets and will appreciate all the assistance provided by the IRS and FSLG to implement ACA.

To summarize the findings and recommendations of this report:

1. The ACA law and the accompanying regulations are complex. While the IRS website is thorough, the IRS should consider:
    a. Use of tables and graphics to better summarize the law's provisions.
    b. Actively manage an FAQ page that should be prominently offered.

2. IRS should develop an outreach program for FSLG clients.
    a. Most of FSLG's clients are ALEs but have not addressed key decisions for compliance and reporting for ACA.
    b. IRS should consider conducting separate training sessions on key ACA topics:
        i. A training session should be developed for and focused on regulatory compliance requirements of an issue
        ii. Likewise, training should be developed and targeted for the operational reporting of that same issue or topic.

    FSLG clients, particularly states, have departments or organizations responsible for regulatory compliance different from the accounting and reporting personnel

who will each need information and answers to questions that the IRS can provide in discreet training sessions.

3. Potential compliance issues for FSLG clients (areas to focus IRS outreach):
    a. Proper identification of full time employees
    b. Data collection for employee dependents
4. Reporting suggestions
    a. PCORI fees including planned revision on Form 720

II. Introduction

The ACT FSLG subcommittee has undertaken this report to provide the Internal Revenue Service an assessment of government employers' general knowledge of and readiness for the ACA as well as implementation processes and challenges anticipated for tax years 2014 and 2015. The goal is to assist the Federal, State and Local Governments division in leveraging resources needed to expand the expected outreach/ education plan for the relevant ACA provisions while also improving customer service and support. At the time of this report writing, some ACA regulations that were in draft when the related survey was issued; have been finalized.

It is important to recognize that in the last three years the IRS has achieved measurable success by transitioning training opportunities to their customer base away from costly, but effective, instructor-led training sessions to effective online webinar and phone forum regional training offerings. The electronic delivery of these trainings has quickly gained broad acceptance. Each offer clear consistent messaging and provides significant savings to both the Service and the attendees. Any lessons learned by the IRS from these prior training sessions should be reviewed immediately because volume of training, for both topics and delivery is expected to expand substantially with the ACA.

We understand the initial impetus for the FSLG move to online learning were the ongoing budget constraints of the IRS, and most of their customer base, as a result of the Great Recession. The quick acceptance and expansion of IRS online training opportunities can be attributed to the quality of sessions, expanded attendance options to attendees and flexibility to train or review materials on the attendees' schedules.

The FSLG subcommittee developed and implemented a survey to state and local governments that was open through April 4, 2014. The ACA survey questions are presented in Appendix A. A summary of the responses in chart form are presented in

Appendix B. More than 20 states participated as well as more than 50 local governments, authorities and others from different regions of the country (Appendix B Chart 1). Eighty-six percent of the responders identified their office as responsible for their entity's tax reporting (Appendix B Chart 2). In contrast, fully 45% of states said no or not yet defined in answer to the question if their department was the required ACA reporter (Appendix B, Chart 3). ACA reporting and compliance requirements will necessitate multiple training sessions to be developed and presented in a short period of time. Resources continue to be reduced at TEGE at a time when employer education necessary to inform correct and complete ACA implementation is being built from the ground up. The ACT FSLG subcommittee members have observed and commend the continuous improvements made to meet the education needs of its customers while also moving to enhance enforcement and compliance while also searching for opportunities to prevent potential fraud and/or abuse of taxpayer funds. There is a concern by ACT that continued TEGE budget constraints may negatively impact future success.

When this ACT report and the survey were being developed the Employer Shared Responsibility regulations were in draft and the definition of ALE was not clear which was of concern to several government entities. Questions were raised to discern whether sovereign governmental units need to be decoupled from the proposal of pension plan unity. Since the final regulations were issued on February 10, 2014, about the same time as the survey, entity boundaries appear to have been clarified. There were no substantive comments or concerns raised with this topic.

Provisions of the ACA, passed in 2010, have already impacted tax reporting requirements for employers. Optional in tax year 2012 and required in 2013, employers are required to disclose the value of the benefit provided for each employee's health insurance coverage on their Form W-2. The Additional Medicare Tax for Higher-Income Taxpayers was implemented for tax year 2013. The survey found no anomalies nor received questions on the topic so the ACT makes no recommendations on that

provision in this report for employers. Each of these changes has impacted employers' W-2 systems, incurring both generation and production costs. In tax year 2013 for some plan sponsors and all plan sponsors in tax year 2014, the required PCORI fee, which is covered more specifically further in this report, is being implemented. Since most states are plan sponsors this is another aspect of the ACA that impacts system and financial resources. The reforms for tax year 2015 will need support and training from the IRS that needs to begin as soon as possible. This report will highlight several of these for consideration and prioritization.

III. History

On March 23, 2010 President Barack Obama signed into law the Patient Protection and Affordable Care Act (ACA). It is said to be the most significant regulatory overhaul of the health care system since Medicare and Medicaid were introduced in 1965. The goal was to increase the affordability and quality of health care for the uninsured and reduce costs for insured individuals, lower the uninsured rate, and reduce the costs of healthcare for individuals and the government.

ACA includes mandates, subsidies, and insurance exchanges. One of the mandates is that insurance companies cover all applicants with new minimum standards and offer the same rates regardless of pre-existing conditions or gender. Health insurance exchanges operate as a new avenue by which individuals and small businesses in every state can compare policies and buy insurance (with a government subsidy if eligible). In the first year of operation, open enrollment on the exchanges ran from October 1, 2013 to March 31, 2014.

On June 28, 2012, the United States Supreme Court upheld the constitutionality of the ACA's individual mandate as an exercise of Congress' taxing power in the case National Federation of Independent Business v. Sebelius. However, the Court held that states cannot be forced to participate in the ACA's Medicaid expansion under penalty of losing their current Medicaid funding.

For the initial year of the law, the legislative changes made were primarily health coverage changes as well as changes to Health Flexible Savings Accounts. For apparent large employers, system requirements to implement those changes were minor, mainly modifying parameter or data settings. The one reform with significant impact for employers was the addition of reporting of the cost of employer-sponsored health coverage on the W-2 through the use of box 12 DD, optional for tax year 2011

and mandatory for tax year 2012 for employers with 250 or more employees, a threshold most government entities meet.

Another requirement of ACA that has already been implemented is the additional Medicare tax increase on high income taxpayers. The survey issued did cover this change and a third of respondents did have, and reported on, employee(s) exceeding the threshold. Beyond increased workload, there were no issues identified on changes to date so this report will not cover those topics further.

IV. Due Diligence

PCORI fees

Final regulations regarding the "Fees on Health Insurance Policies and Self-Insured Plans for the Patient Centered Outcomes Research Trust Fund" were issued on December 6, 2012 under 26 CFR Parts 40, 46, and 602. These regulations were issued to provide guidance for the implementation of proposed fee that is accessed and remitted to fund this Trust Fund. The effective period of these regulations began December 6, 2012 and continues through October 1, 2019.

The Patient Centered Outcomes Research Institute (PCORI) was established through the Patient Protection and Affordable Care Act (ACA). PCORI is a private nonprofit corporation which through research will assist patients, clinicians, purchasers, and policy makers in making informed health decisions. This research is funded by the fee collected and deposited within the Trust Fund.

The fee is imposed on both health insurance policies and self-insured health plans. The fee is one dollar for plan years ending after September 30, 2012 and before October 1, 2013 and two dollars for plan years end after September 30, 2013 and before October 1, 2014. For plan or policy years beginning on or after October 1, 2014 and before October 1, 2019, the fee will be indexed to increases in National Health Expenditures. The fee is accessed per the number of covered lives of the health plan. This fee shall be paid by the plan sponsor, which is defined in Section 4376(b)(2). This section states that the plan sponsor is generally the employer for a plan that is established or maintained by a single employer, or the employee organization for a plan that is established or maintained by an employee organization. It also goes on to say that the plan sponsor may be the association, committee, joint board of trustees, or other similar group of trustees or representatives of the parties who establish or maintain the plan.

As explained in the above paragraph, the fee accessed is based upon the plan year. However, plan years may be changed due to contractual negotiations or management decisions to align the multiple plans offered to employees. For a plan that had a year-end of June 30, but changed to a plan year end of December 31, a question arises for this six month plan period with regards to the PCORI fee. No official guidance on the application of the PCORI fee is available addressing a plan year change and this shortened plan period. Verbal guidance was sought on this situation, and the IRS stated that the fee would be $1 per covered life for the plan year from July 1, 2012 through June 30, 2013 and then a fee of $2 per covered life for the plan year for six months July 1, 2013 through December 31, 2013. Since the fee is based upon an average covered life it appears that the employers that have a six month plan period will in fact be paying more PCORI fees in the year of change when compared to other entities that did not have a change in their plan year. There is no relief in applying the fee towards the covered life if that plan period is only for a six month period, thus 50% of the year. However, due to the application of the fee based upon the plan year end date, it does appear that this inequity will be resolved at the expiration of the fee.

The regulations identify the acceptable methods to determine the average number of covered lives. The method selected must be consistently used for the duration of the year.

For health insurance policies the average number of covered lives must use either:

1. Actual count method,
2. Snapshot method,
3. Member months method, or
4. State form method.

For self-insured health plans, the average number of covered lives must use either:

1. Actual count method,
2. Snapshot method, or
3. Form 5500 method

Through the survey it was found that over 35% of state responders and more than 60% of local responders have not yet determined the methodology for PCORI reporting. Appendix B, Chart 9 presents a summary of responses.

The PCORI fee must be reported and paid on the Form 720, "Quarterly Federal Excise Tax Return." It is due on July 31 for the calendar year immediately following the last day of the plan year. The fee paid is the product of the average covered lives by the applicable dollar amount defined in the regulations. The Form 720 revised as of April, 2013 identifies the PCORI fee in Part II. There is a row for specified health insurances policies and a row for applicable self-insured health plans. It requires the input of the average number of lives covered and identifies the fee of $1 and calculates the fee due. (See Form – Appendix D)

The Form 720 has not yet been revised for the July 31, 2014 reporting period. Consultation with the IRS on the planned form revision indicated the only revision would be a change in the dollar amount of the fee from $1 to $2. However, there are circumstances where there will be a need for both the $1 and $2 fee to appear on the form for those employers that have a six month stub period for a plan year change transition. If the form is not modified to accommodate this situation to include both fees ($1 and $2), the calculation of the fee will not properly compute. The IRS has notified the Committee that the form is currently under development, and the fee amount is likely going to be removed, and the form instructions will include directions on the fee calculation. The Committee concurs with this change as it will likely prevent the need for annual form updates due to the changing fee structure (indexing) scheduled.

Benefits administered by Union Health Trust

State and local governments may have employee unions that represent their employees, and those unions may also have an established health trust in which health benefits are available to their members. This relationship in providing health insurance to employees complicates the implementation of some of the ACA provisions.

The local or state government is defined as the employer of these employees. However, if the Union Health Trust is defined as the plan administrator, they will be responsible for the submission of the 720 report and the payment of the PCORI fee. It is not clear if the Health Trusts can or should submit this information under their EIN. State and local governments may need to engage their legal counsel to determine who is the “plan sponsor” for health insurance provided to their employees. This determination is based on the individual facts and circumstances surrounding the particular health insurance plan. The determination of the “plan sponsor” is something that should be defined early and clearly communicated with all involved parties so there is no confusion as to the tax responsibilities.

Another area where confusion exists is in the reporting requirements under ACA Sections 6055 and 6056. Although the local or state governments have the required information related to the employee, they typically do not maintain the information regarding the dependents covered by the health trust. Reporting of this data should be able to be assigned/ delegated to the Union Health Trusts. The local and state governments are not in control of the data. In addition, the validation of the data is outside of the employer’s direct control. There is no recourse over these entities to provide the data to the local or state governments in a timely manner to comply with the reporting requirements.

If this reporting requirement cannot be assigned to these Health Trusts, it seems the local and state governments are being held accountable for compliance over items that are outside of their control. For instance, if the governmental entity has a third party administrator or a union health trust that maintains the data required for reporting, the governmental entity is dependent on them to provide this required data. There is no means to force these entities to provide accurate and timely information to the responsible governmental entity. If the information is not provided the governmental entity would then be required to survey the employees directly, which would be a significant effort.

This is an area where focused training and frequently asked questions (FAQs) would assist to ensure an adequate understanding, which would then result in proper compliance. Please see Appendix C for suggested FAQs.

Proper identification of full-time employees

For government employers, as well as many from the private sector, the definition of a full-time employee is well established but does not equate to the ACA full-time definition, adding another layer of complexity to reporting. This is illustrated on Chart 7, Appendix B, where there are established and well understood entity definitions of Full-Time Employees as well as Benefit Eligible Employees.

Responders also recognized the ACA definition is known to be different by more than a quarter of those entities and still unknown to more than 55% of all entities. Beyond the educational needs of a majority of governmental employers for general full-time versus part-time employee population there are further complexities. There are certain categories of employees that will require additional evaluation and which employers will ask for clarity from the IRS and informational training. Twenty-five percent of state respondents indicated that they employ adjunct faculty. Many entities employ seasonal employees. Developing a methodology to accurately track

work hours for these employees is not just a technical activity. Employees and their unions have engaged many employers already to assure equitable treatment for them or their members. Again there is the potential of tangible budget outlays by the employer and/or the employee based on the measurement definitions implemented. It is crucial for the employer to determine parity at the start; a win-win strategy should offer reasonable budget impacts to each side and remove the possibility of legal challenges.

State entities have payroll processing systems but smaller ALE's do not have sophisticated payroll and tracking systems which adds very different responsibilities to general payroll resources. There should be broad communications to entities and their staff at various levels for all ALEs to engage in the training opportunities expected from FSLG and the IRS. Employers' systems would be calibrated to measure employees based on internal definitions so when different a second methodology may not be easily or fiscally obtained.

The initial year calls for a look back period to calculate full-time employees, all subsequent annual reporting will require monthly actual information unless an employer plan meets exclusion criteria. For that level of detailed reporting, a systemic solution is absolutely necessary which comes at a cost to each, and every, ALE.

Data Collection for Employee Dependents

The reporting requirements are within two sections of ACA, Sections 6055 and 6056, which were issued in final form effective February 12, 2014 and published on March 10, 2014. The final regulations are applicable for periods after December 31, 2014. Reporting is required to the Internal Revenue Service to enable verification that individuals who request the premium tax credit are entitled to that tax credit and also to assist in the determination of a penalty assessment to the employer for failure to

offer affordable and adequate health insurance to their full-time employees. Originally, reporting requirements were proposed to be effective for 2014; however, Notice 2013-45 was issued on July 9, 2013 giving transition relief for the reporting for 2014. This relief was well received, as the final regulations had yet to be issued. As a result, reporting will be required in 2016 for coverage in 2015.

Section 6055 is information reporting to determine whether the individual employee received minimum essential coverage. This reporting will be required of the insurer for fully insured plans that are issued outside of the Marketplace. In addition, employees that have self-insured plans will also be required to complete this reporting requirement.

Section 6056 is information reporting for large employers to identify whether the coverage offered is considered affordable, provides minimum value coverage for full-time employees and their dependents covered by the plan/policy. This information will be used to calculate the penalty against the larger employer. Another use of this information will be to verify that the employees and their dependents are eligible to receive a premium tax credit.

The information will be reported to the employee on Form 1095 and will be summarized by the employer on a Form 1094. One copy of the 1095 will go to the employee no later than January 31 following the calendar year being reported. No later than February 28 (March 31 if electronic filing is performed), the summary 1094 will be provided to the IRS along with a copy of each 1095. The 1095 form has not yet been released.

The data elements required on the ACA Section 6055 reporting include:

1. Name, address, and employer identification number (EIN)
2. Name, address and social security number (SSN) of the “responsible individual” (employee or primary insured)

3. Name, SSN (or date of birth if a SSN is not available and reasonable efforts were exhausted to obtain the SSN) of each covered spouse and dependent
4. Calendar months each employee, spouse or dependent child was covered for at least one day
5. Name, address, and EIN of the employer sponsoring the plan
6. If coverage is through a Small Business Health Options Program (SHOP) Marketplace, the SHOP's unique identifier is required

The data elements required on the 6056 reporting include:

1. Applicable Large Employer (ALE) name, address and EIN
2. Name and telephone number of the ALE contact person
3. Calendar year for which the information is reported
4. Certification by calendar month on whether minimum essential coverage was offered to its full-time employees and dependents.
5. Number of full-time employees for each month
6. Name address and SSN for each full time employee
7. The months of the year that minimum value coverage was offered to the employee
8. The full-time employee's share of the lowest premium cost of self-only coverage providing minimum value plan offered by the employee, by calendar month

As part of 6056, the IRS is also contemplating development of a series of codes necessary for employers to use which identifies:

1. Whether the coverage offered to full-time employees and dependents met minimum value (60%)
2. Whether the employee's spouse was eligible for the coverage
3. The total number of employees by calendar month

4. If full-time employee was not offered coverage, whether they were excluded due to a permissible reason or another reason.
5. Whether the coverage met an affordability safe harbor
6. If the employer had no full-time employees during a given calendar month
7. If a member of a controlled or affiliated service group, the name and EIN of all other employers in the group
8. Name, address, and EIN of anyone filing on behalf of the employer
9. If a contributing employer to a multiemployer plan, whether the employee is eligible for that plan because of the employer's contributions, and the name, address, and EIN of the administrator of the multiemployer plan
10. Whether minimum essential coverage meeting minimum value was offered to the employee only, the employee and children only, the employee and spouse only, or the employee, spouse, and children
11. If coverage was not offered to the employee, codes to explain why coverage was not offered
12. Coverage was offered to employees during a month that were not full-time employees during that month
13. The full-time employee was offered coverage under plan
14. Whether one of the affordability safe harbor rules was met with respect to an employee

The employer is ultimately responsible for the reporting requirements. However, the reporting requirements are requesting information from employers that have not previously been requested to be provided to the IRS. A bit of a surprise to the subcommittee were the responses when the local and state governments were surveyed on whether they maintain the name and SSN for all covered dependents, 72% stated yes, 19% stated no, and 9% were not sure (See Appendix B, Chart 10). Anecdotally the percentage of yes and no were quite different. The final regulations did provide some relief to employers by stating that if a reasonable effort was made to obtain the SSN unsuccessfully, the date of birth may be reported in place of the

SSN. However, it does appear that the majority of the governmental entities are prepared to provide the required information.

Delegation and or combining of ACA Section 6055 and/or 6056 Reporting

The final regulations for ACA Sections 6055 and 6056 reporting allow the ALE to combine the reporting for all employees and reference the use of the new Forms 1094-C (a transmittal) and 1095-C (an employee statement). To read that the fields required from the employers to report ACA compliance has been issued, enumerated above, is encouraging. But the forms themselves have not been issued which is limiting to ALE's and their vendors. As currently understood the changes needed to comply with Section 6055 and/or 6056 are significant. The extensions provided the IRS are necessary and appreciated, but the timeline for employer implementation continues to be squeezed by the delays in the issuance of data and form requirements.

The survey included questions on report delegation. Chart 12 depicts the responses to the four questions posed; for either Section 6055 or 6056 reporting, whether the responders had asked others to report on their behalf or if any entity had asked them to report for that entity. Less than 10% answered yes that they may request delegation of reporting to another governmental entity and not one responder said that they had been asked. Once again highlighting the minimal knowledge employers have of the ACA requirements, more than 40% were not sure if they would or would not ask. This raises a concern that assumptions may linger with some employers creating compliance gaps if those that are not sure ask for delegation producing a negative response and then leaves the inquiring employer without a timely solution.

For combined reporting of Sections 6055 and 6056, it is appreciated that the final regulations acknowledge that ALE's may report all information through the 1094-C

and 1095-C, eliminating the need to also report some data using the 1094-B and 1095-B. Even with this combined reporting, the cost to all employers increases now that most of their employees will receive two distinct tax documents through the mail.

Another matter in this area is the potential to create efficiency and cost savings in the years ahead if employees receive tax forms, including the W-2, the form alluded to in Section 6055 and/or 1095-C, electronically. For the employers that have an option to electronically deliver an employee's W-2, and less than 20% of responders currently offer electronic W-2's, there is an the allowance for electronic delivery of the forms required in both of the Sections, 6055 and 6056, final regulations. This report highlights the fact that the employee consent is being siloed by the IRS as discreet authorizations for each tax form an employee may receive. We ask that the IRS consider consolidated authorization by an employee so that acceptance of W-2 electronic delivery can be broadened by employer for all forms issued. Without this change in regulations the employer will need to separately obtain confirmation for each form which is another layer of complexity and cost for outreach and training.

V. Conclusion

The IRS through FSLG is up for the challenges ahead. And the ACA presents the same reporting standards for all Applicable Large Employers (ALE), so this is not an FSLG-only mandate. It is anticipated that materials may be leveraged across all IRS service Divisions. But unlike the overall ACA fact sheet which states that only 10% of all employers would be designated as ALE's, for FSLG the percentages are almost reversed as it is estimated that almost 80% (in the survey 85% of local respondents described themselves as ALE) of governmental entities employ 50 or more employees.

Recommendations - PCORI

The FSLG office is planning to offer webinar training on the PCORI fee in May, 2014. The Committee is very excited that FSLG has taken the lead to provide training and outreach on this topic. It is needed. However, it would have been ideal to have training regarding the PCORI fee prior to the effective date of the regulations and the required submission of the fees due. For some employers, the PCORI fee has already been assessed and paid in July, 2013. Timing of this training is only a few months prior to the July, 2014 720 submission. According to IRS staff, training needs had to first be identified, developed and then prepared for delivery. In addition all ACA training must first be approved and reviewed by the ACA office prior to going public.

State and local governments are very diverse. For instance, health insurance administration and management of the state and local government entities are in many different forms. Some governments are self-insured, some have purchased health insurance, some have health insurance provided directly by the employee unions, and some are a mixture of the above. As a result, the training that is presented by the IRS must be able to address these particular situations, as the compliance applicability will be very diverse.

The planned revision of the Form 720 should be reconsidered. It should be revised to include both fees of $1 and $2 to accommodate plans that might have a shortened six month period when transitioning to a new plan year end. If the form is not modified to include both rates, the amount of tax will not properly calculate. In addition, FAQs should be developed to explain how this shortened plan period should be handled and how the fee is accessed.

State and local governments have been under increasing fiscal strain. The PCORI fee is considered by some to be an unfunded mandate. Many legislative bodies have been asked for general fund appropriations to fund the assessment of this fee upon their employees and dependents. Some governments have also expressed the lack of staff to adequately administer this additional reporting burden.

Recommendations - Benefits Administered by Union Health Trusts and Other Topics

Frequently Asked Questions posted quickly and updated as often as needed to keep information fresh. New questions should be encouraged and taken in through this site. This will be viewed as the IRS offering a strong support tool to the ALEs as deadlines continue to loom.

Recommendations - Proper identification of full-time employees

A fixed, preferably single, definition of hours per class hour should be adopted to address the adjunct faculty.

Recommendations - Data Collection for Employee Dependents

Due to the magnitude of the reporting requirements, the IRS needs to release the information reporting forms as soon as possible. Employers have a significant amount

of work ahead to ensure compliance with these requirements. Software will need to be reconfigured, which is not a simple endeavor. Some governmental entities are utilizing legacy systems where program changes are difficult to make to achieve systemic reporting of this information; thus, an alternative solution will need to be identified.

Recommendations - Delegation and or combining of Section 6055 and/or 6056 Reporting

Educational training on the parameters or options for allowable delegation should be delivered immediately to minimize erroneous or uniformed decisions by certain employers.

A change is recommended and should be made to regulations which support electronic delivery of all tax documents from an employer by the employee with a single confirmation of employee affirmative consent.

Special Thanks

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

- Paul Marmolejo, Director, Federal, State and Local Governments (FSLG);
- Tennille Francis, Tax Law Specialist, FSLG
- Phyllis Burnside, Senior Analyst, Compliance and Program Management; S
- Stephen Tackney, General Counsel Deputy Division Counsel/Deputy Associate Chief Counsel (Employee Benefits) Tax Exempt and Government Entities Division Office of Chief Counsel, IRS
- Ligeia Donis, Senior Technician Reviewer, Employment Tax, Tax Exempt and Government Entities Division Office of Chief Counsel, IRS
- Kathryn Johnson, Attorney, Health and Welfare Branch, Tax Exempt and Government Entities Division Office of Chief Counsel, IRS

FEDERAL, STATE AND LOCAL GOVERNMENTS – APPENDIX A

ACT Survey 2014

Please Read and Respond to this Survey

We, Lisa Pusich (AK), Robert Jaros (CO), and Kathy Sheppard (MA) are members of the Advisory Committee on Tax Exempt and Government Entities of the Internal Revenue Service. The ACT was established under the Federal Advisory Committee Act to provide an organized public forum for discussion of relevant issues affecting the tax exempt and government entities communities. Annually the ACT Committee provides advisory reports to the Commissioner. While this is not an IRS survey and no personal information will go to the IRS, the summary results will be very helpful to IRS FSLG (Federal, State, and Local Government) in developing outreach/educational tools, materials and/or support on these important matters.

We are conducting this survey to gather data on 2 distinct business topics that government entities manage: (a) current knowledge /readiness assessment of the future reporting requirements of the Affordable Care Act (ACA) and (b) your awareness and current use of IRS eServices.

The survey is meant to be answered by someone that manages/oversees employer tax reporting for your entity. Please feel free to share the survey link with the appropriate person that manages tax reporting matters. Also if there are departments, for example higher education, that maintain their own tax ID, please forward this and ask them to complete this survey as well.

It should take about 20 minutes to respond.

Section A - Readiness Survey for ACA Reporting Requirements

1. Type of Government?

State Regional Authority County Local Other (please specify)

2. Responses to this Survey are best answered by the office/agency/department responsible for employer tax reporting on behalf of your entity.
Please identify:

- My office is responsible for the entity's tax reporting
- Input from the appropriate person
- Department responsible for the entity's tax reporting (name dept below)
- Responses based on general knowledge

If different from responder, please list name of office/agency/department responsible for entity's tax reporting

2. For Responder, Please Provide the Following:
   - Name
   - Title
   - Department

4. Is your office/ agency/ department responsible for your entity's ACA employer reporting required by sections 6055 and 6056 of the Internal Revenue Code?
   - Yes
   - Multi-Agency Responsibility including my Office
   - No
   - Not yet defined

Comments, if any

Please answer the following questions for your Entity. If there are any departments (i.e. Higher Education) within your entity that maintain a separate Tax ID, please forward this survey to each of their offices so they can also respond:

5. What is your health insurance plan's year end date for plans offered to active employees? (month / date)

- We have one health insurance plan available for active employees
- 2 health insurance plans are available to active employees
- 3 health insurance plans are available to active employees
- 4 or more health insurance plans available to active employees

Please Enter Month / Date & List approx # of employees in each plan

6. Number of full-time employees

7. Do you offer /provide electronic tax forms to employees?

- Yes
- No

7a. If Yes - Please indicate how employee consent is made and maintained.

8. Does your entity employ Adjunct Faculty?

- Yes
- No

8a. If yes, how does your entity count adjunct faculty hours for the purposes of assessing whether they are full time under the ACA?

9. Applicable Large Employer (ALE) is defined as an employer with 50 or more full time employees. All employees of a controlled group under Sec. 414(b) or (c), or an affiliated service group under Sec. 414(m), are taken into account in making this determination. However, pending further guidance, government entities and certain other entities may rely on a reasonable, good-faith interpretation of Secs. 414(b), (c), (m), and (o) in determining whether a person or group of persons is an applicable large employer.

How are you determining the members of your ALE group?

A. W-2 reporting
B. Shared pension system
C. Shared purchasing group for health insurance
D. Not determined
E. You are Not an ALE (explain)
F. Other (describe);
G. Explain or describe

10. How is Health Insurance managed/ purchased for your entity currently?

- Entity is Self-Insured with benefits administered by a third party administrator
- Entity purchases health insurance on a fully insured basis
- Entity provides payment only to Responsible External or Union Sponsored Plan
- Other
- Combination or Other - Please Describe

11. Please describe your Entity's current ACA required Employer reporting knowledge.

- Implementation Not yet started
- Considering Educational Information Available
- Planning Committee Established
- Single Department Workgroup
- Multi Department Committee
- Active Implementation

- Other (please specify)

11a. If you have a multi department committee, please list/identify member offices/ agencies/ departments.

Tax Year 2013

Additional Medicare Tax for Higher Income Taxpayers - Beginning Jan. 1, 2013, you must withhold and report an additional 0.9 percent on employee wages or compensation that exceed $200,000 (there is no employer match)

12. Do you have any employees that meet this reporting threshold?
- Yes
- No
- Not Sure

13. Was Additional Medicare Tax withheld and reported for tax year 2013?
- Yes
- No
- Not Sure

Tax Year 2014

PCORI fees and Form 720 Reporting - Patient-Centered Outcomes Research Trust Fund Fee (The PCORI fee final regulations were published on Dec. 6, 2012)

- New research trust fund fees are due July 31 from health insurers and the plan sponsors of self-insured plans. The fee is paid annually using Form 720, Quarterly Federal Excise Tax Return. The payment, paid through the Electronic Federal Tax Payment System (EFTPS), should be applied to the second quarter

(in EFTPS, select Q2 for the Quarter under Tax Period on the "Business Tax Payment" page).

- The amount of the PCORI fee is equal to the average number of lives covered during the policy year or plan year multiplied by the applicable dollar amount for the year. For policy and plan years ending after Sept. 30, 2012, and before Oct. 1, 2013, the applicable dollar amount is $1. For policy and plan years ending after Sept. 30, 2013, and before Oct.1, 2014, the applicable dollar amount is $2. For policy and plan years beginning on or after Oct. 1, 2014, and before Oct. 1, 2019, the applicable dollar amount is further adjusted to reflect inflation in National Health Expenditures, as determined by the Secretary of Health and Human Services

14. Is there a different office/ agency/ department responsible for your Form 720 filing?

- Yes
- No
- Not Sure

14a. If Yes, Please Identify

15. For Entities that offer a self-insured plan what office/ agency/ department is responsible for PCORI data / payment? Please identify if you have contracted with a 3rd party administrator to do reporting.

16. What methodology will be used to calculate and report? (reporting Due 2nd Quarter filing)

- Actual Count
- Snapshot Method
- Member Month Method
- State Form Method

- Not Determined
- Combination or other? Please Describe

Tax Year 2015

Applicable Large Employer: Required Reporting to all Employees (originally a tax year 2014 requirement, relief provided July 2013, now tax year 2015 (Transition Relief for 2014 Under §§ 6055 (§ 6055 Information Reporting), 6056 (§ 6056 Information Reporting) and 4980H (Employer Shared Responsibility Provisions).

- Effective for calendar year 2015, you must file an annual return reporting whether and what health insurance you offered your employees

- Effective for calendar year 2015, if you provide self-insured health coverage to your employees, you must file an annual return reporting certain information for each employee you cover.

17. Do you have a definition of Employee for purposes of health insurance eligibility?
    - Yes
    - No
    - Not Sure

If Yes, please provide.

18. Is the ACA definition of Employee different?
    - Yes
    - No
    - Not Sure

If Yes, please explain

19. Do you have a definition of Benefit-Eligible Employee?

- Yes
- No
- Not Sure

If Yes, please provide

20. Is the ACA definition for Benefit-Eligible Employees different?

- Yes
- No
- Not Sure

If Yes, please explain

21. At this time do you anticipate paying a penalty for not offering coverage to 95% of your full time employees as defined in s. 4980H(a)?

- Yes, Probably
- No, Unlikely
- Don't know at this time
- Other (please specify)

22. Will you request delegation of 6055 reporting to another related governmental entity?

- Yes
- No
- Not Sure

If yes – enter name of entity, your relationship to this entity (and/or comments)

23. Have you been requested to handle a delegation of 6055 reporting from another related governmental entity?

- Yes
- No
- Not Sure

If yes – enter name of entity, relationship to your entity (and/or comments)

24. Will you request delegation of 6056 reporting to another related governmental entity?

- Yes
- No
- Not Sure

If yes – enter name of entity, your relationship to this entity (and/or comments)

25. Have you been requested to handle a delegation of 6056 reporting from related another governmental entity?

- Yes
- No
- Not Sure

If yes – enter name of entity, relationship to your entity (and/or comments)

The next questions concern Dependent Coverage Information Gathering

26. Does your entity or another governmental entity maintain Name, SSN for all covered dependents?

- Yes
- No
- Not Sure

If Yes - name of office/agency/dept/entity maintaining this information

26a. If not, is there a plan in place to have necessary data available for tax year 2015?

- Yes
- No

Comments

Please provide any topics or areas of interest that you would like FLSG to consider for possible training or outreach opportunities in the next year.6

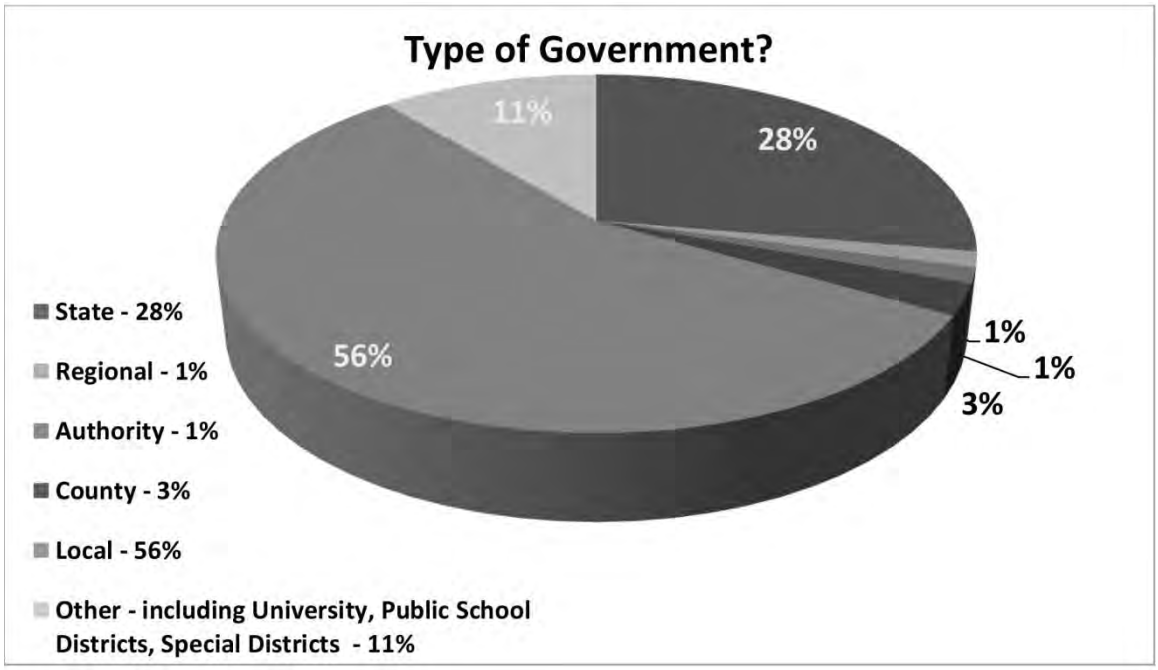

CHART 1

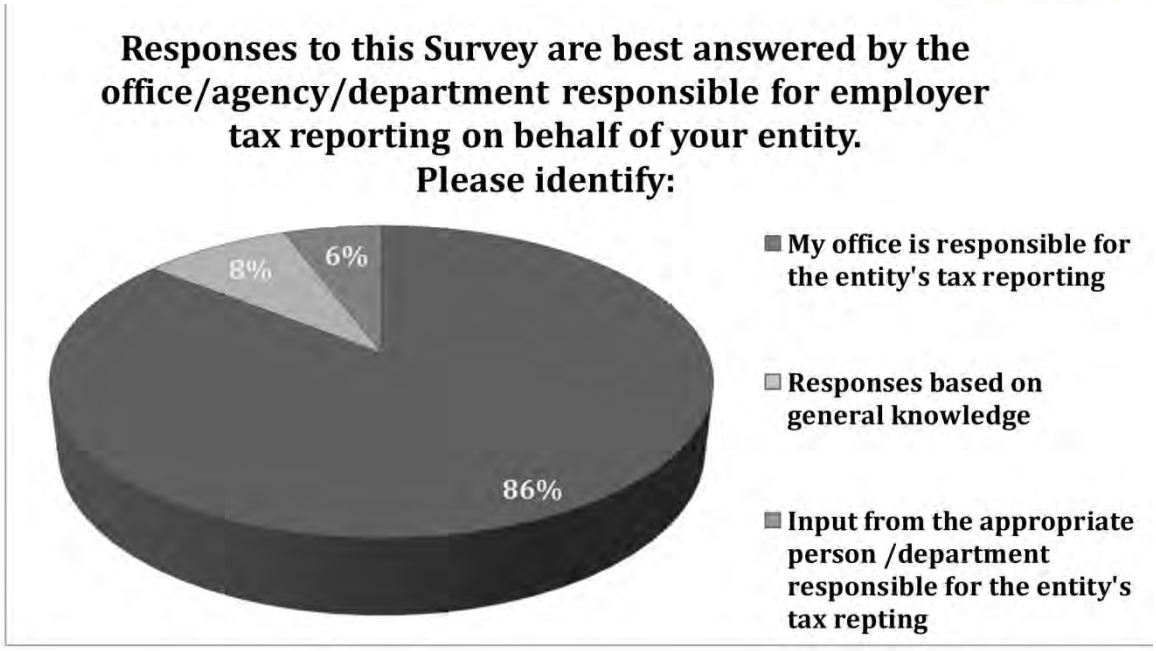

CHART 2

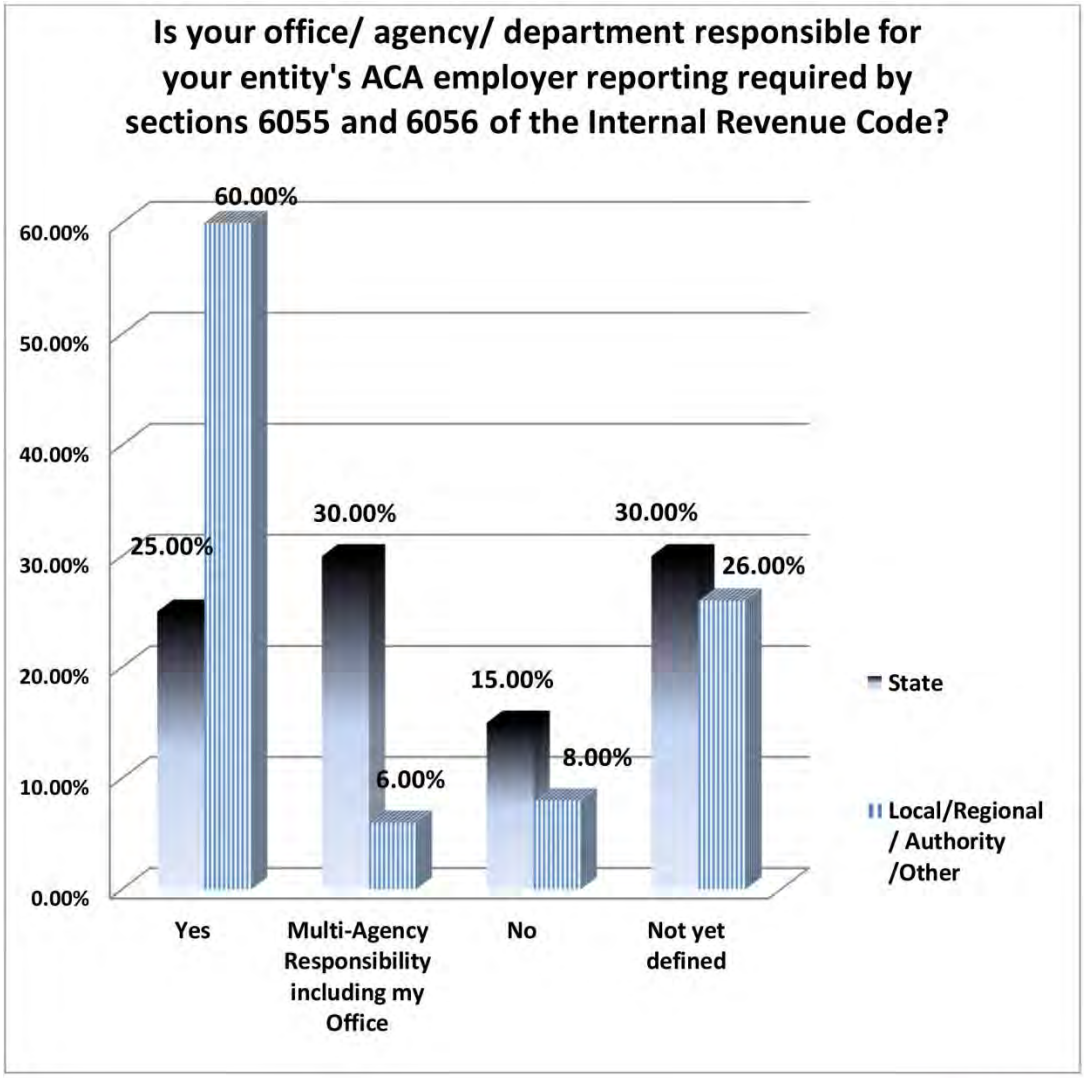
Is your office/ agency/ department responsible for your entity's ACA employer reporting required by sections 6055 and 6056 of the Internal Revenue Code?
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
25.00%
60.00%
30.00%
6.00%
15.00%
8.00%
30.00%
26.00%
Yes
Multi-Agency Responsibility including my Office
No
Not yet defined
State
Local/Regional / Authority /Other

CHART 3

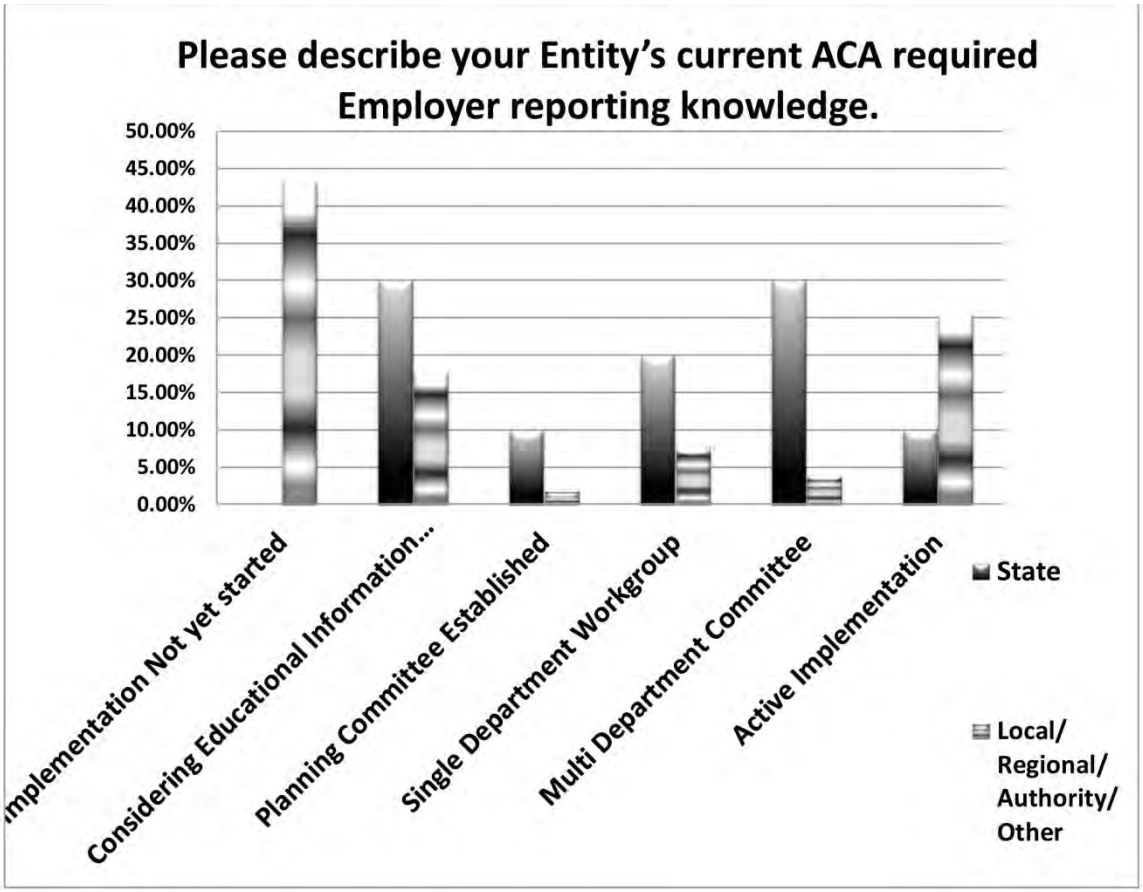

CHART NOTE - ALL STATES HAVE BEGUN AN IMPLEMENTATION PROCESS

CHART 4

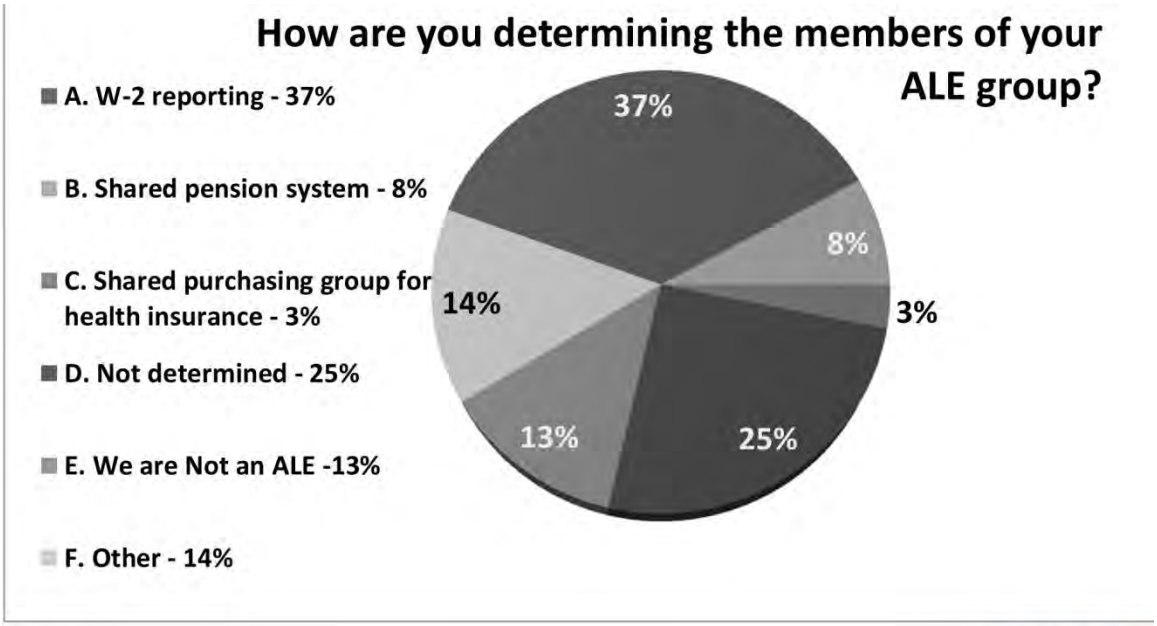

CHART 5

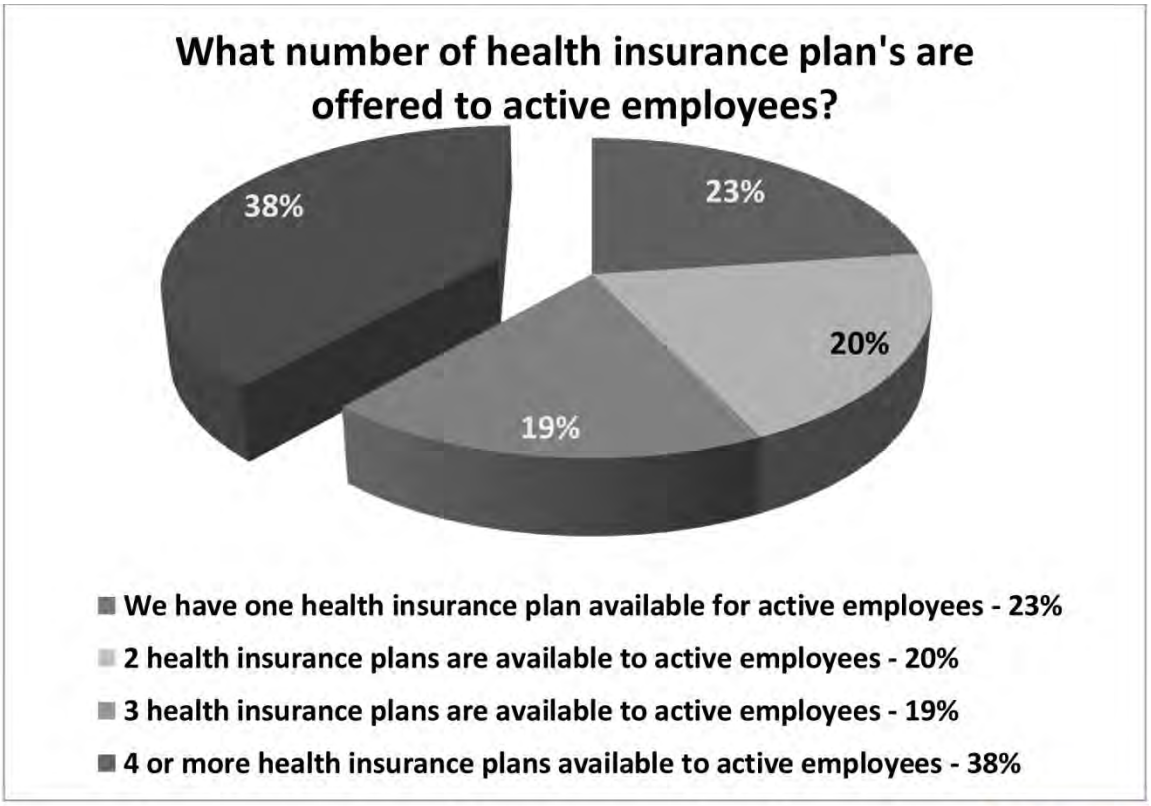

CHART 6

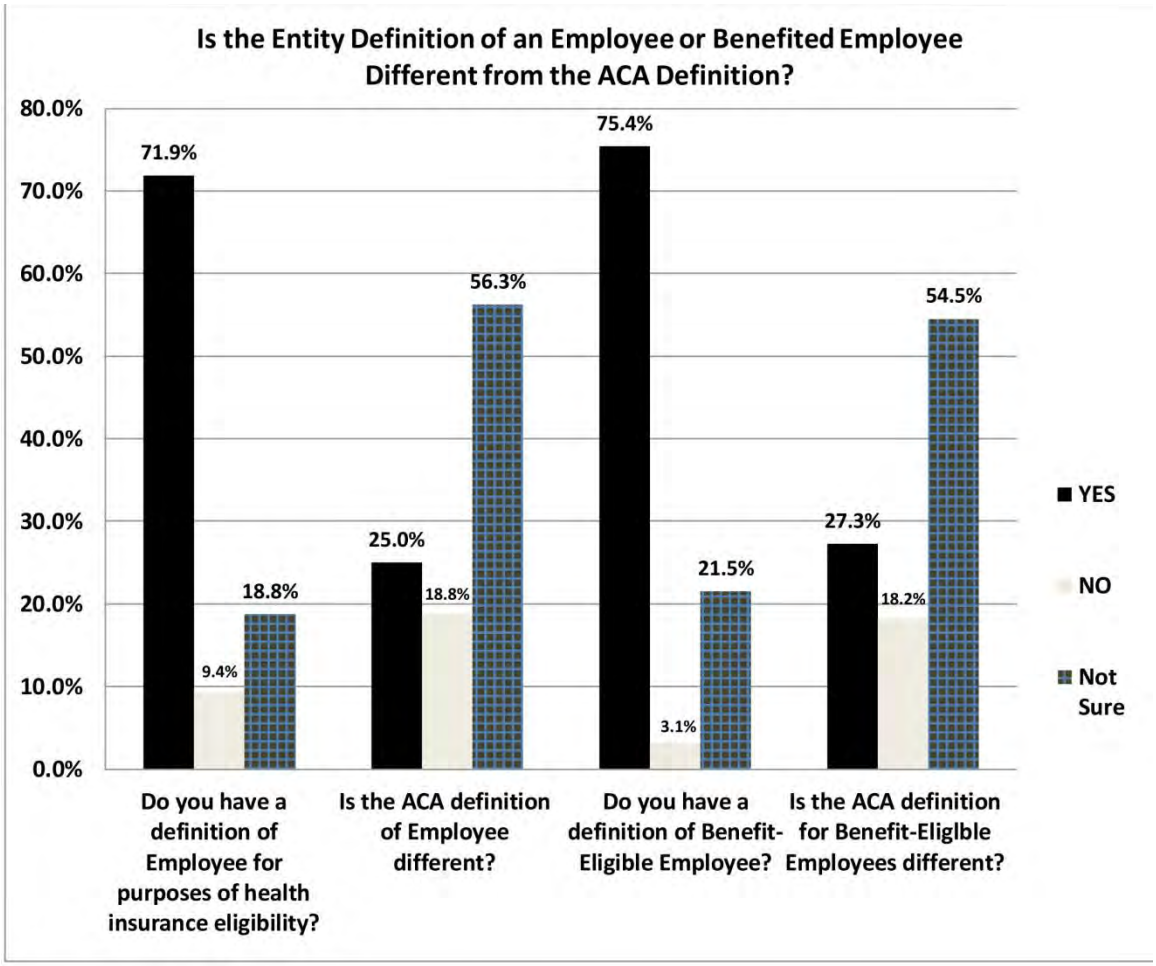

CHART NOTE - ENTITIES HAVE EMPLOYEE DEFINITIONS / ACA DEFINITION OFTEN DIFFERENT OR NOT WELL UNDERSTOOD

CHART 7

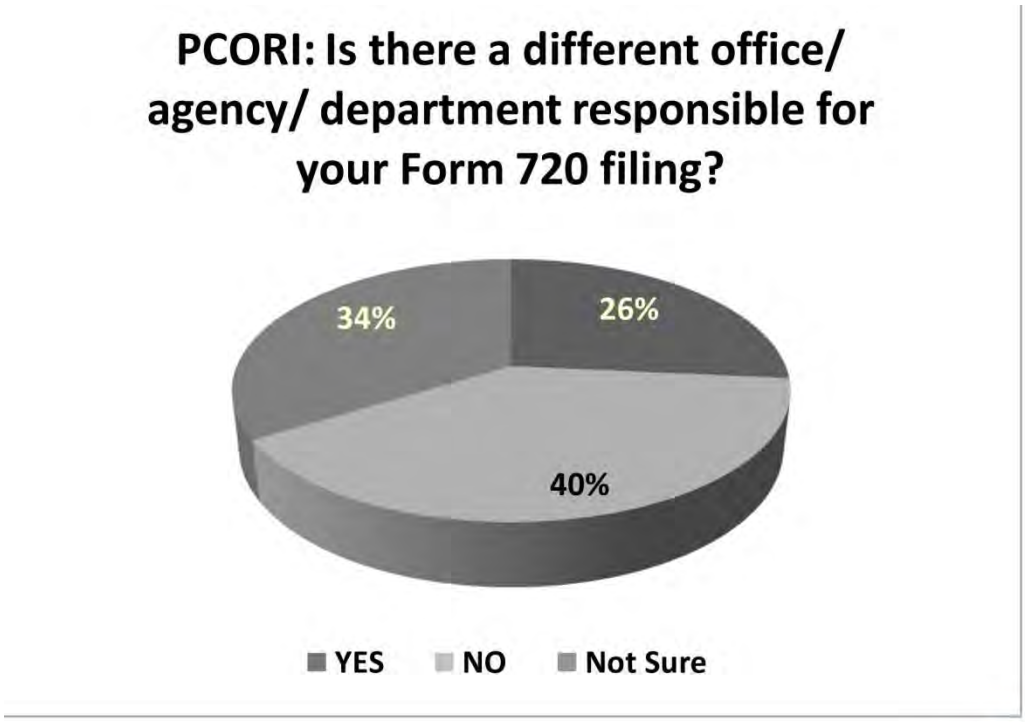

CHART 8

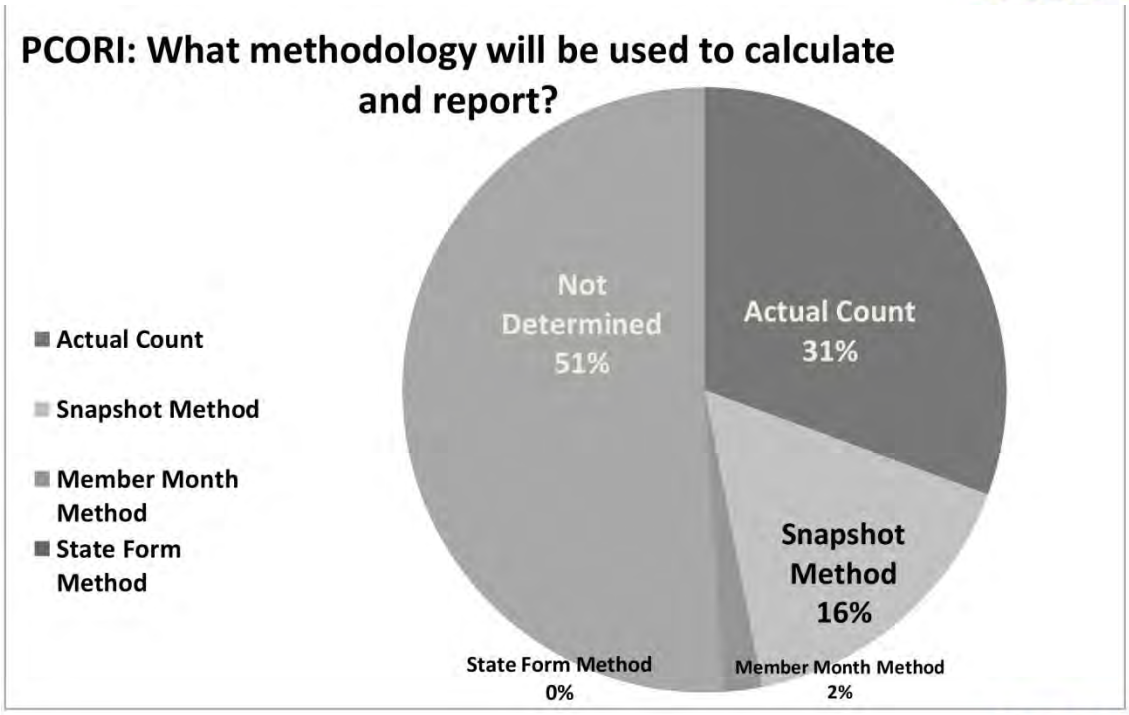

CHART 9

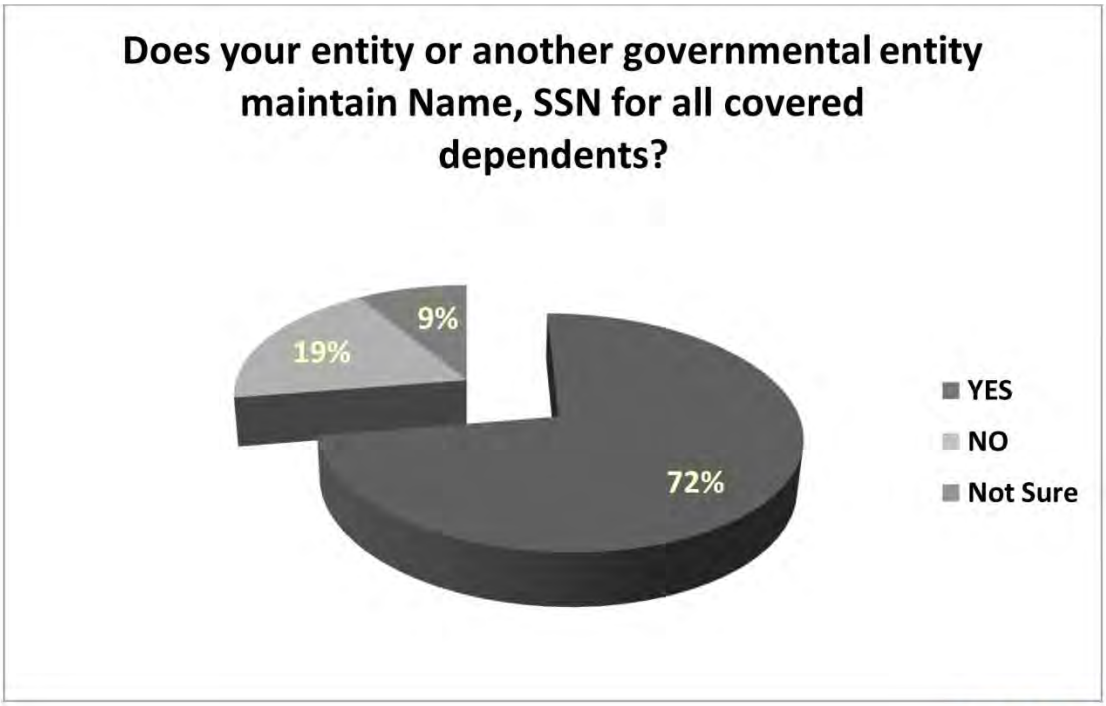

CHART 10

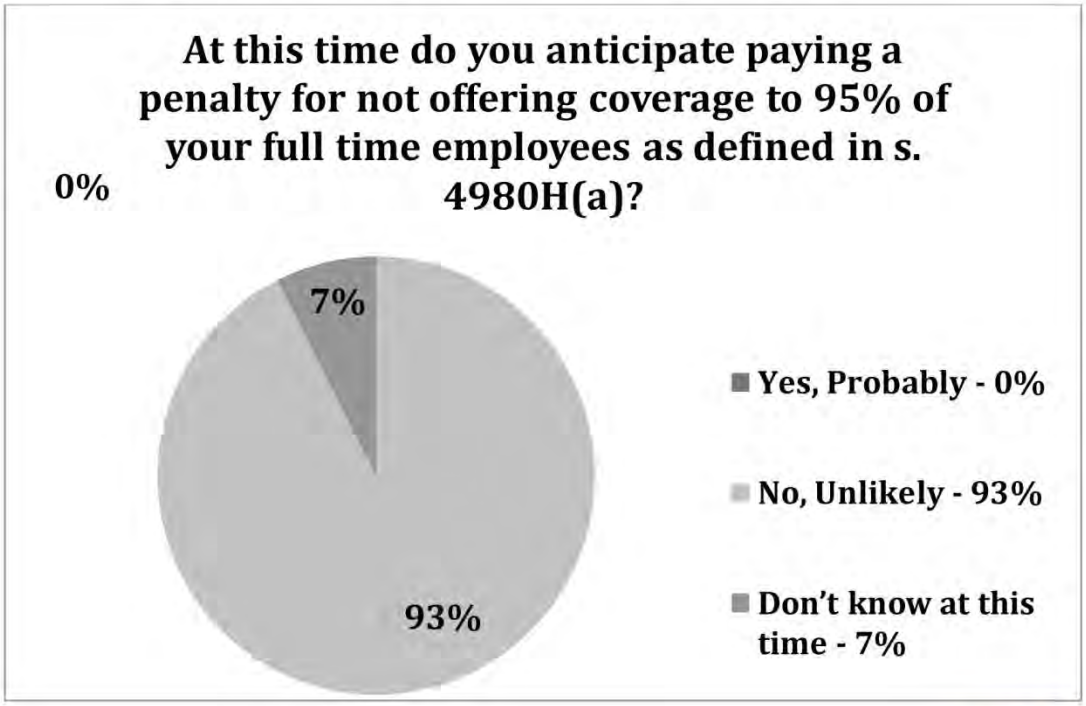

CHART 11

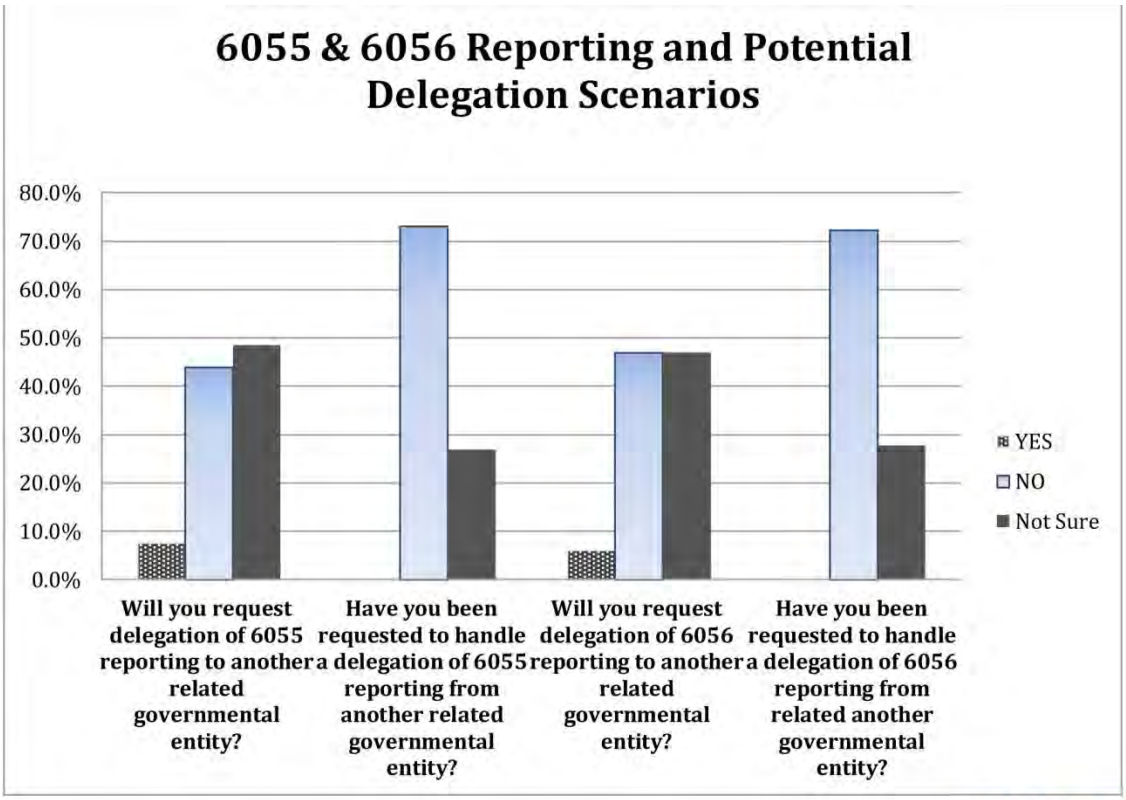
6055 & 6056 Reporting and Potential Delegation Scenarios
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
Will you request delegation of 6055 reporting to another related governmental entity?
Have you been requested to handle a delegation of 6055 reporting from another related governmental entity?
Will you request delegation of 6056 reporting to another related governmental entity?
Have you been requested to handle a delegation of 6056 reporting from related another governmental entity?
YES
NO
Not Sure

CHART 12

FEDERAL, STATE AND LOCAL GOVERNMENTS – APPENDIX C

Recommendations for Frequently Asked Questions

PCORI

- The entity has a new plan with a different plan year. The change impacts the PCORI by creating a partial year's reporting, referred to as stub period, where both fees, $1 and $2, are valid. How should the two calculations be reported?
- The local or state government is defined as the employer of these employees. However, if the Union Health Trust is defined as the plan administrator, they will be responsible for the submission of the 720 report and the payment of the PCORI fee.
    - Can the Health Trusts submit this information under their EIN?
    - Is there some liability to the employer if these health trusts do not submit the 720 with the related fee for their employees?
    - How is it that the IRS will identify these government and Union Health Trust relationships?
- If a government entity is filing as insurer or plan sponsor and the filing includes other employers (independent agencies and municipalities) – is using the entity's TIN problematic?

Benefits administered by external entities (i.e. Union Health Trusts)

- May the reporting of this data be assigned/delegated to the Union Health Trusts?

Employee Dependents

- Will the 1095-C tax form be required to be filed with individual income tax reporting? If, for instance, a covered dependent files the Form 1040 and is not a dependent for any other purpose. Please confirm that there is no employer requirement to provide duplicate reporting to any dependent or spouse of the employee.

- Can the employer request and/or retain only the last 4 digits of a dependent's SSN?
- Can the employer report, on the 1094-C and 1095-C, only the last 4 digits of a dependent's SSN?

Delegation

- A government employer (entity A) is considering if it should request another separate, distinct, government entity (entity B) within its hierarchy to provide ACA reporting for them. What documentation for an arrangement is required?
- With 20 months left until the first required ACA employee reporting (from June 2014) should delegation arrangements be finalized on or before December 31, 2014.

Full Time Employees

- An employer has intermittent employees that work in multiple seasonal jobs. Please provide explanation and training for the implementation of the look-back and stability measurement periods.

General

- What is the effect on reporting when deductions occur prior to a benefit month, for example the offer of insurance would be in one month, but the actual coverage would be in a future month (after employee share of premium is collected)?

Form **720** (Rev. January 2014) Department of the Treasury Internal Revenue Service

Quarterly Federal Excise Tax Return

▶ See the Instructions for Form 720.
▶ Information about Form 720 and its instructions is at *www.irs.gov/form720.*

OMB No. 1545-0023

Check here if:
☐ Final return
☐ Address change

Name | Quarter ending
Number, street, and room or suite no. (If you have a P.O. box, see the instructions.) | Employer identification number
City or town, state or province, country, and ZIP or foreign postal code

FOR IRS USE ONLY	
T	
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FD	
FP	
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T	

Part I

IRS No.	Environmental Taxes (attach Form 6627)			Tax	IRS No.
18	Domestic petroleum oil spill tax				18
21	Imported petroleum products oil spill tax				21
98	Ozone-depleting chemicals (ODCs)				98
19	ODC tax on imported products				19
	Communications and Air Transportation Taxes (see instructions)			Tax	
22	Local telephone service and teletypewriter exchange service				22
26	Transportation of persons by air				26
28	Transportation of property by air				28
27	Use of international air travel facilities				27
	Fuel Taxes	Number of gallons	Rate	Tax	
	(a) Diesel, tax on removal at terminal rack		$.244		
60	(b) Diesel, tax on taxable events other than removal at terminal rack		.244		60
	(c) Diesel, tax on sale or removal of biodiesel mixture (not at terminal rack)		.244		
104	Diesel-water fuel emulsion		.198		104
105	Dyed diesel, LUST tax		.001		105
107	Dyed kerosene, LUST tax		.001		107
119	LUST tax, other exempt removals (see instructions)		.001		119
35	(a) Kerosene, tax on removal at terminal rack (see instructions)		.244		
	(b) Kerosene, tax on taxable events other than removal at terminal rack		.244		35
69	Kerosene for use in aviation (see instructions)		.219		69
77	Kerosene for use in commercial aviation (other than foreign trade)		.044		77
111	Kerosene for use in aviation, LUST tax on nontaxable uses		.001		111
79	Other fuels (see instructions)				79
	(a) Gasoline, tax on removal at terminal rack		.184		
62	(b) Gasoline, tax on taxable events other than removal at terminal rack		.184		62
13	Any liquid fuel used in a fractional ownership program aircraft		.141		13
14	Aviation gasoline		.194		14
112	Liquefied petroleum gas (LPG)		.183		112
118	"P Series" fuels		.184		118
120	Compressed natural gas (CNG) (GGE = 126.67 cu. ft.)		.183		120
121	Liquefied hydrogen		.184		121
122	Fischer-Tropsch process liquid fuel from coal (including peat)		.244		122
123	Liquid fuel derived from biomass		.244		123
124	Liquefied natural gas (LNG)		.243		124
33	**Retail Tax**—Truck, trailer, and semitrailer chassis and bodies, and tractor		12% of sales price		33
	Ship Passenger Tax	Number of persons	Rate	Tax	
29	Transportation by water		$3 per person		29
	Other Excise Tax	Amount of obligations	Rate	Tax	
31	Obligations not in registered form		$ .01		31
	Foreign Insurance Taxes— Policies issued by foreign insurers	Premiums paid	Rate	Tax	IRS No.
	Casualty insurance and indemnity bonds		$ .04		
30	Life insurance, sickness and accident policies, and annuity contracts		.01		30
	Reinsurance		.01		

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 10175Y Form **720** (Rev. 1-2014)

Form 720 (Rev. 1-2014) Page 2

IRS No.	Manufacturers Taxes	Number of tons	Sales price	Rate	Tax	IRS No.
36	Coal—Underground mined			$1.10 per ton		36
37				4.4% of sales price		37
38	Coal—Surface mined			$ .55 per ton		38
39				4.4% of sales price		39
				Number of tires	Tax	IRS No.
108	Taxable tires other than bias ply or super single tires					108
109	Taxable bias ply or super single tires (other than super single tires designed for steering)					109
113	Taxable tires, super single tires designed for steering					113
40	Gas guzzler tax. Attach Form 6197. Check if one-time filing . . . . . ☐					40
97	Vaccines (see instructions)					97
136	Taxable medical devices		Sales price	2.3% of sales price		136
1	**Total.** Add all amounts in Part I. Complete Schedule A unless one-time filing ▶				$	

Part II

IRS No.	Patient-Centered Outcomes Research Fee (see instructions)	(a) Avg. number of lives covered	(b) Rate for avg. covered life	Col. (a) x Col. (b)	Tax	IRS No.
133	Specified health insurance policies		$1.00			
	Applicable self-insured health plans		$1.00			133
				Rate		
41	Sport fishing equipment (other than fishing rods and fishing poles)			10% of sales price		41
110	Fishing rods and fishing poles (limits apply, see instructions)			10% of sales price		110
42	Electric outboard motors			3% of sales price		42
114	Fishing tackle boxes			3% of sales price		114
44	Bows, quivers, broadheads, and points			11% of sales price		44
106	Arrow shafts			$ .48 per shaft		106
140	Indoor tanning services			10% of amount paid		140
			Number of gallons	Rate	Tax	
64	Inland waterways fuel use tax			$ .20		64
125	LUST tax on inland waterways fuel use (see instructions)			.001		125
51	Alcohol and cellulosic biofuel sold as but not used as fuel					51
117	Biodiesel sold as but not used as fuel					117
20	**Floor Stocks Tax—** Ozone-depleting chemicals (floor stocks). Attach Form 6627.					20
2	**Total.** Add all amounts in Part II ▶				$	

Part III

3	Total tax. Add Part I, line 1, and Part II, line 2 . . . . . ▶		3	
4	Claims (see instructions; complete Schedule C) . . . . . ▶	4		
5	Deposits made for the quarter . . . . ▶	5		
	☐ Check here if you used the safe harbor rule to make your deposits.			
6	Overpayment from previous quarters . . ▶	6		
7	Enter the amount from Form 720X included on line 6, if any . . . . . ▶	7		
8	Add lines 5 and 6 . . . . . ▶	8		
9	Add lines 4 and 8 . . . . . ▶		9	
10	**Balance Due.** If line 3 is greater than line 9, enter the difference. Pay the full amount with the return (see instructions) ▶		10	
11	**Overpayment.** If line 9 is greater than line 3, enter the difference. Check if you want the overpayment: ☐ **Applied to your next return, or** ☐ **Refunded to you.**		11	

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☐ **No**

Designee name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature Date ▶ Title

Type or print name below signature. ▶ Telephone number ▶

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Form **720** (Rev. 1-2014)

Form 720 (Rev. 1-2014) Page 3

Schedule A **Excise Tax Liability** (see instructions)

Note. *You must complete Schedule A if you have a liability for any tax in Part I of Form 720. Do not complete Schedule A for Part II taxes or for a one-time filing of the gas guzzler tax.*

1 Regular method taxes

(a) Record of Net Tax Liability	**Period**					
	1st–15th day			**16th–last day**		
First month	**A**			**B**		
Second month	**C**			**D**		
Third month	**E**			**F**		
Special rule for September* . . . . . ▶				**G**		

(b) Net liability for regular method taxes. Add the amounts for each semimonthly period.

2 Alternative method taxes (IRS Nos. 22, 26, 28, and 27)

(a) Record of Taxes Considered as Collected	**Period**					
	1st–15th day			**16th–last day**		
First month	**M**			**N**		
Second month	**O**			**P**		
Third month	**Q**			**R**		
Special rule for September* . . . . . ▶				**S**		

(b) Alternative method taxes. Add the amounts for each semimonthly period.

*Complete only as instructed (see instructions).

Schedule T **Two-Party Exchange Information Reporting** (see instructions)

Fuel	**Number of gallons**
Diesel fuel, gallons received in a two-party exchange within a terminal, included on IRS No. 60(a) on Form 720	
Diesel fuel, gallons delivered in a two-party exchange within a terminal	
Kerosene, gallons received in a two-party exchange within a terminal, included on IRS No. 35(a), 69, 77, or 111 on Form 720	
Kerosene, gallons delivered in a two-party exchange within a terminal	
Gasoline, gallons received in a two-party exchange within a terminal, included on IRS No. 62(a) on Form 720	
Gasoline, gallons delivered in a two-party exchange within a terminal	
Aviation gasoline, gallons received in a two-party exchange within a terminal, included on IRS No. 14 on Form 720	
Aviation gasoline, gallons delivered in a two-party exchange within a terminal	

Form **720** (Rev. 1-2014)

Form 720 (Rev. 1-2014) Page 4

Schedule C **Claims** Month your income tax year ends ▶

- **Complete Schedule C for claims *only* if you are reporting liability in Part I or II of Form 720.**
- Attach a statement explaining each claim as required. Include your name and EIN on the statement (see instructions).

Caution. *Claimant has the name and address of the person(s) who sold the fuel to the claimant, the dates of purchase, and if exported, the required proof of export. For claims on lines 1a and 2b (type of use 13 and 14), 3c, 4b, and 5, claimant has not waived the right to make the claim.*

1 Nontaxable Use of Gasoline **Note.** CRN is credit reference number. Period of claim ▶

		Type of use	Rate	Gallons	Amount of claim		CRN
a	Gasoline (see **Caution** above line 1)		$.183		$		362
b	Exported (see **Caution** above line 1)		.184				411

2 Nontaxable Use of Aviation Gasoline Period of claim ▶

		Type of use	Rate	Gallons	Amount of claim		CRN
a	Used in commercial aviation (other than foreign trade)		$.15		$		354
b	Other nontaxable use (see **Caution** above line 1)		.193				324
c	Exported (see **Caution** above line 1)		.194				412
d	LUST tax on aviation fuels used in foreign trade		.001				433

3 Nontaxable Use of Undyed Diesel Fuel Period of claim ▶

Claimant certifies that the diesel fuel did not contain visible evidence of dye.
Exception. If any of the diesel fuel included in this claim **did** contain visible evidence of dye, attach a detailed explanation and check here . . . . . ▶ ☐

		Type of use	Rate	Gallons	Amount of claim		CRN
a	Nontaxable use		$.243		$		360
b	Use in trains		.243				353
c	Use in certain intercity and local buses (see **Caution** above line 1)		.17				350
d	Use on a farm for farming purposes		.243				360
e	Exported (see **Caution** above line 1)		.244				413

4 Nontaxable Use of Undyed Kerosene (Other Than Kerosene Used in Aviation) Period of claim ▶

Claimant certifies that the kerosene did not contain visible evidence of dye.
Exception. If any of the kerosene included in this claim **did** contain visible evidence of dye, attach a detailed explanation and check here . . . . . ▶ ☐

	Caution. *Claims cannot be made on line 4 for kerosene sales from a blocked pump.*	Type of use	Rate	Gallons	Amount of claim		CRN
a	Nontaxable use		$.243		$		346
b	Use in certain intercity and local buses (see **Caution** above line 1)		.17				347
c	Use on a farm for farming purposes		.243				346
d	Exported (see **Caution** above line 1)		.244				414
e	Nontaxable use taxed at $.044		.043				377
f	Nontaxable use taxed at $.219		.218				369

5 Kerosene Used in Aviation (see **Caution** above line 1) Period of claim ▶

		Type of use	Rate	Gallons	Amount of claim		CRN
a	Kerosene used in commercial aviation (other than foreign trade) taxed at $.244		$.200		$		417
b	Kerosene used in commercial aviation (other than foreign trade) taxed at $.219		.175				355
c	Nontaxable use (other than use by state or local government) taxed at $.244		.243				346
d	Nontaxable use (other than use by state or local government) taxed at $.219		.218				369
e	LUST tax on aviation fuels used in foreign trade		.001				433

Form **720** (Rev. 1-2014)

Form 720 (Rev. 1-2014) Page 5

6 Nontaxable Use of Alternative Fuel

Caution. *There is a reduced credit rate for use in certain intercity and local buses (type of use 5) (see instructions).*

		Type of use	Rate	Gallons or gasoline gallon equivalents (GGE)	Amount of claim	CRN
a	Liquefied petroleum gas (LPG)		$.183		$	419
b	"P Series" fuels		.183			420
c	Compressed natural gas (CNG) (GGE = 126.67 cu. ft.)		.183			421
d	Liquefied hydrogen		.183			422
e	Fischer-Tropsch process liquid fuel from coal (including peat)		.243			423
f	Liquid fuel derived from biomass		.243			424
g	Liquefied natural gas (LNG)		.243			425
h	Liquefied gas derived from biomass		.183			435

7 Sales by Registered Ultimate Vendors of Undyed Diesel Fuel Period of claim ▶ _____ Registration number ▶

Claimant certifies that it sold the diesel fuel at a tax-excluded price, repaid the amount of tax to the buyer, or has obtained written consent of the buyer to make the claim. Claimant certifies that the diesel fuel did not contain visible evidence of dye.

Exception. If any of the diesel fuel included in this claim **did** contain visible evidence of dye, attach a detailed explanation and check here . . . . . ▶ ☐

		Rate	Gallons	Amount of claim	CRN
a	Use by a state or local government	$.243		$	360
b	Use in certain intercity and local buses	.17			350

8 Sales by Registered Ultimate Vendors of Undyed Kerosene (Other Than Kerosene For Use in Aviation) Period of claim ▶ _____ Registration number ▶

Claimant certifies that it sold the kerosene at a tax-excluded price, repaid the amount of tax to the buyer, or has obtained the written consent of the buyer to make the claim. Claimant certifies that the kerosene did not contain visible evidence of dye.

Exception. If any of the kerosene included in this claim **did** contain visible evidence of dye, attach a detailed explanation and check here . . . . . ▶ ☐

		Rate	Gallons	Amount of claim	CRN
a	Use by a state or local government	$.243		$	346
b	Sales from a blocked pump	.243			
c	Use in certain intercity and local buses	.17			347

9 Sales by Registered Ultimate Vendors of Kerosene For Use in Aviation Registration number ▶

Claimant sold the kerosene for use in aviation at a tax-excluded price and has not collected the amount of tax from the buyer, repaid the amount of tax to the buyer, or has obtained written consent of the buyer to make the claim. See the instructions for additional information to be submitted.

		Type of use	Rate	Gallons	Amount of claim	CRN
a	Use in commercial aviation (other than foreign trade) taxed at $.219		$.175		$	355
b	Use in commercial aviation (other than foreign trade) taxed at $.244		.200			417
c	Nonexempt use in noncommercial aviation		.025			418
d	Other nontaxable uses taxed at $.244		.243			346
e	Other nontaxable uses taxed at $.219		.218			369
f	LUST tax on aviation fuels used in foreign trade		.001			433

10 Sales by Registered Ultimate Vendors of Gasoline Registration number ▶

Claimant sold the gasoline at a tax-excluded price and has not collected the amount of tax from the buyer, repaid the amount of tax to the buyer, or has obtained written consent of the buyer to take the claim; and obtained an unexpired certificate from the buyer and has no reason to believe any information in the certificate is false. See the instructions for additional information to be submitted.

		Rate	Gallons	Amount of claim	CRN
a	Use by a nonprofit educational organization	$.183		$	362
b	Use by a state or local government	.183			

11 Sales by Registered Ultimate Vendors of Aviation Gasoline Registration number ▶

Claimant sold the aviation gasoline at a tax-excluded price and has not collected the amount of tax from the buyer, repaid the amount of tax to the buyer, or has obtained written consent of the buyer to take the claim; and obtained an unexpired certificate from the buyer and has no reason to believe any information in the certificate is false. See the instructions for additional information to be submitted.

		Rate	Gallons	Amount of claim	CRN
a	Use by a nonprofit educational organization	$.193		$	324
b	Use by a state or local government	.193			

Form 720 (Rev. 1-2014)

Form 720 (Rev. 1-2014) Page 6

12	**Reserved**	Period of claim ▶	Registration number ▶			
	Reserved					
		Rate	Gallons	Amount of claim		CRN
a	**Reserved**					
b	**Reserved**					
13	**Reserved**	Period of claim ▶	Registration number ▶			
	Reserved					
		Rate	Gal. of biodiesel or renewable diesel	Amount of claim		CRN
a	**Reserved**					
b	**Reserved**					
c	**Reserved**					
14	**Alternative Fuel Credit and Alternative Fuel Mixture Credit**	Registration number ▶				

For the alternative fuel mixture credit, claimant produced a mixture by mixing taxable fuel with alternative fuel. Claimant certifies that it (a) produced the alternative fuel, or (b) has in its possession the name, address, and EIN of the person(s) that sold the alternative fuel to the claimant; the date of purchase; and an invoice or other documentation identifying the amount of the alternative fuel. The claimant also certifies that it made no other claim for the amount of the alternative fuel, or has repaid the amount to the government. The alternative fuel mixture was sold by the claimant to any person for use as a fuel or was used as a fuel by the claimant.

		Rate	Gallons or gasoline gallon equivalents (GGE) (see instructions)	Amount of claim		CRN
a	**Reserved**					
b	**Reserved**					
c	**Reserved**					
d	Liquefied hydrogen	.50		$		429
e	**Reserved**					
f	**Reserved**					
g	**Reserved**					
h	**Reserved**					
i	**Reserved**					

15	**Other claims.** See the instructions. For lines 15b and 15c, see the **Caution** above line 1 on page 4.		Amount of claim	CRN
a	Section 4051(d) tire credit (tax on vehicle reported on IRS No. 33)		$	366
b	Exported dyed diesel fuel and exported gasoline blendstocks taxed at $.001			415
c	Exported dyed kerosene			416
d	Diesel-water fuel emulsion			
e	Registered credit card issuers			
		Number of tires	Amount of claim	CRN
f	Taxable tires other than bias ply or super single tires		$	396
g	Taxable tires, bias ply or super single tires (other than super single tires designed for steering)			304
h	Taxable tires, super single tires designed for steering			305
i				
j				
k				
16	**Total claims.** Add amounts on lines 1 through 15. Enter the result here and on Form 720, Part III, line 4.	16		

Form **720** (Rev. 1-2014)

Form 720-V, Payment Voucher

Purpose of Form

Complete Form 720-V if you are making a payment by check or money order with Form 720, Quarterly Federal Excise Tax Return. We will use the completed voucher to credit your payment more promptly and accurately, and to improve our service to you.

If you have your return prepared by a third party and a payment is required, provide this payment voucher to the return preparer.

Do not file Form 720-V if you are paying the balance due on line 10 of Form 720 using EFTPS.

Specific Instructions

Box 1. If you do not have an EIN, you may apply for one online. Go to the IRS website at *www.irs.gov/businesses/small* and click on the "Employer ID Numbers (EINs)" link. You may also apply for an EIN by calling 1-800-829-4933, or you can fax or mail Form SS-4, Application for Employer Identification Number, to the IRS. However, if you are making a one-time filing, enter your social security number.

Box 2. Enter the amount paid from line 10 of Form 720.

Box 3. Darken the circle identifying the quarter for which the payment is made. Darken only one circle.

Box 4. Enter your name and address as shown on Form 720.

- Enclose your check or money order made payable to "United States Treasury." Be sure to enter your EIN, (SSN for one-time filing), "Form 720," and the tax period on your check or money order. Do not send cash. Do not staple this voucher or your payment to the return (or to each other).
- Detach the completed voucher and send it with your payment and Form 720. See *Where To File* in the Instructions for Form 720.

Form **720-V** (2014)

▼ Detach Here and Mail With Your Payment and Form 720. ▼

720-V
Department of the Treasury
Internal Revenue Service

Payment Voucher

► Do not staple or attach this voucher to your payment.

OMB No. 1545-0023
2014

1 Enter your employer identification number (EIN) (see instructions).

2 **Enter the amount of your payment.** ►
Make your check or money order payable to "United States Treasury."

Dollars | Cents

3 Tax Period

○ 1st Quarter ○ 3rd Quarter
○ 2nd Quarter ○ 4th Quarter

4 Enter your business name (individual name if sole proprietor).

Enter your address.

City or town, state or province, country, and ZIP or foreign postal code

FEDERAL, STATE AND LOCAL GOVERNMENTS – APPENDIX E

What Customers Are Asking For - ACA: Open Responses to TEGE:FSLG

- We are a local government and have a limited budget each year. We do not have funds available to hire someone to assure compliance with the new laws. As a result, we are at risk of non-compliance since the information that is available differs from source to source and the IRS/Feds do not provide clear, concise "How To" documents.
- You need to provide a source document that spells out in plain language exactly what is required under the new law and when. When does an employer need to start reporting information; what information & to whom. What taxes are required to be paid; when are they due; what forms must be sent with the payment; who must pay each. This document would assure that we are all on the same page about what we are required to do & would eliminate the various interpretations floating around.
- PCORI 6055 and 6056 Reporting Requirements Delegation of Reporting Requirements E-Services
- Small communities are so short staffed it is very difficult to take on more reporting. The reporting for the Massachusetts mandatory healthcare was difficult and never fully understood by most as municipalities operate so differently than the private sector.
- Training on 6056 Reporting and all the associated requirements
- Training on requirements and form completion would be good.
- We appreciate the fact that we are assigned a dedicated large business IRS contact though we would like to see faster response times to our inquiries.
- Discussion on variable hour & seasonal employees not for ALE purposes but for benefit eligibility and look-back period testing purposes - as a local govt
- we have many variable hour and seasonal employees in our parks & recreation, public works & other departments

- FSLG MUST ADDRESS THE ISSUE OF FIREFIGHTERS WHO HAVE BOTH A PRIMARY AND SECONDARY EMPLOYER AND WORK MORE THAN 30 HOURS AT EACH. DOES THE SECONDARY EMPLOYER HAVE TO OFFER INSURANCE EVEN IF THE PRIMARY EMPLOYER OFFERS AND/OR COVERS THE EMPLOYEE? THIS REMAINS UNCLEAR.

What Customers Are Asking For - General: Open Responses to TEGE:FSLG

- 941 Form which could be filled out on-line and transmitted electronically to the IRS each quarter
- All payroll/IRS services are provided through a 3rd party vendor.
- Bulk 1098-T matching
- I think it would be beneficial to IRS and us if quarterly reporting (941) could be accomplished electronically.
- On-Line 941-X filing
- TIN matching recommendations from the 2013 ACT Report.
- We are not able to file our 941 Quarterly taxes electronically. We pay electronically, but the report must be mailed. We have been the victim of several large data entry errors by the IRS which resulted in 2 years of aggravation which included 2 visits from IRS collection agents before it was straightened out.
- I would like training on the IRS reporting requirements for the ACA.
- It would be nice to be able to e-file the 941 quarterly reports.
- Keep providing educational opportunities!
- My responsibilities regarding IRS is to file the State's employment tax returns. I am not familiar with the e-Services you are asking about. Answers to this survey resulted from a collaborative effort with our Dept of Human Resources.
- TIN matching recommendations from the 2013 ACT Report.

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ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

Indian Tribal Governments
IRS Tribal Consultation: A Compliance Audit and Recommendations for Improvement

Holly Easterling
Diane Gange
Will Micklin

June 11, 2014

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I. Executive Summary

The 2014 Indian Tribal Government ACT report is essentially a compliance audit of the Internal Revenue Service's tribal consultation procedures pursuant to Presidential executive orders and memoranda requiring meaningful tribal consultation through government-to-governments consultation prior to any action by a federal agency with tribal implications. This report also reviews the recommendations of five (5) previous ITG ACT reports that addressed the subject, and assesses the Service's responses to the recommendations.

This report concludes that the Service's tribal consultation procedures are not fully compliant with either the Presidential requirements for prior and meaningful tribal consultation, nor the aspirations described in the Service's procedures or Treasury process described in Treasury's annual report on tribal consultation to the Office of Management and Budget, and, as such, are inconsistent with the trust obligation of a federal trustee to Indian tribal governments. While the Service did employ components of tribal consultation to resolve three recent matters with tribal implications, controversies arose in these matters because the Service took action on these matters with tribal implications without prior consultation with Indian tribes. The Service's subsequent actions in meeting with Indian tribes and responding to their interests proved to be key to the successful resolution of the disputes. Had the Service implemented meaningful tribal consultation prior to the Service's actions that indisputably had substantial direct effects on Indian tribes, such disputes would have been avoided.

A Service internal review determined approximately one third of the issues related to Indian tribes have a lack of clarity regarding how a particular piece of tax authority applies to Indian tribes, and noted a diversity of understanding across the Service regarding matters with tribal implications. The Inspector General and the National

Taxpayer Advocate both issued recent reports critical of the Service's practices concerning Indian tribes and their tribal citizens, which support the conclusions of our report.

The Presidential executive orders and memoranda mandating tribal consultation established expectation rights for Indian tribes that tribal consultation would be implemented prior to federal agencies taking action with tribal implications in order for such consultation to be meaningful. This report expresses concern with the Service's continued aversion to recognition of and respect for inherent tribal sovereignty and the government-to-government relationship with tribes in the context of the Internal Revenue Code as a law of general applicability. We also report on the Treasury and Service's apparent aversion to adopting a formal tribal consultation policy as an internal guidance document in order to assert tribal consultation is discretionary and creates no expectation right for Indian tribes to tribal consultation.

The prevailing view among Indian tribes is that the Treasury and Service should by now have established written policy, processes and procedures implementing meaningful tribal consultation compliant with Presidential executive orders and memoranda. These processes and procedures should be carefully crafted to be clear on what circumstances would require consultation, that the consultation would occur prior to Service action on matters with tribal implication, and how the consultation would be conducted so as to be meaningful. The Treasury and the Service have asserted they have developed a credible consultation policy. The Service's own review states its policy needs to be carefully crafted. Indian tribes and tribal leaders, and this ITG committee, do not believe the Treasury processes or Service procedures meet this standard.

Due diligence for our report included review of Service and Treasury policies, processes and procedures for tribal consultation. For policy and processes we received status reports issued by the Treasury describing actual consultation efforts and

the results. We were not given and could not find a formal written policy. For procedures we were informed by the Indian Tribal Government staff that procedures vary based on the type of issue and we received nothing in writing.

We had hoped that our review of and detailed report about how the Service handles issues related to Indian tribes, including the process for Service review of tribal tax implications, would have resulted in a report that would improve the relationship between the Service and Indian tribes and help to reduce the diversity of understanding of tribal issues within the Service, in addition to assisting in the continued development of meaningful tribal consultation. Our original goals were to make recommendations to the Service on possible improvements to their tribal consultation practices and to educate tribes on how the process worked in order to promote a better working relationship between Indian tribes and the Service. Unfortunately, we did not receive the material necessary for such an analysis, therefore our report must conclude with a speculative opinion of the reasons for the reasons why a compliant Treasury and the Service tribal consultation policy does is not currently in place. We are disappointed we did not receive the information necessary for us to achieve all of the goals of our report.

While our assessment is that essentially none of the recommendations of the previous five ACT ITG reports on tribal consultation have been fully implemented by the Service or Treasury, we are optimistic that the Treasury and Service is beginning a slow but steady turn towards compliance with the Presidential mandates for meaningful tribal consultation, the government-to-government relationship and the trust obligation. It is apparent to us that the expertise of the Service's ITG is too often not involved or does not enjoy the weight properly afforded subject matter experts when the Service makes decisions on issues implicating tribes. Such decisions are made without the benefit of an ongoing relationship between the Service and Indian tribes or guidance from an advisory committee of tribal leaders. The Service benefits greatly from relationship programs established with practitioners in various tax-related communities of interest,

such as with tax preparers, tax exempt bonds, retirement plans and exempt organizations. It is puzzling why no such outreach occurs with Indian tribes, and ITG is limited to compliance, enforcement, and the most rudimentary of education programs.

A meaningful tribal consultation need not be lengthy, but it should exist as a written guidance adopted by the Treasury and Service for compulsory implementation. In fact, we recommend the policy be quite short. The Treasury and the Service need only adopt in its internal regulations and guidance that it will consult with Indian tribal governments prior to undertaking any action on matters with tribal implications that could have a substantial effect on an Indian tribal government or its citizens as a government-to-government consultation, and in compliance with Presidential mandates. This policy need only add a trigger mechanism, an implementation process and accountability measures. Most federal agencies have already adopted similar policies that are compliant with the Presidential mandate. Some, like the Department of Health and Human Services have implemented tribal consultation policies with advisory committees to the Secretary and outreach to Indian tribal governments. The Treasury and the Service must, however, reconcile its aversion to tribal sovereignty and the exercise of expectation rights with its apparent concern over the general application of the Internal Revenue code. A policy to consult with tribal governments is only compliant when the sovereignty, governmental authority and jurisdiction of Indian tribal governments are accepted and respected. The beneficial effect of a compliant and meaningful tribal consultation policy is it will build trust and create strong working relationships with Indian tribal governments, and promote effective administration of tax policy by the Service and Treasury. This committee believes that the time has come for Indian tribal governments and Service to expand their relationship beyond compliance issues by implementing meaningful tribal consultation as a sound business practice that strategically deals with the complex tax issues facing Indian tribal governments and the federal government.

In closing, we thank Service ITG Director Ms. Christie Jacobs and her expert staff for their Sisyphean efforts on behalf of our committee and for their work every day offering assistance to Indian tribal governments. We expect the disappointment expressed by our report will raise questions among the Service and Treasury. We recommend such questioners listen to Ms. Jacobs as your internal resource on tribal consultation and on matters with tribal implications, and we offer ourselves and past committee members for a detailed discussion on the subtler nature of our report. And we strongly recommend, for the third time in the past three reports, the establishment of a tribal advisory committee in the office of the Secretary and Commissioner.

II. Introduction

Meaningful tribal consultation prior to action on issues with tribal implications is mandated for the Internal Revenue Service (the Service) by Presidential memoranda and executive orders. As fast as tribes build strong economies on and off reservation, the Department of Treasury (the Treasury) and the Internal Revenue Service (the Service) find areas of confusion, inconsistency, and need for clarification in applying the Internal Revenue code to tribes and their citizens. In 2009 President Obama extended the mandate for tribal consultation with Indian tribes when he committed to his agencies providing "complete and consistent implementation of Executive Order (EO) 13175."

Executive Order 13175, signed by President Clinton in 2000, mandated that governmental agencies consult with tribes when formulating or implementing policies having tribal implications. Tribal consultation is at the very root of the government-to-government relationship between Indian tribes the United States (US) federal government. Decisions by the federal government that affect tribal governments cannot be made in a vacuum. Tribal input is imperative. The United States Department of Treasury (the Treasury) has aspired to consult with tribes on tax issues. However, tribes believe the respectfulness, effectiveness, and integrity of these processes fall short of meaningful tribal consultation. Tribes believe the Treasury and Service must improve their tribal consultation processes and procedures in order to come into compliance with Presidential requirements.

In a 2010 report issued to Office of Management and Budget (the OMB), as an annual requirement of President Obama's 2009 memorandum, the Treasury stated its commitment to "the establishment of a comprehensive consultation process leading to meaningful dialogue with Indian tribes on Treasury policies that have tribal implication." The Treasury recognized that issuing policies, regulations or establishing administrative actions without a prior understanding of how its processes would affect tribes was not efficient or effective. The Treasury also recognized that each of its bureaus had a

unique relationship with tribes and, therefore, each should have its own consultation procedure. The Treasury identified key concepts that should be addressed in any consultation procedure: (1) timely identification of matters that may require tribal consultation; (2) timely processes for determining whether consultation is required; and (3) ongoing proactive tribal consultation processes. However, we can find no final written policy or process established by the Treasury, nor any formal, cohesive procedures established by the Service. A form of consultation does occur, and in some cases has been effective, however if it does not constitute meaningful tribal consultation pursuant to the Presidential mandate. The National Taxpayer Advocate and the Inspector General both issued reports critical of the Service regarding procedural deficiencies in substantial agreement with tribes' concerns.

There are various forms of consultation, such as informal, bilateral, early, and formal. The Service's interpretation of tribal consultation is currently implemented predominately through listening sessions and notices addressing actions already taken by the Service, and with dialogue noticeably absent. Presentations to tribal leaders at inter-tribal organization summits have not concerned prospective actions and have not addressed tribal consultation processes. The Service notices forthcoming listening sessions via e-mail from IRS ITG staff, postings on ITG websites, and mass e-mailings from inter-tribal organizations. Sessions are scheduled for 1 to 2 hours and normally follow a format with an introduction of the topic, the Service's description of the "how and why" of their prior ruling, determination, and/or guidance, and then accept statements from tribal representatives. Though the Service does not attempt to explain their prior actions or rationale for prior action, often Service representatives cite ongoing disputes that preclude them from answering questions from tribal representatives. The Service has offered the opportunity for Tribes to comment on proposed guidelines resulting from the Service's prior actions. These comments from tribes provide the Service with opinions, recommendations for changes, and insight into the consequence

of prior Service actions. To date, this process has not been expanded to address prospective Service actions.

For tribal consultation to be meaningful, it must occur prior to Service action. The Service's pending final guidelines resolving problems with its application of the General Welfare Exclusion policy is an example. Overzealous IRS audits, exams and compliance checks caused Indian tribes to question the Service's authority to tax benefits to tribal citizens and to seek the support of Congress in rolling back a program that disproportionately harmed the neediest of tribal citizens. Components of tribal consultation ensued, but without consultation prior to Service action, it was not fully compliant with the Presidential mandate. The Service's ITG personnel attended numerous inter-tribal organization conferences and meetings to listen to tribal leader comments. Numerous tribal leaders conference calls were conducted. Written comment periods were noticed and extended. A provisional General Welfare Exclusion (GWE) guidance was issued that excluded from individual income many of the payments and benefits pursuant to the assertions of tribes. Although several GWE provisions were incongruent with the real-life experience of tribal citizens, a final revised guidance is expected to be issued with sensible corrections requested by Indian tribes.

However, three concerns persist. First, that GWE guidance will be subject to a future administration with different priorities that could easily re-write guidance to return to the former ill-advised GWE policies. Second, that the Service fails to acknowledge inherent tribal sovereignty in Indian tribal government jurisdiction over internal tribal affairs by implementation of a tribal general welfare doctrine. And third, that the Service did not adopt as a GWE best practice implementation by a rebuttal presumption in favor of a general welfare exclusion when promulgated under a tribal general welfare plan. The overriding concern is the Service cannot be deemed to be compliant with the Presidential mandate for tribal consultation through a government-to-government relationship when it does not acknowledge the governmental authority of tribal governments. However, this example of success through even limited application of the

tribal consultation procedure demonstrates the benefit of the policy for the Service, provided there is a serious commitment by the Service to listen to tribal governments before taking action and to respect the authority of Indian tribal governments.

Even in the Service's limited and partial application of tribal consultation procedures after Service action rather than prior, most tribes believe the current tribal consultation procedures have improved significantly over the past 4-5 years. Tribal comments to the GWE notices revealed most tribes prefer face-to-face consultation over conference calls, and interactive dialogue over listening sessions. Tribes are most concerned the decision-making process within the Service is entirely opaque, that Service decision-makers do not understand tribal issues, that tribal leaders have no access to decision-makers, and Service tax counsel has limited training or experience in Indian law and do not rely upon the expertise available in ITG. These deficiencies can be easily remedied should the Service fully embrace the Presidential mandate for meaningful tribal consultation. Most important, tribes believe tribal consultation prior to Service action would eliminate the added workload required to resolve the controversies and litigation caused by ill-advised policies enforced without the benefit of consultation.

In addition to the need for meaningful tribal consultation, it is also imperative that clear, concise and detailed communications occur between Treasury, the Service, and tribes. The process that the Treasury and Service use in setting policy is, apparently, a secret, because it is not disclosed despite repeated requests. Even the Service does not hold a uniform opinion on the tribal implications of the Internal Revenue code and regulation. And the Service has a diversity of opinion about the consequence of Service actions regarding Indian tribes. The Service does not offer any guidance tribes may rely upon to understand the consequence on tribal interests of a ruling, guidance, or determinations. Transparency for processes and procedures is critical to meaningful tribal consultation and a government-to-government relationship pursuant to the federal trust obligation.

Tribes do not either know of or understand the process used by the Service for determining priorities for enforcement or compliance projects. In the research phase of this project the ACT members became aware of notice in the Code of Federal Regulations (CFR) asking for input into what projects Treasury and the Service should address in upcoming actions. Few Indian tribes have seen this notice due to inadequate Service outreach and education programs. An effective outreach and education program is imperative if meaningful tribal consultation is to be achieved.

It is so incumbent upon tribes to participate. Tribes will participate if the Service provides educational opportunities and outreach programs. Tribes are eager to understand the authorities and practices of the Treasury and the Service, and a reciprocal interest should be held by Treasury and Service officials.

Budget constraints are limiting the effectiveness of tribal consultation. The Treasury and Service, as well as Indian tribes, are experiencing significant budget decreases. Cuts to travel budgets have required many consultation sessions to be held “virtually” by way of webinars and conference calls. These limit face-to-face contact, which decreases tribal participation .

The Service’s commitment to meaningful communication is of upmost importance. As tribal government gaming enterprise revenues “level” off it will become ever more important for Tribes to diversify and find other economic development opportunities. Those opportunities will require business structures unique to tribal governments, that appropriately monetize available tax-exempt advantages, improve access to capital and apply tax treatments particular to tax exempt bond financing. The Service must understand these issues and, in exercising its trust obligation to Indian tribes, must defer to tribal government authority and act in the best interests of their trust beneficiaries, the Indian tribal governments. Self-governance and self-determination of

Indian tribal governments depends on this government-to-government relationship and trust obligation.

Comprehensive tax reform could help or harm Indian tribes. Executive Order 13175 states that tribes must be consulted with if an agency is taking action that has a direct effect on Indian tribal governments or its tribal citizens. Much too often, the indirect effect on Indian tribes and their tribal citizens is not afforded the same attention. Recognizing the potential for indirect but significant impacts on tribes during the writing of laws and prior to the promulgation of regulations is a best practice preferred to trying to “fix” the situation after laws have been enacted or regulations promulgated. Such forward-looking analysis was done during the development of the Affordable Care Act (ACA), although the Service failed to appropriately interpret the exclusion of benefits to tribal member from individual income for non-prescription medicines, and once again was require to later remedy its misstep.

Tribes appreciate current Treasury and Service ITG efforts to improve tribal consultation process and procedures, although full compliance with the Presidential mandate is not yet achieved. Trust is being built with current ITG personnel. It is our hope that the 2014 ACT report will provide insights into the status of current tribal consultation processes and procedures, recommendations on measures for improvement, and opportunities for improvements in education, outreach and communications.

III. History

The analysis in this section of our report is tribal consultation "promulgated by executive agencies – independent of statutory mandate or authority – primarily pursuant to the government-to-government federal tribal relationship policy of" President Obama and prior administrations back to President Johnson, and may include "unpublished policies which govern the internal management of bureaus and agencies."[1]

The conflicts between agencies' Federal trustee responsibilities and their perceived mission has clouded the interpretation of tribal consultation for certain federal agencies[2], which we assert includes the Department of Treasury and Internal Revenue Service.

Current IRS Procedures

The following is the Internal Revenue Tribal Consultation Procedures as they appear on IRS's Indian Tribal Government webpage.[3]

Consultation Procedures

Numerous Presidential Executive Orders set forth guidelines for all federal agencies to establish regular and meaningful consultation and collaboration with Indian Tribal Governments in the development of federal policies that have tribal implications; and to strengthen the United States government-to-government relationships with Indian Tribes. The Internal Revenue Service worked with tribal governments to develop procedures that, in the spirit of those directives, include the scheduling of periodic Consultation listening meetings. Those meetings allow federally recognized tribal governments the opportunity to raise issues of concern and offer suggestions. Tribes may also request one-on-one Consultation meetings should they wish to discuss

[1] Haskew, Supra note 21 at 25.
[2] Getches, Supra note 73 at 343.
[3] http://www.irs.gov/Government-Entities/Indian-Tribal-Governments/Consultation-Procedures

particular matters privately. The following guidance and information outlines the procedures for these mechanisms.

Listening Meetings

The office of Indian Tribal Governments conducts Consultation Listening meetings, which afford tribal and village representatives the opportunity to raise questions, and to offer suggestions on methods to enhance federal tax administration for tribal and village governments. Up to four such meetings are held each year in various locations throughout the country, and are announced on this web site and in ITG News. In addition, the federally-recognized tribes in the area of each meeting receive a direct mailing to the tribal leader.

Issue-Based Consultation

An Indian Tribe or group of Indian Tribes may request consultation on any issue or IRS action that may impact, or is impacting such governments. An Indian Tribe may also request consultation where it desires to seek the input of the IRS on the potential federal tax consequences of economic opportunities, local laws, agreements, or similar matters that may affect, or be of interest to, the Indian Tribe. Issue-based consultation will not result in a formal ruling from the IRS, but can be helpful as tribes determine whether they want to pursue a more formal process.

All such requests may be submitted to the Director of the office of Indian Tribal Governments at any time by e-mail.

The IRS tribal consultation procedures are shown in full in this report because it is barely over half a printed page in length. Brevity itself does not mean insufficiency, however, these procedures contemplate but two forms of consultation. One is Tribal Consultation Listening meetings of up to four meetings per year, which affords tribal representatives the opportunity to raise questions and offer suggestions. The other is

issue-based consultation upon the request of an Indian tribe or group of tribes, which, however, will not result in a formal ruling from the IRS.

The Treasury Tribal Consultation Process is described in its annual progress reports to the Office of Management and Budget in 2010, 2011 and 2013.

The History and Requirements of Tribal Consultation

President Barack Obama's Memorandum for the Heads of Executive Departments and Agencies, 74 Fed. Reg. 57881, Nov. 5, 2009 (hereinafter 2009 Presidential Memorandum) established "consultation" as the Obama Administration's approach to federal Indian policy. Gabriel S. Galanda[4] accurately characterized the implementation of this policy as federal agencies engaging tribes in tribal consultations *on tribal consultation*, and affirmed by the Bureau of Indian Affairs (BIA) "dear tribal leader" letter dated November 23, 2000 that "takes this directive very seriously."[5]

The President's 2009 Memorandum sets the stage of our examination of the history of tribal consultation, the implementation of the 2009 Presidential Memorandum by federal agencies other than Treasury and IRS, and the implementation by Treasury and IRS with its problems and deficiencies. Finally, we will analyze a model tribal consultation plan that we recommend as the subject for consultation with tribes in order to fully satisfy the 2009 Presidential Memorandum.

The Trust Relationship. The second Indian law decision of the Marshall Trilogy was *Cherokee Nation v. Georgia*,[6] which decided whether the Supreme Court had jurisdiction to hear the Cherokee's claim as a foreign nation, under Article 3, Section 2 of the U.S. Constitution. The Supreme Court decision was the Cherokee Nation is not a foreign nation, because of the U.S. Constitution's "Indian Commerce Clause"[7] that the

[4] Galanda, p. 1.
[5] http://www.bia.gov/idc/groups/public/documents/text/idc002746.pdf
[6] 30 U.S. 1 (1831).
[7] U.S. Const., art. 1, § 8 ("The Congress shall have Power To regulate Commerce with

Court interpreted to give Congress the power to manage the United States' affairs with the Indian tribes. Chief Justice Marshall's argument in support of this finding as questionable legal reasoning is not for this discussion. Accepting Chief Justice Marshall's ruling as precedential law, Indians are not foreign nations, but are referred to as "domestic dependent nations" or tribal nations who have accepted the protection of the United States, yet still retain tribal sovereignty.

Chief Justice Marshall, reflecting the context of the Court's ruling, considered Indians to be "savage," and in need of receiving the gift of civilization from the white man. Indians are in a "state of pupilage" and the U.S. acts as a guardian to award.

Two doctrines result from this state of pupilage: (1) the "duty of protection," and (2) the "guardian/ward relationship." The duty of protection means that the U.S., because it asserts ownership over Indian lands, must protect the Indians. The guardian/ward relationship means that the U.S. holds all land and resources in trust for the Indians: a fiduciary duty. That is why in modern times we call it the "trust relationship." Because the U.S. has a trust relationship with the Indians, the U.S. must keep the best interest of the Indians in mind when the federal government deals with the Indians. The trust relationship is perhaps the most pervasive and important doctrine in Indian law.[8]

Meetings Between All Tribes and the President: Six in 225 Years. The tribal nations summit in November 2009 was the first meeting between tribal leaders and the President since President Clinton invited tribal leaders to witness the signing of a memorandum to heads of a memorandum to heads of executive departments and agencies to strengthen the government-to-government relations with Native American Tribal Governments on April 29, 1994, which was the first time the elected leaders of all the nation's federally recognized Indian tribes had been invited to meet with a President. Prior to 1994, the only similar instance was President Monroe's invitation to Indian

foreign Nations, and among the several States, and with the Indian Tribes. . .").

[8] The Marshall Trilogy, Tribal Government Leadership Forum. http://outreach.asu.edu/tglf.

leaders to a peace summit at the White House in 1822; however, the Indian delegation was forced to remove their traditional clothing for military uniforms, and this only added to brewing tensions. A President and all tribal leaders did not meet as governments for another 172 years.[9] [10] [11] Since President Washington's first election in 1789, or 225 years and 44 Presidents, all Indian tribes' leaders have met with two Presidents on six occasions, once with President Clinton in 1994, and five times with President Obama in 2009 to 2013.

Tribal consultation as one of the cornerstones of federal Indian policy did not begin with President Obama in 2009. President Lyndon B. Johnson's "Special Message to Congress on the Problems of the American Indian: 'The Forgotten American,'" is dated March 6, 1968 (1 Pub. Papers 336) (Mar. 6, 1968).

President Nixon articulated a policy firmly resolved to "break decisively with the past and recognized the need to build upon the capacities and insights of the Indian people." President Nixon announced a new era wherein, "this, then, must be the goal of any new national policy toward the Indian people: to strengthen the Indian's sense of autonomy without threatening his sense of community", and proposed that the "Federal government and the Indian community play complementary goals."[12] [13]

President Jimmy Carter in establishing the Assistant Secretary of Indian Affairs on September 26, 1977 affirmed President Nixon's Indian policy by requiring the federal

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[9] Maureen Hicks, "Past Meets Present: Infusing the Tribal Federal Consultation Process with Visions from Encounter Era Diplomacy and Present Day International Instruments", 2001; School of Law Library – University of New Mexico.

[10] Paul Shakovsky, Clinton to Talk: Hope and Skepticism to Greet Today's Gathering. Seattle-Post Intelligencer, A1 (April 29, 1994).

[11] Marla Williams, Native American Leaders Going to White House – First Meeting in 172 Years not just a Photo Opportunity. The Seattle Times, A1 (April 26, 1994).

[12] Maureen Hicks, "Past Meets Present: Infusing the Tribal Federal Consultation Process with Visions from Encounter Era Diplomacy and Present Day International Instruments", 2001; School of Law Library – University of New Mexico.

[13] Francis Paul Prucha, Documents of United States Indian Policy, President Nixon, Special Message on Indian Affairs, July 8, 1970, 256-257 (2000).

government “administer the laws, functions, responsibilities, and authorities related in Indian affairs matters.”

President Reagan in his Indian Policy Statement on January 24, 1983 stated, ”This administration honors the commitment this nation made in 1970 and 1975 to strengthen tribal governments and lessen federal control over tribal governmental affairs.”

President George H.W. Bush in his Statement on Indian Policy on June 14, 1991 promised, “This is now a relationship in which tribal governments may choose to assume the administration of numerous federal programs pursuant to the 1975 Indian Self-Determination and Education Assistance Act. This is a partnership in which an Office of Self-Governance has established in the Department of the Interior and given the responsibility of working with tribes to craft creative ways of transferring decision-making powers over tribal government functions from the Treasury to tribal governments.”

In 1994 the special relationship that exists between the U.S. government and federally recognized Indian tribal governments was acknowledged in a Presidential Memorandum signed by President Clinton, which stated that federal agencies should respect the legal status of federally recognized tribes as sovereign nations and operate within a government-to-government relationship when dealing with those sovereign tribal governments (59 Fed. Reg. 22951-22952; April 29, 1994). As cited in that memorandum, the legal basis for this special relationship is rooted in “the Constitution of the United States, treaties, statutes, and court decisions.” This government-wide policy was later updated by Executive Orders 13084 (63 Fed. Reg. CFR 27655; May 14, 1998) and 13175 (65 Fed. Reg. 67249-67251; November 6, 2000) and was most recently reinforced in 2009 by a Presidential Memorandum signed by President Obama (November 5, 2009).

Presidential Memorandum (April 29, 1994), Government-to-Government Relations with Native American Tribal Governments (59 Federal Register No. 85, 22951-22952). On April 29, 1994, President Clinton issued a memorandum affirming the federal government's commitment to respect the legal status of federally recognized tribes as sovereign nations and to operate within a government-to-government relationship with federally recognized tribes. The memorandum directs each executive department and agency to consult "to the greatest extent practicable and to the extent permitted by law, with tribal governments prior to taking actions that have substantial direct effects on federally recognized tribal governments."

Executive Order 13007 (1996), Indian Sacred Sites. This executive order pertains to the preservation of tribally acknowledged sacred sites. Stipulations include provisions for tribal access to such sites located upon federal lands and efforts to circumvent potential disturbances to these sites.

Executive Order 13084 (1998), Consultation and Coordination With Indian Tribal Governments. This EO was issued as a supplement to the Presidential Memorandum dated April 29, 1994. It affirms government policy to establish regular and meaningful consultation and collaboration with Indian tribal governments in developing regulatory practices on federal matters that significantly or uniquely affect their communities, to reduce the imposition of unfunded mandates on Indian tribal governments, and to streamline the application process for and increase the availability of waivers to Indian tribal governments. Each federal agency was instructed to have an effective process to permit elected officials and other representatives of Indian tribal governments to provide meaningful and timely input in the development of regulatory policies on matters that significantly or uniquely affect their communities.

Executive Order 13175 (2000), Consultation and Coordination with Indian Tribal Governments. This executive order supersedes EO 13084. It seeks to establish consistent and meaningful consultation and collaboration with tribal officials in the

development of federal policies, including regulations, legislative comments or proposed legislation, and other policy statements or actions that have substantial direct effects on one or more Indian tribes, on the relationship between the federal government and Indian tribes, or on the distribution of power and responsibilities between the federal government and Indian tribes. The order directs each federal agency to "have an accountable process to ensure meaningful and timely input by tribal officials in the development of regulatory policies that have tribal implications."

Presidential Memorandum (September 23, 2004), Memorandum: Government-to-Government Relationship with Tribal Governments. This memorandum reiterated the Bush administration's Requirements for government-to-government consultation with Indian tribes, Eskimos, Aleuts, and Native Hawaiians are also found in a number of statutes and regulations.

Presidential Memorandum (November 5, 2009), Memorandum: Tribal Consultation. This memorandum requires executive departments and agencies to engage in regular and meaningful consultation and collaboration with tribal officials in the development of federal policies that have tribal implications and strengthen the government-to-government relationship between the United States and Indian tribes. Each agency was required to prepare a plan for implementing the policies and directives of EO 13175 in consultation with Indian tribes and tribal officials and provide annual progress reports on the status of implementation.

In 2009 the White House–Indian Affairs Executive Working Group, Consultation and Coordination Advisory Group compiled a list of these legal authorities along with related policy statements, advisory documents, and procedural documents that illustrate the increasing emphasis placed on developing and maintaining proper consultation. This *List of Federal Tribal Consultation Statutes, Orders, Regulations, Rules, Policies,*

INDIAN TRIBAL GOVERNMENTS

Manuals, Protocols and Guidance[14] includes a summary list of government-wide statutes, regulations, orders, and memoranda that require tribal consultation along with others governing the activities of two or more federal agencies, which also references policies and procedural guidelines on a departmental basis.

[14] List of Federal Tribal Consultation Statutes, Orders, Regulations, Rules, Policies, Manuals, Protocols and Guidance.

IV. Due Diligence

A Review of Current Treasury Tribal Consultation Process and IRS Tribal Consultation Procedures

The IRS tribal consultation procedures are based upon the Department of Treasury consultation plan and progress report required by Presidential Memorandum dated November 5, 2009, which requires the Treasury to implement the policies and directives of Executive Order 13175 (EO 13175)[15]. As stated by the Treasury in its 2013 "Treasury Department Progress Report to OMB on Tribal Consultation" (Treasury 2013 Progress Report)[16]:

EO 13175 requires agencies to establish a process to ensure tribal consultation is undertaken as required on policies and regulatory or legislative activities with tribal implications. Policies with tribal implications are ones that have substantial direct effects on one or more Indian tribes, on the relationship between the federal government and Indian tribes, or on the distribution of power and responsibilities between the federal government and Indian tribes.

The Treasury's 2010 "Tribal Consultation Progress Report" (Treasury 2010 Progress Report)[17] states as its tribal consultation guidelines, that are "in addition to the overarching Fundamental Principles stated in Section 2 of Executive Order 13175, three principles … guiding the development of the Treasury [tribal consultation] action plan":

- The Treasury Department is committed to the establishment of a comprehensive consultation process leading to meaningful dialogue with Indian tribes on Treasury policies that have tribal implications for such tribes, including those

[15] http://www.gpo.gov/fdsys/pkg/WCPD-2000-11-13/pdf/WCPD-2000-11-13-Pg2806-2.pdf.
[16] Treasury Department Progress Report to OMB on Tribal Consultation, 2013.
[17] Tribal Consultation Progress Report, 2010.

policies that have a direct and identifiable economic impact on Indian tribes or preempt tribal law.

- Tribal consultation will assist Treasury in development of policy, regulation and legislative activities as it will increase Treasury's understanding of the issues and potential impacts of activities on tribes and American Indians and Alaskan Natives.
- The Treasury Department is also committed to developing and issuing regulations and guidance in a timely and efficient manner.

The Treasury commits to its establishment of a “comprehensive consultation process” through “meaningful dialogue” with tribes for Treasury policies that have “tribal implications” and have a “direct and identifiable impact” on tribes or “preempt tribal law.” The Treasury’s definition and use of “tribal implications” is a derivative but diluted interpretation of EO 13175 definition of “tribal implications” that is an apparent attempt to weaken the definition and its use in the Treasury’s consultation policy and procedures.

The EO 13175 in Section 1.(a) defines policies that have tribal implications as: “…regulations, legislative comments or proposed legislation, and other policy statements or actions that have substantial direct effects on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes.”

EO 13175 in Section 2 defines the Fundamental Principles of tribal consultation that agencies must follow in formulating or implementing policies that have tribal implications:

(a) The United States has a unique legal relationship with Indian tribal governments as set forth in the Constitution of the United States, treaties, statutes, executive orders, and

court decisions. Since the formation of the Union, the United States has recognized Indian tribes as domestic dependent nations under its protection. The federal government has enacted numerous statutes and promulgated numerous regulations that establish and define a trust relationship with Indian tribes.

(b) Our nation, under the law of the United States, in accordance with treaties, statutes, executive orders and judicial decisions, has recognized the right of Indian tribes to self-government. As domestic dependent nations, Indian tribes exercise inherent sovereign powers over their members and territory. The United States continues to work with Indian tribes on a government-to-government basis to address issues concerning Indian tribal self-government, tribal trust resources, and Indian tribal treaty and other rights.
(c) The United States recognizes the right of Indian tribes to self-government and supports tribal sovereignty and self-determination.

EO 13175 in Section 3 defines agencies additional Policymaking Criteria which agencies must adhere to when formulating and implementing policies that have tribal implications (defined in EO 13175 Section 2):

(a) Agencies shall respect Indian tribal self-government and sovereignty, honor tribal treaty and other rights and strive to meet the responsibilities that arise from the unique legal relationship between the federal government and Indian tribal governments.

(b) With respect to federal statutes and regulations administered by Indian tribal governments, the federal government shall grant Indian tribal governments the maximum administrative discretion possible.

(c) When undertaking to formulate and implement policies that have tribal implications, agencies shall:

(1) encourage Indian tribes to develop their own policies to achieve program objectives;
(2) where possible, defer to Indian tribes to establish standards; and
(3) in determining whether to establish federal standards, consult with tribal officials as to the need for Federal standards and any alternatives that would limit the scope of Federal standards or otherwise preserve the prerogatives and authority of Indian tribes.

EO 13175 in Section 5 requires agency consultation processes be an accountable to tribes such that no agency shall promulgate any regulation that has tribal implications that: “imposes substantial direct compliance costs on Indian tribal governments, and that is not required by statute” unless specific conditions are satisfied (Section 5.(b)(1)&(2)); or that preempts tribal law unless the agency “prior to the formal promulgation of the regulation” consults and communicates with tribes, and involves the OMB (Section 5.(c)(1)-(3)); and uses consensual mechanisms for developing regulations, including negotiated rulemaking (Section 5(d)).

EO 13175 Fundamental Principles of tribal consultation the government-to-government relationship with Indian tribes set forth in the Constitution of the United States, treaties, statutes, executive orders, and court decisions, and the trust relationship. Appropriate emphasis is placed on the right of Indian tribes to self-government and to exercise inherent sovereign powers over their members, territory, tribal trust resources, and the duty of agencies to respect Indian tribal treaty and other rights, and the right of Indian tribes to self-government through support for tribal sovereignty and self-determination.

Further, agencies must grant Indian tribal governments the maximum administrative discretion, encourage Indian tribes to develop their own policies to achieve program objectives, defer to Indian tribes to establish standards and otherwise preserve the prerogatives and authority of Indian tribes.

Finally, agency consultation processes be an accountable to tribes, and agencies must not promulgate any regulation that has tribal implications that imposes substantial costs on tribes or is not required by statute, or that preempts tribal law, unless the agency first consults and communicates with tribes and uses consensual mechanisms for developing regulations, including negotiated rulemaking.

The Treasury acknowledged the importance of tribal sovereignty in its Treasury 2013 Progress Report[18] acknowledges that tribes stress the importance of tribal sovereignty in tribal consultations and the government-to-government relationship, and that the "Treasury Department has taken these matters seriously."[19] However, nowhere in the Treasury Progress Reports of 2010, 2011 or 2013 does the Treasury define a consultation process that implements procedures that respect tribal sovereignty or affirm the government-to-government relationship. The ACT ITG Report of 2012[20] in Section IV and Report of 2013[21] in Section III both emphasized the IRS's failure to acknowledge and respect tribal sovereignty and self-determination or the government-to-government relationship as a reason for its inappropriate actions regarding the general welfare exclusion policy. Both the 2012 and 2013 ACT ITG Reports offered specific recommendations to the Treasury and IRS that, if adopted, would provide for full compliance with the requirements and intent of EO 13175. The IRS has greatly remedied its failures in the general welfare exclusion policy by its issuance of Notice 2012-75 and forthcoming final guidance that are the product of consultation with tribes. However, the Treasury and IRS continue to avoid acceptance of the government status of tribes and the government-to-government relationship with Indian tribal governments, or respect for tribal sovereignty and self-determination, or trust responsibility that is

[18] Treasury Department Progress Report to OMB on Tribal Consultation, 2013, p. 2.
[19] Id.
[20] Indian Tribal Governments: Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members; Advisory Committee on Tax Exempt and Government Organizations; Pearson, Micklin, Easterling; June 6, 2012.
[21] Indian Tribal Governments: Supplemental Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members; Easterling, Gange, Micklin; September 12, 2013.

demanded by EO 13175, the Presidential Memorandum of 2009, and the US Constitution, statutes, regulations, federal Indian policy, and court precedents.
The Treasury 2013 Progress Report asserts its tribal consultation is predicated on respect for tribal sovereignty.[22] How then, do the Treasury's tribal consultation process and the IRS tribal consultation procedures stand up to the requirements of EO 13175?

Treasury and IRS Lack of Compliance with Tribal Consultation Requirements and Adoption of Recommendations

The general consensus among tribal leaders is the Treasury and IRS have not established a formal tribal consultation policy, plan or process. In Gabriel S. Galanda's seminal article on tribal consultation he reports, "…a year after President Obama issued the 2009 Presidential Memorandum, with much federal and tribal fanfare, several federal agencies have yet to honor the President's mandate that they provide a written tribal consultation plan within ninety days from the issuance of that Memorandum. Some of those offending agencies include, not surprisingly, those which increasingly commence inquests of tribal governments and enterprises per so-called federal laws of general applicability."[23] We will examine the effect of laws of general applicability on tribal consultation later in this report.

Each Treasury Tribal Consultation Report (2010, 2011 and 2013) establishes the Deputy Assistant Secretary for Policy Coordination in the Office of Economic Policy as the Point of Contact for Tribal Consultation (POCTC). The Treasury 2013 Tribal Consultation Progress Report reported Dr. Elaine Buckberg serves as the POCTC. In the Self-Governance Advisory Committee meeting in Washington, DC in January of 2014 a member of this ACT ITG committee asked Dr. Buckberg when the Treasury and Treasury would formally establish a tribal consultation policy. Her response was that the Treasury had established a tribal consultation process by its Treasury 2010 Tribal

[22] Treasury Department Progress Report to OMB on Tribal Consultation, 2013, p. 2.
[23] Gabriel S. Galanda, *The Federal Indian Consultation Right: A Frontline Defense Against Tribal Sovereignty Incursion*, footnote 3, p. 1.

Consultation Progress Report, with successive reports to OMB in 2011 and 2013, and the IRS Tribal Consultation Procedures were established in Appendix E to the 2010 report. This view was not shared by tribal leaders and tribal staff at this meeting, not by the members of this ACT ITG committee, and not by any of the large number of tribal leaders we have talked with since January 2014.

Appendix E to the Treasury 2010 Tribal Consultation Progress Report is a Memorandum for Aaron Klein, former POCTC, from Ms. Sarah Hall Ingram, Commissioner for Tax Exempt and Government Entities, with the subject of "Summary of Internal Revenue Service Tribal Consultation Review", dated July 27, 2010 (Ingram Memorandum). The Ingram Memorandum responded to a Memorandum dated March 9, 2010 from Deputy Secretary Wolin that requested the IRS conduct a review of operations and initiatives for potential tribal implications, and this review would be part of the Treasury's effort to develop and implement a comprehensive consultation process. The Ingram Memorandum was a summary of the IRS review.

The Ingram Memorandum noted the ACT ITG issued a report on tribal consultation in 2002 that provided recommendations to the IRS for development and implementation of tribal consultation procedures using EO 13175 and other agency tribal consultation policies adopted pursuant to EO 13175. The Ingram Memorandum reported that although ITG accepted the recommendations and began a draft of consultation principles, formal procedures were never implemented, although principles developed in the process were utilized in ITG business practices.

Several of the findings in the Ingram report are extremely troubling. First, EO 13175 was issued in 2000, and nearly two years thereafter the Treasury and IRS were not compliant with the executive order, and remained non-compliant as of the date of the memorandum in 2010, and, in the view of this report, remains non-compliant today in

2014, nearly 14 years after issuance of EO 13175 and nearly five years after issuance of the President's Memorandum of 2009.

Second, although the Ingram memorandum notes the ACT ITG report on tribal consultation in 2002[24], it ignores the ACT ITG reports on tribal consultation in 2005[25] and 2008[26]. The ACT ITG reports in 2012[27] and 2013[28] also offered recommendations for tribal consultation. With this 2014 ACT ITG Report, six of the fourteen ACT reports will have focused on tribal consultation. Yet, by admission in the Ingram Memorandum, no recommendations were formally adopted as of 2010, and our current review of in 2014 no change.

Third, the Ingram memorandum disclosed the IRS review determined approximately one third of the issues related to Indian tribes have a lack of clarity regarding how a particular piece of tax authority applies to Indian tribes. The review noted a "diversity" of understanding across the IRS regarding matters with tribal impact, which we read as a lack of understanding by IRS officials, and reinforced the need to "craft procedures carefully."[29] The memorandum concludes with a recommendation to establish additional internal procedures and guidelines in place to ensure IRS compliance with "any consultation policy the Treasury adopts."[30] However, the lack of Treasury and IRS adoption of such tribal consultation processes and procedures compliant with EO 13175 and the President's Memorandum of 2009 marks this as an unfulfilled promise.

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[24] Indian Tribal Consultation Process, Advisory Committee on Tax Exempt and Government Entities (ACT); Gipps, Scheffier; June 21, 2002.
[25] Survey and Review of Existing Information and Guidance for Indian Tribal Governments, Advisory Committee on Tax Exempt and Government Entities (ACT); Gipps, Scheffier; June 8, 2005.
[26] Governmental Relationship and Communication Between the Internal Revenue Service and Indian Tribal Governments, Advisory Committee on Tax Exempt and Government Entities (ACT); Puzz Jr., Starnes, Streitz; June 11, 2008.
[27] ACT ITG Report 2012; Pearson, Micklin, Easterling; Section V.
[28] ACT Report 2013; Easterling, Gange, Micklin; Section V.
[29] Ingram Memorandum, p. 3.
[30] Ingram Memorandum, p. 3.

Fourth, the Treasury POCTC asserts Appendix E to the Treasury 2010 Tribal Consultation Progress Report, the Ingram memorandum, represents the IRS tribal consultation procedures. We printed in full the IRS "Tribal Consultation Procedures" above, which we noted was less approximately one half page in length and certainly not compliant with the requirements of the President's Memorandum of 2009 and EO 13175, also analyzed above.

The Treasury's Tribal Consultation Progress Reports are long on aspirational support for the principles of tribal consultation, but far too short on actual process or procedures that fully comply with the requirements of the President's Memorandum of 2009 and EO 13175.

Treasury and IRS Tribal Consultation Activities

A review of the Treasury's actions described in its Treasury 2013 Tribal Consultation Progress Report will determine if the policy deficiencies are matched by deficiencies in actions.

The Treasury's POCTC is reported to have held listening sessions and met with inter-tribal organizations, including the National Congress of American Indians (NCAI), the Native American Finance Officers Association (NAFOA), and the United Southern and Eastern Tribes (USET).[31] However, tribal leaders are disappointed the POCTC has not addressed the Treasury or IRS tribal consultation process or procedures at these or other meetings, and instead has addressed issues related to the Office of Small Business, Community Development, and Housing Policy, and the Native Initiatives Program of the Community Development Financial Institutions (CDFI) Fund. These are important issues, but do not rise to the important or priority of tribal consultation that tribal leaders view as unfulfilled by the Treasury and IRS.

[31] Treasury 2013 Tribal Consultation Progress Report, p. 3.

The progress report among topical consultation activities the General Welfare Exclusion (GWE) and per capita payments from proceeds of settlements of Indian trust cases (Proceeds from Trust). We wish to emphasize that the other activities reported were excellent examples of a positive Treasury tribal consultation process and IRS tribal consultation procedures that are direly needed by Indian tribes in ever greater frequency and for additional topics.

However, even though meaningful consultation finally did occur, the GWE and Proceeds from Trust are examples of IRS enforcement actions that began prior to any tribal consultation and were resolved only after prolonged tribal consultation sessions, and at considerable financial cost to both tribes and the IRS. Further, the fact that these enforcement actions proceeded despite the formal review of IRS issues related to Indian tribes reported in the Ingram memorandum, the GWE and Proceeds from Trust enforcement actions went forward, not only without tribal consultation, but without any advance notice to tribes. Further, tribal leaders reported that when Indian tribes with substantial numbers of tribal citizens affected by these enforcement actions requested tribal consultation from IRS, they were denied because the issues were pending enforcement actions.

Another example is the improper IRS attempt to tax Tribal health benefits, enacted as Section 139D to the Tax Code by Section 9021 of the Patient Protection and Affordable Care Act (PPACA) clarifying that the value of a broad range of Indian Health Care benefits received by Tribal members are excluded from gross income and therefore not taxable. The IRS has subsequently issued internal guidance interpreting non-prescription drug benefits to be outside the scope of non-taxable Indian Health Care benefits in contravention with the letter, intent and spirit of Section 139D of the Tax Code, which provides, in general, that gross income does not include the value of any qualified Indian health care benefit. The IRS imposed the tax requirement on tribal citizens prior to posting Frequently Asked Questions (FAQs) about new section 139D on

its website, and prior to seeking input from tribal leaders on these issues as well as any other tax related items related to the implementation of the Affordable Care Act during multi-agency Consultation sessions held in August and September of 2011. After tribal leader input, and Congressional support, the IRS revised its position to comply with the original intent of the legislation, which was that non-prescription drug benefits were not taxable for tribal citizens, however, this was not an example of a tribal consultation process or procedure.

The Treasury's 2010 to 2013 Tribal Consultation Progress Reports description of the tribal consultation process, and the IRS Tribal Consultation Procedures, rely heavily upon meetings with Indian tribes and tribal organizations. However, these meetings must be meaningful in the context of the tribal consultation requirement.

Meaningful consultation occurs (1) in advance, (2) with the agency decision-maker, (3) with authorized tribal representatives, (4) in a meeting, (5) with prior notification of the proposed action and justification of the agency reasoning, (6) wherein the tribe may support or reject the agency decision in accordance with tribal law or procedure.[32]

There is no process or procedure in Treasury or IRS tribal consultation that specifies these requirements. The prevailing view among tribal leaders is today consistent with the 1993 memorandum of the Navajo Nation, "The majority of agencies with which we are familiar do not distinguish between 'notification' and 'consultation,' and consider the former as adequate to meet their mandates for the latter. This neither meets the letter or spirit of the consultation requirements of the laws mandating consultation."

[32] Lower Brule Sioux Tribe v. Deer, 911 F. Supp. 395, 401 (D.S.D. 1995) (citing Hoopa Valley Tribe v. Christie, 812 F. 2d 1097 (9th Cir. 1987).

Reports Supporting the Lack of Tribal Consultation

The conclusions of this report that the Treasury tribal consultation processes and IRS tribal consultation procedures are not compliant with Presidential memoranda and executive orders find support in the Treasury Inspector General for Tax Administration Report Number 2013-10-018 dated January 28, 2013 (TIGTA Report)[33], and the National Taxpayer Advocate 2013 Annual Report to Congress in MSP#10 Indian Tribal Taxpayers: Inadequate Consideration of Their Unique Needs Causes Burdens (NTA 2013 Report).[34]

TIGTA Report. For many years Indian tribes asserted the IRS was engaged in misguided program of exams and audits of Indian tribal governments. The IRS consistently denied these assertions. However, the TIGTA Report found the IRS had implemented the Abuse Detection and Prevention Team (ADAPT), in contradiction to its representations. The TIGTA Report found fault in ADAPT in that it had not developed specific performance objectives and measures, and, as a result, TIGTA could not determine if the ADAPT is effective. TIGTA could not establish whether the ADAPT use of taxpayer funds provided a good return on investment. Tribes believe the results show this was not the case, given only four cases were referred to and accepted by IRS Criminal Investigation. The important issue is the IRS denied the existence of the program, and has not implemented tribal consultation procedures that would address potential fraud and abuse issues without the cost of the program to the IRS and the burden of the program, and associated proliferation of exams and audits on Indian tribal governments.

NTA 2013 Report. The National Taxpayer Advocate 2013 Annual Report to Congress identified as the Nation's most serious problem (MSP) number 10 the inadequate

[33] Treasury Inspector General for Tax Administration Report Number 2013-10-018.
[34] 2013 Annual Report to Congress, Taxpayer Advocate Service, MSP# 10, p. 30.

consideration of Indian tribal taxpayers' unique needs causes burdens on Indian tribes and tribal citizens.

In filing season 2013, the IRS wrongly flagged tax returns filed by Indian tribal members as fraudulent because they shared characteristics that the IRS has identified as indicators of fraud. Although the National Taxpayer Advocate's 2008 Annual Report to Congress applauded IRS outreach to Indian Nations as exemplary, the National Taxpayer Advocate found it is unclear if all IRS functions are responsive to Indian tribal member needs. In certain cases, the National Taxpayer Advocate found IRS operating divisions remain unaware of particular characteristics and needs of Indian taxpayers, which can lead to unnecessary contact with the IRS and unwarranted audits, tax assessments, or penalties.

The National Taxpayer Advocate found Indian tribes have a unique status in federal tax law. Indian taxpayers are confronted by IRS misunderstandings and delays relating to issues such as improper treatment of tribal distributions; presumed frivolous positions; Misunderstanding of Native American family structure; Ignorance of tribal sovereignty; and Delays in processing certain settlement awards.

The National Taxpayer Advocate found that while the IRS recently issued various pieces of guidance helpful to Indian individuals in the General Welfare Exclusion guidance (GWE), major projects remain outstanding, especially those applicable to tribal entities, and the resulting uncertainty can chill tribal enterprise, distorting the tribes' economic opportunities.

The National Taxpayer Advocate recommended the IRS should train all compliance employees about the culture and needs of Native American taxpayers, rendering assistance as required by this population, after consulting Taxpayer Advocate Service; establish a cross-functional working group on issues facing Indian individuals, parallel to

the IRS Indian Tribal Government (ITG) function that focuses on tribal entities; consult with the ITG function before implementing fraud filters or similar programs that could erroneously target Indian taxpayers; correct routine failure to comply with instructions from the ITG function concerning the needs of Indian taxpayers; and finalize guidance on tribal documentation of qualifying children, frivolous claim penalties, and other questions as they arise.

While the TIGRA Report and the TAS Report MSP #10 focus on specific issues, their findings and recommendations support the conclusions of this report.

An Analysis of the Possible Reasons the Treasury and IRS are Reticent to Adopt Formal Tribal Consultation Policies

This report will briefly explore the possible rationale for the Treasury and IRS to avoid adoption of tribal consultation policies compliant with the President's Memorandum of 2009 and EO 13175 despite the mandate of these orders, despite the aspirations of the Treasury Tribal Consultation Progress Reports, despite the recommendations of six of fourteen ACT ITG Reports, and despite many years of Indian tribes' and tribal leader testimony.

Laws of General Applicability. Galanda echoes the views of tribal leaders in his assertion that the IRS "assumes free reign over the promulgation and enforcement of their prerogative in Indian Country"[35] based on the view that "federal laws of general applicability are presumed to apply to tribes, even on trust and reservation land."[36] This view ignores that fact that under the Tuscarora-Coeur d'Alene analysis, statutes silent on applicability to Indian tribes apply in totality unless one of the three following exceptions applies: (1) the law touches "exclusive rights of self-governance in purely intramural matters"; (2) the application of the law to the tribe would "abrogate rights

[35] Ibid, p. 4.
[36] Ibid, p. 4.

guaranteed by Indian treaties"; or (3) there is proof "by legislative history or some other means that Congress intended [the law] not to apply to Indians on their reservations."[37] However, there is no indication this analysis is applied to Treasury and IRS issues with tribal implications.

Expectation Rights. A rational assumption is that the Treasury and IRS seek to avoid the establishment of expectation rights. Presidential executive orders impose procedural requirements on rulemaking by executive branch agencies, which "executive orders carry force and effect of law if they are issued pursuant to constitutional authority."[38] These executive orders do not "grant or vest any right to any party with whom the agency is thereby required to consult"[39]; however, "the promulgation of these policies, in conjunction with statutes such as the Indian Self-Determination and Education Assistance Act and a failure to carefully delineate internal policy from statutory duty, creates consultation expectations on the part of tribal members, which several courts have recognized amount to the creation of expectation rights."[40] Tribes may raise such expectation rights through the doctrine of trust responsibility and may argue that such rights should be protected from subsequent administrative actions that by effect impair or extinguish those expectation rights.[41]

Three court rulings provide a disparate range of outcomes in case law that derive from a tribe's claim that a federal agency process of tribal consultation violates its expectation rights for meaningful consultation and the federal trust responsibility.

Oglala Sioux Tribe v. Andres. In Oglala Sioux Tribe[42] the 8th Circuit Court decided the Bureau of Indian Affairs' (BIA) policy requiring its prior consultation with tribes in its

[37] *Donovan v. Couer d'Alene Tribal Farm.* 751 F. 2d 1113, 1116 (9th Cir. 1985).
[38] Legal Aid Soc. Of Alameda County v. Brennan, 381 F. Supp. 125 (N.D. Cal. 1974).
[39] Lower Brule Sioux Tribe v. Deer, 911 F. Supp. 295, 401 (D.S.D. 1995).
[40] Haskew, Supra note 21 at 32.
[41] Hicks, p. 18.
[42] *Oglala Sioux Tribe of Indians v. Andrus* 603 F. 2d 707 (8th Cir. 1979).

"Guidelines for Consultation with Tribal Groups on Personnel Management Within the Bureau of Indian Affairs"[43] created justified expectations on behalf of the Tribe that such a policy should be carried out, and that the BIA failed to do so. The court noted, "Failure of the Bureau to make any real attempt to comply with its own policy of consultation not only violates general principles governing administrative decision-making but also violates the distinctive obligation of trust incumbent upon government in its dealing with dependent and sometimes exploited people."[44] This "distinctive obligation of trust incumbent upon the government" was defined in the case of *Morton v. Mancari*[45] wherein the court held the Indian Reorganization Act of 1934 (IRA) mandates "giving to Indians a greater participation in their own self-government; the furthering of the Government's trust obligation toward Indian tribes; and the reduction of the negative effect of having non-Indians administer matters that affect Indian tribal life."[46] In the BIA's failure to follow its own tribal consultation policy, it not only violated administration decision-making principles, but it violated the trust doctrine."[47] Further, the court recognized agency processes which establish a lack of meaningful tribal consultation when allowing for a submission of views after an administrative decision is made is "no substitute for the right of interested persons to make their views known to the agency in time to influence the (administrative) process in a meaningful way."[48]

Hoopa Valley v. Christie. Looking at past cases determining the right of an Indian tribe to consult, *Hoopa Valley Tribe v. Christie* saw the Hoopa Valley Tribe seek an order to enjoin the BIA from transferring BIA office staff away from their reservation. In contract to Oglala Sioux Tribe v. Andrus[49], the court held the BIA's "Guidelines for consultation with Tribal Groups on Personnel Management within the Bureau of Indian Affairs",

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[43] 603 F. 2d 707, 717-719 (8th Cir. 1979). "These guidelines *** recognize the possible variations in scope and intensity of tribal consultation. It is incumbent on all Bureau managers to apply these guidelines to obtain maximum benefit from this relationship with tribal groups. We urge you to seek ways in which the guidelines can be used to accomplish the objectives of the consultation policy."
[44] 603 F. 2d 707, 721 (8th Cir. 1979).
[45] 603 F. 2d 707, 721 (8th Cir. 1979).
[46] 415 U.S. 199, 236 (1974).
[47] Hicks, p. 21.
[48] 603 F. 2d 707, 719 (8th Cir. 1979).
[49] 812 F. 2d 1097 (9th Cir. 1986).

although violated by the BIA in practice, did not have the force of law and were not the same as regulations that must be applied because "the rights of individuals are affected, as in the case of *Morton v. Ruiz*."[50] As analyzed by Maureen Hicks[51], the Guidelines were unpublished[52] and while giving direction to the Bureau, did not establish legal standards that could not be enforced against the BIA.[53] Even if binding, they could not be violated because "consultation is not the same as obeying those who are consulted."[54] In another court ruling defying the underlying facts, the court held there was no violation of the Administrative Procedures Act or of the underlying trust responsibility.[55]

Lower Brule Sioux Tribe v. Deer. The decision in *Lower Brule Sioux Tribe v. Deer*[56] the court issued a mandamus instructing the BIA to engage in meaningful prior consultation with the Tribe before issuing a notice for reduction in force to BIA employees on the reservation. The court noted the BIA had violated its own rules and regulations, and its trust and fiduciary obligations when it failed to provide the tribe meaningful consultation prior to the notices.[57] [58]

The BIA policy of consultation was a policy of tribal involvement in Indian programs and in the operation of activities providing services to Indian people.[59] However, while the Tribe argued the Presidential Memorandum of April 29, 1994 created an enforceable duty to consult, the court ruled this does not create such. Instead, executive orders without specific foundation in congressional action are not judicially enforceable in

[50] *Morton v Ruiz* 415 US 199, 235-236 (1974).
[51] Hicks, p. 23.
[52] 812 F. 2d 1097, 1103 (9th Cir. 1986).
[53] Id.
[54] Id.
[55] Hicks, p. 23.
[56] Lower Brule Sioux Tribe v. Deer 911 F. Supp 395 (D.S.D. 1995).
[57] 911 F. Supp. 395, 399 (D.S.D. 1995).
[58] Hicks, p 23.
[59] 911 F. Supp. 395, 398 (D.S.D. 1995).

private civil suits.[60] However, the court did hold the Presidential Memorandum was further evidence of BIA policy[61], and, together with the Administrative Procedures Act (APA) was sufficient to defeat the BIA's neglect of the consultation process.
The court defined the meaning of meaningful consultation as follows:

Consultation, as described by the tribal chairman, Michael B. Jandreau, would amount to a meeting between the superintendent of the Lower Brule agency and the Tribal council. Consultation has occurred in the past, which consultation comprised a one to two hour meeting, not more than one half day, during which meeting the superintendent notifies the council of the BIA's proposed action, justifying his reasoning. The Tribal Council may either issue a motion or resolution of support for the decision. Meaningful consultation means tribal consultation in advance with the decision maker or with intermediary's with clear authority to present tribal views to the BIA decision-maker. The decision-maker is to comply with BIA and administration policies.[62]

Morton v. Ruiz. In *Morton v. Ruiz,*[63] the Supreme Court held "it is essential that the legitimate expectations of these needy Indians not be extinguished by what amounts to an unpublished ad hoc determination of the agency.[64]

Lincoln v. Vigil. Reflecting on Morton, the court in *Lincoln v. Vigil*[65] the court mused that the action was "driven by an internal BIA procedure in the Indian Affairs Manual subjecting the agency to rulemaking procedures even when the APA did not require it.[66]

Northern Cheyenne Tribe v. Hodel. The court, in *Northern Cheyenne v. Hodel*[67] the court recognized contradictory court decisions of what remains enforceable in requiring

[60] Id.
[61] Id.
[62] 911 F. Supp. 395, 401 (D.S.D. 1995).
[63] 415 US 199 (1974).
[64] Id.
[65] 508 US 182 (1993).
[66] Id.

agencies to consult with tribes and the inherent conflict of interests for agencies in the process.[68] The court held "[T]he Secretary's conflicting responsibilities … do not relieve him of his trust obligations. To the contrary, identifying and fulfilling the trust responsibility is even more important in situations such as the present case where an agency's conflicting goals and responsibilities combined with political pressure asserted by non-Indians can lead federal agencies to compromise or ignore Indian rights."[69] These example cases show the disparate standards courts adopt in efforts by tribes to enforce a duty within the government to consult with tribes. Despite the variances in outcomes, these cases clearly define a meaningful consultation process that must take into account to provide the tribal consultation process with principles of trust, fairness and accountability.[70]

Summary of prior ACT reports and status of recommendations

This report reviewed current documentation regarding consultation for Treasury and the Service and compared it to EO 13175 and actual results of recent consultation opportunities. We also reviewed prior ACT ITG reports which addressed with this topic. Prior ACT ITG reports offered many good sound recommendations. We reviewed the current status of these recommendations as part of this report.

The first report[71] of the Indian Tribal Governments (ITG) subcommittee of the Advisory Committee on Tax Exempt and Governmental Entities (ACT) recommended a process for the Internal Revenue Service to develop a Tribal consultation policy. At that time, several departments and agencies of the federal government had adopted such and, although differing in many respects, all of these policies expressly acknowledged the unique government-to-government relationship that exists between the United States

[67] 851 F.2d 1152/(9th Cir., 03/15/1988, 07/11/1988).
[68] Hicks, p. 26.
[69] Id.
[70] Id.
[71] *See,* "ACT Tribal Consultation Policy", June 21, 2002 by David Mullon, Jayne Fawcett and Perry Israel

and each of the over 550 federally-recognized Indian tribal governments. It was during the first meeting of the ITG subcommittee of the ACT that the committee observed a formal Tribal consultation policy was lacking and adopted the matter as their first project. The 2002 report recommended 4 steps be followed in development of a tribal consultation policy.

The fourth report[72] of the ITG ACT acknowledged that the creation and staffing of the IRS ITG had been significant steps in increasing the understanding of tribal tax and tax-related issues by recognizing the basic principles of tribal sovereignty and conducting tribal outreach which opened the lines of communication leading to increased voluntary compliance.

However, the report conveyed that the ITG as well as the ACT recognized that substantial work was yet to be done and, even in the course of committee work for the annual report, it became apparent that enforcement efforts by the IRS coupled with a lack of progress on promulgation of past promised guidance, threatened to undermine the positive work that has been done by the ITG. This fourth project undertook the following efforts: 1) to review areas where guidance is currently inadequate, including areas where guidance had been under review or promised; 2) to review areas where new guidance was needed; 3) to recommend action in these areas, and 4) to identify and review current sources of web-based information for ITG customers and recommend ways to enhance presentation of this material to ensure greater understanding of the current IRS policy and recommend more consistency, transparency and communication to the tribal government community regarding the guidance process.

The 2005 report highlighted that the issuance of guidance had not kept pace with the speed of economic development initiatives in Indian Country and a strong need existed

[72] *See,* "ACT Survey and Review of Existing Information and Guidance for Tribal Governments", June 8, 2005 by Lenor A. Scheffler and Robert L. Gips

for guidance in the areas of tribal business structures and their taxability, stating, "The IRS has publicly stated for nearly a decade that initiatives to provide guidance in this area were under study or actively under study, but there is a marked lack of tangible progress."

Many ITG customers that were interviewed expressed a sense of frustration and even anger at the slow pace of IRS follow-through on existing guidance projects and these feelings were heightened by the belief that while the IRS failed to deliver promised guidance, it had been seen to be increasingly focused on enforcement (backed up by ITG work plans, overall Tax Exempt and Governmental Entities (TE/GE) new hiring and announcements regarding enforcement efforts). In discussions with TE/GE staff, Chief Counsel's Office and Treasury, it was conveyed that several factors contributed to the slow pace of producing new guidance: 1) lack of resources; 2) complexity of issues presented; 3) concern about precedential effect in seemingly unrelated areas; and 4) the fact that TE/GE is only one of the relevant members of the IRS working groups that must ultimately reach consensus on new guidance.

The seventh report[73] of the ITG ACT was an assessment of the state of the government-to-government relationships between Indian Tribal Governments and the IRS that was accomplished by input received from written surveys sent to all federally recognized tribal governments (and Navajo Chapters), written surveys sent to ITG specialists and their managers, direct input from the director of ITG and the authors' own experiences and that of other contacts at Tribal Governments and their tax advisors.

The report discussed IRS protocols in day-to-day dealings with Indian Tribal Governments, the selection and training, expectations and retention of ITG specialists

[73] "ACT Governmental Relationship and Communication Between the IRS and Indian Tribal Governments", June 11, 2008 by Dennis Puzz Jr., Sandra Starnes and Mary J. Streitz

and IRS ITG's work plan. The second half of the report focuses on consultation and communication methods of the IRS to tribes, tribal perspective on their relationship with the IRS as well as ITG employee's perspectives on IRS relationship with tribes.

At the heart of the matter was the IRS's long delay in adopting its own consultation policy as it informed the Tribes it was committed to during a nearly two-year process that took place in 2003 and 2004. The report urged the IRS to resume its efforts to adopt the consultation policy that was drafted by a joint IRS-Tribal working group and circulated to all Tribes in 2004 for application to matters affecting the Tribes to which the Treasury Department policy does not apply.

Most recently, the 2012 and 2013 reports[74] of the ITG ACT both included recommendations for a tribal consultation policy and the addition of a Secretary's Tribal Advisory Committee (STAC) and Undersecretary for Tribal Affairs. Implementation of the latter two recommendations would improve dialog in how particular tax authority applies to tribes; allow regular and meaningful consultation and collaboration in the development of Federal policies that have tribal implications; and would strengthen the government-to-government relationship between the United States and Indian tribes. The following is a summary of the recommendations and outcomes of the 2002, 2005 and 2008 ACT reports referenced above.

ITG ACT Report of June 2002	
Recommendation	Outcome
1. to give notice to all Tribes of IRS intent to adopt a Tribal consultation policy and conduct regional "scoping" or consultation meetings	Completed
2. to conduct a series of regional consultation meetings	Completed
3. to prepare and circulate a proposed consultation policy and receive back comments from Tribes	Completed
4. to adopt the policy	Unfinished

[74] "ACT Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members", June 6, 2012 by Wendy Pearson, Will Micklin and Holly Easterling and "ACT Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members", June 2013 by Holly Easterling, Diane Gange and Will Micklin

ITG ACT Report of June 2005	
Recommendation	Outcome
1. to issue guidance regarding the federal tax treatment of different legal structures used for tribal businesses and economic development entities	Unfinished
2. to issue guidance regarding tribal trusts	Partially Completed
3. to issue guidance regarding what constitutes an "essential governmental function" for purposes of tribal government issuance of tax-exempt debt	Improper remedy
4. to provide more consistency, transparency and communication to the tribal government community and leading advocates regarding the guidance process	Unfinished
5. to develop a comprehensive, easily-locatable, and cross-referenced set of all statutes, regulations, revenue rulings and other guidance related to Indian Tribal Governments	Partially Completed
6. to post on the ITG website a detailed explanation in plain English of the hierarchy of guidance, in terms of binding precedential value	Unfinished
7. to consider creative ways to update and improve the various FAQs that appear on the website	Unknown Outcome
8. to re-organize ITG's landing page so that the topics addressed in the body of the page serve as guidelines to the places where relevant content can be found	Completed
9. to provide a direct link to ITG's web page from the general IRS landing page	Unknown Outcome
10. to allow more creativity in the design of the ITG web page	Unknown Outcome

ITG ACT Report of June 2008	
Recommendation	Outcome
1. to maximize face-to-face meetings and other personal, immediate contacts; minimize contacts by U.S. mail	Current Budget Issue
2. to review notices and form letters originating from ITG and determine whether they can be simplified	Unknown Outcome
3. to make the Treasury Department's consultation policy available to the public and fully implement this policy	Unfinished
4. to adopt and fully implement an IRS consultation policy	Unfinished
5. to adjust protocols used in ITG's listening meetings	Unknown Outcome
6. to increase cultural awareness training to ITG staff	Unfinished
7. to increase and improve outreach contacts with Tribal Governments	Unknown Outcome
8. to provide Indian Tribal Governments and others the opportunity to subscribe to ITG News directly from links on ITG's website	Completed
9. to make the IRS's protocols for dealing with Tribal Governments available on ITG's website	Completed
10. to develop a plan to better ensure the IRS personnel outside of ITG follow the IRS's protocols for dealing with Tribal Governments, consistently work within a respectful government-to-government relationship with Tribal Governments and understand their obligations to coordinate with ITG	Unfinished

The ACT ITG acknowledges partial implementation of a few of the above recommendations and the efforts made by Treasury and ITG to communicate with tribes via phone forums, webinars and participation in inter-tribal organization meetings. We also appreciate the work that has been done to help educate tribal governments about tax and compliance issues, especially through enhancements to the web page.

However, our review of the ITG home page and its embedded links determined information is either not current or under-developed. We urge ITG to take up a comprehensive review of the web page and put processes in place to keep this information up to date and relevant to tribal tax priorities. The website should be used as a repository for all Treasury and IRS-related issues affecting tribes, and used as an additional means of communication given existing budget constraints.

More clarity and understanding of the guidance issuance process has been requested from tribes for a number of years and remains a challenge. The 2005 report of the ITG ACT included the following observation: “As noted before, even though ITG has done an excellent job of reaching out to Tribes, there is a perception among ITG Customers that the ITG has little control or power over the guidance process, and that the process of guidance formulation is the black hole of uncertainty.” The current ITG ACT agrees with this observation, almost 15 years later. Our teleconference with the ITG Director and staff members this year produced more questions than answers and an inability to flowchart a consistent process. While it is understood that, depending on the subject matter, guidance issuance may involve other agencies outside the IRS, it is imperative to tribes to better understand the process and the key decision makers along the way.

The web page would be an ideal place to convey information about the guidance issuance process to answer the following questions: 1) what are the roles and responsibilities of Treasury staff, Chief Counsel, IRS staff and ITG staff as it relates to guidance issuance, 2) how does IRS/Treasury determine a tax issue becomes a subject for compliance, enforcement, guidance or consultation and how is this communicated to tribes, 3) what is the hierarchy of guidance, in terms of binding precedential value. This subject matter would also be an excellent one to be taken up at a tribal conference such as NAFOA or NCAI or a phone forum with representatives from Treasury and IRS present.

INDIAN TRIBAL GOVERNMENTS

Training and education to Treasury and IRS personnel about Indian Tribal Governments, Indian law and cultural differences as well as government-to-government protocol remain a primary recommendation and concern of the ITG ACT. This was a focus of the 2008 ACT report (and many others). To demonstrate that this should be a priority and remains an alarming matter of deficiency within Treasury, we reference the most current National Taxpayer Advocate's Annual Report to Congress wherein these particular concerns are enumerated:

- Improper treatment of tribal distributions due to incorrect assumptions about tribal member Form 1099s
- Misunderstanding of the Native American family structure regarding eligibility for various tax benefits
- Ignorance of tribal sovereignty and presumed fraud or imposition of the frivolous penalty provision
- Delays in the processing of certain settlement awards
- Failure to publish legal guidance for tribes, in particular the integral part regulations and tribally chartered corporation tax status which have been promised and pending for over six years

The ITG ACT fully supports the National Taxpayer Advocate recommendations that the IRS:

- Train all compliance employees about the culture and needs of Native American taxpayers, rendering assistance as required by this population, after consulting with and referring taxpayers to TAS (Taxpayer Advocate Service) when necessary
- Establish a cross-functional working group on issues of Indian individuals, parallel to the ITG function which focuses on tribal entities
- Consult with the ITG function before implementing filers or similar programs that could have the effect of erroneously targeting Indian taxpayers
- Correct procedures that result in routine failure to comply with ITG directives

- Finalize guidance on tribal documentation of qualifying children, frivolous claim penalties, integral parts of governments including tribal corporations, general welfare exclusion of tribal distributions and other questions as they arise

The particular characteristics and needs of Indian taxpayers can only be understood within a tribal government's unique status in federal tax law. This should be the focus of any and all training, especially among the other IRS departments who lack knowledge of federal Indian policy, the government-to-government relationship, tribal consultation requirements or the federal trust obligation. Formalized training as well as leveraging ITG's function within Treasury is crucial to meeting the needs of tribal governments and their citizens. As noted in the conclusion of the NTA annual report, "Informal and published guidance could direct IRS employees to consult the ITG function or otherwise account for special considerations surrounding Native American individuals and tribal governments." This would be a vital part of a plan to mitigate tribes and tribal citizens' unnecessary contact with the IRS as well as unwarranted audits, taxes and penalties.

V. Conclusion

Suppositions. This report's supposition is the Treasury and Service have avoided a clear acknowledgement of tribal sovereignty and self-determination with regard to internal tribal governance in order to avoid questions of general applicability of tax statutes, particularly with regard to the general welfare exclusion policy (GWE). The ACT ITG Report of 2012 and 2013 asserted the application of the Internal Revenue Code (IRC) Section 61, the general application of taxation, is incongruent to inherent Indian tribal government sovereignty retained for internal governance when the Service would seek to tax the benefits provided by Indian tribal governments to its tribal citizens under a tribal general welfare doctrine.

This report further supposes the Treasury and IRS do not adopt formal tribal consultation policies, processes and procedures fully compliant with Presidential executive orders and memoranda because they are fearful of establishing expectation rights that a court would hold were sufficient to require meaningful tribal consultation with Indian tribal governments prior to taking action of matters with tribal implications, thereby diminishing the absolute discretion of the Service, and disrupt its current policy of enforcement first and consultation later, particularly with regard administrative procedures for exam and audit.

Recommendations. The Treasury's own Ingram Memorandum reported over one-third of tax issues with tribal implications have a lack of clarity regarding the application of tax authority to Indian tribes, and that there is a "diversity" of understanding across the IRS regarding such matters. Yet, despite this great need for meaningful tribal consultation, the Ingram report noted tribal consultation procedures were not adopted. We believe the Treasury tribal consultation process and Service tribal consultation procedures continue to be inadequate and non-compliant with Presidential executive orders and memoranda, and inadequate to the tribal trust obligation. The recommendations of this report are intended to address these findings.

The recommendations of this report are five:

(1) the Treasury and Service immediately engage in meaningful tribal consultation with Indian tribal governments to adopt within one year's time a formal, written tribal consultation policy as an internal and mandatory guidance document for all of the Treasury and Service that is fully compliant with Presidential executive orders and memoranda.

(2) the Service evaluate and seek to adopt the recommendations made in the 5 previous ACT ITG reports that addressed tribal consultation.

(3) the Service and Treasury apply greater deference upon the expertise in Indian law in the Service's Indian Tribal Government (ITG) group, and provide sufficient resources to ITG to participate in policy decisions on matters with tribal implications, and educate the other entities in the Service and Treasury with the "diversity" of opinion on such matters.

(4) the Treasury and Service acknowledge and respect the inherent sovereign governmental authority of Indian tribal governments, including in its pending revision to the general welfare exclusion policy by adoption of a rebuttal presumption in favor of the exclusion from taxation of benefits provided to tribal citizens under a tribal general welfare plan promulgated by an Indian tribal government under a tribal general welfare doctrine.

(5) the Treasury and Service establish a Secretary's tribal advisory committee working directly with the Secretary of Treasury and IRS Commissioner.

Thank you.

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Tax Exempt Bonds

Today's Reality: The Increased Reliance on the "Facts and Circumstances" Test in Analyzing Management Contracts for Private Business Use

Katherine A. Newell

J. Sue Painter

Lorraine Tyson

June 11, 2014

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Appendix A: Management Contracts 339

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I. Executive Summary

Under the Internal Revenue Code of 1986, as amended (the "Code"), state and local governments may issue bonds that bear interest that is exempt from federal income tax if the bonds meet conditions that relate to the purposes for which the bonds are issued, how proceeds of the bonds are invested and whether the bonds satisfy a number of other technical requirements prescribed in the Code.[1] If there is "private business use" of state and local government bonds, a series of rules specific to "private activity bonds" must be satisfied in order for interest on those bonds to be tax-exempt.

In general, "private business use" occurs when a for-profit or not-for-profit entity (other than a state or local government) uses property that is financed by tax-exempt bonds. For example, if a local government issues bonds to finance construction of a municipal building and leases a floor of that building to a corporation, there is private business use of that municipal building by the corporation. Ownership and leasing of bond-financed property are easily identifiable forms of private business use. However, other forms of private business use are more difficult to analyze. "Management contracts" provide an example of arrangements that are frequently utilized by governmental issuers and eligible borrowers but under the current regulations and IRS guidance are difficult to analyze to determine whether they create private business use. Treasury Regulation §1.141-3(b)(4) provide that management, service or incentive pay contracts between an eligible user of tax-exempt bonds and a service provider that is ineligible to use tax-exempt bonds may result in private business use based on all of the facts and circumstances. Determination of the existence of private business use of tax-exempt bond financed property is of critical importance because the existence of private business use can adversely affect the tax-exempt status of bonds that financed the property.

In Revenue Procedure 97-13, 1997-1 C. B. 632 as amended by Revenue Procedure 2001-39, 2001-2 C. B. 38 ("Rev. Proc. 97-13"), the Internal Revenue Service (the “IRS”)

[1] Sections 103 and 141 through 150 of the Code.

provides safe harbors which, if met, assure that a management contract does not result in private business use. Several stakeholder organizations have submitted written comments to the Treasury Department and the Internal Revenue Service that describe the increased utilization of management contracts over the years since Rev. Proc. 97-13 was published and the difficulty of fitting a wide range of management contracts that make sense from an operational standpoint into the very specific safe harbors afforded by Rev. Proc. 97-13. These organizations suggested modifications to Rev. Proc. 97-13 to update its provisions to coincide with current business practices and changes in legislation and economic conditions. The Tax Exempt Bonds Subcommittee (the "TEB Subcommittee") of the Advisory Committee on Tax Exempt and Government Entities (ACT) believes that the IRS should consider these suggestions and update Rev. Proc. 97-13. However, issuers and borrowers negotiating these arrangements also need more guidance about applying the "facts and circumstances" test in Treasury Regulations. The TEB Subcommittee recommends that the IRS provide guidance in a form that may be relied on by all issuers and borrowers. The TEB Subcommittee also believes that providing additional training to IRS personnel in applying the "facts and circumstances test" will expedite providing specific guidance to an issuer or borrower when it is requested and analyzing management contracts that do not meet a safe harbor in the event a bond issue is subject to examination. The TEB Subcommittee's proposed revised training materials are attached as *Appendix A* to this Report.

II. Introduction

Interest on bonds issued by a state and local government to finance one or more public, governmental projects is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code")[2]. Interest on private activity bonds (i.e. bonds issued by a state and local government to finance private projects) may also be excluded from gross income if the bonds fall into one of seven categories classified as "qualified bonds"[3] as defined in Section 141 of the Code.

In determining whether bonds are private activity bonds one factor that must be considered is the extent to which bond proceeds are to be used in a private business use. The general rule is that a bond is a "private activity bond" if more than 10% of the proceeds of the bonds are to be both (1) used in a private business use, and (2) payable from, or secured by, an interest in property used in a private business use.[4] The percentage of private business use (sometimes referred to in this Report as "non-qualifying use") is reduced to 5% in applying the test where the private business use is unrelated or disproportionate to the use that qualifies for tax-exempt financing (sometimes referred to herein as " qualifying use").[5] The percentage allowable for non-qualifying use is also reduced to 5% for purposes of testing whether bonds issued to finance projects for organizations described in Section 501(c)(3) of the Code ("501(c)(3)

[2] To qualify to tax-exempt status, as a general rule, the bonds must be in registered form and must not be "arbitrage bonds". Section 103(b) of the Code.
[3] There are seven categories of "qualified bonds": exempt facility bonds, qualified mortgage bonds, qualified veteran mortgage bonds, qualified small issue bonds, qualified student loan bonds, qualified redevelopment bonds and qualified 501(c)(3) bonds. Section 141(e) of the Code.
[4] Under Section 141 (a) and (b) of the Code, bonds are "private activity bonds" if more than 10 percent of the proceeds of the bond issue are to be used in a "private business use" and if more than 10 percent of the proceeds of the issue are secured by any interest in property used or to be used for a private business use, payments in respect of such property, the bonds are private activity bonds. Bonds are also private activity bonds under Section 141 if they meet the private loan financing test of Section 103 (c) of the Code.
[5] Section 141(a)(3) of the Code.

Organizations") bear tax-exempt interest because they are "qualified 501(c) (3) bonds" as defined in Section 145 of the Code.[6]

Private business use is defined in Section 141 (a) (6) of the Code as direct or indirect use in a trade or business carried on by any person other than a governmental unit.[7] The Treasury Regulations identify various types of arrangements which may result in private business use. These arrangements include ownership and leasing of property by non-governmental persons. The Treasury Regulations also identify management, service or incentive pay contracts between a governmental or a 501(c)(3) Organization user of tax-exempt bond financed property (i.e., a "qualified user")[8] and a service provider that is not a qualified user as a type of arrangement that can result in private business use. Treasury Regulation §1.141-3(b)(4) provides that a management contract may result in private business use of bond-financed property, based on all of the facts and circumstances.

A qualified user does not need to apply the "facts and circumstances" test to a management contract that meets one of the safe harbors set forth in Revenue Procedure 97-13, 1997-1 C. B. 632 as amended by Revenue Procedure 2001-39, 2001-2 C. B. 38 ("Rev. Proc. 97-13"). If one of the safe harbors is met, a qualified user is assured that a management contract it has entered into does not result in private business use of bond-financed property. The safe harbors in Rev. Proc. 97-13 are based on factors including the length of the contract, the reasonableness and method of determining the compensation of the service provider and whether there is an arms length relationship between the qualified user and the service provider or whether they are related in some way.

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[6] As noted in footnote 2, supra, "Qualified 501(c)(3) bonds" are one of the categories of "qualified bonds". Section 141 (e) of the Code. Non-qualifying use for qualified 501(c)(3) bonds includes use by a 501(c)(3) Organization in an unrelated trade or business.

[7] 501(c)(3) Organizations generally are not governmental units and bonds issued to finance projects for 501(c)(3) Organizations are private activity bonds. However, such bonds may bear interest excludable from gross income if the bonds are "qualified 501(c)(3) bonds".

[8] Section 3.07 of Rev. Proc. 97-13 discussed in this report, defines the term "qualified user" as a governmental entity or a Section 501(c)(3) Organization that uses bond proceeds in furtherance of its tax-exempt purpose. When used in this report, the term will have the meaning set forth in Rev. Proc. 97-13.

As noted in Part III, the safe harbors of Rev. Proc. 97-13 expanded safe harbor guidelines for management contracts set forth in earlier Revenue Procedures.[9] However, during the almost twenty years since the publication of Rev. Proc. 97-13, there have been many changes in legislation, regulations, business practices and the economy and qualified users have found it increasingly useful to employ management contracts that do not meet the Rev. Proc. 97-13 safe harbors in managing their operations. In the past few years, a number of organizations have submitted carefully considered, detailed comments proposing changes to Rev. Proc. 97-13 that update the existing safe harbors to take current business conditions and changes in legislation and regulations into account.

The Tax Exempt Bond Subcommittee (the "TEB Subcommittee") of the Advisory Committee on Tax Exempt and Government Entities (ACT) agrees that Rev. Proc. 97-13 should be updated to reflect current business realities. However, even updated safe harbors cannot conceivably apply to all possible arrangements. The TEB Subcommittee believes that qualified users need more guidance about the application of the facts and circumstances test in determining whether a management contract results in private business use. Because the existence and extent of private business use can cause loss of tax-exemption for an issue of bonds, it is paramount that a qualified user correctly applies the "facts and circumstances" test. In order to provide assurance that a management contract that does not meet any of the Rev. Proc. 97-13 safe harbors (a "non-safe-harbor management contract") does result in private business use, a number of issuers have requested private letter rulings from the Internal Revenue Service that a specific management contract does not result in private business use. In response to these requests, the IRS has issued several private letter rulings that conclude, based on the facts and circumstances test, that a particular non-safe-harbor management contract does not create private business use. Although a qualified user has the option to request a private letter ruling for assurance about the treatment of a specific management contract, it is expensive to apply for a private letter ruling (in

[9] Rev. Proc. 82-14, 1982 -1 C.B. 459 and Rev. Proc. 82-15, 1982 -1 C.B. 460 both obsoleted by Rev. Proc. 93-19, 1993-1 C.B. 526, obsoleted by Rev. Proc. 97-13. 1997-1 C. B. 632.

terms of both fees charged to request one[10] and attorney's fees incurred to draft a private letter ruling request), the conclusion relates only to the specific non-safe-harbor management contract analyzed in the ruling and only the qualified user that requests the private letter ruling may rely on the conclusion expressed in the ruling.[11] In addition to updated safe harbors, qualified users need general guidance about the treatment of non-safe-harbor management contracts and the TEB Subcommittee recommends that the IRS publish guidance regarding the application of the facts and circumstances test that may be relied on by all qualified users. The TEB Subcommittee also recommends that additional training be provided to IRS personnel about the application of the facts and circumstances test. The TEB Subcommittee believes that additional training will increase efficiency in responding to private letter ruling requests, VCAP requests and examinations involving non-safe-harbor management contracts. The TEB Subcommittee is providing updated IRS training materials relating to management contracts and the determination of private business use with this Report in *Appendix A*.

[10] See "Appendix A – Schedule of User Fees" of Rev. Proc. 2014-1 which provides the current schedule of user fees for a private letter ruling request.
[11] See footnote 34 infra for a list of these private letter rulings.

III. History

Overview

Before 1968, federal tax law permitted exclusion of interest on bonds issued by state and local governments from gross income whether the bond proceeds were used solely for governmental purposes or for some private, non-governmental use.[12] The Revenue Expenditure and Control Act of 1968[13] limited the exclusion from gross income of interest to certain categories of "industrial development bonds" (i.e. bonds issued by governmental entities that were used for non-governmental purposes or for exempt purposes of 501(c)(3) Organizations [14]). The 1982 Tax Equity and Fiscal Responsibility Act,[15] imposed additional public approval and reporting requirements on private activity bonds including industrial development bonds, student loan bonds and bonds used by 501(c)(3) organizations. Also in 1982, the IRS issued two revenue procedures relating to management contracts that provided safe harbors and also provided assurance on the treatment of management contracts that met these safe harbors.

The Original Safe Harbors

Revenue Procedure 82-14[16] ("Rev. Proc. 82-14") and Revenue Procedure 82-15[17] ("Rev. Proc. 82-15") both provided guidelines regarding the circumstances under which the IRS would issue a private letter ruling that a particular management contract between a qualified user and a non-exempt service provider would not result in private business use (the "Advance Ruling Guidelines"). Rev. Proc. 82-14 provided guidance for contracts compensating the service provider with a periodic fixed fee if the term of the contract did not exceed five years and was cancellable by the qualified user at any

[12] After World War II, state and local governments began issuing bonds to finance non-governmental purposes. See, IRS 1993 CPE Textbook, "501(c)(3) Bonds, A Mini Text," Kawecki and Friedlander.
[13] P.L. 90-364 (1968).
[14] As defined at that time, industrial development bonds did not include bonds used by governmental entities or by 501(c)(3) Organizations for exempt purposes in contrast to private activity bonds which include use by 501(c)(3) Organizations even if in furtherance of exempt purposes.
[15] P.L. 97-248 (1982).
[16] 1982-1 C. B. 459 *obsoleted* by Rev. Proc. 93-19, 1993-1 C.B. 526, *obsoleted* by Rev. Proc. 97-13.
[17] 1982 -1 C. B. 460 *obsoleted* by Rev. Proc. 93-19, 1993-1 C.B. 526, *obsoleted* by Rev. Proc. 97-13.

time without penalty if the contract term exceeded two years. Under Rev. Proc. 82-14, if it was not possible to ascertain annual gross revenues and expenses for the facility because the period of operation of the bond-financed facility was too short, the service provider could be compensated with up to one percent of gross revenues for a maximum of one year if compensation thereafter was a periodic fixed fee. Rev. Proc. 82-15 provided guidance where the service provider's compensation was based on a percentage of fees charged for services rendered, if the contract term did not exceed two years and was cancellable by the qualified user on 90 days notice without penalty. No compensation could be based on net profits. Both Rev. Proc. 82-14 and Rev. Proc. 82-15 included conditions intended to assure that the parties to a management contract acted at arms-length and could not exercise control over the other party.[18]

Rev. Proc. 93-19

In the Tax Reform Act of 1986 (the "1986 Act")[19], Congress directed that the ruling guidelines set forth in Rev. Proc. 82-14 and Rev. Proc. 82-15 be expanded. Section 1031(e) of the 1986 Act, provides:

> "Management Contracts. The Secretary of the Treasury or his delegate shall modify the Secretary's advance ruling guidelines relating to when use of property pursuant to a management contract is not considered a trade or business use by a private person for purposes of section 141(a) of the Internal Revenue Code of 1986 to provide that use pursuant to a management contract generally shall not be treated as trade or business use as long as-
>
> > (1) the term of such contract (including renewal options) does not exceed 5 years,

[18] Both 1982 revenue procedures provided that if the governing board of the qualified user or of the service provided consisted of five or more members, no more than one member (or 20%) could be an employee or member of the governing board of other party with the further caveat that a service provider member of the qualified user's board could not serve as the chief operating officer of the qualified user. In addition, members of the governing board of the qualified user of the facility could not own a controlling interest in the service contract.

[19] P.L. 99-514.

> (2) the exempt owner has the option to cancel such contract at the end of any 3-year period,
> (3) the manager under the contract is not compensated (in whole or in part) on the basis of a share of net profits, and
> (4) at least 50 percent of the annual compensation of the manager under such contract is based on a periodic fixed fee." [20]

The IRS responded to this legislative direction with Revenue Procedure 93-19[21] ("Rev. Proc. 93-19") which incorporated the conditions set forth in Section 1031 (e) of the 1986 Act. In order to meet one of the safe harbors in Rev. Proc. 93-19, compensation under the contract must be reasonable, no compensation could be based in whole or in part on net profits, the maximum term of the contract could not exceed five years and the qualified user must have the right to terminate the contract at the end of any three-year period. In addition, Rev. Proc. 93-19 modified the relationship rules of Rev. Proc. 82-14 and Rev. Proc. 82-15 to specify that the service provider must not have any role or relationship with the qualified user that, in effect, substantially limited the qualified user's ability to exercise its rights, including cancellation rights, under the service contract.[22] A contract meeting all of the foregoing conditions met a safe harbor if it satisfied one of four specific compensation arrangements. In one of the four safe harbor compensation arrangements, at least 50 percent of annual compensation must be a fixed fee. The other three safe harbor compensation arrangements permitted capitation or fixed fee arrangements if additional conditions relating to term of the contract and/or cancellation rights of the qualified user were satisfied.

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[20] Section 1301 (e) of the 1986 Act.
[21] 1993-1 C.B. 526 *obsoleting* Rev. Proc. 82-14 and Rev. Proc. 82-15 and *obsoleted* by Rev. Proc. 97-13.
[22] In addition, as a modification of Rev. Proc. 82-14 and Rev. Proc. 82-15, not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate could be vested in the service provider and its directors, officers, shareholders, and employees and not more than 20 percent of the voting power of the governing body of the service provider in the aggregate could be vested in the qualified user and its directors, officers, shareholders, and employees. Furthermore, the overlapping board members must not include the chief executive officers of the service provider and the qualified user, or their respective governing bodies. The qualified user and the service provider under the service contract must not be members of the same controlled group, as defined in section 1.150-1(f) of the regulations, or related persons, as defined in Section 144(a)(3) of the Code. Rev. Proc. 93-19, Section 5.05.

The 1997 Regulations and Rev. Proc. 97-13

In 1997, the IRS issued both final regulations relating to private use [23] and Rev. Proc. 97-13, 1997-1 C. B. 63 [24] provided safe harbors and modified Rev. Proc. 97-13.[25]

Treasury Regulation § 1.141-3(b)(4)(i)[26] provides that a management contract generally results in private business use of bond financed property if the contract provides that compensation is based, in whole or in part, on a share of the net profits of the facility. [27]

Under Rev. Proc. 97-13, generally, compensation under a management contract is not based on net profits if it is based on: (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee.[28]

Section 5.03 of Rev. Proc. 97-13 expands to six (6) the number of permissible arrangements that are eligible for safe harbor treatment. An arrangement is permissible if:

(1) at least 95 percent of compensation per annual period is based on a periodic fixed fee *and* the term is no longer than the lesser of 85 percent of reasonably expected useful life of financed property and 15 years (the "95 /15 test");

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[23] T.D. 8712, 62 Fed. Reg. 2275 (1/16/97)

[24] The Revenue Procedure as issued in 1997 was subsequently modified by Rev. Proc. 2001-39, 2001-2 C. B. 38.

[25] The regulations included safe-harbors when proposed at FI-72-88, 59 Fed. Reg. 67658 but were finalized without safe-harbors which were published in Rev. Proc. 97-13.

[26] This provision is incorporated in Treasury Regulation §1.145-1(a) which applies to "qualified 501(c)(3) bonds.

[27] A “management contract” is defined as any management, service, or incentive payment contract between a governmental person and a service provider where the provider supplies services for all, a portion of, or any function of the facility. Examples of management contracts are the provision of management services for an entire hospital or a hospital department, and an incentive pay system for physician services provided to hospital patients. Treasury Reg. §1.141-3 (b)(4)(ii).

[28] See Rev. Proc 97-13, § 5.02(2).

(2) at least 80 percent of compensation per annual period is based on a periodic fixed fee *and* the term is no longer than the lesser of 80 percent of reasonably expected useful life of financed property and 10 years (the "80/10 test");

(3) under a special rule, if all property subject to the contract is predominantly public utility property (as defined in section 168 (i) (10) of the Code, the safe harbors in Section 5.03 (1) and (2) are applied using 20 years instead of 15 or 10, respectively (the "public utility property test");

(4) at least 50 percent of compensation per annual period is based on a periodic fixed fee *or* all compensation is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee *and* the term does not exceed five years (the “50/5 test");

(5) all compensation is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee *and* the term does not exceed three years (the "three-year test");

(6) all compensation is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee (except during the start up period when compensation may be based on a percentage of either gross revenues, adjusted revenues or expenses of the facility) and the term does not exceed two years (the "two-year test").[29]

As with the earlier revenue procedures, under Rev. Proc. 97-13, an arrangement cannot meet a safe harbor if, the non-qualified service provider has a role or relationship with the qualified user that limits the ability of the qualified user to exercise its rights, including the right to terminate the contract. No such role or relationship is present if:

[29] In defining a periodic fixed fee, Section 3.05 of Rev. Proc. 97-13 provides that the stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. Revenue Procedure 2001-39 added a similar provision to Section 3.02 for capitation fees and Section 3.06 for per unit fees.

(a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

Moreover, the qualified user and the service provider under the contract are not related parties, as defined in Treasury Regulation §1.150-1(b).[30] In addition, specific rules apply in testing whether a contract meets one of the permissible arrangements. [31]

Additional Guidance Is Needed

During the almost twenty years since the publication of Rev. Proc. 97-13, there have been many changes in legislation, regulations, business practices and economic conditions and qualified users have found non-safe-harbor management contracts increasingly useful in managing their operations. Comments submitted to the Treasury Department and the IRS describe these changes and suggest updates to Rev. Proc. 97-13 to respond to these changes.

In May, 2012, both the American Bar Association (ABA) and the National Association of Bond Lawyers (NABL) submitted comments and suggestions for updating Rev. Proc. 97-13.

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[30] See Section 5.04 of Rev. Proc. 97-13.

[31] (1) In applying each of the Permissible Arrangement tests, the term of the contract is determined including all renewal options.

(2) For purposes of the 95/15 and 80/10 tests, a fee does not fail to be a periodic fixed fee as a result of a one-time incentive award during the term under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(3) In applying the 50/5 test, the three-year test and the two-year test, the contract must be terminable by the qualified user, on reasonable notice, without penalty or cause, at the end of the third, second and first year of the contract, respectively.

(4) The two-year test applies only to (a) contracts under which the service provider primarily provides services to third parties, and (b) contracts involving a facility during an initial start-up period for which there have not been sufficient operations to establish a reasonable estimate of the amount of annual gross revenues and expenses.

The ABA commented that there are many sound reasons for a governmental entity or a 501(c)(3) organization to engage an independent contractor including obtaining needed expertise, retaining operational flexibility, and avoiding labor issues associated with using public employees (e.g., pension costs). The ABA suggested changes to Rev. Proc. 97-13 intended to allow these entities to utilize management contracts in connection with their operations while addressing Congressional concerns with private business use.[32]

NABL noted that: "[q]ualified [u]sers are negotiating an increasing number of [m]anagement [c]ontracts pursuant to which more than one method of compensation is used, and these methods often cannot neatly be categorized under any of the existing compensation categories described in Rev. Proc. 97-13 (i.e., each such compensation method is neither per-unit, percentage of revenue, percentage of expense, capitation nor fixed)."[33] NABL further pointed out that using a combination of compensation methods "aligns the amounts paid by the [q]ualified [u]ser more effectively with the services being provided. However, attempts by counsel and [q]ualified [u]sers to force these complex business relationships into one of the current [s]hort-[t]erm [s]afe [h]arbors often results in fundamental changes to the business terms or the disaggregation of services from a single contract to multiple contracts in ways that make little economic sense. Not infrequently, the result of these efforts is increased service-related costs to the [q]ualified [u]ser with no resulting control by the [q]ualified [u]ser over the facility or higher performance levels by the vendor. '[34]

Both the ABA and NABL comments provide examples of management contracts used for services ranging from operating municipal utilities, managing parking facilities, delivering food services, providing administrative services and delivering health care. These examples apply to state and local governments and agencies and 501(c)(3) Organizations such as schools, colleges and health care entities and illustrate the

[32] Letter from the American Bar Association to the Internal Revenue Commissioner dated May 9, 2012 (the "ABA May 12, 2012 Comments"), Page 5.
[33] Letter from the National Association of Bond Lawyers to the Treasury Department and the Office of Chief Counsel dated May 2, 2012 (the "NABL May 12, 2012 Comments"), page 2.
[34] Id.

breadth of the importance of management contracts and Rev. Proc. 97-13. These comments from the ABA and NABL reflect experience gained by qualified users and their counsel in applying the private business use rules and Rev. Proc. 97-13 over a significant period of time to a significant number of arrangements and activities. The enactment of the Patient Protection and Affordable Care Act (the "Affordable Care Act" or "ACA")[35] in 2010 raised concerns specific to the healthcare industry. These are important concerns that must be addressed but, in doing so, the TEB Subcommittee does not intend that the issues raised by the Affordable Care Act detract from the need to address the issues presented by management agreements for governmental entities or non-profits engaged in other industries.

The Affordable Care Act

The Affordable Care Act was enacted on March 23, 2010 to increase access and affordable health care services to all Americans[36]; mandate new consumer protections[37]; improve the quality of care and reduce total health care costs. There are two types of arrangements specifically contemplated by the ACA that have been the subject of comments submitted by the American Hospital Association ("American Hospital Association" or "AHA")[38] and by NABL.[39] The first arrangement of concern is the "accountable care organization" ("ACO"); the second is "bundled payments".

[35] Pub. L. 111-148, Stat. 119.

[36] The ACA provides access to insurance for the uninsured with pre-existing conditions; permits young adults to be covered on their parents' plan until they turn 26 years old; expands the availability of primary care providers through new incentives; requires insurance companies to justify premium increases; and strengthens community health centers by providing new funding support for certain projects.

[37] Consumer protections include: prohibiting denial of coverage to children under the age of 19 due to a pre-existing condition; eliminating a lifetime dollar limits on insurance coverage; regulating annual dollar limits on insurance coverage and the establishing consumer assistance programs in the states.

[38] Letter from the American Hospital Association to the Internal Revenue Commissioner dated May 11, 2012 (the "AHA May 11, 2012 Comments") and Letter to IRS from the American Hospital Association to the IRS Chief Counsel's Office dated November 15, 2012 (the "AHA November 15, 2012 Comments")

[39] Letter from the National Association of Bond Lawyers to the Treasury Department and IRS Chief Counsel's Office dated April 1, 2013 (the "NABL April 1, 2013 Comments").

Accountable Care Organizations (ACOs)

An ACO is a distinct legal entity established by two or more health care providers or suppliers to coordinate and improve care for Medicare fee-for- service beneficiaries. Coordination can reduce costs in various ways such as eliminating unnecessary and duplicative tests and/or taking preventative measures to reduce disease and infection. The Affordable Care Act established the Medicare Shared Savings Program (MSSP)[40] pursuant to which an ACO that meets quality performance standards and satisfies certain cost savings benchmarks is eligible to receive payment from the Center for Medicare and Medicaid Services ("CMS") of a portion of the total savings generated. Both for-profit entities and 501(c)(3) organizations may participate in an ACO. Hospitals that are 501(c)(3) organizations have significant concerns whether their participation in an ACO with a for-profit entity will result in private business use of their tax-exempt bond financed facilities. In a letter to the Commissioner of Internal Revenue dated May 11, 2012, the American Hospital Association stated:

"....in recent years hospitals have been seeking various ways to reduce health care costs and improve the quality of care by better aligning the incentives of hospitals and physicians. One way to achieve this is to have contractual arrangements under which cost savings are shared with physicians and other service providers. A recent example of such arrangements is ACOs established pursuant to provisions of the ACA." [41]

The American Hospital Association pointed out that in Notice 2011-20, 2011-16 I.R.B. 652 (the "Notice"), the IRS stated that because of CMS regulation and oversight of MSSP, it does not expect that participation in an ACO will result in private inurement or private benefit and thus jeopardize the status of an entity as a 501(c)(3) organization provided that certain factors as present. In the Notice, the IRS also stated that, in the absence of private inurement or impermissible private benefit, the MSSP income

[40] Section 3022 of the ACA established the MSSP promotes accountability for a patient population and coordinates items and services under parts A and B of Medicare and encourage investment in infrastructure and redesigned care processes for high quality and efficient service delivery

[41] See the AHA's May 11, 2012 Comments cited in footnote 36 supra.

received by a 501(c)(3) organization will not be taxable income from an unrelated trade or business. The American Hospital Association requested a similar result with respect to the treatment of ACOs as management contracts and requested that the IRS amend Rev. Proc. 97-13 to clarify that ACOs do not result in private business use.[42]

Bundled Payments

Section 3021 of the Affordable Care Act established the Center for Medicaid and Medicare Innovation within the CMS to test innovative payment and service delivery models to reduce program expenditures under Medicare and Medicaid while preserving or enhancing the quality of care furnished to individuals under those programs. Pursuant to the Affordable Care Act, on August 23, 2011, the CMS announced a pilot program run through the Center for Medicaid and Medicare Innovation to test four different models of bundling payments (the Bundled Payment Initiative (BPI)). Medicare historically has made separate payments to each provider for services rendered for a single illness or course of treatment. Under the BPI, CMS will link payments for payments for multiple services that a patient receives in a single episode of care and make a single "bundled" payment to all the providers of services for that single episode rather than separate payments being made to each individual service. The program is intended to give physicians new incentives to coordinate care, reduce preventable errors, and reduce costs.

In its comments, the American Hospital Association explains the difficulty in fitting bundled payment arrangements into the safe harbors of Rev. Proc. 97-13 and requests modifications to the safe harbors that will allow health care providers to utilize bundled payments and other innovative arrangements either developed by the Center for Medicaid and Medicare Innovation or agreed to with respect to care provided to populations other than those served by Medicaid and Medicare without adversely affecting the tax-exempt status of bonds used to finance the health care providers' facilities.

[42] The American Hospital Association requested the same treatment for ACO-like arrangements that are not entered expressly under the ACA. See the AHA's May 11, 2012 Comments cited in footnote 36 supra.

Additional comments submitted by NABL on April 1, 2013 [43] discuss the treatment of ACOs, bundled payments and other innovative arrangements that have been proposed under the ACA and suggest a special safe harbor for "health care management contracts" to provide assurance that utilizing these arrangements or others intended to promote quality health care and reduce costs do not adversely affect the tax-exempt bonds utilized by hospitals and other non-profit health care providers.

[43] See footnote 39, *supra*.

IV. TEB Recommendations

The comments submitted by the ABA, NABL and the American Hospital Association point out the need for more guidance on the treatment of management contracts for all qualified users of tax-exempt bonds. These comments make specific suggestions in cases that affect a wide range of qualified users as well as suggestions dealing with the significant changes in delivery of health care services engendered by the Affordable Care Act.

The TEB Subcommittee recommends that Rev. Proc. 97-13 be updated to reflect the increasing use of management contracts by entities eligible to use tax-exempt financing. However, the TEB Subcommittee does not believe it is possible to provide a safe harbor for every conceivable business arrangement that is a management contract.

The IRS has published a number of private letter rulings that conclude that a particular non-safe-harbor management contract does not result in private business use.[44] These private letter rulings provide insight into the application of the "facts and circumstances" test but do not provide definitive guidance since they may be relied on only by the issuers to which they are addressed and require a significant application fee from an issuer[45]. The TEB Subcommittee therefore recommends that the IRS publish guidance in a form that all qualified users may rely on in determining whether a non-safe-harbor contract results in private business use. In addition, the TEB Subcommittee recommends that training of IRS personnel be expanded to provide more in- depth experience in applying the facts and circumstances test to management contracts. The TEB Subcommittee has modified some existing training materials relating to management contracts to add additional information relating to application of the facts

[44] See PLR 201338031 (hotel); PLR 201338026 (hospital); PLR 201228029 (electric utility); PLR 201145005 (convention center); PLR 200926005 (hospital); PLR 200813016 (solid waste facility); PLR 200651012 (university dormitory); PLR 200330010 (water treatment facility); PLR 200250031 (utility system); PLR 200222006 (hotel); PLR 200205009 (tour boat); PLR 200204051 (tour boat); PLR 200148057 (recreation project); PLR 200123057 (hospital relationship to provider); PLR 200116009 (convention center); PLR 200044040 (joint operating agreement between 501(c)(3) Organizations); FSA 199932017 (correctional facility); PLR 199931042 (intergovernmental cooperation agreement); PLR 9835032 (correctional facility); PLR 9823008 (electric utility).

[45] See Internal Revenue Bulletin: 2011-1 which provides a schedule of user fees for a private letter ruling request.

and circumstances test in determining whether a management contract results in private business use. *Appendix A* includes this modified training material.

Updating Rev. Proc. 97-13 and providing additional guidance to qualified users and training for IRS personnel in applying the "facts and circumstances" test is important at this particular time in order to address the increased use of management contracts by all types of qualified users and to address the specific needs of health care institutions. Many management arrangements including those in the health care arena were not envisioned when Rev. Proc. 97-13 was published. In particular, non-profit health care institutions are exercising extreme caution about entering into new arrangements because of the uncertainty on whether they result in private business use. Accordingly, delay in updating guidance may inadvertently impede fulfillment of the purpose of the Affordable Care Act.

Sources of Information

In preparing this report, the TEB Subcommittee reviewed applicable legislation, legislative history, Treasury Regulations and IRS documents including Rev. Proc. 97-13 and its predecessors and the private letter rulings identified in this Report. In addition, the TEB Subcommittee reviewed the written comments submitted by the ABA, NABL and the American Hospital Association noted in this Report, spoke to bond counsel and representatives of qualified users of management contracts and utilized the personal experience of members of the TEB Subcommittee.

V. Conclusion

Management contracts are an important tool for governmental entities and 501(c)(3) organizations in conducting operations. During the years since Rev. Proc. 97-13 was published, the use of management contracts by these entities has increased and become more complex as a result of changes in legislation, business practices and the economy. Several professional organizations have submitted detailed comments to the IRS explaining why and how the safe harbors of Rev. Proc. 97-13 relating to management contracts should be updated to take account of these changes. The TEB Subcommittee agrees that the IRS should review and update Rev. Proc. 97-13. The TEB Subcommittee also recommends that: (1) the IRS provide guidance in a form that all governmental issuers and conduit borrowers may rely on in applying the "facts and circumstances" test in determining whether a management contract results in private business use; and (2) the IRS provide more training for IRS personnel in applying the "facts and circumstances" test to these contracts. To assist in this training, the TEB Subcommittee also recommends some changes and additions to current IRS training materials relating to management contracts. Current training materials outline the general facts and circumstances test, define a management contract, identify important aspects of the conditions needed to satisfy the Rev. Proc. 97-13 safe harbors including excellent examples of compensation arrangements that meet the safe harbors. The TEB Subcommittee believes that, in light of today's realities, the materials should not be limited to one aspect of the necessary analysis and should be expanded to highlight a broader range of issues. The TEB Subcommittee's proposed revisions moves the exceptions to management contract treatment from the end of the current materials and adds several examples of "non-safe-harbor management contracts" that do not result in private business use under the "facts and circumstances" test.[46] The TEB Subcommittee's proposed revised training materials are attached as *Appendix A*. We hope that this Report proves helpful to the Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division in providing additional training to its personnel on a subject that arises frequently in today's regulatory and business environment.

[46] These examples are based on private letter rulings that specific contracts that do not create private business use. See footnote 44.

***Recall* – A Management Contract of Financed Property May Be a Private Business Use**

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- **a management or incentive payment contract**; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

Definition

A management contract is a management, service, or incentive payment contract between a governmental person or a section 501(c)(3) organization and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

See Regulations §§ 1.141-3(b)(4)(ii) and 1.145-2(b)(1).

Arrangements that are not management contracts

***Incidental Contracts*.** A contract for services that is solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services) is **not** a management contract. See Regulations § 1.141-3(b)(4)(iii)(A).

Hospital Admitting Privileges. The mere granting of admitting privileges by a hospital to a doctor is **not** a management contract, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area consistent with the size and nature of its facilities. See Regulations § 1.141-3(b)(4)(iii)(B).

***Operation of Public Utilities*.** A contract to provide for the operation of facilities that consists predominantly of public utility property is **not** a management contract if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider. See Regulations § 1.141-3(b)(4)(iii)(C).

Reimbursement of Expenses Only. A contract to provide for services is not a management contract if the only compensation is reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties. See Regulations § 1.141-3(b)(4)(iii)(D).

General Rule

Generally, a management contract with respect to tax-exempt bond financed property may result in private business use of that property, **based on all of the facts and circumstances**. A management contract with respect to tax-exempt bond financed property **generally** results in private business use of that property if (1) if the service provider is treated as the lessee owner or financed property for federal tax purposes and/or (2) the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Regulations § 1.141-3(b)(4)(i) and (iv); see also Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38 (Management Contract Guidelines) (Rev. Proc. 97-13). Rev. Proc. 97-13 can be found in Federal Taxation of Municipal Bonds.

Arrangements not Treated as Net Profit Arrangements under Rev. Proc. 97-13

Generally, compensation under a management contract is not based on net profits if it is based on: (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee.

See Rev. Proc. 97-13, § 5.02(2)

General Rule for Safe Harbors in Rev. Proc. 97-13

Six (6) different sets of permissible length of contract and compensation arrangements that do not cause a management contract to result in private business use (aka safe harbors) are set forth in Section 5.03 of Rev. Proc. 97-13. Just because the facts and circumstances of a management contract do not meet one of the six safe harbors ***does not*** automatically mean that there is private business use of that property; it just means that that the facts and circumstances of that management contract need to be further analyzed.

Six Safe Harbors in Rev. Proc. 97-13

The six (6) safe harbors are described below:

(1) at least 95 percent of compensation per annual period is based on a periodic fixed fee *and* the term is no longer than the lesser of 80 percent of the reasonably expected useful life of financed property and 15 years (the "95/15 test");

(2) at least 80 percent of compensation per annual period is based on a periodic fixed fee *and* the term is no longer than the lesser of 80 percent of the reasonably expected useful life of financed property and 10 years (the "80/10 test");

(3) under a special rule if all property subject to the contract is predominantly public utility property (as defined in section 168(i)(10) of the Code, the safe harbors in Section 5.03(1) and (2) are applied using 20 years instead of 15 years or 10 years, respectively (the "public utility property test");

(4) at least 50 percent of compensation per annual period is based on a periodic fixed fee *or* all compensation is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee *and* the term does not exceed 5 years (the “50/5 test");

(5) all compensation is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee *and* the term does not exceed 3 years (the "3-year test");

(6) all compensation is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee (except during the start-up period when compensation may be based on a percentage of either gross revenues, adjusted revenues or expenses of the facility) and the term does not exceed 2 years (the "2-year test").

Certain Rules for Rev. Proc. 97-13 Safe Harbors

Renewal Option. For all six safe harbors, the term of the contract is determined by including all renewal options. Under Rev. Proc. 97-13, if the service provider (manager) has a legally enforceable right to renew the contract, the contract has a renewal option.

Incentive Awards. For purposes of the 95/15 and 80/10 tests, a fee does not fail to be a periodic fixed fee as a result of a one-time incentive award during the term under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

Termination. In applying the 50/5 test, the 3-year test and the 2-year test, the contract must be terminable by the qualified user, on reasonable notice, without penalty or cause, at the end of the third, second and first year of the contract, respectively.

Limits to Application of 2-year Test. The 2-year test applies only to (a) contracts under which the service provider primarily provides services to third parties, and (b) contracts involving a facility during an initial start-up period for which there have not been sufficient operations to establish a reasonable estimate of the amount of annual gross revenues and expenses.

Relationship Between Service Provider and Qualified User. A management contract is not within any of the safe harbors if the service provider has a role or relationship with the qualified user (governmental person or section 501(c)(3) organization) to the extent that the relationship limits the ability of the qualified user to exercise its rights, including the right to terminate the contract. No such role or relationship is present if:

(a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(b) Overlapping board members do not include the chief executive officer officers of the service provider or its governing body or the qualified user or its governing body; and

(c) The qualified user and the service provider under the contract are not related parties, as defined in Regulations § 1.150-1(b).

Analysis if Contract Does Not Satisfy Rev. Proc. 97-13 Safe Harbors

If a management or incentive payment contract does not satisfy any of the safe harbors of Rev. Proc. 97-13, the following are factors to consider in determining whether the contract results in private business use of a tax-exempt bond financed facility:

All facts and circumstances must be considered.

Nature of the contract:

- what are the objectives of the parties?
- what are the obligations of the provider?
- is the type of contract representative of current business practices?
- is the qualified user "privatizing" its asset or is it engaging a party to perform one or more aspects of its operations under the terms and conditions set by the qualified user?
- does the qualified user retain control of the financed facility and the product/service of the provider?
- does the provider have either risk of loss, possibility of gain or both
- are the parties related to each other or controlled or controlling?
- what are the financial terms of the contract?
- how is compensation determined?
- are there objective business reasons or factors that support financial incentives?
- are incentives or bonuses capped, limited or bounded?
- does the provider bear the risk of economic failure of operations?

Is compensation based in whole or in part on net profits?

- compensation based on a percentage of gross revenues, or gross receipts or on a percentage of costs or expenses (but not both) is not based on net profits
    - adjusted gross revenues as defined in Rev. Proc. 97-13 do not represent net profits
- compensation based on a periodic fixed fee, per-unit fee or capitation fee is not based on net profits
- compensation (or portion thereof) determined by reference to non-cost based performance factors such as patient/client satisfaction is not based on net profits
- compensation (or portion thereof) including incentive compensation determined by reference to revenue/receipts or cost/expenses factors (but not both) are not based on net profits: examples include sharing of cost savings and incentives based on increases in gross receipts
- in analyzing compensation arrangements, caps on amounts of

compensation determined by reference to cost factors may contradict a conclusion that there is private business use

- reimbursement of expenses of manager is not based on net profits

Selected Definitions in Section 3 of Rev. Proc. 97-13

***Adjusted Gross Revenues*:** gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

Capitation Fee: a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility for all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as catastrophic loss.

An example of a capitation fee: A fixed dollar amount payable per month to a physician for each member of an HMO for all medical services for a specified period.

***Periodic Fixed Fee**:* a stated dollar amount for services rendered for a specified period of time. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility such as the Consumer Price Index and similar external indices that track increases in prices in an area or costs in an industry. Capitation fees and per-unit fees are not periodic fixed fees.

An example of a periodic fixed fee: A payment of $X per month.

Per-Unit Fee: A fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fees.

Examples of per-unit fees: $A per meal served in the cafeteria; $B per car parked; $C per tonsillectomy; $D per passenger mile.

***Qualified User**:* any state or local governmental unit as defined in Regulations § 1.103-1 or any instrumentality thereof *and* an organization described in Section 501(c)(3) of the Code to the extent that the financed property is not used in an unrelated trade or business (a "section 501(c)(3) organization").

Service Provider: any person other than a "qualified user" that provides services under a contract to, or for the benefit of, a "qualified user".

Management Contract for Cafeteria - Hypothetical Set #1

County of Alpha uses proceeds of tax-exempt bonds to finance the construction of a courthouse. Alpha enters into a contract with Corporation Beta pursuant to which Beta is to manage the cafeteria located in the courthouse.

- *The contract is a management contract and may result in private use depending on all the facts and circumstances*

What if Beta receives $2 for each meal served at the cafeteria?

- *The management contract is based on a **per-unit fee.** See definition of "per-unit fee" in section 3.06 of Rev. Proc. 97-13 as modified by section 4.02 of Rev. Proc. 2001-39.*

Fee Arrangements

What if Beta's compensation will be $X per month?

- *The management contract is based on a **periodic fixed fee.***

Rev. Proc. 97-13 Safe Harbors Met

What if the contract is for a term of 15 years (including renewal options) and Beta's compensation will be (i) $X per month and (ii) 1 percent of gross receipts of the cafeteria during such month. The contract further provides that in no event will the amount received by Beta under clause (ii) be more than 5 percent of Beta's total compensation each month.

- *The management contract does not result in private use because the management contract provides that **95 percent of Beta's compensation is a periodic fixed fee** and the term of the agreement is **15 years**. See section 5.03(1) of Rev. Proc. 97-13.*

What if the contract is for a term of 7 years (including renewal options) and Beta's compensation will be (i) $X per month and (ii) 5 percent of gross receipts of the cafeteria during such month. The contract provides that in no event will the amount received by Beta under clause (ii) be more than 20 percent of Beta's total compensation each month.

- *The management contract does not result in private use because the management contract provides that **80 percent** of Beta's compensation is a periodic fixed fee and the term of the agreement is for a term of less than **10 years**. See section 5.03(2) of Rev. Proc. 97-13.*

What if the contract is for a term of 5 years (including all renewal options) terminable by Alpha after three years without penalty after reasonable notice and Beta's compensation for each month will be (i) $X per month and (ii) the lesser of 2 percent of gross revenues per month and $X dollars?

- *The management contract does not result in private use because at least 50% of Beta's compensation is based on a periodic fixed fee, and the term of the agreement is **5 years and terminable by Alpha after three years without penalty**. See section 5.03(4) of Rev. Proc. 97-13.*

Various Hospital Management Contracts) – Hypothetical Set #2	County of Gamma uses proceeds of tax-exempt bonds to finance the construction of a hospital to be owned by Gamma.
Rev. Proc. 97-13 Safe Harbors Met	***What if*** Gamma enters into a management contract with Corporation Delta, a for-profit entity, to manage its dialysis department for a term of 3 years, the contract is terminable by Gamma without penalty after 2 years and Delta will receive $10 from each payment that County receives from Medicare reimbursement for each patient using the dialysis department? • The management contract does not result in private use because Delta's compensation is a per-unit fee and the term of the agreement (including renewal options) is 3 years and is terminable by Gamma without penalty after 2 years. The management contract meets the requirements of section 5.03(5) of Rev. Proc. 97-13. ***What if*** the dialysis department is a new facility and the management contract provides that Delta will receive 25 percent of the gross revenues of the dialysis department for the first two years and Gamma may terminate the contract (after providing 60 days' notice) at the end of the first year without payment of any penalty to Delta?. • The management contract does not result in private use because the facility is in its "start up" phase, Delta's compensation is based on a percentage of gross revenues, the term of the agreement (including renewal options) is 2 years and the contract is terminable by Gamma without penalty after 1 year after reasonable notice. The management contract meets the requirements of section 5.03(6) of Rev. Proc. 97-13.

Various Hospital Management Contracts – Hypothetical Set #3

Delta Hospital, a Section 501(c) (3) organization, uses proceeds of tax-exempt bonds to finance the construction of a hospital.

Examples of Type of Compensation

What if Delta enters into a contract with HMO pursuant to which HMO will send its patients to Delta and Delta will provide services to such patients? The contract provides that HMO will pay $100 per patient per month to Epsilon.

- *The compensation is not considered to be based on a share of net profits because the compensation under the management contract is based on a capitation fee. See definition of capitation fee under section 3.02 of Rev. Proc. 97-13 as modified by section 4.01 of Rev. Proc. 2001-39*

What if Delta enters into a contract with Corporation Zeta pursuant to which Zeta is to manage the radiology department located in the hospital facility and the contract provides that Zeta will receive $100 at the end of Delta's fiscal year if the gross receipts of the radiology department increase by 5 percent during Delta's fiscal year?

- *The productivity reward does not cause the compensation to be based on a share of net profits because the productivity reward is based on increase of gross receipts only. See section 5.02(3) of Rev. Proc. 97-13.*

Example of How the Relationship Between Qualified User and Service Provider Affects Meeting a Safe Harbor Test

What if Delta enters into a contract with Zeta to manage the department, there are 6 members on the Board of Directors of Epsilon and Zeta is wholly owned by the chairperson of the Board of Directors of Epsilon and two doctors that serve on the Board?

- *The management contract does not meet the safe harbor under section 5.04(2) of Rev. Proc. 97-13 because more than 20% of the voting power of the Board of Directors of Delta is vested in shareholders of the Zeta. Whether the management contract results in private use will depend on all the facts and circumstances.*

Management Contract between Hospital and Medical Group - Hypothetical Set #4

Epsilon Hospital, a 501(c)(3) organization, uses proceeds of tax-exempt bonds to construct a facility it will own to provide clinical medical services (the "Clinical Facilities").

Examples of Compensation That Do Not Result in Private Business Use Where NoSafe Harbor is Met

What if Epsilon enters into a 6-year contract with Medical Group which either party may terminate on a date that is at least 3 ½ years prior to the end of the contract. The Medical Group will receive Base Compensation computed for each division (which are generally organized by medical specialty) by multiplying the number of work relative value units ("WRVUs") produced by a division over a specified period of time by an agreed upon fee for that division.

- *The contract does not meet any of the safe harbor provisions of Section 5.03 of Rev. Proc. 97-13. However, the compensation is similar to a per-unit fee arrangement and is not based on net profits. Therefore, the contract does not result in private business use assuming there are no other adverse facts and circumstances.*

What if, in addition to the Base Compensation, the contract also provides for Incentive Compensation based on the achievement of benchmarks in the performance categories of cost management, patient access, emergency medicine patient satisfaction, emergency medicine patient throughput and neonatal intensive care interaction? Incentive Compensation will be paid for each benchmark met, but for most performance categories, the Medical Group must return compensation for each benchmark it fails to meet.

No performance category will be based on gross revenues or adjusted gross revenues. For the cost management category, the Medical Group will receive a percent of the amount by which expenses for salaries and wages, agency labor, supplies and purchased services are less than x percent of the budgeted amount. The Medical Group will be required to return compensation to Epsilon in an amount equal to a percent of the amount by which those expenses exceed y percent of the amount budgeted. The total amount earned or returned each year is capped and will not exceed z percent of the Base Compensation expected to be paid that year.

Both Base Compensation and Incentive Compensation will be renegotiated every third year to make sure the compensation remains within fair market value determined by industry standards.

- *The Incentive Compensation, although based in part on reductions in expenses, is not based on a share of net profits because it is not, and will not be, based on gross revenues or adjusted gross revenues. In*

addition, the compensation is reasonable because it will be renegotiated periodically to determine that compensation remains within fair market value as determined by an external standard. Although the contract does not meet any of the safe harbors of Rev. Proc. 97-13, it does not result in private business use assuming there are no other adverse facts or circumstances.

What if in addition to the Base Compensation and the Incentive Compensation, the Hospital will pay or reimburse the Medical Group for miscellaneous expenses consisting of (1) expenses for travel, meetings and professional dues of each Medical Group physician up to a specified maximum amount; (2) administrative expenses up to a budgeted amount, including accounting expenses, meeting expenses, supply expenses, and management services expenses; and (3) reasonable professional liability tail insurance for certain resigned or terminated physicians.

- *The miscellaneous expenses to be reimbursed are not calculated based on net profits and do not when taken into account with the Base Compensation and the Incentive Compensation cause the contract to result in private business use.*

What if in addition to the Base Compensation, the Incentive Compensation and the reimbursement of miscellaneous expenses, under the contract, the Hospital will also pay or reimburse the Medical Group for the compensation of the following employees and officers: (1) certain newly recruited physicians during their first year of employment, (2) fellows in certain medical specialties, (3) legal counsel, (4) an administrator, (5) the Vice President, Surgery, (6) the Vice President, Medicine, (7) the Compliance Officer, and (8) the President.

The amount of the compensation paid to each of these individuals and reimbursed to the Medical Group under the Management Contract will be a stated amount or a stated amount increasing periodically by a stated percentage and will be determined without reference to gross revenues or expenses of the Clinical Facilities except that the President is also eligible for incentive compensation. The Hospital will also pay or reimburse the Medical Group for the cost of employee benefits furnished to the physicians providing medical services through the Medical Group and fellows in certain medical specialties. The employee benefits will not be determined by reference to either gross revenue or expenses from the Clinical Facilities.

The President's total incentive compensation is also a stated amount but is only paid if certain criteria (which are to be redetermined each year) are attained. For the first year: (1) not more than x percent of total incentive compensation will be awarded at the discretion of the Hospital's board; (2) not more than y percent will be awarded if Clinical Facilities achieve their budgeted WRVUs, and (3) not more than z percent will be awarded if the Clinical Facilities both reduce expenses and achieve a stated number of

WRVUs. Historical financial data establishes that gross revenue of the Clinical Facilities does not increase or decrease in concert with the number of WRVUs generated in those Facilities. In addition, the Hospital board will not award its discretionary portion of the incentive compensation on the basis of the Clinical Facilities' net profits and other than the 3 criteria used for the first year, no criteria for any other year will be determined by reference to revenues, expenses or net profits. In addition, the criteria and the percentages related to each criteria will be determined by the end of the first quarter of the applicable year.

- *The compensation expenses to be reimbursed do not cause the contract to result in private business use.*
  - *The reimbursed expenses (excluding the President's incentive compensation) are not based on net profits.*
  - *With respect to the President's incentive compensation:*
    - *The portion based on achievement of budgeted WRVUs is a per-unit fee; the award in the Hospital board's discretion is not based on net profits; and based on historical data, WRVUs do not represent gross revenue with the result that the target based on a combination of reduction of expenses and achievement of a WRVU target does not track net profits.*

Management Contract between Hospital and Physicians Groups - Hypothetical Set # 5

County Hospital Authority issued Bonds to finance Theta Hospital, a section 501(c)(3) organization owned by a system that is also a Section 501(c)(3) organization. The System and the Hospital will enter into Agreements with the Physicians for medical services for an initial term of 3 years with automatic renewals for additional 3-year terms unless either party gives notice of non-renewal at least 90 days prior to the end of the term. The Agreements are terminable by the System and the Hospital upon breaches by the Physicians and by mutual agreement of the parties. There is no overlap between governing bodies of the Physicians, on the one hand and the Hospital and the System on the other hand. In addition, the Hospital has experienced difficulty in recruiting and keeping qualified physicians and the nature of the compensation provided under the Agreements is intended to help the Hospital overcome this difficulty.

Examples of Compensation That Do Not Result in Private Business Use Where No Safe Harbor is Met

What if each Physician's Base Compensation under the Agreements is a percentage of Net Professional Patient Billings ("NPPB") of the Physician plus a percentage of NPPB generated by physicians' assistants and nurse practitioners supervised by the Physician.

NPPBs are gross patient billings for the professional component of direct physician care services provided by the Contracting Physician (but not for the technical component of any ancillary services) and specifically excludes the

provision of services that are defined as "designated health services" under the Federal Ethics in Patient Referrals Act, 42 U. S. C. Section 1395nn. Gross patient billings also include capitation fees, and will be reduced by Medicare and Medicaid contractual write-offs, usual and customary reductions by private insurers, physician discretionary discounts and managed care discounts. Charitable expenses (uninsured, indigent patients) and bad debt, unless caused by the Physician's lack of medical records and proper coding which causes the bad debt to be incurred, will not reduce gross billings. If actual compensation under the percentage formula exceeds ***x*** percent of the most current Medical Group Management Association (MGMA) Physician Compensation Survey for physicians practicing the same medical specialty within the same or comparable location with the United States the Hospital will review the Physician's practice and billing to determine if the compensation is equitable for both parties and consistent with fair market value for the services.

During the year, Physicians will be paid an amount agreed upon at the beginning of that year. A reconciliation will be performed within 60 days after the end of the year. Any excess will be repaid by the Physicians through a decrease in compensation during the next 3 months and any shortfall will be paid in the next biweekly payment to the Physicians.

- *These Agreements do not meet any of the relevant safe harbors of Rev. Proc. 97-13. However, the Agreements provide for reasonable compensation because the Hospital has the right to review the Physician's portion of Base Compensation allocable to direct provision of services if that portion reaches **x** percent of an objective industry standard. In addition, NPPB represents adjusted gross revenues so Base Compensation is not based on any share of net profits from the operation of the Facility and none of the expenses of the Facility or the Physicians are taken into account in determining the amount of the Base Compensation. Unless the other aspects of compensation provided under the Agreements lead to a different conclusion, the Agreements do not result in private business use.*

What if, in addition to Base Compensation, the Physicians are eligible for Supplemental Compensation a portion of which is Incentive Compensation and a portion of which is Deferred Compensation.

The Incentive Portion is up to ***y*** percent of the Base Compensation but the actual amount is subject to the Physician's satisfaction of three goals based on (1) Quality (which targets directives relating to national quality initiatives and clinical best practices established by national health services organizations); (2) Learning (which is designed to build a high performance culture through education, effective communication among staff and promotion of use of technology to support quality and patient satisfaction);

and (3) Customer Satisfaction (which is intended to promote a customer service culture and patient satisfaction). Each criteria is assigned a percentage of incentive compensation. Total Incentive Compensation is based on cumulative attainment of the three goals.

The Deferred Compensation is a percentage of Base Compensation but the percentage is determined by the number of years of service of the Physician. The Deferred Compensation is contributed to a deferred compensation plan and is subject to a substantial risk of forfeiture under Section 457 of the Code relating to a specifically required term of service.

What if in addition to the Base Compensation and the Supplemental Compensation, Theta Hospital will also reimburse the Physicians' expenses for continuing education, professional reference materials, text books, licensing fees and professional membership dues up to a specified maximum.

- *Reimbursement of the Physicians' expenses incurred for continuing medical education, professional reference materials, text books, licensing fees, and professional membership dues up to a stated maximum, as provided in the Agreements, is not treated as compensation and does not cause the Agreements to result in private business use.*

Hotel Management Contract - Hypothetical Set #6

City of ETA (an on behalf of issuer) issues tax-exempt bonds to renovate and expand a Hotel.

Examples of Compensation That Do Not Result in Private Business Use Where No Safe Harbor is Met

What if ETA enters a 15 year contract with no renewal option for management of the Hotel that provides for: (1) an annual "Base Fee" that is the greater of (a) a periodic fixed fee if paid every year or (b) a percent of the Hotel's actual gross receipts for the year and (2) an annual "Incentive Fee" of x percent of actual gross receipts for the year. The Incentive Fee will be paid only if the Hotel's Achieved Revenue Per Available Room (RevPAR) is at least y percent of the "Achieved RevPAR" of a group of specific hotels that are comparable to the Hotel. "Achieved RevPAR" for a year is calculated by multiplying (1) the average daily occupancy rate for the Hotel or the comparable hotels, as applicable by (2) the average daily room rental rate achieved by the Hotel or the comparable hotels, as applicable, for the year.

The contract does not meet any of the safe harbors of Section 5.03 of Rev. Proc. 97-13. However, the Base Fee is not based on net profits since in any given year it will be either a periodic fixed fee or a fee based

on a percentage of gross receipts. Further, the Incentive Fee is based on gross revenues since Achieved RevPAR is based solely on gross revenue from room rentals and the Incentive Fee is a percentage of that. Neither the Base Fee or the Incentive Fee, either alone or in combination, is based on a share of net profits and the contract will not result in private business use assuming there are no other facts and circumstances that need to be considered.

Management Contract for Electric Company - Hypothetical Set #7

Examples of Compensation That Do Not Result in Private Business Use Where No Safe Harbor is Met

Regional Utility Authority issued bonds to finance the transmission and distribution system (the "T & D System") of the public electric company owned by the Authority (the "Electric Company")

What if the Electric Company enters into a management contract pursuant to which a for-profit manager (the "Operator") will provide substantially all management and operations services for the Electric Company on an exclusive basis for a maximum of 10 years with no renewal or extension option? The contract may be terminated by either party due to specified events of default. The parties are unrelated and there is no overlap in their boards.

The Operator will be responsible for the operation and maintenance of the T & D System and management and performance of capital improvements to the T & D System and may only use the T & D System to transmit or distribute electric power and energy obtained by, on behalf of, or with the approval of the Electric Company and may use the System only to serve the Electric Company and its customers in the service area.

The Operator will receive compensation consisting of a fixed component amount of $a annually which assumes $b of credit support provided to the Electric Company by the Operator (the "Annual Fee"). The Electric Company has the option to reduce the credit support in $c increments, triggering a reduction in the Annual Fee at a stated rate. The Annual Fee will also be increased by a factor based on the Consumer Price Index fixed portion if the factor is positive but will not be adjusted if the factor is negative. The Operator must pay the Electric Company a penalty equal to a specified percent of the Annual Fee if it does not meet certain performance standards.

- *The Annual Fee is not a periodic fixed fee that meets a safe harbor in Rev. Proc. 97-13 because it is subject to adjustment based on reduced credit support and reductions because of poor performance. These are not specified, objective and external within the meaning of section 3.05 of Rev. Proc. 97-13. Nevertheless the contract will not result in private business use because neither the credit support or*

performance adjustment is based on net profits.

What if, in addition to the Annual Fee, the Operator's compensation includes an Incentive Compensation Component that will be paid from a pool into which the Electric Company will make an annual tentative deposit of $d which assumes $b of credit support. The Operator will be eligible for payment from the pool based on the achievement of performance goals in the categories of: (1) cost management (materially completing capital and operating plans within the respective budgets); (2) customer satisfaction (achieving high levels of end-use customer satisfaction); (3) technical and regulatory performance (providing safe, reliable power supply in compliance with regulation); and (4) financial performance (meeting Electric Company's financial needs).

Each category has "Performance Metrics." The cost performance category has separate Performance Metrics for both the operating budget and work plan and the capital budget and work plan. If, for any year, the Operator does not achieve the expected performance level for both the Performance Metrics, or, alternatively, if it does not achieve the expected performance level for the same cost management Performance Metric for two consecutive years, the Operator will not be eligible for any incentive compensation for that year or second year, as applicable. If, in any year, the Operator achieves the expected performance level for only one of the Performance Metrics, the Operator will be eligible for a maximum of 50 percent of the Incentive Compensation Component for that year.

For each year for all categories other than cost management, the Operator's level of performance will be measured based on actual results. These other categories are weighted according to relative importance. The weighted percentages determine the share of the compensation pool that may be allocated to a performance category.

Incentive Compensation earned for any year will be reduced by 50% if the Operator has failed to achieve a stated minimum performance level for the same Performance Metric for any 2 years of a consecutive 3 year period, and by 100% if the Manager has failed to achieve the minimum level for 2 or more of the same Performance Metrics for any 2 years of a consecutive 3 year period (unless, in either case, the minimum performance level has been satisfied in the current year).

Poor performance with respect to certain Performance Metrics relating to customer satisfaction and service interruptions will cause the Operator to forfeit all of its Incentive Compensation for the year and pay a penalty equal to a certain percent of the Annual Fee for the year.

- *The Incentive Compensation Fee does not cause the contract to result in private business use. Although the various categories that make up the Performance Metrics provide incentives to reduce expenses, none*

of the performance categories are based on gross revenues or net profits of the T & D System.

What if in addition to the Annual Fee and the Incentive Compensation Component, the Operator is reimbursed for "Pass-through Expenditures" provided in the budget? These Expenditures are generally those expenditures incurred by Operator (without any mark-up or profit) in the course of providing operations services including wages, salaries, benefits, and other labor costs of the general workforce (i.e., management, professional, and union personnel employed by Operator); costs incurred by Operator for all materials, supplies, vehicles, purchased services, and other costs; subcontractor costs with respect to leases, permits, and similar instruments in performing operations services, including the cost of capital improvements; costs incurred in connection with a large variety of potential claims; costs related to storm events; various taxes; and costs incurred in transactions with affiliates of Operator. Pass-through Expenditures do not include amounts paid by Operator to or for individuals who are part of senior management and who are employed by Manager.

The Operator will be reimbursed by Electric Company for the Pass-through Expenditures at its cost of service without markup, multiplier, or other adjustment. However, the costs to the Operator, if any, of transactions with affiliates may include a mark-up of the affiliate's direct expenses in accordance with Federal Energy Regulatory Commission (FERC) sanctioned cost allocation methods, including a FERC-approved return, where applicable.

- *Under the facts and circumstances, the reimbursements for Pass-through Expenditures, do not cause the contract to result in private business use. Although charges from affiliates may include a FERC-approved return on its direct expenses, any such markup will be based on FERC cost allocation methods and will not be based on a share of T & D net profits.*

Management Contract for Convention Center Hypothetical Set #8

City Improvement Authority issues bonds to finance construction of an exhibition and convention center. The Authority enters into a Management Contract with a for-profit Manager for a term of 5 years and 2 months. There is no overlap between the boards of the Authority and the Manager and the parties are not related within the meaning of Regulations § 1.150-1(b).

What if the Manager's compensation consists of a base fee, an incentive fee and reimbursement of certain expenses? The Contract does not meet the safe harbors of Rev. Proc. 97-13.

The annual *Base Fee* for each of the first and second fiscal years is $2. Beginning in the third year, the Base Fee will be adjusted by the percentage change in the Consumer Price Index but in no event by more than b% in

anyone fiscal year.

- *The Base Fee is a periodic fixed fee within the meaning of Rev. Proc. 97-13 because it is a stated amount adjusted by an external index.*

The Incentive Fee Arrangement is agreed to by the parties prior to the end of the first month of the first year of the Contract. If the Manager satisfies each of three incentive tests - (1) the "Revenue Benchmark", (2) the “Net Operating Surplus/Deficit Benchmark", and (3) "Customer Satisfaction Test" - in each of the first and second years of the Contract, the Manager will be eligible for an Incentive Fee in each of those years in an amount not greater than the Base Fee for that year. Beginning in the third year, the amount of the incentive fee will be adjusted by the percentage change in the CPI but in no event more than by b% in any one fiscal year and, in no event, will exceed the Base Fee paid the Manager for that fiscal year.

To meet the "Revenue Benchmark", the Manager must produce certain total operating revenues at the Facility equal to or greater than a stated amount for the applicable fiscal year that is established in advance of each fiscal year of the term of the Management Contract in the approved budget for such fiscal year. To meet the "Net Operating Surplus/Deficit Benchmark", the Manager must at least meet a stated net operating surplus/deficit level for the applicable fiscal year that is established in advance of each fiscal year of the term of the Management Contract in the approved budget for such fiscal year. To meet the "Customer Satisfaction Test" the Manager must achieve an average overall score for customer satisfaction surveys that is equal to or greater than the customer satisfaction benchmark established in advance of each fiscal year (other than the first fiscal year) of the term of the Management Contract for the applicable fiscal year. Because of several factors, the Revenue Benchmark and the Net Operating Surplus/Deficit Benchmark may increase or decrease from year to year. Thus, the Net Operating Surplus/Deficit Benchmark in one year may reflect a decrease, and in a subsequent year an increase, in the deficit from that of the prior year.

Although the Net Operating Surplus/Deficit Benchmark takes into account both revenue and expenses, it is not based on increases in revenues and decrease in expenses, but on state surplus/deficit amount that may reflect decreasing revenues and expenses. A similar analysis applies to the Net Operating Surplus/Deficit Benchmark and the Revenue Benchmark when taken together.

- *In addition, the amount of the incentive fee will not vary depending on the margin of increase in revenues and/or decrease in expenses or be based on a percentage of revenue increases, a percentage of expenses decreases or a combination of both. Instead, the incentive fee will be determined by negotiation before the end of the first month of the fiscal year of the contract and thereafter adjustments will be*

based on the CPI. The amount will not exceed the Base Fee for that year.

The Reimbursable Expenses are the Manager's actual and direct expenses to employees and unrelated parties.

- *These expenses are not treated as compensation to the Manager. Salaries and bonuses to bonus-eligible employees are not treated as compensation to the Manager since these employees have no ownership interest in the Managers and bonuses are paid on a basis similar to that of the incentive compensation paid to the Manager.*

Management Contract for Dorm - Hypothetical Set #9

University Sigma financed construction of a Dormitory with proceeds of tax-exempt bonds.

What if Sigma enters into a contract for 15 years with Manager, a for-profit, wholly owned subsidiary of Sigma to manage the Dormitory. Manager will be paid a periodic fixed fee annually for its services. The fee will be adjusted annually based on the Consumer Price Index. Manager will also be reimbursed for direct expenses paid to third parties. The contract may be terminated only by Sigma on 90 days notice.

- *The contract does not meet the safe harbors of Section 5.03 of Rev. Proc. 97-13 because Sigma and the Manager are related. However, Manager does not have any role or relationship with University that substantially limits University's ability to exercise its rights, including cancellation rights, under the Contract and compensation under the contract is not based in any way on net profits. Based on the facts and circumstances presented, the contract does not cause private business use.*

Lease of Cafeteria – Hypothetical Set #10

City of Iota uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public.

What if Iota enters into a contract labeled “management contract” with Corporation Kappa to manage the cafeteria for a term of 10 years and Kappa receives all the receipts of the cafeteria and in turn gives $X per month to Iota? Kappa has complete discretion to manage the cafeteria without any input from Iota.

- *Notwithstanding the contract’s title, the contract is a lease and should not be analyzed under Rev. Proc. 97-13. See Regulations § 1.141-3(b)(3).*