

Advisory Committee
On
Tax Exempt and Government Entities
(ACT)

Public Meeting



May 21, 2003
Washington, DC

**Internal Revenue Service
Advisory Committee on Tax Exempt and Government Entities (ACT)
Public Meeting
Treasury Executive Institute
801 9th Street, NW.
Washington, DC 20220**

May 21, 2003

AGENDA

- 8:30 – 9:00 Meet and Greet
- 9:00 – 9:30 Welcome and Opening Remarks
- Bob Wenzel, Deputy Commissioner of Internal Revenue
 - David R. Williams, Chief Communications & Liaison
 - Evelyn A. Petschek, Division Commissioner, Tax Exempt and Government Entities
 - Steven J. Pyrek, Designated Federal Official of the ACT
- 9:30 – 10:00 ACT Overview Report
- Donald J. Segal, Chairman of the ACT
- 10:00 – 10:15 Break
- 10:15 – 11:00 *“Project ASPIRE”: EO Determinations Process Review*
Deirdre Dessingue, Project Leader
- 11:00 – 11:45 *TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities*
Jonathan B. Forman, Project Leader
- 11:45 – 12:45 Lunch
- 12:45 – 1:00 *TE/GE Audit Processes (Interim Report)*
John Schroeder, Project Leader
- 1:00 – 1:45 *Gateway Opportunities: FSLG and its Customers*
Elizabeth Nunnally, Project Leader
- 1:45 – 2:30 Closeout

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

In the year since the Advisory Committee on Tax Exempt and Government Entities (ACT) first met in public session to make its recommendations to the Internal Revenue Service, both the ACT and the Service have made much progress. The ACT members believe that the relationship between the ACT and the Service's Tax Exempt and Government Entities Division (TE/GE) continues to foster a deeper and broader understanding of the issues faced by the Internal Revenue Service and the customers it serves. This mutual understanding benefits the public, because the ACT provides an experienced external perspective on TE/GE's tax administration policies and procedures. Also, it benefits the Service because at a time of tight resources, the IRS can make better-informed decisions about modifying and enhancing its programs based on customer feedback.

We continue to believe that the reorganization of the IRS into four operating units aligned with customer characteristics is especially beneficial to the customers of TE/GE. These customers include employee retirement plans; charities and other tax-exempt organizations; tax-exempt bond issuers; federal, state, local and Indian tribal government bodies, and the professionals who deal with these entities. Each of these groups has a special relationship with the IRS. They generally are not subject to tax, but must comply with specialized and highly complex provisions of tax law.

Because of the specialized nature of its mission to serve this unique customer base, TE/GE has been able to develop new outreach and education programs, as well as products and services to enhance voluntary compliance through increased awareness. As was the case in our previous report of recommendations, the reports we offer today include recommendations on TE/GE's outreach and on compliance programs.

Following are summaries of the four ACT projects being presented today to the Commissioner and senior leadership of TE/GE.

The Exempt Organizations Determination Process

Issue

Over the past ten years, the number of exemption applications filed annually has increased by 40%, reaching 87,000 in 2002. Over the same ten-year period, Exempt Organizations Division staffing has remained essentially

static, at about 790 nationwide. As a result, the percentage of the Exempt Organizations workforce devoted to the determination (application) function has reached historically high levels. This has left relatively fewer employees dedicated to the examination function – for 2002 the EO examination rate was less than 1%. The project team undertook a comprehensive review of the EO determination process with a view toward reforming or replacing it. Streamlining the EO determination process would enable EO to increase its focus on compliance, which is essential to the integrity of the tax-exempt sector. In addition, the project group sought to address the needs of EO applicants for a determination process that is accessible, comprehensible, reliable and timely.

Recommendation

The project group makes ten recommendations for improving the EO determination process:

- Develop a fully interactive Form 1023.
- Develop a fully e-file-able Form 1023.
- Facilitate development of a Form 1023 database.
- Develop a prominent Form 1023 “helpful hints” checklist.
- Conform two public support tests.
- Eliminate Form 8734 at the end of the advance ruling period.
- Specify a particular Section 509(a)(3) test in form 1023 and in the determination letter.
- Develop a standard public charity reclassification process.
- Develop a standard “one-stop” name-change process.
- Link the IRS Website to state charity officials’ Websites.

TE/GE Abusive Tax Shelters

Issue

The ACT created the project team on TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities to study how TE/GE could better respond to abusive tax shelters and other abusive tax schemes. The goal has been to identify various strategies that can be used by the Exempt Organizations, Employee Plans, and Government Entities divisions of TE/GE. Within the spectrum of tax shelter transactions, of particular concern are abusive tax transactions that are heavily “promoted” or that have the risk of becoming widely used. One important goal of the IRS’s initiatives against abusive tax transactions should be to chill the promotion and/or spread of such abusive tax transactions. TE/GE currently uses a variety of statutory provisions, judicial doctrines, and regulatory guidance to identify and curb abusive tax transactions. On the whole, the project team believes that TE/GE is doing a good job in combating abusive tax shelter and other abusive tax schemes.

Recommendation

The project team makes seven recommendations:

- Focus on promoters and self-promoting transactions
- Open a TE/GE Office of Abusive Tax Transactions
- Expand the tools for discovering abusive tax transactions
- Provide additional priority to guidance projects for disputed tax transactions that are promoted or self-promoted
- Keep identifying listed transactions
- Bring more criminal cases
- Modify TE/GE forms to steer clients away from abusive tax transactions

TE/GE's Audit Processes – Interim Report

The project to analyze the audit processes of all areas within TE/GE is extensive. After detailed research and analysis of the current audit processes in Employee Plans; Exempt Organizations; Tax Exempt Bonds; and Federal, State and Local Governments, the team determined that properly addressing a project of this scope and importance, and providing a report with the recommendations of the entire ACT, would require a significant amount of additional work on the part of the team. Accordingly, we recommend that the project continue, with additional meetings, interviews, and research to take place over the next year, and that a report in final form be presented at the next public meeting of the ACT.

Gateway Opportunities: FSLG and Its Customers

Issue

The more than 72,000 federal, state and local governmental entities in the United States range from large federal government agencies, states, cities, counties, institutions of higher learning, and local academic institutions, to agencies with few employees such as water and sewer districts, housing authorities, fire protection districts, airport boards, etc. These tens of thousands of public employers rely on the IRS's TE/GE division for guidance in complying with the myriad federal employment tax withholding and wage reporting requirements that encompass diverse operational concerns.

These governmental employers do not always perceive a clearly defined and formally designated "point of entry" at the IRS – that is, an IRS office or representative with whom contact is the normal first step initiated by a federal,

state or local government entity to resolve an issue with the Service. Federal, state and local governments may become confused and frustrated in their attempts to navigate through the IRS while seeking assistance. TE/GE is likewise frustrated by the difficulty it experiences in identifying and finding its way to all these customers.

Recommendations

The project team's recommendations are based on the committee's best efforts to fashion a system of cooperation and efficiency that will serve TE/GE's Federal, State and Local Governments component (FSLG) and its customers for years to come. In all cases, additional education of the federal, state and local government agencies and/or IRS representatives will enhance the system. The recommendations include the following:

- Public employers need direct access to issue-specific areas.
- Build FSLG employee facilitation skills and navigational experience.
- Develop best practices for establishing relationships with state and local governments.
- Clarify roles and responsibilities of the federal, state and local government specialists.
- Enhance cross-function education and communication within TE/GE.
- Build an accurate and comprehensive inventory of federal, state and local government entities.
- Communicate identities of new governmental employers to the Social Security Administration.

Conclusion

The ACT would like to express our appreciation to the Commissioner of the Tax Exempt and Government Entities Division and all her staff. They continue to be very generous with their time, making themselves available to the workgroups whenever we needed to meet with them, and speaking freely about the operations of their functions, their issues, and their objectives. The Committee could not have completed our projects as efficiently without their help.

As Chairman of the ACT and on behalf of the Committee and the public whom we represent, I would like especially to thank the members of the ACT who are leaving the committee after this meeting.

- Daryl Dunagan, with the State of Kentucky
- Jayne Fawcett, with the Mohegan Tribe
- Jonathan Barry Forman, with the University of Oklahoma School of Law
- Craig Hoffman, with SunGard Corbell

- David A. Mullon, who took a position with the Senate Indian Affairs Committee and left the ACT in March 2003
- Elizabeth D. Nunnally, with the University of Minnesota
- John Von Kannon, with The Heritage Foundation

Each of you has made significant contributions to the work of the Committee and to the operations of the IRS.

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES

Member Biographies

EMPLOYEE PLANS

Brian L. Anderson, Madison, WI

Mr. Anderson, an attorney and CPA, is a member of the IRS Great Lakes Area TE/GE Council. He is the Chair of the Employee Benefits Committee of the Business Law Section of the State Bar of Wisconsin and is an active member of the Federal Taxation Committee of the Wisconsin Institute of Certified Public Accountants. Mr. Anderson is primarily involved with small and mid-sized employer groups. He received a BA from the University of Illinois, a JD cum laude from the University of Wisconsin and an LLM in taxation from New York University.

Mary Beth Braitman, Indianapolis, IN

Ms. Braitman's practice includes involvement with various state retirement systems, including those of Indiana, Iowa, Kansas, Massachusetts, Montana, New York, Ohio, Oklahoma, and Washington. She has expertise in employment tax issues of state and local government, social security coverage issues, and tax sheltered annuity programs in the K-12 and university sectors. She is primarily involved in the representation of public sector plans, large hospital and university plans. Ms. Braitman is a graduate of the Indiana University School of Law.

Jonathan Barry Forman, Norman, OK

Prof. Forman, Professor of Law at the University of Oklahoma, teaches courses on income taxation of corporations and individuals, pension and employee benefit plans, tax policy, procedures and welfare law. He has written extensively on tax and pension policy. He was a delegate to the National Summit on Retirement Savings and a trial attorney with the Department of Justice. He is a trustee of the American Tax Policy Institute and a member of the board of trustees of the Oklahoma Public Employees Retirement System.

Craig Hoffman, Jacksonville, FL

Mr. Hoffman is the immediate past president of the American Society of Pension Actuaries, where he has also served as a member of the Board of Directors and Vice President, as well as the Co-Chair of the Government Affairs Committee. Mr. Hoffman, who serves on the editorial boards of several pension journals, is Vice President and General Counsel of SunGard Corbel, and was an expert speaker at the National Summit on Retirement Savings.

John W. Schroeder, Santa Clara, CA

Mr. Schroeder, Senior Tax Benefits Counsel for Intel Corporation, has been involved with the Silicon Valley Employee Benefits Group as well as the American Corporate Counsel Committee. While he comes with primarily a large plan sponsor perspective, he also has prior experience working with small plans and can offer insight from their perspective. He is a cum laude graduate of the University of California, Los Angeles and received his law degree from the University of California, Berkeley (Boalt Hall).

Donald J. Segal, New York, NY

Mr. Segal, a Fellow of the Society of Actuaries, is Senior Vice President and Research Actuary with The Segal Company. He currently serves as the Chair of the American Academy of Actuaries Pension Committee. He is the former Chair of the Pension Section, Council of the Society of Actuaries, served on the Board of Governors of the Society of Actuaries, and now serves on the Board of the Conference of Consulting Actuaries. He represents the actuarial community and is able to represent the needs and view of private employers, plan sponsors, and service providers.

EXEMPT ORGANIZATIONS

Victoria B. Bjorklund, New York, NY

Ms. Bjorklund is a partner in the law firm of Simpson, Thacher and Bartlett in New York, where her clients include educational organizations, museum, tax-exempt health care organizations and private foundations involved in substantial domestic and international grant-making activities. She is a long-time active participant in the American Bar Association and is the Chair of the ABA Section Taxation-Exempt Organizations Committee. Ms. Bjorklund, a magna cum laude graduate of Princeton University, is a graduate of the Columbia University School of Law and holds a Ph.D. in medieval studies from Yale University.

Deirdre Dessingue, Washington, DC

Ms. Dessingue is the Associate General Counsel of the United State Conference of Catholic Bishops in Washington, DC, and Co-Chair of the Religious Organizations Subcommittee of the American Bar Association Section on Taxation-Exempt Organizations Committee. Her experience as a practitioner reflects the broad range of concerns common to religious exempt organizations. She has particular expertise in the areas of prohibitions on political campaign activity, fund-raising limitations and unrelated business income. Prior to joining the staff of the U.S. Catholic Conference, Ms. Dessingue was a tax law specialist in the Exempt Organizations Division of the IRS. She is a graduate of the Catholic University College of Law.

Karl E. Emerson, Harrisburg, PA

Mr. Emerson is Director of the Pennsylvania Bureau of Charitable Organizations, the state office charged with enforcing the law that regulates organizations soliciting charitable contributions in Pennsylvania. He was President of the National Association of State Charity Officials (NASCO) and served on the NASCO Board for four years. Mr. Emerson holds a BA in economics and a BS in business from the University of New Hampshire and a law degree from Temple University School of Law

Sara E. Meléndez, Washington, DC

Beginning April 1, 2003, Ms. Meléndez is a Professor of Nonprofit Management at the George Washington University School of Public Management. She holds an Ed.D. from the Harvard Graduate School of Education, an MS in education from Long Island University and a BA in English from Brooklyn College, CUNY. Previously she was the President of Independent Sector, a membership organization of more than 700 national nonprofit and philanthropic organizations headquartered in Washington, DC, when she became a member of the ACT in 2001.

Elizabeth D. Nunnally, Minneapolis, MN

Ms. Nunnally is Chief Financial Officer of the Academic Health Center at the University of Minnesota and formerly the Director of Taxation and Debt Management at the University. She is a CPA and a member of the Taxation Council of the National Association of College and University Business Officers (NACUBO).

John Von Kannon, Washington, DC

Mr. Von Kannon is the Vice President and Treasurer of The Heritage Foundation, a public policy organization based in Washington, DC. In this position, he has responsibility for matters relating to the finances and taxation of that organization. As head of the foundation's Development Department, Mr. Von Kannon oversees its education and marketing programs to donors.

GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS

Daryl Dunagan, Frankfort, KY

Mr. Dunagan is the Director of the Division of Social Security for the Kentucky Controller's Office. He has more than 25 years experience with Social Security coverage, employment tax and information return reporting for state and local governments and is a past President of the National Conference of State Social Security Administrators. He currently chairs its Government Affairs Committee.

Don F. Waugh, Raleigh, NC

Mr. Waugh is the Assistant State Controller of North Carolina. He has held various positions in state government since 1975 and has been actively involved in the formation and operations of the Controller's Office. He is a graduate of Elon College and is a member of the Government Finance Officers Association and the National Association of State Auditors, Controllers and Treasurers.

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

Jayne Fawcett, Uncasville, CT

Ms. Fawcett currently serves as treasurer and Board Member of the United States South and Eastern Tribes, Inc. (USET). She has over 20 years of tribal government experience including elected service as the Vice Chair of the Mohegan Tribe of Connecticut. She currently holds the position of Tribal Ambassador for the Mohegan Tribe.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

Terence P. Burke, Dallas, TX

Mr. Burke is a partner with the international accounting firm of Ernst & Young and serves as the National Director of Arbitrage Rebate Services for the firm. His expertise includes arbitrage rebate compliance, public funds investment, and local government investment pool services. Mr. Burke is a member of, and former advisor to, the Government Finance Officers Association and serves on the Board of Advisors of the Texas Tech University Southwest School of Governmental Finance. Mr. Burke is a licensed CPA.

Perry E. Israel, Sacramento, CA

Mr. Israel is a partner in the Tax and Public Finance Department of Orrick, Herrington & Sutcliffe, L.L.P. Mr. Israel specializes in tax-exempt financing, tax-exempt organizations, low-income housing tax credits and mortgage credit certificates. Mr. Israel is an active member of both the Committee on Tax-exempt Financing of the American Bar Association Section on Taxation and the National Association of Bond Lawyers. Israel served as a board member of NABL from 1993 to 1995 and Secretary from 1994 to 1995. He earned an AB in English (Creative Writing) from Princeton University and received a JD cum laude and an LLM in taxation from Boston University School of Law.

Advisory Committee on Tax Exempt and Government Entities
(ACT)

“PROJECT ASPIRE”
EO DETERMINATIONS PROCESS REVIEW
PROJECT GROUP

DEIRDRE DESSINGUE, PROJECT LEADER
VICTORIA BJORKLUND
KARL EMERSON
SARA MELENDEZ
JOHN VON KANNON

MAY 20, 2003

TABLE OF CONTENTS

I.	Executive Summary.....	1
II.	Background.....	3
III.	Project Goals.....	5
IV.	Project Process.....	5
V.	Steps Already Taken.....	6
	<i>Form 1023 Revision Project.....</i>	<i>6</i>
	<i>Determination Letter Revision Project.....</i>	<i>7</i>
	<i>Educational Initiatives.....</i>	<i>8</i>
	<i>TE/GE Call Site.....</i>	<i>8</i>
	<i>Case Assignment Guide Revision.....</i>	<i>9</i>
	<i>Tax-Exempt Determination System.....</i>	<i>9</i>
VI.	Recommendations.....	10
	1. <i>Develop Fully Interactive Form 1023.....</i>	<i>10</i>
	2. <i>Develop Fully e-Fileable Form 1023.....</i>	<i>11</i>
	3. <i>Facilitate Development of Form 1023 Database.....</i>	<i>12</i>
	4. <i>Develop Prominent Form 1023 “Helpful Hints” Checklist.....</i>	<i>12</i>
	5. <i>Conform Two Public Support Tests.....</i>	<i>13</i>
	6. <i>Eliminate Form 8734 at End of Advance Ruling Period.....</i>	<i>14</i>
	7. <i>Specify Particular Section 509(a)(3) Test in Form 1023 and in Determination Letter.....</i>	<i>15</i>
	8. <i>Develop Standard Public Charity Reclassification Process.....</i>	<i>16</i>
	9. <i>Develop Standard, “One-Stop” Name-Change Process.....</i>	<i>17</i>
	10. <i>Link IRS Website to State Charity Officials’ Website.....</i>	<i>17</i>
VII.	Concepts for Further Consideration.....	18
	A. <i>Increase Form 1023 Filing Threshold.....</i>	<i>18</i>
	B. <i>Adopt Registration System with Operational Follow-Up.....</i>	<i>19</i>
	C. <i>Develop Separate Form 1023-PF.....</i>	<i>19</i>
	D. <i>Develop Separate Form 1023-EZ.....</i>	<i>20</i>
	E. <i>Institute Regular Operational Review.....</i>	<i>20</i>
	F. <i>Eliminate Form 1023 Filing for Certain Reincorporations.....</i>	<i>21</i>

I. EXECUTIVE SUMMARY

Over the past ten years, the number of exemption applications filed annually has increased by 40%, reaching 87,000 in 2002. Over the same 10-year period, EO staffing has remained essentially static, currently at the level of approximately 790 nationwide. As a result of this situation, the percentage of the EO workforce devoted to the determinations (application) function has reached historically high levels. This has left relatively fewer employees dedicated to the examinations function. For 2002, the EO examinations rate was less than 1%.

Wishing to advise TE/GE on ameliorating this situation, the Project Group undertook a comprehensive review of the EO determinations process with a view toward reforming or replacing that process. Streamlining the EO determinations process would enable EO to increase its focus on compliance, which is essential to the integrity of the tax-exempt sector. In addition, the Project Group sought to address the needs of EO applicants for a determinations process that is accessible, comprehensible, reliable, and timely.

The Project Group gathered information and statistics, and conducted interviews with a number of individuals both within and outside TE/GE. The ABA Tax Section Exempt Organizations Committee participated in the process through presentation of two panel discussions held in October 2002, the first dealing with Form 1023 and the current EO determinations process, and the second envisioning an EO determinations process of the future. Participants at these sessions provided valuable input. The Project Group also reviewed a sample of over 100 administrative records in order to better understand the EO determinations process from the perspective of the applicant as well as TE/GE.

The Project Group monitored the progress of various TE/GE initiatives already in progress in order to assess their potential impact on the EO determinations process. These included the Form 1023 revision project, the determination letter revision project, various customer educational initiatives, the TE/GE Call Site, the case assignment guide revision, and the Tax-Exempt Determination System. The Project Group provided ongoing, substantive input to TE/GE with respect to these initiatives, and encourages TE/GE to continue these efforts.

On the basis of all information, comments and suggestions gathered throughout the EO determinations review process, the Project Group presents 10 recommendations for improvement of the EO determinations process, which are outlined briefly below. Several recommendations are logical extensions of the ACT's Life Cycle of a Public Charity and Life Cycle of a Private Foundation recommendations, which were made at the June 2002 public meeting.

1. Develop Fully Interactive Form 1023. The Project Group recommends that TE/GE continue efforts to develop and fund a fully interactive Form 1023

(“CyberAssistant”) that will be posted on the IRS website and integrated with the IRS Life Cycle webpages.

2. Develop Fully e-Fileable Form 1023. The Project Group recommends that TE/GE continue its efforts to develop and fund a fully e-fileable Form 1023 that will be posted on the IRS website and integrated with the IRS Life Cycle webpages and CyberAssistant.

3. Facilitate Development of Form 1023 Database. The Project Group recommends that, as Forms 1023 are electronically imaged or filed, TE/GE facilitate development of a database of completed Forms 1023 that will be searchable by organizational type, state of location, and other relevant parameters.

4. Develop Prominent Form 1023 “Helpful Hints” Checklist. The Project Group recommends that TE/GE develop a prominent checklist of “helpful hints” to be added to the Form 1023 application package to assist non-represented or first-time applicants who are unfamiliar with the “ins and outs” of the process.

5. Conform Two Public Support Tests. The Project Group recommends that the two existing public support tests in section 509(a)(1) and section 509(a)(2) be conformed, with a consistent support definition, appropriate qualification threshold, consistent 2 percent limitation, alternative facts-and-circumstances test, and clear instructions regarding the steps an organization must take when it falls below the minimum standards for qualification

6. Eliminate Form 8734 at End of Advance Ruling Period. The Project Group recommends elimination of Form 8734 at the end of the advance ruling period for publicly supported organizations. Instead, the final determination of public support should be made on the basis of the Schedule A to Form 990 containing 5 years’ financial information.

7. Specify Particular Section 509(a)(3) Test in Form 1023 and in Determination Letter. The Project Group recommends that Form 1023 be revised to require applicant organizations to specify the particular section 509(a)(3) test under which they intend to qualify, and that determination letters issued to section 509(a)(3) supporting organizations specify the particular test under which they have qualified for section 509(a)(3) status.

8. Develop Standard Public Charity Reclassification Process. The Project Group recommends development of a convenient, standardized public charity reclassification process, whereby an existing public charity can report relevant changes in activities or support, and obtain a revised determination letter reflecting its new public charity status or its reclassification as a private foundation.

9. Develop Standard, “One-Stop” Name-Change Process. The Project Group recommends the development of a convenient, standardized process whereby an

exempt organization can report a name change for all IRS purposes and obtain a revised determination letter reflecting the organization's new name.

10. Link IRS Website to State Charity Officials' Website. The Project Group recommends that the IRS website include links to state charity officials' websites through the Life Cycle webpages and through CyberAssistant.

In addition to these recommendations, the Project Group also identified several concepts for improving or revising the determinations process that are presented in the interest of stimulating further discussion and development among interested stakeholders. These concepts are noted briefly below.

- A. Increase the Form 1023 filing threshold from \$5,000 to \$25,000.
- B. Eliminate the Form 1023 filing requirement in favor of a simple registration system with an operational review after an appropriate period of time.
- C. Develop a separate Form 1023-PF for organizations that know they wish to be classified as private foundations.
- D. Develop a separate Form 1023-EZ for small organizations that fall below the current \$5,000 or other filing threshold, e.g., \$25,000.
- E. Institute a system of regular operational reviews conducted at 3-year, 5-year, or some other appropriate interval after initial recognition of exemption.
- F. Eliminate the Form 1023 filing requirement for organizations that move from one state to another and reincorporate in the second state without any other material changes.

II. BACKGROUND

EO determination applications are processed principally at the IRS determination processing center in Cincinnati, Ohio¹. During 2002², the Cincinnati processing center received almost 87,000 applications, the vast majority of which (91 percent) were Form 1023 applications for recognition of section 501(c)(3) status. This is an increase over the 86,000 applications filed during 2001, and continues the 10-year trend, which has seen a 40 percent increase in total applications, from 63,000³ in 1993 to 88,000 in 2002.

¹ Full geographical centralization of determinations processing will not be accomplished in the foreseeable future. Thus, although all applications are submitted to the Cincinnati office, processing of a significant minority of applications will continue to occur at various satellite sites around the country. However, centralized reporting will be accomplished with all EO determinations staff, wherever located, reporting to one of two new area managers.

² Unless otherwise noted, references are to the IRS fiscal year, October 1 – September 30.

³ Eighty-four (84) percent of these applications were Forms 1023.

During 2002, approximately 87,000 applications were closed. The physical processing of each exemption application at the Cincinnati determination processing center involves no fewer than 20 distinct steps. During 2002, the average processing time per application was 3 hours, and the average cycle time⁴ was 105 days. Eighty (80) percent of the applications were approved. Thirty-two (32) percent of the approved applications were sufficiently complete to be approved on the merits without any further contact between the applicant and the EO determination specialist (“merit closures”). Approximately 12 percent were “failure to establish” cases, namely, applications that were missing certain required information and were closed administratively after the applicant failed to respond to IRS inquiries within the requisite 35 days.

Over the 10-year period 1993-2002, total EO staffing has remained relatively stable, hovering between 750 and 850. The current EO staffing level is approximately 750, at the lower end of the 10-year range. With a relatively static workforce and a dramatically increased determinations workload, the percentage of the EO workforce devoted to the determinations function has reached historically high levels. Recently, authorization was given for the realignment of approximately 100 EO examination agents solely to the determinations function⁵. It is not anticipated that additional EO staff will be assigned to the determinations function.

Thus, the primary challenge is to address the increasing demands on the EO determinations function, which has left relatively fewer employees available for the examinations function. During 2002, the examinations rate with respect to some 1.5 million exempt organizations was less than 1 percent. Given the unlikelihood that EO determinations workload will decrease or staffing will increase in the foreseeable future, the determinations process must become more efficient and less time-consuming, without sacrificing the integrity of the process, if additional attention is to be given to the essential examinations function.

In an effort to increase compliance within the EO community, EO examinations intends to establish the Exempt Organizations Compliance Unit (“EOCU”) and a data analysis unit during 2004. These two units will enable EO to meet the increasing challenges presented by the growth in the EO sector and a declining examinations rate. The EOCU will address customer non-compliance through correspondence and telephone contacts. The data analysis function will investigate emerging compliance trends to improve return selection for soft contacts and examinations, as well as future compliance projects.

⁴ Cycle time refers to the number of days elapsed from the time an application first enters the determinations system to the time it exits the system through closure or otherwise.

⁵ These examination agents had, in fact, been performing determinations work, but now have been formally assigned to the determinations function.

III. PROJECT GOALS

With this background and the approval of the entire ACT, the Project Group undertook a comprehensive review of the EO determinations process with a view toward recommending a range of alternatives for reforming or replacing that process. In addressing this task, the Project Group sought to take into account both the needs of TE/GE to administer an application review program in an accurate, complete, and impartial manner, and the needs of EO applicants for a determinations program that is accessible, comprehensible, reliable and timely.

“Project ASPIRE”, the informal name given to the this determinations process project by the Project Group, reflects specific subsidiary goals of the EO determinations review conducted by the Project Group: A = alleviate any application backlog; S = streamline the determinations process; P = prioritize application review; I = improve customer service; R = redirect resources to cases deserving enhanced review and compliance; and E = enhance quality control.

IV. PROJECT PROCESS

The Project Group gathered information and statistics, and conducted interviews with a number of individuals both within and outside TE/GE. The IRS TE/GE interviewees included Steven Miller, Lois Lerner, Marv Friedlander, and Tom Miller of TE/GE - Washington, DC; Cindy Westcott and Janna Skufca of TE/GE – Cincinnati, OH; and Mike Rachael of TE/GE – Atlanta, GA. Members of the Project Group also conducted structured interviews⁶ with Marc Owens [Caplin & Drysdale, Washington, DC, former Director, EO Division], Celia Rody [Morgan, Lewis & Bockius, Washington, DC], Paul Streckfus [Paul Streckfus’ EO Tax Journal, Pasedena, MD], Betsy Adler, Terry Miller and Ruth Masterson [Silk, Adler & Colvin, San Francisco, CA], Linda Manley [director of filings, Lawyers Alliance of New York, New York City, NY], Jay Rotz [Webster, Chamberlain & Bean, Washington, DC, former Executive Assistant, EO Division], and Peter Turk and Marnie Berk [New York Lawyers for the Public Interest, New York City, NY].

Victoria Bjorklund, chair of the ABA Section of Taxation Exempt Organizations Committee and Project Group member, was instrumental in developing two panel presentations on the EO determinations process that were delivered during the Exempt Organizations Committee meeting on October 18, 2002. The first panel addressed Form 1023 and the current EO determinations process. Presenters were Lois Lerner, Director, Rulings and Agreements, and Cindy Wescott, then-EO Program Analyst,

⁶ Structured interviews conducted by the Project Group followed a questionnaire developed by the Project Group, which covered the following: issues in the current EO determination process (length of time, merit closure, impact on exam function, reviewer training, deficiencies in Form 1023, advanced ruling period, etc.); potential remedies (improvement of Form 1023, quality control, training, registration in lieu of application, etc.); and open-ended questions on development of the EO determinations process of the future. Interviewees were also asked to identify other individuals that the Project Group should contact.

Cincinnati. The highlight of this discussion was a video depiction of the physical EO determination process in Cincinnati that had been viewed previously by members of the Project Group. Ms. Lerner and Ms. Wescott also outlined the work of the EO Customer Satisfaction Team, headed by Ms. Wescott, in revising Form 1023 and commonly-used form determination letters.

Participants in the second panel, entitled *Shaping the IRS Determination Process of the Future*, were LaVerne Woods [Davis Wright Tremaine, Seattle, WA], Dick Gallagher [Foley & Lardner, Milwaukee, WI] (for Jody Blazek); Alexis Neely [Munger, Tolles & Olson, Los Angeles, CA], and Jennifer Franklin [Simpson Thacher & Bartlett, New York City, NY]. The panel offered suggestions for improving the EO determinations process on a range of organizational and operational issues, assistance in the preparation of Form 1023, Form 1023 design, the application process, the determination letter, and post-determination follow-up.

Approximately 100 ABA members attended these panels and participated in the question and answer periods that followed. In addition, the transcript of the approximately three-hour session was published in the December 2002 edition of the Exempt Organization Tax Review and was posted on several other websites.

Finally, the Project Group spent two days in Washington, DC reviewing 108 administrative records. These records represented a random sample of applications filed in the Cincinnati office over a particular time period. The vast majority were Forms 1023. Thirty-three (33) were merit closures; thirty-six (36) involved contacts with the applicant; and thirty-nine (39) were reviews of the advance ruling of public charity status, including a few mergers and terminations. A significant percentage (approximately 50%) of applicants were not represented by professional advisors (attorneys or accountants). The most common filing errors related to public charity classification, particularly with respect to the alternative public support tests under sections 509(a)(1) and 509(a)(2), followed by governing document insufficiencies. The Project Group review of the records revealed no incidents of case over-development and a surprising number of applications from churches⁷.

V. STEPS ALREADY TAKEN

Throughout the entire determinations review process, the Project Group provided substantive input and advice to TE/GE regarding its ongoing efforts to improve the determinations process, and encourages TE/GE to continue these efforts, which are outlined in detail below.

Form 1023 Revision Project. The EO Determinations Customer Satisfaction Team has made significant progress in its Form 1023 revision project, with the ultimate goal of developing a more streamlined, comprehensive, efficient, and user-friendly

⁷ During 2002, approximately 4,400 exemption applications were filed by churches, which under section 508(c)(1)(A) are not required to file applications for exemption.

instrument for evaluating the qualification of applicant organizations for exemption under section 501(c)(3). Noteworthy improvements have been made in the area of streamlining by integrating several formerly separate forms, e.g., Form 872-C (Consent Fixing Period of Limitations), and Form 8718 (User Fee) into the Form 1023. Questions have been rearranged to flow in a more logical sequence. Other questions have been revised to elicit more useful information or have been eliminated. The Form 1023 instructions have been modified to provide more useful, easily-understood information.

The Project Group provided substantive comments on the Form 1023 revision project, and encourages the Customer Satisfaction Team to continue its efforts on the Form 1023 revision project, e.g., incorporating additional forms such as Form 2848 (Power of Attorney), Form SS-4 (Application for Employer Identification Number), and Form 5768 (Section 501(h) Lobbying Election), into the Form 1023, or the Form 1023 package; taking steps to ensure that organizations do not end up with two employer identification numbers ("EIN") -- one applied for by the organization prior to filing its Form 1023, and another assigned when its application is processed -- by requiring an EIN before a Form 1023 is processed and making EINs available by e-mail or telephone; as well as other appropriate modifications as suggested by various commenters.

In October 2002, IRS solicited comments on its proposed revisions to Form 1023⁸, and in early December 2002, received comments from approximately 50 submitters, including the ABA Section of Taxation Exempt Organizations Committee and the American Institute of Certified Public Accountants⁹. The Project Group acknowledges the challenges faced by the Customer Satisfaction Team as it attempts to reconcile the frequently contradictory suggestions made by various commenters. The overall goal of the Form 1023 revision project should be production of a technically accurate, simplified application package that solicits relevant information in a manner that minimizes additional, time-consuming contacts between determination specialists and applicant organizations.

Determination Letter Revision Project. The Customer Satisfaction Team has also made significant progress in its determination letter revision project. The batch of letters released in the first phase of the project met the Team's goal to produce more user-friendly, informative, flexible, and consistent determination letters. The Project Group has provided substantive comments on the determination letter revision project. Among the issues addressed by the Customer Satisfaction Team were inconsistencies in the form letters originating at the Cincinnati and Washington offices, and the need for more flexibility to incorporate customized paragraphs in unusual situations. The need to simplify the determination letter was addressed by placing essential exemption information in the body of the determination letter and using plain language attachments that contain important general information about the exempt organization's ongoing

⁸ Announcement 2002-92, 2002-41 I.R.B. 709 (October 15, 2002).

⁹ These comments were published in the January/February 2003 edition of Paul Streckfus' EO Tax Journal.

obligations. This will enable an exempt organization to retain its determination letter in a safe place, while filing the attachments in its operational files for future reference.

Educational Initiatives. Roberta Zarin, Director, Customer Education and Outreach (“CE & O”), has initiated a series of one-day workshops for small and mid-sized tax exempt organizations, which covers topics such as exemption and filing requirements, unrelated business income tax, public inspection and disclosure of information returns, employment taxes, gaming activities, and the audit process. These workshops are designed for board members, officers and staff of exempt organizations that have received exemption within the last five years and have annual income of less than \$1 million. Workshops held during 2002 were surprisingly well attended, and confirmed that many smaller exempt organizations are not represented by professional advisors. The popularity of these workshops underlines the hunger for sound, basic advice in the exempt organizations community. Workshops have been scheduled in 12 cities (three one-day workshops in each city) from January through June 2003. In addition, CE & O is developing a “How to Apply for Tax-Exempt Status” workshop in collaboration with state charity officials. This four-hour, hands-on workshop will use a combination of lectures and exercises to address key application stumbling blocks, such as incomplete governing documents, the basics of private benefit, inurement and the adoption of a conflict of interest policy, foundation classification, and preparation of a budget. The workshop will be launched as a pilot at the six IRS nationwide tax forums. Participants in the tax forums are primarily enrolled agents and sole-practitioner CPAs, who are unskilled in EO filings. The Project Group commends these efforts, particularly the development of Form 1023-specific programs.

TE/GE Call Site. Often an exempt organization’s first contact with TE/GE involves a call to its Customer Account Services Call Site [1-877-829-5500]. Sophisticated EO practitioners are also familiar with the value of the Call Site and use it frequently. During 2002, the Call Site received 508,000 calls, of which 80 percent were exempt organizations inquiries. The Call Site anticipates receiving 620,000 calls during 2003. Ten (10) additional Call Site staff will be added in 2004, 7 of which will be from the EO function. Increased utilization of the Call Site derives in part from the excellent responsiveness of Call Site staff, who have access to helpful computer data, e.g., whether and when an applicant organization has been assigned to a determination specialist.

The contributions of the Call Site in the determinations process cannot be underestimated. The provision of accurate information and direction, particularly at the pre-application stage, can result in more expeditious application processing, an increase in the percentage of applications that are merit closures, and fewer and less intrusive subsequent contacts between applications and determination specialists. Efforts should continue to be made to provide Call Site staff with the most comprehensive, up-to-date information to facilitate responses to EO inquiries. Call Site staff should refer EO callers to the Life Cycle of a Public Charity and Life Cycle of a Private Foundation webpages, once they are posted on the IRS website.

Case Assignment Guide Revision. In the past, agents working as determination specialists operated within a grade level structure that was lower than that applicable to agents working in the examinations function, making retention of qualified personnel on the determination side problematic. Grade level structure is based in part on the EO case assignment guide (“CAG”), which was established in 1978 and had not been updated until recently. The CAG establishes broad issue categories, and within each issue category identifies cases as grade 11, grade 12, or grade 13 based upon specific sub-issues presented. Cases are given a preliminary grade upon intake, but final grading is not accomplished until closure, when a full evaluation can be made. Case grading is based on a range of factors including factual complexity, analytical complexity, application of the tax law, interpersonal factors (e.g., media exposure), projected impact of the application (e.g., national, regional, or local), and importance of the issues presented.

During 2003, realignment in grade structure between the determinations function and examinations function has been achieved¹⁰, as a positive byproduct of the revision of the CAG. This process has resulted in several promotion opportunities within the determinations function. The Project Group commends TE/GE for having pursued this solution and believes that the achievement of grade parity between the determinations and examinations functions within EO should result in enhanced longevity and experience of determination specialists, with concomitant increases in quality, efficiency and productivity.

Tax-Exempt Determination System. During 2003, authorization was obtained to implement the Tax-Exempt Determination System (“TEDS”) and the electronic imaging of Forms 1023. Implementation of TEDS will achieve efficiencies in grading and assignment of cases, particularly to determination specialists located outside of Cincinnati, and in developing statistics, analyzing issue trends, etc. Application processing time should decrease because fewer people will be involved in physically handling each Form 1023. While still not as advanced technologically as it should be, TEDS should improve the tracking of applications and expedite their release to the public until more advanced technology can be acquired and implemented.

Observation: The Project Group encourages increased coordination and information sharing within the EO function nationwide. Such coordination between all EO functions in Washington, Cincinnati, and various field offices is vital to the integrity of the determinations process. Both formal and informal mechanisms of information sharing among the Washington, Cincinnati and other field offices within the Rulings and Agreements function already exist, and consistent training is currently provided either in Cincinnati or at various field offices. Additional means of coordination and information sharing might include regular, ongoing training updates by means of internal broadcast e-mail or similar means; internal listservs or regional practice groups to pose questions,

¹⁰ The realignment achieved parity in the grade progressions for both the determinations and examinations functions. Parity does not exist with respect to the number of slots at each grade level, which reflects the increased complexity of cases in the examinations function.

discuss emerging trends, and share insights on case development; regular rotations among the Washington, Cincinnati, and various field offices; and prompt sharing of new information and emerging EO trends with the TE/GE Call Site. Closer coordination would encourage more trend analysis and quicker attention to emerging issue areas, e.g., web-based exempt organizations.

VI. RECOMMENDATIONS

The Project Group considered information, comments and suggestions gathered from interviews with practitioners, press, and IRS representatives, from comments offered at the ABA meeting and submitted as part of the Form 1023 revision process, and from reviewing selected application records, as well as from their own experience and observations.

The ACT previously recommended installation of the Life Cycle of a Public Charity and Life Cycle of a Private Foundation¹¹ webpages on the IRS website as a means of providing access to narrative explanations and applicable forms and instructions relating to significant events in the “life” of a charity. The Project Group presents below a range of recommendations with respect to the determinations process, many of which are logical extensions of the ACT’s earlier Life Cycle recommendation, and follow upon the steps that have already been initiated within TE/GE.

Recommendation #1: Develop Fully Interactive Form 1023. The Project Group recommends that TE/GE continue efforts to develop and fund a fully interactive Form 1023 (“CyberAssistant”) that will be posted on the IRS website and integrated with the IRS Life Cycle webpages.

Observation: In addition to serving as the instrument whereby eligibility for recognition of section 501(c)(3) exemption is determined, Form 1023 and its accompanying instructions serve an important educational function for exempt organizations, the significant majority of which are not represented by experienced advisors. In addition to the exemption determination letter, the Form 1023 is a principal source of information about an organization’s ongoing obligations with respect to maintaining exempt status.

The majority of Form 1023 filers are one- or two-time filers, whether they are organization volunteers, local practitioners or practitioners providing services through pro bono agencies. Information to assist these filers is available through IRS publications, the IRS website, and the Call Site. In addition, the needs of these filers are being addressed by an emerging industry in EO “how to” books and websites. The

¹¹ These recommendations were made at the ACT public meeting held in Washington, DC on June 21, 2002, the report of which is found on the EO website, www.irs.gov/eo.

high attendance at the CE & O workshops indicates that more can and should be done to educate these filers.

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

CyberAssistant could also provide practical pop-up advice, (e.g., that having the word “foundation” in an organization’s name doesn’t make it a private foundation), checklists, decision trees for key issues (e.g., choosing among various public charity categories), prompts, and question-series designed to assist applicants in completing Form 1023. In a fully interactive format, CyberAssistant could include a dedicated e-mail feature whereby applicants would be able to pose questions and receive answers as they encounter snags or obstacles in completing Form 1023. An applicant could download and print the completed Form 1023 and mail it to IRS, or e-file it directly. “Fail safe” features could be installed to prevent the applicant from providing inconsistent responses or printing a Form 1023 that lacked essential information.

Comments: The benefits of a fully interactive Form 1023 are obvious and significant. In addition to providing essential technical information to applicants, CyberAssistant will provide practical guidance that will enable applicants to avoid the most common pitfalls resulting in unnecessary application delays. The Project Group anticipates that implementation of CyberAssistant will increase the quality of Form 1023 submissions, and will result in a marked increase in the percentage of applications that will qualify for merit closure without the need for additional contact between the applicant organization and determination specialist. Further, based on discussions with TE/GE representatives, the Project Group anticipates that the implementation of CyberAssistant can be funded as a later phase of the TEDS process. In addition, elements of the technology developed for the TE/GE Form 990 e-filing and Section 527 e-filing initiatives may be transferable to a CyberAssistant project.

Recommendation #2: Develop Fully e-Fileable Form 1023. The Project Group recommends that TE/GE continue its efforts to develop and fund a fully e-fileable Form 1023 that will be posted on the IRS website and integrated with the IRS Life Cycle webpages and CyberAssistant.

Observation: Development of a fully e-fileable Form 1023 would save significant time in mailing, processing, assigning and developing applications. Further, TE/GE would be able to more easily track applications, isolate specific application characteristics and trends, sort applications for data analysis, statistical, and compliance purposes, and more efficiently make applications available to the public.

Comment: Protocols would need to be developed relating to the acceptance of electronic signatures, applicant privacy, and verification of organizing documents that cannot be provided electronically.

Recommendation #3: Facilitate Development of Form 1023 Database. The Project Group recommends that, as Forms 1023 are electronically imaged or filed, TE/GE facilitate development of a database of completed Forms 1023 that will be searchable by type of organization, state of location, and other relevant parameters.

Observation: Forms 1023 are subject to public disclosure, but are not available online. Currently, the Guidestar website [www.guidestar.org] provides imaged Forms 990 that are available to all segments of the public, including contributors, government officials, members of the press, and EO advisors. The easy public access to these Forms 990 has been extremely beneficial. Among other things, Forms 990 can provide EO advisors with a source of useful information and ideas for filing Forms 1023.

Comment: Easy public access to Forms 1023 would provide a better source of useful information regarding the type of organizations that qualify for exemption under section 501(c)(3). Among other things, these Forms 1023 could be used as models for applicant organizations, particularly organizations not represented by experienced advisors.

Recommendation # 4: Develop Prominent Form 1023 “Helpful Hints” Checklist. The Project Group recommends that a prominent checklist of “helpful hints” be added to the Form 1023 application package. This checklist should include: all required documentation; clear instructions to insure that the organization’s name on the application is the same as the name on the governing document; the order in which forms, documents, and user fee check must be arranged; the need to pay the user fee by certified check in order to avoid a mandatory 30-day check-holding period; and similar items designed to expedite application processing time and increase the likelihood that the application can be closed on a merit closure basis.

Observation: A significant percentage of exemption applications are filed without benefit of legal or other professional advisor. Even when an application is filed with the assistance of a professional advisor, frequently the advisor is not an EO specialist, and may be providing pro bono or first-time EO assistance. Non-represented applicants and non-frequent-filer practitioners are more likely to be unfamiliar with the law and application procedures, and thus submit incomplete or unclear applications that require

additional, sometimes repetitive contacts by determination specialists, resulting in processing delays or failures to establish exemption.

Comment: There are a number of “helpful hints”, known to frequent-filer practitioners, but often overlooked by first-time and unrepresented Form 1023 filers, which could be developed into a checklist as a means of reducing unnecessary delays and repetitive contacts with determination specialists. Requiring the checklist to be submitted with the application or providing expedited treatment for applications submitting the checklist would encourage its use. The Project Group anticipates that use of this checklist will increase the number of applicants filed by first-time and unrepresented filers that will qualify for closure on a merit basis.

Recommendation # 5: Conform Two Public Support Tests. The Project Group recommends that the two existing public support tests in sections 509(a)(1) and 509(a)(2) be conformed with a consistent support definition, appropriate qualification threshold, consistent 2 percent limitation, alternative facts-and-circumstances test, and clear instructions regarding the steps an organization must take when it falls below the minimum standards for qualification under either test.

Observation: All section 501(c)(3) organizations are either public charities or private foundations. Different rules apply for each classification. There are several methods whereby an organization can establish that it is a public charity (the more favored classification), based on type of organization, sources of support, or relationship to other organizations. Classification as a public charity or private foundation is perhaps the single most confusing concept for section 501(c)(3) applicants, including those represented by non-frequent-filer practitioners.

Adding to the general confusion is the fact that there are two alternative “public support” tests for establishing public charity status under sections 509(a)(1) and 509(a)(2)¹². Briefly, the section 509(a)(1) public support test applies to organizations that normally (on a rolling 4-year basis) receive at least one-third of their total support from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources. The section 509(a)(2) public support test applies to organizations that normally receive more than one-third of their support from any combination of gifts, grants, contributions, membership fees and gross receipts from exempt activities, and that normally receive no more than one-third of their support from gross investment income and the net unrelated business income.

The inherent confusion created by two alternative public support tests is exacerbated by the fact that different standards and definitions apply within each test. For example, an organization failing to meet the section 509(a)(1) one-third test may qualify under a facts-and-circumstances test, provided that it normally receives 10

¹² As of the end of 2002, there were 501,268 section 509(a)(1) publicly supported organizations, and 223,731 section 509(a)(2) publicly supported organizations.

percent of its support from approved sources. There is no corresponding facts-and-circumstances test under section 509(a)(2). There are different definitions of support under the section 509(a)(1) and section 509(a)(2) public support tests, and different limitations in the computation of support received from a single source, generally 2 percent from a single donor for section 509(a)(1) and \$5,000 or 1 percent for section 509(a)(2). Further, government support is considered “public” with no limitation under the section 509(a)(1) test, but is subject to the \$5,000/1 percent limitation under section 509(a)(2). Section 509(a)(2) also excludes all support from disqualified persons, whereas section 509(a)(1) merely subjects such support to the 2 percent limitation. Finally, there are limitations on the amount of investment and unrelated business income permitted for section 509(a)(2) organizations, but not for section 509(a)(1) organizations.

Comment: Any original rationale¹³ for the development and maintenance of complex standards under two different public support tests is today outweighed by the need for increased simplicity, consistency, and efficiency in the administration of the public support tests. Conforming and simplifying the two alternative public support tests would ameliorate a significant source of confusion for applicant organizations and their representatives, and would thereby simplify the application review process. The Project Group also urges interested stakeholders to consider the benefits, drawbacks, and mechanics of combining the two existing support tests in sections 509(a)(1) and 509(a)(2) into a single, coherent test, and whether such a combined support test would represent a significant improvement over the recommendation for key conforming changes in the two existing tests¹⁴.

Recommendation # 6: Eliminate Form 8734 at End of Advance Ruling Period. The Project Group recommends elimination of Form 8734 at the end of the advance ruling period for publicly supported organizations. Instead, the final determination of public support should be made on the basis of Schedule A to Form 990

¹³ Both the House and Senate Reports to the Tax Reform Act of 1969 (“TRA”) indicated a desire to exclude from the definition of private foundation four broad categories of organization: (1) organizations, contributions to which may be deducted to the extent of 30 percent [increased to 50 percent in TRA] of an individual’s income [509(a)(1)]; (2) certain types of broadly publicly-supported organizations (including membership organizations) [509(a)(2)]; organizations which are organized and operated exclusively for the benefit of one or more organizations described in (1) or (2), and are controlled by one or more organizations, or operated in connection with one organization described in (1) or (2); and (4) organizations which are organized and operated exclusively for testing for public safety. The House Report indicated that the type of organizations that would typically be classified under type (2) above include “symphony societies, garden clubs, alumni associations, Boy Scouts, Parent-Teachers Associations and many other membership organizations”. See H.Rep. 91-413, 91st Cong., 1st Sess., 1969-3 C.B. 226-227. The Senate report makes a clear distinction between type (1) broadly publicly supported organization and certain “other” type (2) organizations, but does not explain why the one-third limit on investment income, for example, is appropriate for type (2) organizations but not for type (1) organizations. See S. Rep. 91-552, 91st Cong., 1st Sess., 1969-3 C.B. 460-461.

¹⁴ Replacing the two existing public support tests of section 509(a)(1) and 509(a)(2) would require legislative changes.

that would contain 5 years' financial data. The Project Group further recommends that the financial information requested on the Form 1023 and Form 990 be conformed.

Observation: Form 8734 must be completed at the end of the 5-year advance ruling period by newly-created organizations that claim public charity status under either of the two alternative public support tests of sections 509(a)(1) or 509(a)(2) and receive an advance ruling of such status. The advance ruling period and Form 8734 are a source of confusion for exempt organizations, many of which erroneously believe that Form 8734 requires them to re-establish their exempt status. Many new organizations deviate significantly from their sources of support as estimated in their Forms 1023. Further, the financial information requested on Form 8734 differs from the financial information required on Schedule A of Form 990¹⁵.

Comment: A definitive ruling of public charity status or private foundation status could be issued automatically at the end of the 5-year advance ruling period on the basis of the financial information provided on an organization's annual Form 990. Issuance of the definitive ruling could be the responsibility of the Ogden Service Center.

Thereafter, the computation of public support could be made automatically by the Ogden Service Center annually on the basis of information provided on the Form 990. Ogden could be responsible for notifying an organization of any change in status. Such a system of automatic support computation could eliminate the confusion experienced by section 509(a)(1) organizations that fall below the 10% threshold by informing them of their new private foundation status and filing instructions.

The fact that definitive rulings of public charity status are currently made in Cincinnati and Forms 990 are currently reviewed in Ogden should not pose an obstacle to implementation of this recommendation. Likewise, the fact that Schedule A currently requests 4-year financial data and definitive rulings of public charity status at the end of the advance ruling period require 5-year financial data should not prevent implementation of this recommendation.

At a minimum, electronic imaging of Form 990 with automatic tracking/computation of financial information for organizations coded under section 509(a)(1) or 509(a)(2) would be required before automatic computation of public support could be implemented. In addition, small organizations (below the \$25,000 filing threshold) and any other publicly supported organization not required to file Form 990, e.g., an integrated auxiliary of a church, would not be tracked for compliance.

Recommendation # 7: Specify Section 509(a)(3) Test in Form 1023 and in Determination Letter. The Project Group recommends that Form 1023 be revised to require applicants seeking public charity classification as section 509(a)(3) supporting organizations specify the particular test ("operated, supervised or controlled by",

¹⁵ A current EO project is addressing this situation.

“supervised or controlled in connection with”, or “operated in connection with”) under which they intend to qualify. The Project Group further recommends that determination letters issued to section 509(a)(3) supporting organizations specify the particular test under which they have qualified for section 509(a)(3) status¹⁶.

Observation: One essential piece of information included in an organization’s initial determination letter is its specific public charity classification. Currently, the initial determination letter indicates that an organization qualifies for public charity classification as a supporting organization under section 509(a)(3), but fails to specify under which of the three supporting organization tests the organization qualifies.

Comment: Awareness of the specific section 509(a)(3) test (“operated, supervised or controlled by”, “supervised or controlled in connection with”, or “operated in connection with”) under which an organization qualifies is essential for initial compliance. Although Schedule D of Form 1023 (revised draft) requests information regarding the three section 509(a)(3) tests, the applicant organization is not required to specify which test it intends to meet. Amending Schedule D to request this information will require the applicant organization to focus on the requirements of the particular test selected, and increase the likelihood that the requirements of that test will be met. This will in turn reduce subsequent contacts between the applicant organization and the determination specialist.

Awareness of the specific section 509(a)(3) test under which an organization qualified as a public charity is also necessary for ongoing compliance. Although the specific test may have been known to an organization’s initial board of directors, with the passage of time this information is often lost to subsequent boards, legal counsel or accountants. Including this information in the initial determination letter will preserve it for future reference and will increase the likelihood of compliance with the requirements of the particular test on an ongoing basis.

Recommendation # 8: Develop Standard Public Charity Reclassification Process. The Project Group recommends development of a convenient, standardized public charity reclassification process, whereby an existing public charity can report relevant changes in activities or support, and obtain a revised determination letter reflecting its new public charity status or its reclassification as a private foundation.

Observation: At the time of filing Form 1023, many newly-created organizations are not able to predict accurately their actual activities or sources of support. Thus, it is not unusual for an organization to receive an initial classification of public charity status that several years into its operations is no longer appropriate. In addition, even established public charities may decide to modify their operations or sources of support in a manner that would result in a reclassification of their public charity status into a different public charity category or private foundation status. Organizations may report these changes in activities and support on their Form 990s, but there is no clearly-

¹⁶ As of the end of 2002, there were 29,843 section 509(a)(3) supporting organizations.

defined process for requesting reclassification of public charity status. There can be serious consequences for organizations that continue to operate as public charities when they are properly classified as private foundations, e.g., liability for excise tax under section 4940 and potential self-dealing problems under section 4941.

Comment: A standardized system for reclassification of public charity status is needed whether IRS retains or eliminates Form 8734. Currently, exempt organizations and their advisors have no clear guidance on the appropriate action to take when circumstances result in a change in public charity status. They don't know what to send, where or to whom. Experienced advisors have developed their own ad hoc systems for writing to Cincinnati, but most organizations erroneously expect that any change in public charity status will be noted and implemented automatically on the basis of the filing of Form 990 with the Ogden Service Center. The 60-month termination process for private foundations seeking reclassification as public charities is an appropriate prototype, albeit for the reverse situation.

Recommendation # 9: Develop Standard, "One-Stop" Name-Change Process. The Project Group recommends the development of a convenient, standardized process, whereby an exempt organization can report a name change and obtain a revised determination letter reflecting the organization's new name. This should be a one-stop process, enabling the organization to record its name change for all necessary purposes, e.g., Exempt Organizations Business Master File, EIN, Publication 78, employment tax accounts, etc.

Observation: It is not unusual for an exempt organization to change its name during the course of its existence to reflect a new location, change in emphasis or activities, or change in relationship to another organization. Such name changes are currently reported to IRS on Form 990 or in separate correspondence. However, there is no clearly-defined process for reporting changes in organizational name or obtaining a revised determination letter reflecting the new name¹⁷.

Comment: As a result, an organization may spend needless time and effort convincing donors, foundations, state charity and tax officials, and others that it is, in fact, the same organization as the organization to which its IRS determination letter was originally issued and which is listed in Publication 78..

Recommendation # 10: Link IRS Website to State Charity Officials Website. The Project Group recommends that the IRS website include links to state charity officials, through the Life Cycle webpages and through the CyberAssistant interactive Form 1023 (when implemented), beginning with the NAAG/NASCO website

¹⁷ Form 8822 exists for recording a change of address for employment, excise, income, and other business returns, but this form does not address organization name changes for returns and publications specific to exempt organizations.

[www.nasconet.org], which contains links to various state charity officials' websites. In the future, direct links to various state websites should be added, as part of a "Where are you located?" assistance prompt that could lead applicants to information about state incorporation, registration, charitable solicitation, and other useful information.

Observation: When the ACT-recommended Life Cycle webpages are posted on the IRS website, they will include information on charitable solicitation, with links to sites that provide state charitable registration requirements.

Comment: In order to maximize their usefulness, the Life Cycle webpages need to be reviewed regularly and enhanced as additional information useful to exempt organizations becomes available online.

VII. CONCEPTS FOR FURTHER CONSIDERATION

The Project Group gave thorough consideration to all recommendations developed by interviewees and other participants throughout the determinations review process. In addition to its 10 recommendations detailed above, the Project Group also identified several concepts for improving or revising the determinations process that were not recommended. In the interest of completeness, and to stimulate further discussion and development among interested stakeholders, the Project Group presents these concepts below.

Concept A: Increase Form 1023 Filing Threshold. The current Form 1023 filing threshold, established in section 508(c)(1)(B) is \$5,000. Increasing this threshold would eliminate the need for review of the applications of the smallest organizations, many of which can be expected to go out of existence within the first few years. For example, conforming the Form 1023 filing threshold to the Form 990 filing threshold (currently \$25,000) could, in addition to eliminating confusion and enhancing consistency in EO filing requirements¹⁸, free up determination specialists for more consequential application review, and reduce "deadwood" listings on the Exempt Organizations Business Master File¹⁹. IRS might also explore whether there are other discrete categories of organization for which filing Form 1023 is unnecessary in the efficient administration of the tax law.

Comment: Abuses can occur in small organizations as well as large organizations. One of the benefits of the Form 1023 process is its virtual universality. The initial application review provides IRS a unique opportunity to eliminate unqualified

¹⁸ The initial Form 990 threshold was also \$5,000 until it was increased by discretionary authority of the Secretary of the Treasury; see Announcement 82-88, 1982-25 I.R.B. 23. Presumably, the same discretionary authority could be used to increase the Form 1023 filing requirement under the rubric of section 508(c)(2)(B).

¹⁹ The EOBFM currently lists many small organizations that are no longer in existence, because the organizations never informed IRS of their terminations.

organizations. Raising the threshold to \$25,000 would permit unqualified or abusive organizations to operate under the IRS radar screen. In addition, since most organizations need the IRS determination letter in order to assure deductibility of contributions, it is not clear that raising the filing threshold would eliminate a significant number of applications. Finally, the Form 1023 serves an educative function, by informing organizations of the basic requirements for maintaining exempt status, which would be lost to smaller organizations if the Form 1023 filing threshold were increased.

Concept B: Adopt Registration System with Operational Follow-Up. Many organizations filing Form 1023 are new organizations that are unable to provide definitive information about their activities or sources of support. It has been suggested that too much emphasis is placed on the initial determination of exempt status, which is frequently based on proposed, anticipated, or conjectural activities and sources of support. Although sources of support are reviewed after 5 years for organizations receiving advance rulings as publicly supported organizations, this process does not involve an operational review. It has been recommended that Form 1023 be eliminated completely, in favor of a simple postcard registration system whereby organizations could provide basic identifying information, self-select public charity status, and certify that basic criteria for section 501(c)(3) status are satisfied, e.g., private benefit, inurement, lobbying, political activity²⁰. By eliminating the initial determination, EO personnel could focus on compliance, by means of a full operational review at 3-year, 5-year or some other appropriate interval after initial registration.

Comment: The opportunities for abuse are obvious and significant. Organizations would have an unfettered “free ride” in which to enjoy the benefits of exemption and deductible contributions during the period from initial registration until subsequent compliance review. Unscrupulous individuals could divert significant funds during a five-year period. If an organization were to go out of existence before any compliance review could take place, there would be no easy means of correction. Even well-intentioned organizations could be certifying to section 501(c)(3) requirements and public charity status that they do not understand. Finally, at current levels, EO would lack the staffing necessary to undertake 88,000 (based on current application levels) operational reviews annually.

Concept C: Develop Separate Form 1023-PF. Organizations that are private foundations present unique and complex issues not relevant to public charities.

²⁰ Interestingly, the version of the CARE bill currently under consideration by the Congress includes a provision that would require small organizations that are excused from filing Form 990 because they do not meet the \$25,000 filing threshold to file a short annual notice in order to enable IRS to maintain a record of the continuing existence of these organizations and to permit the public more easily to obtain basic information about them. This annual notice would include the legal name of the organization, any name under which it operates or does business, the organization’s mailing address and Internet website address, its taxpayer identification number, the name and address of a principal officer, and evidence of the organization’s continuing basis for exemption from the Form 990 filing requirement. Failure to file the annual notice for three consecutive years would result in revocation of exemption, with the obligation to file Form 1023 in order to re-establish exemption.

Advisors who represent organizations that wish to be classified as private foundations have suggested the development of a separate Form 1023-PF that would more quickly and fully develop issues relevant to that status.

Comment: Basic exemption qualification criteria are shared by both public charities and private foundations. A relatively small percentage of information solicited in the current Form 1023 (draft revision) relates solely to private foundations. A separate application for private foundations could help isolate classification issues for novice applicants, and could be processed more quickly. However, these potential benefits are offset by the risk that the Form 1023-PF would be submitted by organizations that are actually public charities. An inexperienced submitter could make this error for a number reasons, e.g. the word “foundation” in an organization’s name.

Concept D: Develop Separate Form 1023-EZ. It has been suggested that small organizations – either organizations below the current \$5,000 filing threshold that nonetheless wish to have an exemption determination letter for fundraising, or organizations below the \$25,000 Form 990 filing threshold – be permitted to file a Form 1023-EZ. This would be a simplified application that requested basic identification information, governing documents, a description of activities, and posed a series of questions to determine public charity status and potential disqualification for private benefit, inurement, lobbying and political activity.

Comment: There is actually very little “fat” in the current Form 1023 (revised draft). Most questions are necessary to a principled determination of eligibility for exemption under section 501(c)(3). Further, it is unclear what would happen when a small organization encounters a growth spurt, attracting additional funds and conducting expanded activities: should such an organization then be required to file the “full” Form 1023?

Concept E: Institute Regular Operational Reviews. Most organizations filing Form 1023 are new organizations that are unable to provide reliable information or predictions about their activities or sources of support. It has been suggested that TE/GE institute a regular system of operational reviews at 3-year, 5-year or some other appropriate interval after exemption is recognized. Such reviews could be conducted either on a random basis or on the basis of coding that would occur at the time of the initial determination letter. These reviews would not simply replicate the current review of financial information provided on Form 8734 for publicly supported organizations, but rather would focus on actual operations, charitable accomplishments, relationships with insiders, lobbying, and political activity, etc.

Comment: Information gathered from a system of 3-year, 5-year, etc., operational reviews could provide important statistical data, enhance trend analysis, identify organizations that have gone out of existence, and form the basis of future compliance efforts. Further, organizations’ awareness of the pendency of such an

operational review could serve a deterrent effect. However, such a program would require significantly increased staffing at a higher grade level, as the issues presented would be more complex than those presented upon initial application. It could not be accomplished within current EO staffing levels unless the initial Form 1023 review were eliminated.

Concept F: Eliminate Form 1023 Filing for Certain Reincorporations. From time to time, exempt organizations relocate from one state to another. In association with such an interstate move, an organization may elect to dissolve its corporation in the old state and incorporate as a new corporation in the new state in order to qualify as a domestic corporation. When an organization reincorporates under the laws of another state, it is considered by IRS to be a new legal entity. That new entity is required to refile Form 1023 even if its purposes, activities, and sources of support remain exactly the same.²¹ An organization that merely relocates to another state without reincorporating is not required to file a new application. It has been suggested that the new application requirement be simplified or eliminated for exempt organizations that relocate and reincorporate in a new state without any other changes in purposes, activities, or sources of support.

Comment: Organizations reincorporate for many different reasons, among them, relocation to another state. It would be difficult to justify relieving only certain reincorporated organizations from the new Form 1023 application requirement. Without a new application, it would be difficult to ensure that no other material changes in purposes, activities, or sources of support had, in fact, been made. In addition, the new Form 1023 provides IRS an additional opportunity to ensure that the organization continues to meet the requirements of section 501(c)(3) and public charity status. However, a “new” organization reincorporating under these circumstances should be able to obtain a definitive public support ruling based on the financial data of the “old” organization.

²¹ See Rev. Rul. 67-390, 1967-2 C.B. 179.

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

**TE/GE ABUSIVE TAX SHELTERS
INVOLVING TAX-EXEMPT AND GOVERNMENT ENTITIES
PROJECT GROUP**

JONATHAN B. FORMAN, PROJECT LEADER
BRIAN L. ANDERSON
PERRY ISRAEL
VICTORIA B. BJORKLUND (ADJUNCT)
KARL E. EMERSON (ADJUNCT)
DAVID MULLON (ADJUNCT)

MAY 20, 2003

TE/GE ABUSIVE TAX SHELTERS INVOLVING TAX-EXEMPT AND GOVERNMENT ENTITIES PROJECT

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
I. INTRODUCTION.....	4
II. BACKGROUND.....	4
A. PRESENT-LAW PRINCIPLES APPLIED TO TAX SHELTERS.....	5
1. <i>Selected Statutory Provisions Limiting Tax Benefits in Certain Transactions</i> ..	5
2. <i>Judicial Doctrines</i>	6
3. <i>Regulatory and Administrative Guidance with Respect to Tax Shelters</i>	8
a) Disclosure of reportable transactions by taxpayers.....	9
b) Registration and list maintenance requirements of tax shelter promoter....	11
B. PENALTIES AND SANCTIONS APPLICABLE TO TAX SHELTERS	11
1. <i>Penalties</i>	11
a) Taxpayer penalties relating to tax shelters	11
b) Non-taxpayer penalties.....	12
2. <i>Injunctive Actions</i>	14
C. GENERAL IRS INITIATIVES	14
1. <i>The Office of Tax Shelter Analysis</i>	14
2. <i>The Office of Flow-Through Entities and Abusive Tax Schemes</i>	15
3. <i>Other Compliance and Enforcement Efforts</i>	15
4. <i>Criminal Investigation (CI)</i>	16
5. <i>Publications</i>	16
D. STANDARDS OF TAX PRACTICE AND PROFESSIONAL CONDUCT REGARDING TAX SHELTERS AND OTHER TAX SCHEMES.....	17
1. <i>Circular 230 – Treasury Regulations that Govern Practice Before the IRS</i>	17
2. <i>American Bar Association Guidelines</i>	18
3. <i>American Institute of Certified Public Accountants Guidance</i>	18
4. <i>State Licensing Authorities</i>	18
III. HOW THE IRS HAS DEALT WITH TAX SHELTERS AND OTHER ABUSIVE TAX SCHEMES INVOLVING THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION	18
A. THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION.....	18
B. SOME EXAMPLES OF HOW THE IRS ADDRESSES ABUSIVE TAX TRANSACTIONS THAT INVOLVE TE/GE	20
1. <i>General Efforts to Achieve Compliance</i>	20

a)	Qualified appraisal rules for charitable contributions	20
b)	Anti-abuse provisions in the regulations	20
c)	Yield-burning tax-exempt bonds	21
d)	Soft Guidance.....	21
2.	<i>Listed Transactions</i>	22
a)	Section 401(k) Accelerators	23
b)	Abuses Associated with S Corporation ESOPs.....	24
c)	Certain Trusts Purporting to be Multiple Employer Welfare Funds Exempt from the Limits of Sections 419 and 419A	25
d)	Off-shore Reinsurance Companies	25
e)	Certain Trust Arrangements Seeking to Qualify for the Exception for Collectively Bargained Welfare Benefit Funds under Section 419A(f)(5).....	26
3.	<i>Civil and Criminal Investigations of Promoters</i>	26
4.	<i>Use of the Determination Letter Process</i>	27
5.	<i>IRS Forms Can Also Promote Compliance</i>	27
6.	<i>The TE/GE Abusive Tax Shelter Committee</i>	28
7.	<i>Other Activities</i>	28
C.	SPECIAL PROBLEMS FOR THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION.....	28
1.	<i>TE/GE Has Difficulty Learning About Abusive Tax Transactions</i>	29
2.	<i>TE/GE Needs to Coordinate with the Other IRS Operating Divisions</i>	29
3.	<i>TE/GE Has Limited Resources</i>	29
4.	<i>Section 6103 Limits Disclosure</i>	30
IV.	RECOMMENDATIONS	30
A.	FOCUS ON PROMOTERS AND SELF-PROMOTING TRANSACTIONS	30
B.	OPEN AN OFFICE OF ABUSIVE TAX TRANSACTIONS	30
C.	EXPAND THE TOOLS FOR DISCOVERING ABUSIVE TAX TRANSACTIONS.....	32
D.	PROVIDE ADDITIONAL PRIORITY TO GUIDANCE PROJECTS FOR DISPUTED TAX TRANSACTIONS THAT ARE PROMOTED OR THAT ARE SELF- PROMOTED	32
E.	KEEP IDENTIFYING LISTED TRANSACTIONS.....	32
F.	BRING MORE CRIMINAL CASES	33
G.	MODIFY TE/GE FORMS TO STEER CLIENTS AWAY FROM ABUSIVE TAX TRANSACTIONS.....	34

TE/GE ABUSIVE TAX SHELTERS INVOLVING TAX-EXEMPT AND GOVERNMENT ENTITIES PROJECT GROUP

The TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities Project Group respectfully submits the following report to the Advisory Committee on Tax Exempt and Government Entities (ACT) for transmittal to the Internal Revenue Service, Tax Exempt and Government Entities (TE/GE) Division.

EXECUTIVE SUMMARY

The Advisory Committee on Tax Exempt and Government Entities (ACT) created the TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities Project Group to study how the Tax Exempt and Government Entities (TE/GE) Division could better respond to abusive tax shelters and other abusive tax schemes. The goal of this project has been to identify various strategies that can be used by TE/GE and its component segments: Employee Plans (EP); Exempt Organizations (EO); and Government Entities (GE).

A. CATEGORIES OF TAX TRANSACTIONS

Tax transactions generally fall into three general categories, described below.

The first category consists of legitimate tax shelters that take advantage of the tax-savings advantages that Congress has written into the Code. For example, tax-exempt organizations, tax-qualified retirement plans, and tax-exempt bonds all involve such legitimate “tax shelters.” Monitoring and enforcing compliance with the rules necessary to obtain the advantages of such legitimate “tax shelters” is, of course, a core part of the TE/GE mission.

At the other end of the spectrum, there is another category of tax shelters and schemes consisting of abusive transactions that are aggressively sold by promoters in reckless disregard of Code provisions and that, under any reasonable interpretation, provide no basis for the tax advantages purportedly offered by those transactions. Such abusive tax transactions should (and do) lead to criminal prosecution and to civil enforcement mechanisms that focus on fraud.

In the middle is a broad category of tax transactions that may comply with the literal language of a specific tax provision yet yield tax results that may be unwarranted, unintended, or inconsistent with the underlying policy of the provision. Some of these disputed transactions should also be characterized as abusive tax transactions.

Of particular concern, are abusive tax transactions that are heavily “promoted” or that have the risk of becoming widely used. One important goal of the IRS’s initiatives against abusive tax transactions should be to chill the promotion or spread of such abusive tax transactions.

TE/GE uses a variety of statutory provisions, judicial doctrines, and regulatory guidance to identify and curb abusive tax transactions. For example, a number of the abusive tax transactions involving tax-exempts have been identified as "listed transactions" that must be disclosed on taxpayer returns. Similarly, many Code section 6700 tax-promoter-penalty cases involve tax-exempt bonds. Still other abusive schemes involve overvaluation of contributions to tax-exempt organizations. On the whole, the Project Group believes that TE/GE is doing a good job in combating abusive tax shelters and other abusive tax schemes.

B. RECOMMENDATIONS

The Project Group makes the following recommendations that are elaborated on in Part IV of this report:

1. Focus on Promoters and Self-Promoting Transactions

With limited resources, the TE/GE Division simply cannot curb many abusive tax transactions audit-by-audit or taxpayer-by-taxpayer. The normal audit process catches many abuses, but, of course, this approach is very labor intensive. It is a kind of "retail" approach to catching abuses, and with limited resources, TE/GE should strive to curb abuses on a more "wholesale" basis. The more effective strategy is to try to stop the promoters who are marketing abusive tax transactions to multiple taxpayers. A second related "wholesale" approach is to focus on transactions that tend to "self-promote" and spread widely quickly. TE/GE should focus on these promoted and self-promoting transactions.

2. Open an Office of Abusive Tax Transactions

Another way to help TE/GE deal with abusive tax transactions would be to provide a single location to coordinate information received relating to abuses. Such an "Office of Abusive Tax Transactions" could also help to coordinate a more effective response by the TE/GE Division to identified abusive tax transactions.

This new office could: (1) provide a central "reporting house" for third parties and internal persons to report suspected promotion schemes and self-promoting transactions; (2) catalog and profile schemes and trends; (3) assist the TE/GE functions in the allocation of resources to abusive tax transactions; (4) increase employee knowledge and skills related to abusive tax transactions; and (5) enhance coordination within the IRS on issues related to abusive tax transactions. The office might initially be quite small, and essentially act as a clearinghouse to gather information and pass it along to the directors of the TE/GE segments.

The new office should also help develop a strategy for dealing with each identified abusive tax transaction. The new office would also be instrumental in coordinating with the other IRS operating divisions. That coordination role will be especially important because so many abusive tax transactions that involve tax-exempts show up, if at all, only on tax returns that are reviewed by the other operating divisions.

In short, the new office should help identify abusive tax transactions involving tax-exempt and government entities, help develop the strategies needed to deal with those abuses, and help implement those strategies.

3. Expand the Tools for Discovering Abusive Tax Transactions

The TE/GE Division learns about potentially abusive transactions from: routine audits, the determination letter process, other IRS operating divisions, legitimate practitioners who care about good tax policy, and even from newspaper and magazine stories. TE/GE should streamline its ability to get information about potentially abusive tax shelters and other schemes, perhaps by adding an “abuse line” to its phone bank and a “report-abuses-here” link on its World Wide Web page. In addition, the Project Group believes that TE/GE should be more proactive about uncovering abusive transactions. For example, TE/GE officials should encourage legitimate practitioners and industry representatives to “blow the whistle” on abusive tax transactions.

4. Provide Additional Priority to Guidance Projects for Disputed Tax Transactions that are Promoted or Self-promoted

TE/GE needs to act quickly to identify potentially abusive tax transactions and to develop strategies for dealing with them. If a disputed tax transaction is being promoted or self-promoted and becoming widespread, the sooner that TE/GE can step in and issue formal guidance, the better. Moreover, while the formal guidance process is pending, TE/GE should sometimes issue soft guidance (e.g., Notices and Announcements) to curb the transactions.

5. Keep Identifying Listed Transactions

The Project Group was impressed with the efforts that the TE/GE Division has made to list potentially abusive transactions. The Project Group believes that the listing process has curbed a number of serious abuses. Moreover, the Project Group believes that having an ongoing listing process gives more credibility to honest practitioners who refuse to do suspect deals for clients. Listing puts the IRS on notice that taxpayers are claiming the benefits of a potentially abusive tax transaction and so gives the IRS an opportunity to challenge the transaction or request more information about it.

6. Bring More Criminal Cases

The Project Group believes that bringing more criminal investigations and prosecutions would have a significant deterrent effect on abusive tax transactions. In particular, the Project Group would like to see TE/GE, together with Criminal Investigation (CI) and the Department of Justice, make examples of some of the worst promoters of abusive tax transactions involving tax-exempt and government entities. In that regard, the Project Group recommends that TE/GE work with CI and the Department of Justice to develop a program to better educate TE/GE employees about criminal tax cases and about the “badges of fraud” that CI employees look for in developing cases for prosecution, and to better educate CI employees about abusive tax transactions that involve tax-exempt and government entities.

7. Modify TE/GE Forms to Steer Clients Away from Abusive Tax Transactions

IRS Forms can often steer taxpayers away from abusive tax transactions. For example, IRS Forms 1023 and 1024 help ensure that only qualifying entities can get exempt-organization status. The Project Group believes that TE/GE should solicit taxpayer and practitioner input about how it might change some of its other forms to improve compliance and generate more useful information.

I. INTRODUCTION

At the ACT working session on October 1-2, 2002, ACT determined that one of its projects would be to advise the Tax Exempt and Government Entities (TE/GE) Division about how to respond to abusive tax shelters and other abusive tax schemes involving tax-exempt and government entities. The Project Group's other working sessions were held on January 21-22, 2003, March 25-26, 2003, and May 20, 2003.

The following ACT members worked primarily on this project: Jonathan B. Forman (project leader), Brian L. Anderson, and Perry Israel. In addition, the following ACT members served as adjunct members on this project: Victoria B. Bjorklund, Karl E. Emerson, and David Mullon.

TE/GE and TE/GE Counsel officials and employees devoted countless hours to helping the Project Group understand how the Internal Revenue Service (IRS) deals with abusive tax shelters and other abusive tax schemes involving tax-exempt and government entities. These officials indicated that they were particularly interested in receiving advice about: (1) how to improve TE/GE's ability to find out about abusive tax shelters and other abusive tax schemes; (2) which anti-abuse tools the various segments of TE/GE should use to combat these abuses; (3) how IRS forms could be improved to help TE/GE identify these abuses; and (4) how TE/GE could encourage the other IRS Divisions to tap the expertise of TE/GE with respect to abusive tax transactions involving tax-exempt and government entities.

II. BACKGROUND

This part provides some general background about tax shelters and other abusive tax schemes and about how the IRS deals with these abuses.¹ The next part focuses more specifically on how TE/GE and its component parts have been dealing with tax shelters and abusive schemes.

There is no uniform standard as to what constitutes a tax shelter. Tax shelters generally fall into three general categories, described below.

¹ *This part draws heavily from JOINT COMMITTEE ON TAXATION, BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS (JCX-19-02, March 19, 2002); and U.S. GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: EFFORTS TO IDENTIFY AND COMBAT ABUSIVE TAX SCHEMES HAVE INCREASED, BUT CHALLENGES REMAIN, (Report No. GAO-02-733, 2002).*

The first category consists of legitimate tax shelters that take advantage of the tax-savings advantages that Congress has written into the Internal Revenue Code (“Code”). For example, tax-exempt organizations, tax-qualified retirement plans, and tax-exempt bonds all involve such legitimate “tax shelters.” Monitoring and enforcing compliance with the rules necessary to obtain the advantages of such legitimate “tax shelters” is, of course, a core part of the TE/GE mission.

At the other end of the spectrum, there is another category of tax shelters consisting of transactions or products that are aggressively sold by promoters in reckless disregard of Code provisions and that, under any reasonable interpretation, provide no basis for the tax advantages purportedly offered by those transactions or products. Such tax shelters should (and do) lead to criminal prosecution and civil enforcement mechanisms that focus on fraud. For the remainder of this report, we will refer to these as “abusive tax transactions.”

In the middle is a broad category of tax shelters consisting of transactions that may comply with the literal language of a specific tax provision yet yield tax results that may be unwarranted, unintended, or inconsistent with the underlying policy of the provision. As to that middle category, there are a variety of statutory provisions, judicial doctrines, and administrative guidelines that attempt to limit or identify transactions in which a significant purpose is the avoidance or evasion of tax. There may be substantial dispute as to whether these types of transactions qualify for the purported tax benefits they yield. For the remainder of this report, we will refer to this middle category of transactions as “disputed tax transactions.”

Of particular concern, especially for abusive tax transactions, but also for disputed tax transactions, are arrangements that are heavily “promoted” or that have the risk of becoming widely used. One particular goal of the IRS’s initiatives against abusive tax transactions is to chill the promotion or spread of such transactions.

A. PRESENT-LAW PRINCIPLES APPLIED TO TAX SHELTERS

The Internal Revenue Code (“Code”) provides specific rules regarding the determination of tax liability, and taxpayers generally may plan their transactions in reliance on these rules to determine the Federal tax consequences arising from those transactions. Notwithstanding the presence of specific rules for determining tax liability, a body of law has evolved in response to transactions that may comply with the literal language of a specific tax provision yet yield tax results that are unwarranted, unintended, or inconsistent with the underlying policy of the provision.

1. Selected Statutory Provisions Limiting Tax Benefits in Certain Transactions

Section 269. Section 269 provides that if a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the “Secretary”) has the authority to disallow the resulting benefits.

Section 446. Section 446(b) provides that if a taxpayer's method of accounting does not clearly reflect income, taxable income shall be computed under the method that, in the opinion of the Secretary, does clearly reflect income. The Secretary has broad discretion to determine whether a method of accounting clearly reflects income, and the Secretary may employ section 446 as a substantive means to modify the taxpayer's method of accounting in order to clearly reflect income.

Section 469. The rules of section 469, known as the passive loss rules, limit deductions and credits from passive trade or business activities.

Section 482. Section 482 provides that when two or more entities are controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among the entities in order to prevent the evasion of taxes or to reflect clearly the income of an entity.

Section 7701(l). Section 7701(l) provides the IRS with the authority to address tax shelter arrangements involving financing transactions. It provides: "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent [the] avoidance of . . . tax" The subsection authorizes Treasury to prescribe regulations to deal generally with complicated, tax-motivated lending transactions that lack economic substance.

Section 7805. Section 7805 and many other sections of the Code give the IRS authority to issue rules and regulations to enforce the tax laws.

2. Judicial Doctrines

In addition to the statutory provisions, the courts have developed several doctrines over the years to deny certain tax-motivated transactions their intended tax benefits. The general doctrines used to deny such tax benefits are: (1) the sham-transaction doctrine, (2) the economic-substance doctrine, (3) the business-purpose doctrine, (4) the substance-over-form doctrine, and (5) the step transaction doctrine.

Sham-transaction doctrine. Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions," and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent. Courts have recognized two basic types of sham transactions:

Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.²

² *United Parcel Service of America, Inc. v. Commissioner*, 78 T.C.M. (CCH) 262 at n. 29 (1999), reversed 254 F.3d 1014 (11th Cir. 2001).

Economic-substance doctrine. The courts generally will deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations – notwithstanding that the purported activity did actually occur. The Tax Court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.³

Business-purpose doctrine. Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham-transaction and economic-substance doctrines is the business-purpose doctrine. In its common application, the courts use business purpose (in combination with economic substance) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction; and (2) the transaction lacks economic substance. In essence, a transaction will only be respected for tax purposes if it has “economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached.”⁴

Substance-over-form doctrine. The concept of the substance-over-form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. Under this doctrine, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.

Step-transaction doctrine. An extension of the substance-over-form doctrine is the step-transaction doctrine. The step-transaction doctrine “treats a series of formally separate ‘steps’ as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.”⁵ The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end-result test, (2) the interdependence test, and (3) the binding-commitment test.

³ *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 2215 (1997), affirmed 157 F.3d 231 (3d Cir. 1998), certiorari denied 526 U.S. 1017 (1999).

⁴ *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978).

⁵ *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987).

Of note, Congress is currently considering legislation that would codify many of the above judicial doctrines.⁶

3. Regulatory and Administrative Guidance with Respect to Tax Shelters

Over the years, the Treasury has promulgated a number of anti-abuse rules that specifically allow the Commissioner to recharacterize a transaction that might otherwise legitimately meet the applicable rules set forth in the regulations or other administrative guidance. In the Tax Exempt Bond area, for example, one regulation gives the Commissioner the ability to depart from the specific regulations relating to arbitrage as necessary to “clearly reflect the economic substance of the transaction.”⁷ Another regulation allows the Commissioner, by publication of a revenue ruling or revenue procedure, to specify contracts that, although they do not fall within the formal requirements of the qualified hedging rules, will nonetheless be treated as qualifying hedges.⁸ Similarly, in the Employee Plans area, one of the nondiscrimination regulations advises that the regulations “must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of [highly compensated employees].”⁹ Like the sham-transaction, economic-substance, and substance-over-form judicial doctrines, these regulations are weapons that the IRS can use in its fight against abusive tax transactions.

More recently, the Treasury Department and the IRS have issued regulatory and administrative guidance that focuses specifically on abusive tax transactions. This guidance focuses primarily on requiring disclosure of transactions that may be considered potentially abusive, though it also includes notices that identify specific transactions in which the IRS will disallow the purported tax benefits. The IRS also has implemented certain organizational changes designed to improve the agency’s collection, utilization, and dissemination of information regarding abusive tax transactions.

In particular, in the past few years, the IRS issued temporary and now final regulations relating to tax shelters.¹⁰ The regulations establish certain disclosure

⁶ See, for example, *Joint Committee on Taxation, Description of the “CARE Act of 2003” (JCX-04-03, February 3, 2003)*, at 72 (clarifying the economic substance doctrine).

⁷ *Treasury Regulation § 1.148-10(e)*. Similarly, *Treasury Regulation § 1.140-1(c)(5)* provides that in order “to clearly reflect the economic substance of a transaction,” the Commissioner may treat bonds as part of the same issue or as part of separate issues notwithstanding the regulatory rules relating to the definition of an “issue.”

⁸ *Treasury Regulation § 1.148-4(h)(6)*.

⁹ *Treasury Regulation § 1.401(a)(4)-1(c)(2)*.

¹⁰ See, for example, *Treasury Regulation § 1.6011-4* and related regulations recently finalized by T.D. 9046, 68 *FEDERAL REGISTER* 10,161 (2003). See generally Mark H. Leeds, *Tax Shelter Disclosure, Registration, and Listing Rules for 2003 and Beyond*, *TAX NOTES*, March 31, 2003, at 2025; Amy Hamilton, *Treasury Issues Final Tax Shelter Disclosure Regs*, *TAX NOTES*, March 3, 2003, at 1295; Steven M. Rosenthal & Jeanne K. Falstrom, *Me, A Material Adviser? What Now?*, *TAX NOTES*, March 17, 2003, at 1749. See also Erika W. Nijenhuis et al, *The New Disclosure and Listing Regulations for Tax Shelters*, *TAX NOTES*, November 18, 2002, at 943; Beckett G. Cantley, *The Tax Shelter Disclosure Act: The Next Advisory Committee on Tax Exempt and Government Entities*

obligations of taxpayers that participate in any “reportable transaction.”¹¹ The regulations also describe the registration requirements of organizers who promote confidential corporate tax shelters under section 6111(d)(1),¹² as well as the requirement under section 6112 that organizers of potentially abusive tax shelters maintain a list identifying each person who was sold an interest in such shelter and certain other information about the shelter.¹³ Additional administrative guidance included a description of the functions of the new Office of Tax Shelter Analysis,¹⁴ as well as IRS Notices that have identified several transactions (“listed transactions”) that must be disclosed by taxpayers and registered by promoters.¹⁵

a) Disclosure of reportable transactions by taxpayers

The regulations under section 6011 require certain taxpayers to disclose with their tax returns certain information for each “reportable transaction” in which the taxpayer participates. Reportable transactions fall into six categories: (1) listed transactions, (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference, and (6) transactions involving a brief asset holding period.¹⁶

The regulations require disclosure of participation in reportable transactions by all direct and indirect participants.¹⁷ Disclosure must be made on a Form 8886, “Reportable Transaction Disclosure Statement.” While most disclosures will be made with respect to transactions involving income tax issues, starting in 2003, the regulations also authorize the IRS to require disclosure of listed transactions that involve Federal estate, gift, employment, pension, or exempt organization issues.

The regulations allow taxpayers to request a ruling as to whether a transaction must be disclosed.¹⁸ A transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction, if the Commissioner makes a determination, by published guidance, individual ruling, or otherwise, that the transaction is not subject to the disclosure requirements.

Listed transactions. First, according to the regulations, a “listed transaction” is a transaction that the IRS has identified as having a tax avoidance purpose and that the

Battle in the Tax Shelter War, 22 *VIRGINIA TAX REVIEW* 105 (2002); Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 *TAX LAW REVIEW* 289 (2002).

¹¹ Treasury Regulation § 1.6011-4(b).

¹² Treasury Regulation § 301.6111-2.

¹³ Treasury Regulation § 1.6112-1.

¹⁴ See, for example, Announcement 2000-12; 2000-12 *INTERNAL REVENUE BULLETIN* 1.

¹⁵ See, for example, Notice 2001-51, 2001-34 *INTERNAL REVENUE BULLETIN* 190 (providing a comprehensive list of “listed transactions” as of August 20, 2001). In addition, certain “material advisors” must keep lists and other information with respect to these transactions. Treasury Regulation § 301.6112-1(c)(2) provides a broad definition of who is a “material advisor.”

¹⁶ Treasury Regulation § 1.6011-4(b).

¹⁷ Treasury Regulation § 1.6011-4(c)(3).

¹⁸ Treasury Regulation § 1.6011-4(f).

tax benefits are subject to disallowance under existing law. When the IRS determines a transaction has a tax-avoidance purpose, a notice is issued informing taxpayers of the details of such transaction.¹⁹ The list is supplemented from time to time, when other such tax-avoidance transactions are identified.²⁰ Listing is used by the IRS to chill particular types of transactions as well as to collect additional information that may be useful in curtailing the spread of the identified transactions.

Confidential transactions. Second, a “confidential transaction” is a transaction that is offered under conditions of confidentiality, unless one of the exceptions in the regulations applies. Of note, one exception in the regulations provides a presumption if the promoter specifically authorizes the taxpayer to freely disclose the structure and tax aspects of the transaction.

Transactions with contractual protection. Third, a “transaction with contractual protection” is a transaction for which the taxpayer has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained.

Loss transactions. Fourth, a “loss transaction” is any transaction resulting in, or that is reasonably expected to result in, a loss under section 165 of at least:

\$10 million in any single taxable year or \$20 million in any combination of taxable years for corporations;

\$10 million in any single taxable year or \$20 million in any combination of taxable years for partnerships that have only corporations as partners; or \$2 million in any single taxable year or \$4 million in any combination of taxable years for all other partnerships;

\$2 million in any single taxable year or \$4 million in any combination of taxable years for individuals, S corporations, or trusts; and

\$50,000 in any single taxable year for individuals or trusts, if the loss arises with respect to a section 988 foreign currency transactions.

Transactions with a significant book-tax difference. Fifth, a “transaction with a significant book-tax difference” is a transaction where the treatment for Federal income tax purposes of any item or items from the transaction differs, or is reasonably expected to differ, by more than \$10 million on a gross basis from the treatment of the item or items for book purposes in any taxable year. Book income is determined by applying U.S. generally accepted accounting principles (GAAP) for worldwide income. A recent Revenue Procedure identifies a number of book-tax differences that will not be taken

¹⁹ See, for example, Notice 2002-21, 2002-14 INTERNAL REVENUE BULLETIN 730, for a recent example of a transaction that has been identified as a listed transaction for purposes of the taxpayer disclosure, promoter registration, and list maintenance requirements.

²⁰ See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (providing a comprehensive list of “listed transactions” as of August 20, 2001).

into account in determining whether a transaction has a significant book-tax difference.²¹ This category of reportable transactions only applies to reporting companies under the Securities and Exchange Act of 1934 (15 U.S.C. § 78a) and certain related business entities.²²

Transactions involving a brief asset holding period. Sixth, a “transaction involving a brief asset holding period” is a transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding \$250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days.

b) Registration and list maintenance requirements of tax shelter promoter

Registration of tax shelters (sec. 6111). Section 6111 requires an organizer of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered for sale. The definition of tax shelter is not quite as broad as the definition under section 6011.²³

Tax shelter promoter investor lists (sec. 6112). Section 6112 requires promoters to maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111.²⁴ Promoters are required to provide the lists and other required information to the IRS within 20 days of an IRS request; no administrative summons is required.²⁵ The term promoter is broadly defined and includes “material advisors” to the transaction.²⁶

B. PENALTIES AND SANCTIONS APPLICABLE TO TAX SHELTERS

1. Penalties

a) Taxpayer penalties relating to tax shelters

Accuracy-related penalty (sec. 6662). The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift-tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most

²¹ Revenue Procedure 2003-25, 2003-11 INTERNAL REVENUE BULLETIN 1. Of note, section 4.08 of this ruling exempts book-tax differences relating to “Compensation....including pensions.”

²² See Treasury Regulation § 1.6011-4(b)(6)(ii)(A)(1).

²³ Section 6111(d) relating to confidential tax shelters is limited to certain corporate tax shelters.

²⁴ The concept of “owners and sellers” (who must keep lists) is very broad and includes not only tax advisors that make “tax statements” with respect to reportable transactions (and receive the requisite minimum fee) but also non-tax advisors who talk about tax consequences and receive a fee. Treasury Regulation § 301.6112-1(c)(2).

²⁵ Treasury Regulation § 301.6112-1(g).

²⁶ Treasury Regulation § 301.6112-1(c)(2).

corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.²⁷ Under section 6664 of the Code, the accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion. There are special rules which apply to tax shelter items.

Fraud penalty (sec. 6663). The accuracy-related penalty under section 6662 discussed above does not apply to any underpayment of tax that is attributable to fraud. Rather, a penalty under section 6663 equal to 75 percent of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined “fraud” to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.

b) Non-taxpayer penalties

Understatement of taxpayer’s liability by income-tax preparer (sec. 6694). Section 6694 imposes a penalty on an income-tax preparer for any understatement of tax liability on a tax return due to a position for which there was not a realistic possibility of success of being sustained on its merits, but only if: (1) the return preparer knew (or reasonably should have known) of the position; and (2) the position was not adequately disclosed on the return or was frivolous. The penalty is \$250 with respect to each return, unless the preparer establishes that there was reasonable cause for the understatement and the preparer acted in good faith. The penalty amount is increased to \$1,000 if any part of the understatement is due to the preparer’s willful conduct, or reckless or intentional disregard of the rules and regulations.

Penalties with respect to the preparation of income-tax returns for others (sec. 6695). Section 6695 imposes a penalty on any income-tax return preparer who, in connection with the preparation of an income-tax return, fails to: (1) furnish the taxpayer with a completed copy of the tax return; (2) sign the tax return (if required to do so by regulations); (3) furnish the proper identification number with respect to the tax return; (4) retain a copy of the completed return or a list (with names and taxpayer identification numbers) of the taxpayers for whom a return was prepared; or (5) comply with certain due-diligence requirements in determining a taxpayer’s eligibility for the earned income credit. Section 6695 also prohibits an income tax preparer from endorsing or otherwise negotiating a refund check that is issued to the taxpayer. In most cases, the penalty is \$50 for each failure, with a maximum penalty of \$25,000 per category. The failure to comply with the due-diligence requirements in determining eligibility for the earned income credit carries a \$100 penalty for each failure.

²⁷ *Of note, the IRS recently issued proposed regulations that limit the defenses available to taxpayers facing the penalty for failing to disclose reportable transactions or for failing to disclose their position that a regulation is invalid. See Internal Revenue Service, Notice of Proposed Rulemaking, 67 FEDERAL REGISTER 79,894 (2002).*

Promoting abusive tax shelters (sec. 6700). Section 6700 imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty equals \$1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Aiding and abetting understatement of tax liability (sec. 6701). Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person’s tax liability.

Failure to register tax shelters (sec. 6707). Under section 6707, the penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees. Section 6707 also imposes (1) a \$100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a \$250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Failure to maintain lists of investors in potentially abusive tax shelters (sec. 6708). Under section 6708, the penalty for failing to maintain the list required under section 6112 is \$50 for each name omitted from the list (with a maximum penalty of \$100,000 per year).

2. Injunctive Actions

Action to enjoin income-tax return preparers (sec. 7407). Under section 7407, the Secretary may bring a civil action in district court to enjoin a tax return preparer from further engaging in conduct (1) described in section 6694 (the understatement of tax liability by a return preparer penalty, discussed above) or section 6695 (other assessable penalties with respect to the preparation of income tax returns, also discussed above), (2) misrepresenting his eligibility to practice or his experience or education, (3) guaranteeing the payment of any tax refund or allowance of any tax credit, or (4) engaging in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws. For repeat offenses, the court may enjoin the person from acting as an income-tax preparer.

Action to enjoin promoters of abusive tax shelters (sec. 7408). Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters, discussed above) or section 6701 (the penalties for aiding and abetting the understatement of tax liability, also discussed above). Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. These actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the penalty. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

C. GENERAL IRS INITIATIVES

The IRS has undertaken a variety of general initiatives to curb abusive tax transactions.

1. The Office of Tax Shelter Analysis

In February of 2000, the IRS established the Office of Tax Shelter Analysis (OTSA), located in the Large and Mid-Size Business (LMSB) Division, to serve as a focal point for many tax shelter compliance initiatives, including the gathering of information relating to tax shelters affecting taxpayers other than those served by the LMSB.

The responsibilities of the OTSA include: (1) reviewing all disclosures by promoters and taxpayers under the tax shelter disclosure regulations; (2) identifying taxpayers that have participated in such transactions, to assist in evaluating the tax treatment of cutting edge tax-structured transactions to identify improper tax shelters; and (3) providing a better assessment of the overall extent of tax-shelter activity by taxpayers. The OTSA also helps review many of the tax-shelter transactions that come to the attention of the IRS in other ways, including transactions examined by field personnel and those that are disclosed to the IRS by taxpayers, practitioners, and other

members of the public. In addition, the OTSA is responsible for planning, coordinating and providing assistance to LMSB field personnel on tax shelter issues.

2. The Office of Flow-Through Entities and Abusive Tax Schemes

Also, in January of 2000, the IRS established the Office of Flow-Through Entities and Abusive Tax Schemes, located in the Small Business and Self-Employed (SB/SE) Division. This office was created to organize the IRS's efforts in addressing abusive tax schemes, particularly trusts, and to identify their promoters and sellers. The office's goals are: (1) to catalog and profile schemes and trends; (2) direct compliance resources to examine schemes and promoters and participants for criminal prosecution; (3) increase employee knowledge and skills related to abusive tax scheme issues; and (4) enhance coordination within the IRS on issues related to abusive tax schemes.²⁸

Flow-through entities include domestic trusts and offshore trusts and partnerships. These are flow-through entities because their income "flows through" to their partners or other beneficiaries subject to taxation.

According to the General Accounting Office, the IRS characterizes an "abusive tax scheme" as any plan or arrangement created and used to obtain tax benefits not allowable by law.²⁹ As such, schemes can be based on improper use of domestic and foreign trusts, inflated business expenses and deductions, falsely claimed tax credits and refunds, and various anti-tax arguments. According to the IRS, abusive tax schemes fall into four categories: frivolous returns, frivolous refunds, abusive domestic trusts, and offshore schemes.

For example, the Frivolous Return Program, located in the SB/SE Division, identifies the tax returns of individuals who assert unfounded legal or constitutional arguments and refuse to pay their taxes or to file a proper tax return. The program also identifies returns claiming frivolous refunds, such as those involving slavery reparations.

The IRS estimates the potential revenue loss from abusive tax schemes to be in the tens of billions of dollars annually. For example, in February 2002, the IRS estimated that about 740,000 taxpayers used abusive tax schemes in tax-year 2000. The IRS detected approximately \$5 billion in improper tax avoidance or tax credit and refund claims, and it estimated that another \$20 billion to \$40 billion in taxes had not been identified and addressed related to offshore schemes.

3. Other Compliance and Enforcement Efforts

The IRS has taken a number of other steps to enhance compliance and enforcement activities – its audit and other civil enforcement activities – that focus on abusive tax transactions. The Wage and Investment (W&I) Division, the SB/SE

²⁸ See, for example, *Small Bus/Self-Employed, Abusive Schemes Counter-Marketing Tools*, available at <http://www.irs.gov/businesses/small/article/0,,id=106788,00.html>.

²⁹ U.S. GENERAL ACCOUNTING OFFICE, *INTERNAL REVENUE SERVICE: EFFORTS TO IDENTIFY AND COMBAT ABUSIVE TAX SCHEMES HAVE INCREASED, BUT CHALLENGES REMAIN*, above note 1, at 1.

Division, and the LMSB Divisions process taxpayers' tax returns, and all have responsibility for identifying tax returns that may involve abusive tax transactions.

Also, the National Fraud Program, which operates at IRS campuses and field offices, coordinates efforts and provides oversight to IRS's compliance efforts to identify potential tax fraud.

4. Criminal Investigation (CI)

Criminal Investigation (CI) is the investigative arm of the IRS and is comprised of approximately 2,900 special agents. Criminal Investigation is responsible for the enforcement of tax, money laundering, and Bank Secrecy Act laws. Pertinent here, CI investigates and pursues promoters and sellers of abusive schemes and the individuals using such schemes. CI's role is the enforcement of the tax laws for individuals who willfully fail to comply with their obligation to file and pay taxes and who ignore IRS's collection and compliance efforts. The most flagrant cases are recommended for criminal prosecution.

CI also administers the Questionable Refund Program that focuses on stopping the payment of various false tax refunds and, if warranted, prosecuting the taxpayers involved. Furthermore, CI develops education and publicity activities warning taxpayers about abusive tax schemes.

CI's enforcement strategy as it relates to fraudulent tax schemes is to focus primarily on the promoters of these schemes and on taxpayers who willfully use these schemes to evade taxes. For example, during a tax scheme investigation, CI generally attempts to gain access to a fraudulent promoter's list of clients to whom the promoter sold the scheme. In addition to pursuing the promoter, CI can then use the list of clients to determine who may have used the abusive scheme.

CI carries out IRS's criminal law enforcement responsibilities under three principal statutes.³⁰ Under the Internal Revenue Code, the IRS has the authority to investigate alleged criminal tax violations, such as tax evasion and filing a false tax return. Under title 18 U.S. Code, IRS has the authority to investigate a broad range of fraudulent activities, such as false claims against the government and money laundering. Under title 31 U.S. Code, IRS is responsible for enforcing certain recordkeeping and reporting requirements of large currency transactions, such as cash bank deposits of more than \$10,000. In fulfilling these responsibilities, CI coordinates as necessary with the IRS Chief Counsel, the U.S. Department of Justice, and the U.S. Attorneys.

5. Publications

Another initiative for discouraging abusive tax transactions involves IRS publication of the abuse and notice that the IRS is investigating. For example, the web

³⁰ U.S. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS' AUDIT AND CRIMINAL ENFORCEMENT RATES FOR INDIVIDUAL TAXPAYERS ACROSS THE COUNTRY (Report No. GAO/GGD-99-19, 1998).
Advisory Committee on Tax Exempt and Government Entities
May 20, 2003 – Page II - 16

page for Criminal Investigation identifies such tax fraud schemes as: the Slavery Reparation Scam and the Abusive Trust Schemes.³¹ Similarly, in IRS News Release IR-2003-18, the IRS warns taxpayers about the “Dirty Dozen” tax scams.³²

D. STANDARDS OF TAX PRACTICE AND PROFESSIONAL CONDUCT REGARDING TAX SHELTERS AND OTHER TAX SCHEMES

1. Circular 230 – Treasury Regulations that Govern Practice Before the IRS

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before the IRS. Similarly, an individual who is duly qualified to practice as a CPA in a State may represent a person before the IRS. Individuals not qualifying under either the attorney or the CPA rules may represent a person before the IRS if they qualify either by passing an examination or by nature of their previous employment with the IRS. The Treasury Department is authorized to regulate the practice of representatives before the Treasury Department (which includes the IRS), and (after notice and opportunity for a proceeding) to suspend or disbar any representative from practice before the Treasury Department for a violation of such rules and regulations. In accordance with this grant of authority, the Treasury Department has issued regulations that govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients (hereafter “practitioners”) before the IRS. These regulations are commonly referred to as Circular 230.³³

Circular 230 contains rules governing the standards for certain tax shelter opinions, as well as rules governing the standards for advising a taxpayer to take a position on its return. Historically, the IRS Office of Director of Practice was responsible for the enforcement of Circular 230.

On January 8, 2003, however, the IRS created a new Office of Professional Responsibility, taking the place of the Office of the Director of Practice.³⁴ A major emphasis of the new Office of Professional Responsibility will be to investigate allegations of misconduct and negligence against agents, attorneys, accountants and other professionals representing taxpayers before the IRS. The new office will have more than twice the staff that was available under the previous organization, and with those additional resources, the IRS has announced that the Office of Professional Responsibility “will thoroughly concentrate on enforcing the standards of practice for those who represent taxpayers before the IRS as detailed in Circular 230.”

³¹ See <http://www.irs.gov/irs/content/0,,id=106057,00.html>.

³² See IRS News Release IR 2003-18 (February 19, 2003), available at <http://www.irs.gov/newsroom/article/0,,id=107493,00.html>.

³³ Circular 230, Regulations Governing Practice Before the IRS, 31 CODE OF FEDERAL REGULATIONS Part 10 (2002).

³⁴ IRS News Release IR 2003-3 (January 8, 2003), available at <http://www.irs.gov/newsroom/index.html>.

In addition, the Treasury Department recently proposed modifying and expanding the Circular 230 rules that relate to tax shelter opinions.³⁵

2. American Bar Association Guidelines

The American Bar Association (“ABA”) has promulgated a series of rules and guidelines concerning the standards of practice for lawyers. The ABA rules, in and of themselves, do not have legal effect. However, most States have adopted rules of professional conduct based on rules promulgated by the ABA (which rules of conduct do have the force and effect of law). The two primary sets of rules that have been promulgated by the ABA are the Model Code of Professional Responsibility (“Model Code”) and Model Rules of Professional Conduct (“Model Rules”). The ABA, through its Standing Committee on Ethics and Professional Responsibility, issues formal and informal opinions that interpret the Model Code and Model Rules. Of particular relevance to tax practitioners are: (1) ABA Formal Opinion 346, regarding a lawyer’s duties and responsibilities in rendering tax shelter opinions, and (2) ABA Formal Opinion 85-352, regarding a lawyer’s duty in advising a client on a position that can be taken on a tax return.

3. American Institute of Certified Public Accountants Guidance

The American Institute of Certified Public Accountants (“AICPA”) has not issued standards of practice specifically related to tax shelter arrangements. However, AICPA Statements on Responsibilities in Tax Practice (1991 Revision) represent general guidance for AICPA members, but do not constitute enforceable standards. Rather, the statements are considered only educational and advisory in nature.

4. State Licensing Authorities

Each State, by virtue of the State courts (for lawyers), or through a licensing board (for CPAs), regulates and disciplines practitioners who are authorized or licensed to practice in the State. Many State regulatory bodies maintain rules that mirror the standards of national organizations, such as the ABA and the AICPA. Tax practitioners that fail to abide by their respective State requirements may be subject to disciplinary actions, such as disbarment, suspension, reprimand, or denial of license to practice within such State.

III. HOW THE IRS HAS DEALT WITH TAX SHELTERS AND OTHER ABUSIVE TAX SCHEMES INVOLVING THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

A. THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

The Tax Exempt and Government Entities Division (TE/GE) was established in late 1999 as part of the Internal Revenue Service's modernization effort.³⁶ The division

³⁵ See, for example, Advanced Notice of Proposed Rulemaking, 67 *FEDERAL REGISTER* 77,725 (2002).
Advisory Committee on Tax Exempt and Government Entities
May 20, 2003 – Page II - 18

is designed to serve the needs of three very distinct customer segments: Employee Plans (EP), Exempt Organizations (EO), and Government Entities (GE).³⁷ The customers range from small local community organizations and municipalities to major universities, huge pension funds, state governments, Indian tribal governments, and complex tax-exempt bond issuers.

These organizations represent a large economic sector with unique needs and are governed by complex, highly specialized provisions of the tax law. For example, in the employee-plans, exempt-organizations, and tax-exempt-bond areas, these provisions are not designed to generate revenue, but rather to ensure that the entities fulfill the policy goals that their tax exemptions were designed to achieve. Although generally paying no income tax, the tax-exempt sector does pay more than \$220 billion in employment taxes and income tax withholding and controls approximately \$6.7 trillion in assets.

TE/GE was created to address four basic key customer needs: education and communication, rulings and agreements, examination, and customer account services. Education and communication efforts focus on helping customers understand their tax responsibilities with outreach programs and activities tailored to their specific needs. Rulings and Agreements efforts provide a strong emphasis on up-front compliance programs, such as the determination, voluntary compliance, and private letter ruling programs. Examination initiatives identify and address non-compliance, through customized activities within each customer segment, and Customer Account Services provide taxpayers with efficient tax filings as well as accurate and timely responses to questions and requests for information.

The Commissioner of TE/GE is responsible for the uniform interpretation and application of the Federal tax laws on matters pertaining to the Division's customer base. In addition, the Commissioner provides advice and assistance throughout the Service, to the Department of the Treasury, other government agencies, including state governments and Congressional committees, and maintains particularly close liaison with the Department of Labor and the Pension Benefit Guaranty Corporation.

TE/GE headquarters is located in Washington, D.C. The EP and EO determination letter programs are managed in Cincinnati, Ohio, and the EP and EO audit functions are managed through six area offices. GE is centrally managed out of the headquarters office.

³⁶ This section follows: *Tax Exempt & Government Entities Operating Division, At-a-Glance*, available at <http://www.irs.gov> (click on About IRS, IRS History and Structure, and TAX EXEMPT AND GOVERNMENT ENTITIES).

³⁷ The mission of TE/GE is:

To provide TE/GE customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.

B. SOME EXAMPLES OF HOW THE IRS ADDRESSES ABUSIVE TAX TRANSACTIONS THAT INVOLVE TE/GE

1. General Efforts to Achieve Compliance

Regulations are the most powerful guidance that the IRS can issue as these typically have “the full force and effect of law.” The IRS also identifies abusive tax transactions through revenue rulings and revenue procedures. Finally, the IRS has used so-called “soft guidance” to inform and direct practitioners. Examples of TE/GE-related guidance to curb abusive tax transactions include:³⁸

a) Qualified appraisal rules for charitable contributions

Since only section 501(c)(3) organizations are eligible for section 170 tax-deductible contributions, they are the number one target for abuses targeted by the Exempt Organization segment of TE/GE. Historically, one of the most common abuses has involved overvaluation of charitable contributions to section 501(c)(3) organizations. Most of those abuses have been curtailed by extensive recordkeeping, valuation, and appraisal requirements.³⁹ IRS forms, instructions, and publications have also been particularly effective in curbing these abuses.⁴⁰

In that regard, the IRS recently issued Revenue Ruling 2002-67 to deter taxpayers from claiming excessive charitable deductions for giving used cars to charities.⁴¹ This ruling tells taxpayers how to determine the proper amount to deduct. The ruling advises that the donor may use a used car pricing guide to determine the car’s fair market value as long as the comparison is for the same make, model, and year, is sold in the same geographical area, and in the same condition as the donated car. If not (*i.e.*, if the car doesn’t run), the donor must use some other reasonable method.

b) Anti-abuse provisions in the regulations

The Treasury has promulgated a number of regulations that are intended to curb abuses.⁴² For example in the tax-exempt bond area, one particularly broad provision gives the Commissioner the authority to “take any action to reflect the substance of the transaction” if an issuer enters into a transaction “with a principal purpose of transferring to governmental persons . . . significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141.”⁴³

³⁸ See also the regulations described in the first paragraph of Part II.A.3 above.

³⁹ See, for example, Treasury Regulation § 1.170A-13.

⁴⁰ See, for example, *Charitable Contributions*, IRS Publication No. 526 (2000) and *Determining the Value of Donated Property*, IRS Publication No. 561; see also U.S. GENERAL ACCOUNTING OFFICE, *VEHICLE DONATIONS: TAXPAYER CONSIDERATIONS WHEN DONATING VEHICLES TO CHARITIES* (Report No. GAO-03-608T, 2003).

⁴¹ 2002-47 INTERNAL REVENUE BULLETIN 873.

⁴² A complete discussion of the use of these anti-abuse rules is beyond the scope of this report.

⁴³ Treasury Regulation § 1.141-14.

Similarly, in the pension plan area, a number of Treasury regulations are designed to prevent retirement plans from discriminating significantly in favor of highly compensated employees. For example, with respect to the timing of retirement-plan amendments, when a pension-plan sponsor winds up its business, it might consider first terminating its nonhighly compensated employees, and then, while the plan covers only highly compensated employees, amending the plan (before it is terminated) to provide significantly increased benefits for those highly compensated employees. Treasury regulations, however, provide a clear warning to plan sponsors by stating that the determination of whether the timing of a plan amendment (or series of amendments) is discriminatory shall be determined based on all the facts and circumstances.⁴⁴ The regulations contain several examples of plan amendments that have an improper discriminatory effect (including the one just described).

Another Treasury regulation provides that all the pension-plan nondiscrimination regulations under section 401(a)(4) “must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of [highly compensated employees].”⁴⁵

c) Yield-burning tax-exempt bonds

In the tax-exempt bond area, one abuse, known as yield-burning, involves issuing tax-exempt bonds that remarket Treasury bonds and other Treasury securities. The IRS has issued several rulings that address this abuse.⁴⁶

d) Soft Guidance

A variety of other forms of guidance have also been used to curb abusive tax transactions. In that regard, notice that the IRS is “concerned” about a transaction is often enough for the many relatively compliant communities of taxpayers serviced by the TE/GE Division. For example, TE/GE officials advised the Project Group that merely announcing that IRS Employee Plans and the Department of Labor’s Employee Benefits Security Administration were going to be investigating non-filers led to an increase in the number of plans coming into the Department of Labor’s delinquent-filer program.⁴⁷

In short, TE/GE can speak softly and still have significant powers of persuasion. For TE/GE soft guidance can be particularly effective because of the nature of the regulated entities. Charities, pensions, and governmental entities generally strive to comply with the prescribed laws. Similarly, in order to market a tax-exempt bond, the issuer must be able to provide an unqualified tax opinion. Consequently, the IRS is

⁴⁴ Treasury Regulation § 1.401(a)(4)-5.

⁴⁵ Treasury Regulation § 1.401(a)(4)-1(c)(2).

⁴⁶ See, for example, Revenue Ruling 94-42, 1994-2 CUMULATIVE BULLETIN 15 (curbing zero coupon bonds that remarket Treasury bonds); Revenue Procedure 96-41, 1996-2 CUMULATIVE BULLETIN 301 (curbing yield-burning).

⁴⁷ See, for example, http://www.dol.gov/ebsa/newsroom/0302fact_sheet.html.

often able to stop a perceived abuse merely by issuing a notice indicating that the IRS is looking at a certain type of transaction.

Even just talking about a perceived abuse can help curb it. For example, the IRS recently let practitioners know that it is looking at certain section 412(i) plans.⁴⁸ While there are many legitimate uses of section 412(i), the IRS has recently become aware of certain schemes that use section 412(i) as a vehicle for abuse. These abusive schemes purportedly enable small businesses to generate large tax-deductible contributions to plans and tax-free retirement distributions and death benefits. The IRS addressed a similar issue in Notice 89-25,⁴⁹ and the IRS is expected to issue formal guidance with respect to these abusive section 412(i) plans soon.

TE/GE's many voluntary compliance programs are also soft guidance mechanisms for encouraging compliance and discouraging abusive tax transactions.⁵⁰

2. Listed Transactions

Tax shelters that are determined to be abusive are often identified as "listed transactions."⁵¹ Listed transactions require disclosure by participating taxpayers.⁵² TE/GE has been instrumental in identifying and listing a number of potentially abusive tax transactions. Listing a potentially abusive transaction takes it out of the audit lottery, as practitioners and taxpayers are required to disclose these transactions, and those disclosures give the IRS enough information to decide if the transaction merits further investigation.

The process of getting a specific transaction listed is evolving, and currently involves a team approach. All of the operating divisions share tips. Any operating division can suggest a potential abuse for listing. Once a potential abuse is identified, a collaborative process involving all interested operating divisions takes place. For each identified transaction, the team develops a strategy for dealing with the abuse, which may include a recommendation that the transaction be listed. Listing a transaction is treated as the equivalent of published guidance and ultimately requires the approval of the Commissioner, the Chief Counsel, and the Assistant Secretary of the Treasury for Tax Policy. At present the list is maintained by the Office of Tax Shelter Analysis (OTSA) in the Large and Mid-Size Business (LM/SB) Division.

⁴⁸ See, for example, Tom Gilroy, *Treasury, IRS Promise Guidance on Abusive Insurance-funded Benefit Plans*, 30 BNA PENSION AND BENEFITS REPORTER 246 (No. 5; February 4, 2003); 412(i) Plan: A "Dream" or "Nightmare" for the Small Business Owner?, MILBERG CONSULTING, LLC NEWS AND INSIGHTS (March 28, 2003) available at <http://www.milbergconsulting.com/articles.asp?id=39>.

⁴⁹ 1989-1 CUMULATIVE BULLETIN 662.

⁵⁰ For example, the IRS recently started an initiative aimed at bringing taxpayers who used "offshore" credit cards and other devices to hide their income back into compliance with tax law. See Revenue Procedure 2003-11, 2003-4 INTERNAL REVENUE BULLETIN 311.

⁵¹ See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190; see also <http://www.irs.gov/businesses/corporations/index.html> (click on Abusive Tax Shelters).

⁵² Treasury Regulation § 1.6011-4.

As far as TE/GE customers are concerned, it is not always easy to tell whether they “participate” in a listed transaction and so must disclose the transaction. According to the regulations, a “taxpayer has participated in a listed transaction if the taxpayer’s tax return reflects tax consequences or a tax strategy described in published guidance that lists the transaction” or “if the taxpayer knows or has reason to know that the taxpayer’s tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction.”⁵³ Of note, the definition of tax benefit specifically includes, *inter alia*, “exclusions from gross income” and “status as an entity exempt from Federal income taxation.”⁵⁴

Examples of TE/GE-related listed transactions include:

a) *Section 401(k) Accelerators*

The underlying transaction here occurs when employers take premature deductions for certain 401(k) plan contributions. TE/GE efforts have resulted in identifying this abusive transaction in two separate listings.⁵⁵

More specifically, this listed transaction involves contributions to a 401(k) plan made during the section 404(a)(6) grace period. The abuse occurs when an employer takes a deduction for the taxable year for employer contributions that are attributable to compensation earned by plan participants after the end of that taxable year. The proper tax treatment is for the employer to take the deduction in the following year – the year in which the underlying compensation is earned by the plan participants.

This type of abuse was found on audit and, at about the same time, disclosed to the IRS by third-party contacts. The IRS studied the matter, identified it as an abuse, and noted the abuse in Revenue Ruling 90-105.⁵⁶ The matter was successfully litigated by the IRS,⁵⁷ and it was later identified as the first listed transaction in Revenue Ruling 2001-15.⁵⁸ Revenue Ruling 2002-46 indicates that “substantially similar” transactions

⁵³ Treasury Regulation § 1.6011-4(c)(3).

⁵⁴ Treasury Regulation §§ 1.6011-4(c)(6), 301.6112-1(d)(6).

⁵⁵ Revenue Ruling 2002-46, 2002-29 INTERNAL REVENUE BULLETIN 1; Revenue Ruling 90-105, 1990-2 CUMULATIVE BULLETIN 69

⁵⁶ 1990-2 CUMULATIVE BULLETIN 69.

⁵⁷ See, for example, *Lucky Stores, Inc. v. Commissioner*, 153 F.3d 964 (9th Cir. 1998), certiorari denied, 526 U.S. 1111 (1999) (indicating, in the context of a defined benefit plan, that the plain meaning of § 404(a)(6) precludes deduction in the preceding taxable year of grace period contributions that are required under collective bargaining agreements for work performed after the end of that preceding taxable year).

⁵⁸ 2000-1 CUMULATIVE BULLETIN 826; see also Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (Listed transaction number (1): “(transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year (identified as “listed transactions” on February 28, 2000)).” See also *Vons Companies, Inc. v. United States*, No. 00-234T, (United States Court of Federal Claims, filed March 28, 2003).

are also abuses.⁵⁹ To date, the largest number of disclosures received by the Office of Tax Shelter Analysis have been associated with this type of 401(k) deferral abuse.

b) Abuses Associated with S Corporation ESOPs

The underlying abuse here has to do with certain transactions involving S Corporation Employee Stock Ownership Plans (ESOPs). The ESOPs in question were trying to take advantage of a transition rule under section 656(d)(2) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that permitted certain ESOPs to use a delayed effective date for the nonallocation rules of Code section 409(p).⁶⁰ The IRS has since ruled that these S Corporation ESOPs are not eligible for the transition rule, and thus these S Corporation ESOPs are subject to the nonallocation rules of section 409(p) of the Code.⁶¹

TE/GE discovered this potentially abusive transaction after it received some 300 determination letter requests from a few practitioners. The letters asked TE/GE to issue determination letters with respect to certain ESOPs for S corporations that were not actually conducting business. Instead, it appeared that the promoters were creating inventories of shell S corporations and related ESOPs for sale in the future as tax shelters.

Alert TE/GE employees discovered these potentially abusive tax shelters, and TE/GE ceased issuing determination letters to those promoters. Subsequently, TE/GE got the IRS to identify the S Corporation ESOP abuse as a listed transaction.⁶²

Of note, the applicable ruling listing the transaction avoids the issue of whether the ESOP must disclose the transaction on its Form 5500 information return. Instead, the ruling specifically says that the transaction is listed only with respect to “disqualified persons” (*i.e.*, the individual participants in the ESOP).⁶³

⁵⁹ 2002-29 INTERNAL REVENUE BULLETIN 118; see also Notice 2002-48, 2002-29 INTERNAL REVENUE BULLETIN 130.

⁶⁰ Section 656 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended § 409 of the Code to add a new subsection (p) regarding the allocation of employer securities consisting of stock in an S corporation. However, EGTRRA § 656(d)(2) provides that § 409(p) of the Code applies to plan years ending after March 14, 2001 (the date the provision was introduced in committee), in the case of any ESOP established after March 14, 2001, or in the case of an ESOP established on or before March 14, 2001, if employer securities held by the ESOP consist of stock in a corporation with respect to which an election to be an S corporation under § 1362(a) of the Code is not in effect on such date. Here, the promoter created straw S corporations and related ESOPs prior to March 14, 2001, for sale to taxpayers after March 14, 2001.

⁶¹ Revenue Ruling 2003-6, 2003-1 INTERNAL REVENUE BULLETIN 6.

⁶² *Id.*

⁶³ This is unusual in the listing announcements, perhaps even unprecedented. It is worth wondering whether the ESOP would have had to disclose on its Form 5500 if the ruling had not be limited to “disqualified persons.”

c) Certain Trusts Purporting to be Multiple Employer Welfare Funds Exempt from the Limits of Sections 419 and 419A

Another listed transaction involves section 419A(f)(6). In this transaction, certain trust arrangements purport to qualify as multiple employer welfare benefit funds in order to be able to deduct what would otherwise be nondeductible life insurance premiums. Initially, SB/SE, with technical support from TE/GE, found this type of abuse on audit. At about the same time, TE/GE learned of this abuse from third-party contacts. The IRS subsequently noted the abuse in Revenue Ruling 95-34⁶⁴ and successfully litigated some of the more egregious violations.⁶⁵ The transaction was later identified as a listed transaction in Revenue Ruling 2001-15⁶⁶ and in proposed regulations.⁶⁷ TE/GE is involved in this listing primarily because of its actuarial expertise.

d) Off-shore Reinsurance Companies

Another listed transaction generally involves certain income-shifting transactions involving producer-owned reinsurance companies that are subject to little or no U.S. income tax.⁶⁸ The transaction involves a taxpayer (typically a service provider, automobile dealer, lender, or retailer) that offers its customers an insurance contract in connection with the products being sold. The insurance covers repair or replacement costs if the product breaks down, is lost, stolen, or damaged. The taxpayer acts as an insurance agent for an unrelated insurance company (Company X). The taxpayer gets a sales commission from Company X equal to a percentage of the premiums paid by taxpayer's customers. The taxpayer forms a wholly owned corporation (Corporation Y), typically in a foreign country, to reinsure the policies sold by the taxpayer. Promoters refer to these companies as producer-owned reinsurance companies (PORCs). The IRS guidance listing this transaction tells taxpayers that these transactions often do not generate the tax benefits claimed and informs taxpayers, their representatives, and promoters of these transactions about the applicable reporting and record-keeping requirements, and about the penalties that may result from these transactions. TE/GE is directly and substantially involved in this listing because one of the issues involves Exempt Organization qualification under section 501(c)(15).

⁶⁴ 1995-1 CUMULATIVE BULLETIN 309.

⁶⁵ See *Booth v. Commissioner*, 108 T.C. 524 (1997); *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000), affirmed 299 F.3d 221 (3d Cir. 2002).

⁶⁶ 2000-1 CUMULATIVE BULLETIN 826. See also Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (Listed transaction number (2): "(certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of §§ 419 and 419A of the Internal Revenue Code (identified as "listed transactions" on February 28, 2000))."

⁶⁷ Proposed Treasury Regulation § 1.419A(f)(6)-1, 67 FEDERAL REGISTER 45,933 (2002).

⁶⁸ Revenue Ruling 2002-70, 2002-44 INTERNAL REVENUE BULLETIN 765.

e) Certain Trust Arrangements Seeking to Qualify for the Exception for Collectively Bargained Welfare Benefit Funds under Section 419A(f)(5)

Another listed transaction generally involves certain businesses seeking to deduct extraordinarily large contributions made to a welfare benefit fund under certain new collective bargaining agreements.⁶⁹ In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses of the taxpayer and only to the extent allowable under Code sections 419 and 419A. Those sections impose strict limits on the deduction for contributions in excess of current costs, but an exception to some of those limits is provided under section 419A(f)(5) for contributions to a welfare benefit fund required by a collective bargaining agreement. In the typical listed transaction, the business had no prior involvement with a union or with the collective bargaining process until a tax-shelter promoter helped the business create a welfare benefit fund that purportedly qualifies for the exception for collectively bargained funds. The IRS guidance listing this transaction tells taxpayers that these transactions are not allowable for federal income tax purposes and informs taxpayers, their representatives, and promoters of these transactions about the applicable reporting and record-keeping requirements, and about the penalties that may result from these transactions.

3. Civil and Criminal Investigations of Promoters

TE/GE officials often learn about abusive tax transactions that are being promoted through routine audits and from information shared by legitimate practitioners concerned about those abuses. At that point, TE/GE officials have a number of tools. TE/GE can initiate a civil investigation under section 6700 (promoter penalties) or section 6701 (aiding and abetting penalties), make a referral to the IRS Office of Professional Responsibility, or refer the matter to Criminal Investigation (CI).

The Tax Exempt Bonds unit generally initiates its own section 6700 investigations. Other TE/GE units typically initiate their section 6700 investigations in conjunction with the SB/SE or LMSB Divisions and with the Chief Counsel's Procedure and Administrative Office. Once a section 6700 investigation begins, the IRS may seek to enjoin the abusive transaction, and it may issue summonses to the promoters and other related parties to gather more information.

With respect to criminal investigations, TE/GE and TE/GE Counsel often consider criminal penalties – for example, for tax evasion, wire fraud, embezzlement, or perjury. In that regard, for example, Tax Exempt Bonds (TEB) officials advised the Project Group that TEB has made a number of referrals to Criminal Investigation (CI). All in all, however, relatively few promoters end up being investigated by CI and even fewer are prosecuted.

TEB often uses its investigative powers to curb abusive transactions, including: yield-burning, abuses involving zero coupon bonds, the improper use of private activity

⁶⁹ Notice 2003-24, 2003-18 INTERNAL REVENUE BULLETIN 1.
Advisory Committee on Tax Exempt and Government Entities
May 20, 2003 – Page II - 26

bonds, and false valuations. These section 6700 proceedings typically involve some material misrepresentation or a false statement by the promoter or issuer of the tax-exempt bonds. TEB uses section 6700 to take the money out of the deals by forcing the promoters to disgorge any fees or profits they might otherwise have made. The issuer or investment banker agrees to pay a penalty, and the bonds remain tax-exempt.

For example, consider the yield-burning cases. Yield-burning has to do with the tax-exempt remarketing of Treasury bonds and securities. According to TEB officials, something like 4,000 to 5,000 bond issues involved such improper markups of Treasury securities. IRS efforts to curb this abuse grew out of a 1991 study of the problem by the IRS Chief Counsel. Then, a 1993 report of the U.S. General Accounting Office urged the IRS to develop a section 6700 program to curb yield-burning.⁷⁰ In the typical section 6700 case, the IRS pursued the bond issuers, bond counsel, and the conduit buyers of the abusive bonds. The IRS has entered into a number of settlement agreements, including one that resulted in a \$15 million penalty.

Similarly, the zero coupon bond abuse involves an arbitrage, with the promoter taking a large, up-front fee. In the private-activity bond area, the typical abuse is that the bonds are used for something they should not be used for.

In addition to conducting section 6700 investigations of abusive transactions, TEB often issues Revenue Rulings and other guidance to curb abusive deals.⁷¹

4. Use of the Determination Letter Process

Sometimes, the determination letter process can alert TE/GE to potentially abusive tax transactions relating to Employee Plans (EP) and Exempt Organizations (EO). For example, TE/GE recently learned about the S Corporation ESOP abuse when EP received hundreds of applications for ESOP determination letters from just a few applicants.⁷² EP initially refused to issue determination letters for those ESOPs. Soon thereafter, the S Corporation ESOP abuse was identified as a listed transaction.⁷³

5. IRS Forms Can Also Promote Compliance

IRS forms can also be used to push taxpayers towards compliance and away from abusive tax transactions. For example, in the charitable area, the determination letter process is meant to be the first barrier to sham charities and other abuses of exempt-organization status. IRS Forms 1023 and 1024 help ensure that only qualifying entities can get through the process and secure an exemption.

⁷⁰ See, for example, Edward I. Foster, Tax-Exempt Bond Examination and Appeals Process, 29 *EXEMPT ORGANIZATION TAX REVIEW* 269 (2001).

⁷¹ See, for example, Revenue Ruling 94-42, 1994-2 *CUMULATIVE BULLETIN* 15 (curbing zero coupon bonds that remarket of Treasuries); Revenue Procedure 96-41, 1996-2 *CUMULATIVE BULLETIN* 301 (curbing yield-burning).

⁷² See Part III.B.2.b above.

⁷³ Revenue Ruling 2003-6, 2003-1 *INTERNAL REVENUE BULLETIN* 6. If the transaction involves an abuse of the deduction or funding provisions, or plan qualification operational defects, the determination letter program may not be an effective tool.

The IRS Form 8038 series of information returns can help serve a similar function in the tax-exempt bond area.

6. The TE/GE Abusive Tax Shelter Committee

In order to better address the problems associated with tax shelters and other abusive transactions, TE/GE recently formed an Abusive Tax Shelter Committee. The committee includes representatives from Employee Plans, Exempt Organizations, Government Entities, and advisory input from the TE/GE Counsel. The committee collects information that TE/GE has about abusive tax transactions, and the committee is beginning to coordinate all of TE/GE's anti-abuse activities.

In addition, key officials from TE/GE and TE/GE Counsel participate in a new Service-wide committee designed to deal with abusive tax transactions.

7. Other Activities

TE/GE is also in the process of developing a comprehensive strategy to address the growth of abusive tax transactions. In particular, TE/GE has recently made it a priority to develop education and examination strategies to identify and counter abusive tax schemes. All segments of TE/GE are working to train their employees to recognize and address abusive tax transactions.

TE/GE segments are also developing their own strategies. For example, Employee Plans is collaborating with the Department of Labor to share information about abusive tax transactions. Exempt Organizations has already developed a new compliance unit and is developing a new fraud unit, too. Government Entities is developing a broad-based strategy to educate Indian tribal customers on the nature of abusive tax transactions and working with other IRS operating divisions to identify those transactions.

C. SPECIAL PROBLEMS FOR THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

The Tax Exempt and Government Entities Division clients can be involved in abusive tax transactions in a variety of ways. Sometimes a promoter uses a tax-exempt entity as the core of the abuse. For example, an exempt organization might give fraudulent appraisals in exchange for used car donations. Similarly, a promoter might use a purportedly exempt trust as an asset-management or estate-planning tool.

Sometimes the tax-exempt entity acts as an intermediate accommodation partner in a much larger scheme. For example, in so-called "lease-stripping", a limited partnership sells the rights to lease payments to investors but tries to allocate the "taxable" income to an exempt organization.⁷⁴ Abusive schemes involving charitable remainder trusts also implicate exempt organizations, either directly or indirectly.

⁷⁴ See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (Listed transaction number (3) "(certain multiple-party transactions intended to allow one party to realize rental or other Advisory Committee on Tax Exempt and Government Entities
May 20, 2003 – Page II - 28

Still other times, TE/GE clients are the victims of a scam, not the abusers. Indian tribes, for example, are often approached by promoters who want to take advantage of their unique tax status. For example, promoters of tax avoidance schemes have begun to approach Indian tribes about joint ventures structured to bring limited income to an exempt Indian tribe and substantial tax savings to a third party.

As more fully explained in this subpart, TE/GE has some special problems with learning about these various kinds of abuses, and with shutting them down.

1. TE/GE Has Difficulty Learning About Abusive Tax Transactions

One of the biggest problems for TE/GE is simply finding out about abusive tax transactions. TE/GE often learns about abusive tax transactions in the course of routine audits. Also, TE/GE sometimes learns about potentially abusive tax transactions through the determination letter process. In both instances, topic specialization by TE/GE employees has helped improve TE/GE's ability to see and flag many key problems.

TE/GE also often learns about abusive tax transactions from other IRS operating divisions. For example, sometimes the TE/GE finds out about abuses because its expertise is sought after by the other operating divisions. For example, TE/GE sometimes learns about abuses because IRS officials in the other operating divisions seek out TE/GE's actuarial expertise.⁷⁵

Of particular importance, TE/GE often learns about abusive tax transactions from legitimate practitioners and industry groups that take the time to share their tips with TE/GE officials in Washington and around the country at various professional meetings. TE/GE also sometimes learns about abusive tax transactions from newspaper and magazine stories and from disgruntled employees of promoters.

2. TE/GE Needs to Coordinate with the Other IRS Operating Divisions

More than almost any other operating division of the IRS, the TE/GE Division needs to coordinate its efforts with other parts of the IRS. Many abusive tax transactions involving tax-exempt and government entities show up on individual and business tax returns that are reviewed by other operating divisions.

3. TE/GE Has Limited Resources

Given limited resources, TE/GE may have to concentrate on transactions that are being promoted. TE/GE simply does not have time to audit all its clients. With limited resources such a "retail" approach to catching abusive transactions could never work. Instead, TE/GE will probably need to focus on the more "wholesale" approach of stopping abusive tax transactions that are being promoted to multiple taxpayers.

income from property or service contracts and to allow another party to report deductions related to that income (often referred to as "lease strips") (identified as "listed transactions" on February 28, 2000))."

⁷⁵ See Part III.B.2.c above.

Even then, TE/GE will need to ask questions that will enable it to focus its resources effectively. TE/GE will need to ask questions like:

How bad is the transaction? Is it real bad? Is it being promoted? Or is it just one advisor and one client making a mistake? If it is being promoted, who is the promoter? Is it a big four accounting firm, a mid-level accounting firm, or an independent promoter? Who are the investors? Are they unsophisticated individuals or large corporations?

Answering these kinds of questions will help TE/GE decide how to best allocate its resources.

4. Section 6103 Limits Disclosure

In trying to deter abusive tax transactions, it can be important to penalize bad promoters and make examples of them. In that regard, however, Code section 6103 prevents disclosure of most taxpayer information. Matters of public record, such as criminal convictions and civil summonses, however, can be publicized, but TE/GE is involved in relatively few such cases. Without mentioning the particular taxpayers involved, however, TE/GE can disclose the types of transactions that it is investigating and the kinds of tools it is using to curb the underlying abusive tax transactions.

IV. RECOMMENDATIONS

The Project Group offers the following recommendations:

A. FOCUS ON PROMOTERS AND SELF-PROMOTING TRANSACTIONS

With limited resources, the TE/GE Division simply cannot curb many abuses audit-by-audit or taxpayer-by-taxpayer. The normal audit process catches many abuses, but, of course, this approach is very labor intensive. It is a kind of “retail” approach to catching abuses, and with limited resources, TE/GE should strive to curb abuses on a more “wholesale” basis. As noted by many of the IRS officials that the Project Group spoke with, the more effective strategy is to try to stop the promoters who are marketing abusive tax transactions to multiple taxpayers. A second related “wholesale” approach is to focus on transactions that tend to “self-promote” and spread widely quickly (such as employee classification schemes). TE/GE should focus on these promoted and self-promoting transactions.

B. OPEN AN OFFICE OF ABUSIVE TAX TRANSACTIONS

Another way to help TE/GE deal with abusive tax transactions would be to provide a single location to coordinate information received relating to abuses. Such an “Office of Abusive Tax Transactions” could also help to coordinate a more effective response by the TE/GE Division to identified abusive tax transactions.

In the course of this project, the TE/GE Division created an abusive tax shelter committee to coordinate the TE/GE response to tax shelters and other tax schemes.

The Project Group congratulates TE/GE on this effort and urges TE/GE to set up an Office of Abusive Tax Transactions.

This new office could: (1) provide a central “reporting house” for third parties and internal persons to report suspected promotion schemes and “self-promoting” transactions; (2) catalog and profile schemes and trends; (3) assist the TE/GE functions in the allocation of resources to abusive tax transactions; (4) increase employee knowledge and skills related to abusive tax transactions; and (5) enhance coordination within the IRS on issues related to abusive tax transactions. The office might initially be quite small, and essentially act as a clearinghouse to gather information and pass it along to the directors of the TE/GE segments.

The new office should also help develop a strategy for dealing with each identified abusive tax transaction. In that regard, however, much of the responsibility for developing the strategy should remain in the various TE/GE segments. That is where most of the substantive expertise is, and that is where the employees who must find and curb the abuses reside.

The new office would also be instrumental in coordinating with other IRS operating divisions. That coordination role will be especially important because so many abusive tax transactions that involve tax-exempt and government entities show up, if at all, only on tax returns that are reviewed by other operating divisions. For example, many tax abuses involve unwarranted charitable contributions, either because the taxpayer gets value back⁷⁶ or because the donated property is overly or improperly valued.⁷⁷ Code section 170 is not directly within TE/GE’s purview, except to alert and educate charities and cooperate with W&I Division agents. Similarly, abuses involving business taxpayers will typically show up on tax returns handled by SB/SE or LMSB. TE/GE needs to establish itself as a resource to be pulled in on abusive tax transaction issues involving tax-exempt and government entities.

Coordination is also important when it comes to shutting down promoters. For example, in order to list a transaction, TE/GE often needs to coordinate with other operating divisions. Similarly, criminal cases must be coordinated with Criminal Investigation and with the Department of Justice and the U.S. Attorneys.

In short, this new office should help identify abusive tax transactions involving tax-exempt and government entities, help develop the strategies needed to deal with those abuses, and help implement those strategies.

⁷⁶ For example, the IRS recently attacked certain life-insurance purchases through National Heritage Foundation’s donor-advised funds. See, for example, *Gary L. Weiner v. Commissioner*, T.C. Memo. 2002-153 (2002).

⁷⁷ Requiring “qualified appraisals” has helped compliance in this area. See Part III.B.1.a above.

C. EXPAND THE TOOLS FOR DISCOVERING ABUSIVE TAX TRANSACTIONS

The TE/GE Division learns about potentially abusive transactions from: routine audits, the determination letter process, other IRS operating divisions, legitimate practitioners who care about good tax policy, and even from newspaper and magazine stories. TE/GE should streamline its ability to get information about abusive tax transactions, perhaps by adding an “abuse line” to its phone bank and a “report-abuses-here” link on its World Wide Web page.

In addition, the Project Group believes that TE/GE should also be more proactive about uncovering abusive tax transactions. TE/GE officials should encourage legitimate practitioners and industry representatives to “blow the whistle” on abusive tax transactions. When TE/GE officials are speaking and attending meetings of professional groups and industry association, they should ask for leads and ideas about promoted transactions and self-promoting schemes.

D. PROVIDE ADDITIONAL PRIORITY TO GUIDANCE PROJECTS FOR DISPUTED TAX TRANSACTIONS THAT ARE PROMOTED OR THAT ARE SELF-PROMOTED

TE/GE needs to act quickly to identify potentially abusive tax transactions and to develop strategies for dealing with them. If a disputed tax transaction is being promoted or self-promoted and becoming widespread, the sooner that TE/GE can step in and issue guidance, the sooner it will be able to curb the abusive tax transactions and validate the legitimate ones. Guidance is always greatly appreciated by practitioners and their tax-exempt clients. In that regard, the Project Group notes that that the IRS, the Office of Chief Counsel, and the Office of the Assistant Secretary of Treasury for Tax Policy are working well at providing as much guidance as possible to TE/GE clients and their advisors.

While the formal guidance process is pending, TE/GE also needs to consider whether it should issue soft guidance to curb the disputed transaction. Some transactions may call for public remarks by TE/GE officials or even a warning notice indicating that TE/GE is looking at a particular type of transaction. Of course, such soft guidance needs to be used carefully so as not to curb legitimate transactions. In general, soft guidance is most appropriate where the rules are clear or at least generally agreed upon, but the IRS has not yet issued formal guidance curbing the particular transaction in question.

E. KEEP IDENTIFYING LISTED TRANSACTIONS

The Project Group was very impressed with the efforts that TE/GE has made to list potentially abusive tax transactions. The Project Group believes that the listing process has curbed a number of serious abuses. Moreover, the Project Group believes that having an ongoing listing process gives more credibility to honest practitioners who refuse to do suspect deals for clients.

To be sure, the listing process can present some problems for the IRS and for the TE/GE Division. The biggest problem is deciding just where to draw the line. If the listed transaction is defined too broadly, many nonabusive taxpayers will be required to report on their legitimate transactions, and the IRS will be overwhelmed with disclosures that it might not have the time to follow up on. The Office of Tax Shelter Analysis has committed itself to give at least some degree of scrutiny to each listed transaction that is reported.

On the other hand, if the listed transaction is defined too narrowly, taxpayers will try to game the system – even when the IRS indicates that “substantially similar” transactions are to be included. Abusive taxpayers will do something slightly different from the published listing and argue that it is not “substantially similar” to the listed transaction. For example, in the case of the 401(k) deferral abuse,⁷⁸ the IRS has already felt it necessary to expand upon its initial determination by subsequently issuing Revenue Ruling 2002-46 outlining a “substantially similar” transaction that is reportable,⁷⁹ and Notice 2002-48 outlining a somewhat similar transaction that is not reportable.⁸⁰

Moreover, listing is not the best approach for all abusive tax transactions. For example, listing would probably not be very useful in the tax-exempt bond area – any concern raised about a bond issue would make the bonds unmarketable. Consequently, listing a tax-exempt bond transaction would not just shut down the abusive tax transactions, it would shut down all similar transactions, even those that were legitimate.

Nevertheless, the Project Group believes that the listing process is working well in helping to curb many identified abuses. The listing process does not automatically shut down abusive tax transactions. For example, listing has not stopped taxpayers from claiming accelerated deductions with respect to 401(k) plan contributions or the questionable deductions of life insurance premiums under section 419A(f)(6).⁸¹ But listing does put the IRS on notice that taxpayers are claiming the benefits of a potentially abusive tax transaction and so gives the IRS an opportunity to challenge the transaction or request additional information about it.

F. BRING MORE CRIMINAL CASES

The Project Group also believes that bringing more criminal investigations and prosecutions would have a significant deterrent effect on abusive tax transactions. In particular, the Project Group would like to see TE/GE, together with Criminal Investigation (CI) and the Department of Justice, make examples of some of the worst promoters of abusive tax transactions involving tax-exempt and government entities.

⁷⁸ See Part III.B.2.a above.

⁷⁹ 2002-29 INTERNAL REVENUE BULLETIN 118.

⁸⁰ Notice 2002-48, 2002-29 INTERNAL REVENUE BULLETIN 130, described the same basic 401(k) transaction with one twist: the money was actually contributed to the plan in the prior taxable year. In that instance, the IRS indicated that it would not challenge the employer's deduction for the prior year.

⁸¹ See Part III.B.2.a and c, respectively, above.

TE/GE officials acknowledged that the TE/GE employees receive relatively little training about how to help develop criminal tax cases. In that regard, the Project Group recommends that TE/GE work with CI and the Department of Justice to develop a program to better educate TE/GE employees about criminal tax cases and about the “badges of fraud” that CI employees look for in developing cases for prosecution, and to better educate CI employees about abusive tax transactions that involve tax-exempt and government entities.

G. MODIFY TE/GE FORMS TO STEER CLIENTS AWAY FROM ABUSIVE TAX TRANSACTIONS

IRS Forms can often steer taxpayers away from abusive tax transactions. For example, IRS Forms 1023 and 1024 help ensure that only qualifying entities can get exempt-organization status. IRS Forms might also be designed in a way that could help the IRS discover more potentially abusive tax transactions. TE/GE should think about whether it should modify some of its other tax forms to help promote greater compliance and get the information that TE/GE needs to discover abusive tax transactions more quickly.

For example, Tax Exempt Bonds might want to modify its series of Form 8038 information returns so that the forms elicit more relevant information about new bond issues, and Employee Plans might want to think about ways that it could improve Form 5300 to elicit more relevant information from plan sponsors seeking determination letters.

The Project Group recognizes that changing forms can be burdensome for taxpayers. Nevertheless, TE/GE would do well to solicit taxpayer and practitioner input about how it might change some of its forms to improve compliance and generate more useful information.

Advisory Committee on Tax Exempt and Government Entities
(ACT)

TE/GE Audit Processes

Interim Report

Terry Burke
Craig Hoffman
John Schroeder
Donald Segal

Perry Israel (adjunct)
Beth Nunnally (adjunct)

May 20, 2003

Interim Report

The group project to analyze the audit processes of all areas of the Tax Exempt and Government Entities (TE/GE) Division is extensive. After detailed research and analysis of the current audit processes in Employee Plans, Exempt Organizations, Tax Exempt Bonds, and Federal, State and Local Governments, the group determined that properly addressing this project and providing a report with the recommendations of the entire ACT would require additional work on the part of the project team.

Accordingly, we submit this interim report and a recommendation that the project continue, with additional meetings, interviews, and research to take place over the next year, and that a report in final form be presented at the next public meeting of the ACT.

Purposes of an Audit

As related to the TE/GE Mission, an effective audit program serves several purposes:

- **Visible enforcement** – To encourage self-compliance by others
- **Correction** – To ensure that past improper practices are corrected retroactively
- **Compliance** – To ensure that the customer operates in compliance going forward and that current rules can be complied with (demonstrate that the rules work)
- **Education** – To collect information to shape audit and self-corrections processes

Self-compliance is the cornerstone of U.S. tax compliance. An effective audit program can encourage higher compliance by ensuring that non-compliers are targeted for audit, and that entities that are abusing the tax process experience heavy penalties relative to those who are merely negligent or who do not profit from their non-compliance. Accordingly, we believe that audit processes should be shaped to target abusive practices and be more tolerant of those who do not profit from their noncompliance.

Audits should determine whether required tests and activities are being undertaken, and should test the honesty and integrity of the information being provided to the Service. Missed processes and inaccurate information should be corrected retroactively, and the Service should be prepared to help those audited identify how to correct their processes and information going forward.

An effective audit program should start with communication to the customer about the purpose of the audit, the process to be followed, and the rights of the customer. It should also produce informational feedback elements to help the Service in its other missions. Results of audits should be used to help identify issues about which taxpayers need greater education, practices that should be reviewed as part of future audits, and areas where self-corrections processes could be expanded. Analysis of audit results should be used by the Service to develop measurement tools to more

effectively select audit targets. Audits can also be the means by which the Service gains greater understanding of industry compliance in particular market segments, as with the Service's 2003 audits of single-family housing bond issues and the market segmentation approach of the Exempt Organizations Division.

**Advisory Committee on Tax Exempt and Government Entities
(ACT)**

Gateway Opportunities: FSLG and its Customers

MARY BETH BRAITMAN
DARYL DUNAGAN
JAYNE FAWCETT
ELIZABETH NUNNALLY
DON WAUGH

MAY 20, 2003

GATEWAY OPPORTUNITIES: FSLG AND ITS CUSTOMERS

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY.....	1
II. INTRODUCTION.....	3
III. OVERVIEW.....	4
• Government Entity Customers.....	4
• Impact of IRS Reorganization.....	5
• TE/GE Service Platform.....	5
• Points of Intersection between FSLG and Other IRS Units.....	6
• TE/GE Partnership with Social Security Administration.....	7
IV. ISSUES IDENTIFIED THROUGH INTERVIEWS AND DATA REVIEW.....	8
V. CRITICAL CONSIDERATIONS.....	12
VI. GUIDING PRINCIPLES.....	13
VII. RECOMMENDATIONS.....	13
VIII. EXHIBITS.....	18
• Exhibit A – Points of Intersection.....	18
• Exhibit B – Memorandum of Agreement between IRS and SSA.....	19
• Exhibit C – June 29, 2001 IRS Memorandum.....	20
• Exhibit D – FSLG Web Site.....	23
• Exhibit E – Information Systems Coding Structure.....	24

Gateway Opportunities: FSLG and its Customers

EXECUTIVE SUMMARY

It is estimated there are more than 72,000 federal, state and local governmental entities in the United States that are involved, as employers, in federal employment tax withholding and wage reporting. This number includes a conglomeration of entities ranging from federal government agencies, states, cities, counties, institutions of higher learning, and local academic institutions to those agencies with few employees such as water and sewer districts, housing authorities, fire protection districts, airport boards, etc. These tens of thousands of public employers rely on the Tax Exempt/Government Entities Division (TE/GE) for guidance in complying with the myriad of federal requirements that encompass diverse operational concerns.

These governmental employers do not always perceive a clearly defined and formally designated “point of entry” at the IRS. By “point of entry” we mean an IRS office or representative with whom contact is the normal first step initiated by a federal, state or local government entity to resolve an issue with the Service. Federal, state and local governments may become confused and frustrated in their attempts to navigate through the IRS while seeking assistance. This frustration is encountered not only by governmental employers, but also by TE/GE which acknowledges its difficulty in finding its way to all these customers.

The *Gateway Opportunities: FSLG and its Customers* project committee recognizes the tremendous challenge faced by TE/GE in identifying and working with the thousands of federal, state and local entities who have quite diverse needs.

The committee conducted a series of interviews with leadership from various IRS divisions to understand how such components interrelate with federal, state and local governments. The committee has also reviewed certain other operations of the IRS to learn how assistance efforts for their customers are proceeding, some of which are working very well.

The following recommendations are based on the committee’s best efforts to fashion a system of cooperation and efficiency that will serve TE/GE's Federal, State and Local Governments component (FSLG) and its customers for years to come. In all cases, additional education of the federal, state and local government agencies and/or IRS representatives will enhance the system. The recommendations (in summary) include:

- **Public employers need direct access to issue-specific areas.** We recognized that a “forced” point of entry is not the most efficient way to accept incoming requests for assistance. Some government entities, however, will not know the specific IRS office best suited to handle their issue. In those cases, it is recommended that the TE/GE Call Site be used as the entry point.

- **Build FSLG employee facilitation skills and navigational experience.** FSLG's goal is to get the right person on the issue and encourage timely and appropriate attention to the issue in question. FSLG should continue to emphasize among its specialists the service mentality that has been developed over its initial two years.
- **Develop best practices for establishing relationships with state and local governments.** Experienced FSLG employees have developed direct points of contact throughout their state that have proven very effective. It is recommended that FSLG assemble its most experienced specialists and build upon their successes. We suggest this group should develop best practices for establishing working relationships at the state and local level.
- **Clarify roles and responsibilities of the federal, state and local government specialists.** It is not expected that FSLG employees become skilled on issues outside the employment tax arena of the public employer. TE/GE should formalize the respective roles and responsibilities of their employees for responding to government entity tax issues. We recommend that FSLG continue working with the Government Liaison staff to refine the standards and responsibilities that each is charged with for federal, state and local governments.
- **Enhance cross-function education and communication within TE/GE.** It is recommended that TE/GE encourage greater information sharing and better communication across the division. The unique nature of the technical issues and employment tax problems facing state and local governments should be stressed.
- **Build accurate and comprehensive inventory of federal, state and local government entities.** Each State and its local governments may be organized very differently which results in different needs. It is imperative that the many state and local agencies be identified, and their differences recognized, to ensure an efficient and accurate assistance program.
- **Communicate identities of new governmental employers to the Social Security Administration (SSA).** FSLG and the SSA share the objective of providing quality service to federal, state and local government employers. Neither FSLG nor the SSA currently identify or catalogue the establishment of new governmental employers. There are also no procedures in existence for the exchange of such information. It is recommended that FSLG implement a process to identify new entities by using existing IRS system coding, classify such entities within its database, and sharing the information with the SSA.

INTRODUCTION

Government entity (GE) customers do not have a clear “point of entry” at the Internal Revenue Service (IRS) for addressing the range of tax issues they face. Government entities, as taxpayers, include federal, state and local government (FSLG) units. Yet their tax compliance concerns sweep across the Tax-Exempt and Government Entities (TE/GE) division of IRS, as well as other divisions of IRS, and include the following areas: tax-exempt bonds, employee plans, unrelated business income, employment tax, information reporting, excise tax, foreign withholding and reporting.

A General Accounting Office (GAO) report, issued in July 2002, focuses on TE/GE’s inability to track government entity tax issues internally. It should be noted that while this report was issued in 2002, FSLG hired most of its employees in late 2001 and 2002 and, since that time, has made significant progress in addressing issues raised in this report. However, some federal, state and local government units, their advisors and IRS personnel may still be confused on how to most effectively channel their issues through the IRS.

Just as federal, state and local government customers have difficulty finding their way through the IRS, so does the IRS acknowledge difficulty finding its way to all these customers. TE/GE’s Federal, State and Local Governments unit (FSLG) has a good general understanding of the needs of the customer base. However, work needs to be done to clearly understand characteristics of various market segments within the overall customer base (i.e., political structure within each state, county, city, etc.).

In an attempt to address these basic issues, our ACT project committee set out the following charge for itself:

- Review and understand how current IRS units interrelate with federal, state and local government entities in various ways
- Recommend ways in which TE/GE can best engage and respond to federal, state and local government entity tax customers
- Recommend how federal, state and local government entity customers might best leverage and maximize the value of the reorganized IRS structure

The project team organized a work plan through which information was gathered and these questions were addressed. The work plan included a series of interviews with leadership from various IRS units. The project committee also reviewed various documentation related to such issues as: program mission statements, division work plans, relevant position descriptions, GAO reports, Internal Revenue Manual updates, information systems codes, customer call statistics, and the like.

OVERVIEW

Government Entity Customers

The IRS has identified some 72,000 federal agencies, state governments, and local municipalities that file Forms 941. Many states and larger local governments have multiple Employee Identification Numbers (EINs) or multiple subsidiary units feeding payment information through a single payroll and Form 941 tax filing.

To illustrate the scope of government entity customers, consider the state of North Carolina. North Carolina's government entity population is described as follows:

- 200 state entities and agencies (i.e., including colleges and universities)
- 100 counties
- 117 local education authorities
- 543 cities
- 1200+ special districts, boards and authorities (e.g., economic development, water, sewer, housing, health, airport, alcoholic beverage)

In addition to the categories above, other government clients may include the following:

- Federal agencies and entities (e.g., Department of Treasury, Department of Agriculture)
- Federal quasi-governmental entities (e.g., U.S. Postal Service)
- State and local quasi-governmental entities (i.e., legislatively established, legally separate operations)
- Inter-state instrumentalities (i.e., entities formed across state lines, such as regional port authorities or regional transportation authorities)
- Charter schools (i.e., state sanctioned/funded schools, alternatives to public schools)

The number of EINs assigned to these various entities differs dramatically across the states. A state's entities and agencies may operate under multiple EINs or a single EIN, while each city and county may also have its own unique EIN. Similarly, public colleges and universities within a state could be operated under a single EIN or function with unique EINs.

Even where there is a consolidation for 941 filing purposes, FSLG believes that it ultimately needs to reach local units that feed information to a consolidated government reporting entity, because many tax compliance decisions are made at a local unit level. FSLG would like to reach all FSLG customers to communicate law changes, educate and undertake compliance checks and examinations. This 72,000 estimate of government clients does not include any subdivisions of government, quasi-government agencies, interstate instrumentalities or other federal, state or local government units that file no Form 941. FSLG estimates that the total number of governmental clients could be several times the number of 941 filings.

Impact of IRS Reorganization

Prior to the IRS reorganization, state and local government entities were served by various components within the IRS, including the Fed-State Office which functioned out of the Commissioner's Office. Although the Fed-State Office was originally created to address the interface between the federal government and state government on tax administration (i.e., joint filings, information sharing, joint administration), in some situations, the Fed-State Office often become involved in tax compliance matters, particularly employment tax matters.

The IRS reorganization design team recognized the difference between 1) a government unit as taxpayer and 2) the relationship of partnering with a state or local government on how to collect taxes and share information and systems. The government as taxpayer had different needs and interests than the government as joint administrator. The team's review of government units also revealed how many departments there could be in a state government and the different tax functions those departments are assigned. For example, overseers of state employment tax issues are not necessarily involved in bond transactions. Another example is that the state department responsible for withholding and remitting federal taxes for state employees may be wholly separate from the state department responsible for distributing and monitoring federal highway grants.

Because of these unique functions, a decision was made to create two separate functions, Government Liaison (GL) and Government Entities (GE), for IRS purposes:

- GL- oriented toward joint federal, state and local tax administration efforts
- GE - oriented toward governmental taxpayer compliance and education

Also, the reorganization determined that Tax-Exempt Bonds (TEB) should be separated out of Exempt Organizations (EO), where it had been administratively housed. TEB activity is transaction oriented, and the related laws are extremely technical. The design team felt TEB should be viewed from the perspective of the end user of proceeds by governments. The consensus was that tax-exempt bonds were principally designed to fund state and local government activities and that if the TEB area was set aside as separate area, it would contribute to a broader understanding of financing and other aspects of TEB transactions.

TE/GE Service Platform

Tax Exempt Government Entities (TE/GE) serves state and local customers through three very different service paradigms:

- Taxpayer Based Units

- Federal State Local Government (FSLG)
- Exempt Organization (EO)
- Transaction/Technical Based Units
 - Tax Exempt Bonds (TEB)
 - Employee Plans (EP)
- Supporting Service Units
 - Call Site Operations (Customer Account Services)
 - Processing Center (Ogden Service Center)

By definition, federal, state and local government entities are considered taxpayer customers of FSLG. However, a state or local government entity might be inclined to approach FSLG for an issue for which FSLG does not have issue responsibility. The Employee Plans (EP) division, for example, has been delegated legal authority for state and local retirement plan issues, and the Tax Exempt Bonds (TEB) division has been delegated legal authority for state and local bond issues.

Because TE/GE has organized its responsibility around technical issues (i.e., bond transaction, employee plan, collections, unrelated business income) and entities (i.e., state government unit, IRC section 501(c)(3) organization), the customer service platform for state and local taxpayers is complicated. FSLG customers potentially intersect with many divisions of the IRS.

As one example, state universities that do not have IRS recognition of IRC section 501(c)(3) status are considered to fall within the jurisdiction of FSLG for employment tax purposes. Yet such public universities have tax compliance requirements that encompass a range of issues, including unrelated business income tax, tax-exempt bonds, and employee plans. Moreover, the Exempt Organizations (EO) division has the comprehensive college and university audit experience within TE/GE and will typically conduct audits for EO compliance.

Points of Intersection between “FSLG” and Other IRS Units

Exhibit A provides an overview of the potential points of contact between a federal, state or local government entity and the IRS.

The project team scheduled a series of interviews with representatives from these other areas of IRS to pursue the following questions:

- How do these other units understand their mission with respect to federal, state and local government customers?
- How do these units define their working relationship with FSLG?
- How do these units view the mission of FSLG?
- What lessons, learned within these units, might be applied to FSLG?

The project team also interviewed management of the IRS TE/GE division of Indian Tribal Governments (ITG). Similar to state and local government entities, tribal nations have a wide range of tax compliance issues they must address. The new ITG program is considered a success among its customer base for its ability to facilitate the resolution of the tax issues of tribal nations.

TE/GE Partnership with Social Security Administration

In 1987, tax responsibility for FICA withholding and reporting was transferred from the Social Security Administration (SSA) to IRS. Prior to this transfer of responsibility, social security tax reporting was managed through a consolidated reporting by each state (i.e., including all EIN numbers), on behalf of all state and local government entities, directly to SSA. Since this transfer of responsibility, reporting has been decentralized generally to the EIN level of activity. However, responsibility for administering social security coverage has remained with SSA and the states under their Section 218 agreements. A Section 218 agreement is a voluntary agreement entered into by a state with SSA to provide social security coverage to certain public employees.

When SSA was collecting data directly, it was easier for SSA to maintain its records. SSA also had a system for periodically reviewing and updating its customer base. In the new model, SSA has lost its ability to identify new state and local government entities. In response to concerns expressed by SSA, IRS and the states about payments, reporting, and coverage, the SSA Inspector General (IG) conducted a study. An IG report issued in 1996 identified a potential exposure to the social security trust funds (i.e., potentially > \$17 billion) associated with non-compliance related to lack of information exchange, data collection and oversight reviews. The report recommended that IRS and SSA work together to address these potential weaknesses. During 1997-2000, the IRS, SSA and state social security administrators conducted a comprehensive outreach program. As a result, an additional \$ 631 million was collected over a 3-year period of time. This led IRS, in a 2000 letter, to report to the National Conference of State Social Security Administrators that the estimated exposure reported in 1996 was likely higher than actual exposure.

During most of the years since 1987, IRS and SSA have maintained an informal working relationship regarding the roles and responsibilities for continuing program administration for public employers and public employees. In April 2002, however, a Memorandum of Agreement was executed between IRS and SSA to formalize the relationship. See Exhibit B.

The administration of social security coverage depends on good data, and the SSA needs help from IRS in updating its inventory of state and local government clients.

Quality employer data exchange from the IRS to SSA is critical for sound administration of the SSA coverage program.

A joint IRS-SSA Section 218 committee was established to address joint coverage and compliance issues. Quarterly meetings take place during which education and compliance issues are addressed. The committee has addressed information exchange related to changes made to worker status or changes in earnings of a worker covered under Social Security (Voluntary Closing Agreements and examination results) and how SSA might refer information about entities that were having reporting problems to FSLG. However, the committee has not yet focused on information exchange related to identification of new state and local government units that may not understand their Social Security and Medicare coverage obligations to their employees.

SSA faces the following issues related to data exchange:

- Government entity does not comply with the coverage rules applicable to an existing Section 218 agreement
- Government entity has no Section 218 agreement but also offers no retirement plan to its employees
- Protecting the Social Security Trust Fund - If employees are covered by Social Security but employer did not pay, then SSA is obligated to provide coverage, by law, even if funding is not provided to the trust fund by employer or employee
- SSA must be able to retain accurate records and to ensure that public employees entitled to Social Security benefits actually realize those benefits
- Inaccurate records or compliance require substantial resources, both to amend W-2s for past years and to fund potentially “unfunded” benefits
- Social security paid into system for some employees where there is no Section 218 agreement, but the employees are covered by a retirement system
- Information identifying new entities is needed to enable SSA to coordinate with the states on how new entities are to be covered
- Difficulty identifying interstate instrumentalities (i.e., considered “states” for social security coverage purposes under Section 218). Interstate instrumentalities may be unaware of their unique status as a “state,” these special Social Security and Medicare coverage rules for government employees and their responsibilities as a “state” employer
- Lack of communication and legal counsel around data issues and data exchange considerations

ISSUES IDENTIFIED THROUGH INTERVIEWS AND DATA REVIEW

Organizational Boundaries

- In the old IRS, many professionals inside the Fed-State Office worked out ad-hoc one-on-one taxpayer relationships through their employment tax work and relations with various state officials, such as state social security administrators. Today, even

with the new IRS structure, some individuals in state government approach Government Liaison (GL) with taxpayer compliance issues, because GL has been so visible historically. State staff should know when to go to GL and when to go to an FSLG specialist, but some may well not yet. It appears there may still be lingering uncertainty, though much diminished, about the reorganized IRS and the new FSLG division of TE/GE. At the field level, some Government Liaison staff may be having a difficult time letting go of tax compliance relationships and turning those relationships over to FSLG. GL acknowledges the need to continue to clarify roles, but feels it will be easy to get the message out to 58 Government Liaison staff located in the states and the District of Columbia.

- The committee recognizes that FSLG has made significant progress in developing appropriate stakeholder relationships and in identifying government clients and associations with whom it should further develop stakeholder relationships. Notable examples of this include presentations and outreach to National League of Cities, National Association of Public Pension Attorneys, National Association of State Auditors, Controllers and Treasurers, and the National Conference of State Social Security Administrators. The individual State representatives have also spent countless hours meeting with customers, learning their state's governmental structures and personnel, and providing outreach. The committee recognizes this task is a difficult one that will take time. Unlike, EP and EO, organizations that have longstanding affiliations with industry organizations, FSLG is obviously new to this effort.
- GL and FSLG have made a commitment to partner at the state level to reach state and local entity customers. FSLG has many of the same relationships within the state as GL (i.e., controllers, state social security administrators, etc.) FSLG reports that its area managers report monthly on their “cross operating division / function” partnership efforts. We recommend this partnering continue to be fostered and encouraged.

Ambiguous Responsibility for Outreach Activities

- One area of confusion in roles and responsibilities may arise in context of “outreach” activities. Both FSLG and GL perceive and promote their responsibilities as including outreach (i.e., “soft contacts”). It is possible that when either wants to do soft contacts, (outreach), one will cross over into the other’s territory. In certain documentation, the national ranks of FSLG and GL agree on a consistent, clarifying message regarding outreach responsibilities. Specifically, while GL is the primary point of contact with and normally responsible for outreach activities with state and local governments, outreach related to taxpayer compliance is the jurisdiction of FSLG, not GL. See Exhibit B for an excerpt from the GL IRM and a June 29, 2001 memorandum authored by Bob Wenzel, Deputy Commissioner of Internal Revenue, both noting that TE/GE is the primary compliance outreach, education and enforcement contact for state and local governments as taxpaying entities. 11.4.1.6.2 of the Internal Revenue Manual provides that the Field Governmental

Liaisons serve as the primary point of contact with state and local agencies with federal agencies located in their jurisdiction. However, FSLG is responsible for compliance outreach, education and enforcement contacts with state and local governments as taxpaying entities.

Varied Operational Structures of State and Local Governments

- State and local governments are often organized very differently in terms of how they manage their payroll and FICA, pension plans, and other tax compliance and administration. Both GL and FSLG are faced with a variety of different state models of tax administration and need to understand how different states operate differently.

Identification of Customers

FSLG has an objective of providing quality customer service to its government clients across the United States. At the same time, the Social Security Administration (SSA) is charged with collecting wage and tax data via Forms W-2 and also with administering social security coverage agreements that provide various levels of social security and/or Medicare coverage to FSLG clients. Both FSLG and SSA are invested in identifying and classifying this share client base. In context of these objectives, FSLG and SSA confront the following issues:

- FSLG has compiled an initial listing of its state and local government clients based on the number of clients that currently file Form 941, and it has attempted to augment this inventory from the US Census. Yet FSLG believes more complete identification of these clients is needed for education and outreach purposes that will lead to enhanced compliance. FSLG would like to identify the various tax reporting components of these clients, in addition to compiling name of entity, local contact, e-mail to include on list serve.
- The identification of newly created state or local government entities is a key element for FSLG and SSA to fulfill their missions. Such newly formed entities are usually created by the state or by an existing political subdivision, such as county or a city. These entities face challenges with their social security/Medicare coverage, tax compliance, information return reporting, customers service, and educational resources.
- In addition, the identification of quasi-governmental entities and interstate instrumentalities is another challenge facing FSLG. Both FSLG and SSA desire categorization of this select and specialized segment of their client base. Although the unique distinction of these entities may not be of high priority for FSLG, interstate instrumentalities must be treated as “states” for purposes of administering Social Security and Medicare coverage requirements.

Customer Confusion

- During the course of this project, we spent considerable time investigating whether state and local taxpayers have been provided consistent direction about the first point of entry in IRS to address or resolve their variety of tax issues. FSLG has published FSLG specialist phone numbers in recent FSLG newsletters; thus, many state and local entities are now going directly to state FSLG specialists. Call site numbers have also been published in other FSLG communications. While remarkable progress has been made to provide direction to FSLG clients, we believe some state and local government taxpayers may still be confused about the appropriate first point of contact when a question or issue arises.
- The following government client actions would suggest lingering customer confusion about their first point of entry on a tax issue:
 - Client calls local FSLG specialist when routine concern / question could have been handled by Call Site
 - Client calls local FSLG specialist for a question or concern related to an employer plan issue, a bond issue or an unrelated business income tax issue

Conversely, the IRS would expect government clients to call an FSLG specialist directly about particular employment tax and social security tax compliance concerns and not GL.

Role of FSLG and FSLG Specialist

FSLG specialists manage a range of questions that come to them directly; serve as key persons for education and outreach; and undertake compliance checks/examinations in the employment tax and information reporting areas. Comprehensive position descriptions were developed to define FSLG specialist roles and responsibilities.

- The committee is concerned that FSLG specialists neither presume they must be all things to all government clients, nor assume too limited a role in performing their duties. The FSLG specialist position is still relatively new, and specialists need more time to develop their experience and execute their new roles and responsibilities. One area of particular interest to the project team is how specialists perceive their roles with regard to technical issues outside the purview of FSLG.
- FSLG often describes its role as “advocate” with regard to its government client customer base. FSLG’s intent, to provide “end-to-end accountability” and “customer service” to government entities, is noteworthy. The use of this particular terminology can be misunderstood, however. Other technical units of IRS (i.e., tax-exempt bonds or employee plans) would not view FSLG’s role as including

“advocacy” for a particular resolution of technical issues under non-FSLG jurisdiction.

FSLG Resources

- As mentioned earlier, the FSLG customer base, as defined by 941 filers, is approximately 72,000 taxpayers. (The US Census last identified 87,900 federal, state and local government entities as follows: 1 federal, 50 state, and 87,459 local government units.) FSLG staff estimate the total number of government clients (i.e., those filing through consolidated 941s) to be a multiple of this number by several times. With only 80 FSLG specialists, resources to serve this customer base are limited. To put this in perspective, assume a count of 87,900 government clients. The resulting ratio of specialist to taxpayer is approximately 1100 to 1. ITG, by comparison, staffs approximately 60 specialists to support 564 federally recognized tribes (with over 2200 tribal entities), at a ratio of 10 to 1. Staffing will continue to be a challenge as this division matures.
- FSLG has been very successful at resolving issues with federal agencies, universities, and other state and local government entities. However, some issues that require resolution with government entities are politically sensitive with the potential to impact nationwide market segments. Such political issues often inhibit legal and administrative resolution in a timely manner.
- Because FSLG focuses its technical attention on employment tax compliance, certain efficiencies could be achieved across TE/GE by leveraging FSLG employment tax expertise into the Exempt Organizations area. Without additional resources to FSLG, this concept is unlikely to be applied.

CRITICAL CONSIDERATIONS

- FSLG struggles with dilemma of nominally serving a particular market segment but limited to resolution of various employment tax and reporting issues
- FSLG struggles with a huge taxpayer population but limited human resources
- At the national level, GL and FSLG communicate their respective roles consistently (with the exception of a little ambiguity around “outreach”)
- Recommendations must recognize the distinction between advocacy and facilitation
- Recommendations must recognize the distinction between taxpayer driven compliance and practitioner driven compliance
- Successful evolution of ITG program offers some ideas for FSLG; however, organizations have varying levels of resources available
- Customer Account Services (CAS) demonstrates an increasingly substantial capacity to respond to general employment taxpayer questions in an accurate, timely and effective manner.

- Information systems technology offers options for better identifying state and local government entities

PRINCIPLES TO GUIDE RECOMMENDATIONS

- Recommendations should minimize unnecessary bureaucracy
- Customers prefer direct “point of entry” for addressing questions
- Recommendations should not disrupt existing TE/GE programs, such as ITG, that work well.
- IRS roles and responsibilities related to government entity customers must be clear
- Good communication between IRS divisions and effective cross-functional partnering are critical to customer service

RECOMMENDATIONS

Taxpayers Need Direct Access to Issue Specific Areas

- The project team recognizes the most efficient “point of entry” will not be FSLG in some matters involving government entities. During our review, we concluded that taxpayers should be able to go directly to the IRS area best suited to address their particular issues. We considered what process makes the most sense for customers as a first stop. If a government entity already knows where to go, we are not recommending “forcing” them into FSLG as an “entry point.”
- If the government entity is unsure where to enter, we recommend the Call Site serve as the “entry point.” In that event, assistors who answer the 1-800 calls would respond to first inquiries from state and local government entities. Given FSLG resource limitations, Customer Account Services (CAS) offers a resource for first call response. In the last year, FSLG has made significant progress in training call site assistors:
 - The IRM Manual for CAS personnel was rolled out in October 2002 (See 21.3.8.10 for FSLG sections)
 - CAS staff is well trained to handle calls
 - Recent statistics demonstrate CAS capacity to respond effectively to calls

We recommend continued training by FSLG staff to CAS staff.

- FSLG should consider expanding the direction currently provided on its web site for federal, state and local government units on where to go to resolve taxpayer issues. (See current web site provided in Exhibit C.) Expanded direction should include additional links, including the following:
 - For information on employee plans, contact Employee Plans

- For information on tax-exempt bond questions, contact Tax-Exempt Bonds
- For unrelated business income tax information, contact Exempt Organizations
- If FSLG becomes the “point of entry” by taxpayer choice, by default, by referral or for other reasons, we envision the following FSLG responses:
 - If taxpayer approaches FSLG with inquiry about which entry point is appropriate, FSLG should facilitate by redirecting taxpayer to most appropriate entry point.
 - If taxpayer has experienced difficulties in navigating process at either call site or specific issue point of entry, FSLG should facilitate by trouble-shooting the problem and find best point of entry for taxpayer.
 - If call site or other unit of IRS refers taxpayer to FSLG about a technical issue for which FSLG is responsible (i.e. employment tax), FSLG specialist will be responsible for resolution.
 - If taxpayer has matter outstanding with another area of IRS and comes to FSLG due to dissatisfaction with handling of matter, FSLG should serve as facilitator to see if taxpayer can be given better understanding of issue, realistic time frame, or whatever would be helpful in establishing a better relationship between the taxpayer and the IRS area handling the matter.

Build FSLG Facilitation Skills and Navigational Experience

- When FSLG functions in a facilitator role, its goal should be to get the right people on the issue and facilitate timely and appropriate attention to taxpayer issues. Similar to ITG, FSLG could consider an omni buds function for state and local taxpayers who are not sure why an issue is significantly delayed somewhere in the IRS. FSLG would necessarily need to evolve into this position and work through the related growing pains.
- FSLG specialist would benefit from additional training and experience to gain a better understanding of the overall IRS organizational structure, responsibilities of key leadership in areas outside FSLG, and processes around issues resolution.
- When FSLG plays the role of facilitator, navigational skills will be critical. FSLG should provide understanding and be able help explain issues to taxpayer even if it has no delegated authority. FSLG will need to instill in its work force a sense that “this is my job,” to take that call and manage it for someone who does not know their way around the IRS. FSLG should continue to reinforce the service mentality it has developed over its initial two years.

Develop Best Practices for Establishing Relationships with State and Local Governments

- We recognize that across the states, individual FSLG specialists have found effective points of contact throughout state and local government. FSLG specialists have moved, independently, to establish direct relationships with state oversight departments, social security administrators, state and local government agencies and associations that serve government entities.

We suggest FSLG assemble its most experienced specialists to collaborate, leverage upon their individual successes, and develop a best practice for establishing appropriate working relationships at the state and local level. In this effort, FSLG might consider what value might be realized through the following types of relationships:

- Payroll Associations
- County Treasurer Associations
- Leagues or Associations of Counties and Cities
- National Associations of State Auditors, Controllers and Treasurers
- Government Finance Officers Association
- National Conference of State Social Security Administrators

Clarify Roles and Responsibilities of FSLG Specialist

- We do not expect FSLG to try to become skilled at those specialized compliance issues outside the employment tax area that impact government entities. Within the IRS, FSLG and other units within TE/GE should formalize their respective roles and responsibilities for responding to government entity tax issues, perhaps through memorandums of agreement.
- We recommend FSLG continue to work with GL at a national level to reinforce standards for state level representatives of both units on the following:
 - Responsibility for state and local taxpayer employment tax matters resides with FSLG
 - Responsibility for outreach and education for state and local governments as taxpaying entities resides with FSLG
 - Responsibility for outreach and education for state and local governments as joint tax administrators resides with GL
 - Process exists for GL to hand over taxpayer compliance and outreach to FSLG representatives and for FSLG representatives to transfer tax administration issues to GL representatives

- We recommend FSLG continue to work with GL to develop national level programs that will facilitate working relationships between field GL and FSLG personnel with the following objectives:
 - Identification of all potential state and local taxpayer entities that may have education and compliance needs
 - Identification of various process owners and who will take lead for facilitating issues with multiple owners (i.e., investment, wage, electronic tax administration, systems, etc.) to completion

Cross-Functional Education and Communication within TE/GE

- Encourage greater information sharing and better communication, across TE/GE, about the nature of technical issues and problems facing state and local government entities. Cross functional / cross divisional efforts to share substantive issues and educate each other should be expanded. Not only should FSLG continue to internally market its role and expertise to other units, but FSLG should actively pursue education from other units on their issues that may affect state and local government taxpayer entities. Moreover, we strongly urge the other TE/GE units to actively pursue ways to communicate with and educate FSLG about activities in their areas that impact FSLG customers.
- Consider a model that would assign specific responsibility in each TE/GE unit, at a high level of leadership, to facilitate the resolution of FSLG taxpayer issues that must be addressed outside of FSLG. Specifically, Employee Plans, Tax-Exempt Bonds, and Exempt Organizations might each designate a person in their unit that would carry responsibility as the unit liaison to the FSLG staff and also be responsible for timely resolution of FSLG taxpayer issues.
- FSLG needs to know what is going on in other areas of IRS that impact their customers. TE/GE should consider developing a communication practice standard wherein field representatives from various TE/GE units would communicate with FSLG specialist on issues that impact FSLG customers.

Build Accurate and Comprehensive FSLG Customer Inventory

- A number of strategies might be applied to develop an accurate and comprehensive inventory of state and local government entities. IRS has captured an initial list of federal, state and local government entities by extracting from the current IRS systems entities that file Form 941 and whose current IRS accounts are coded F (i.e. Federal Agencies), G (i.e. State and Local Government) and T (i.e. Section 218 Agreement). See Exhibit D for current IRS coding system. This listing could be validated and augmented through other means:

- US census of governments (i.e., FSLG project in process)
 - States government books and records
 - Associations of state and local government entities and municipalities
 - Secretary of State office records
 - County level registrations
 - SS-4 filing data indicating “government” status
 - Associations of cities and towns and counties
 - School board associations or teachers unions for school districts
 - Economic development commissions
 - Libraries
 - The Tax Directory – Governmental Officials Worldwide
 - taxdir@tax.org - Tax Analysts
 - www.tax.org
 - www.treas.gov/tigta/audit_reports.htm #2002-10-102
- Other resources for identifying state, quasi-governmental, interstate instrumentalities, and local government entities might include the following:
 - State auditors may be able to help with identification of quasi-state and local government agencies
 - Call sites are data oriented and may have call information
 - State departments of management, budget and/or employment security provide data, but in each state these units report to different places; no two state governments are set up alike.
 - GL believes it can be a conduit on behalf of TE/GE and suggests a joint letter to state organization as part of an outreach effort.
 - Federal agencies such as SSA or the Department of Labor

Communicate Identities of New Governmental Employers to SSA

- Neither FSLG nor SSA currently identify or catalog the establishment of a new governmental employer. Additionally, if the data were available, there are no existing procedures for the exchange of this information between these two federal partners. FSLG should consider implementing a process to identify these newly formed entities by using existing IRS system coding, classify such entities into its existing data base and share this information with SSA under their existing Memorandum of Understanding (MOU). This process will increase compliance with payroll tax withholding, payroll tax payments, wage reporting and social security/Medicare coverage. Additionally, early identification of these entities enables FSLG and SSA to avoid costly and time-consuming retroactive resolution of withholding, reporting, reporting, earnings record and coverage errors.

**EXHIBIT A
POINTS OF INTERSECTION WITH IRS**

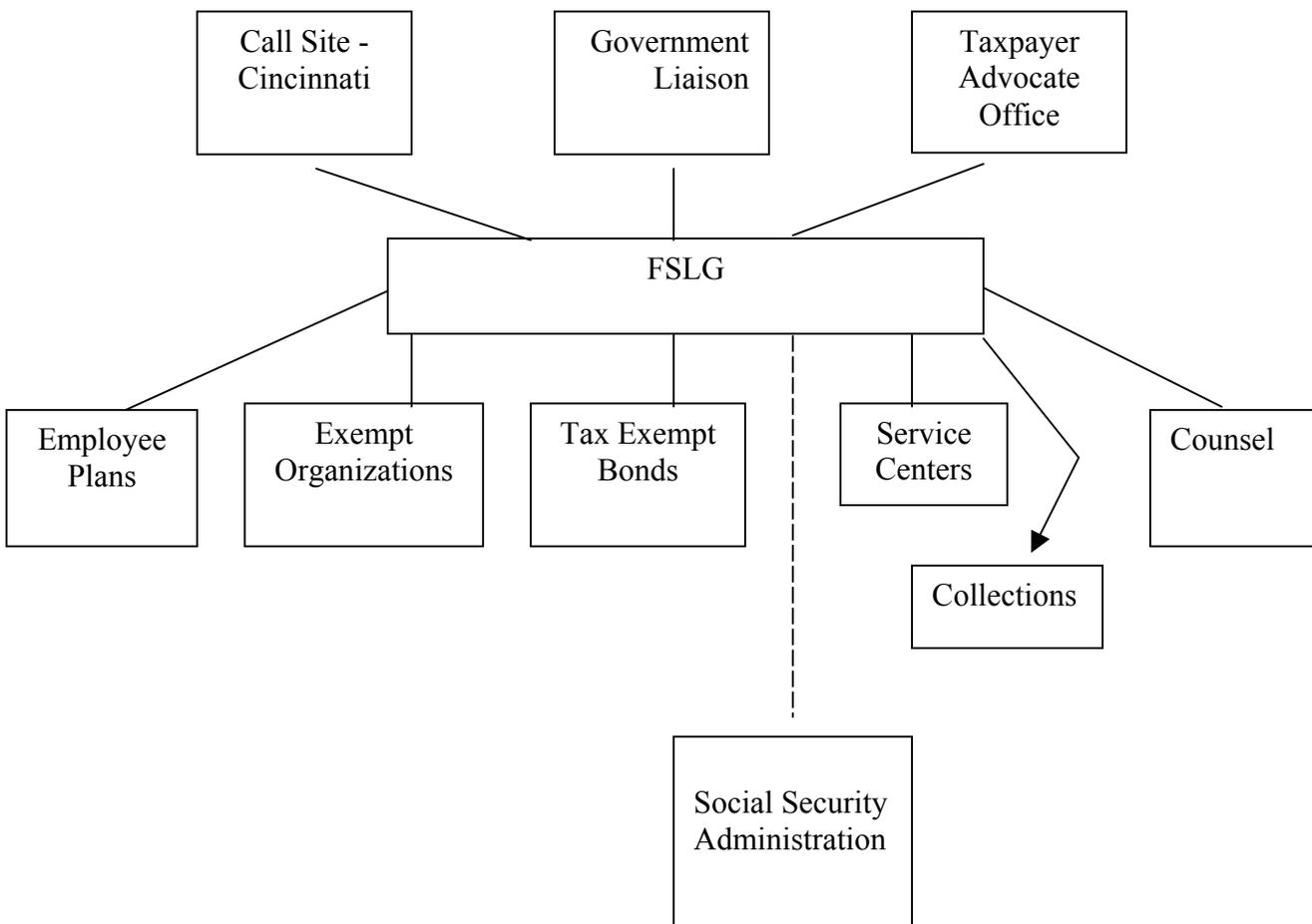


EXHIBIT B

(Memorandum of Agreement between IRS and SSA)

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

**Section 1.
Purpose**

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

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

**Section 2.
Background**

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

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

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

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

Section 3. Responsibilities

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

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

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

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

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

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

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

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

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

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

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

Section 4. Educating State and Local Government Employers

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

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

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

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

Section 5. Improving the Coordination Process Between IRS and SSA

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

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

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

Section 6. Disclosure of Federal Returns and Federal Return Information

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

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

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

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

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

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

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

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

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

Section 7. Disclosure Safeguards

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

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

**Section 8.
Notices and Contacts**

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

**Section 9.
Funding**

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

**Section 10.
Effective Date, Modifications and Termination**

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

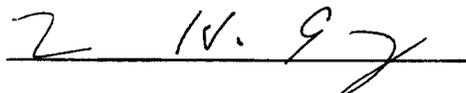
**Section 11.
Signatures**

Internal Revenue Service
Commissioner,
Tax Exempt and Government Entities

Social Security Administration
Deputy Commissioner for
Disability and Income Security
Programs



Date: 2-8-02



Date: APR - 4 2002



EXHIBIT C

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY

June 29, 2001

MEMORANDUM FOR DIVISION COMMISSIONERS

CHIEF COMMUNICATIONS AND LIAISON
NATIONAL TAXPAYER ADVOCATE
CHIEF, APPEALS
CHIEF COUNSEL

FROM: Bob Wenzel /s/ Bob Wenzel
Deputy Commissioner of Internal Revenue

SUBJECT: Governmental Liaison Program – Clarification of Role

The purpose of this memo is to clarify the role of the Governmental Liaison function in the modernized IRS and how that function will work in partnership with the operating and functional divisions.

In the past few months, we have heard from our state and local partners about contacts they have had with the IRS. The general tenor of their concerns is that representatives of different IRS operating divisions have made independent contacts with the same individual or office for different, but often related, purposes. The resulting confusion underscores the need for the Governmental Liaison Program - a program designed to work within the IRS to coordinate outreach and build and maintain relationships with our operating and functional divisions, state and local governments and federal agencies.

Role of the Governmental Liaison Program

Organizationally, Governmental Liaison (GL), formally known as FedState, is a function of the Office of Governmental Liaison and Disclosure (GLD) under Communications and Liaison (C&L). It was developed in the modernization design to ensure that:

- All contacts with other government tax entities are well coordinated and that IRS resources are used in an efficient and effective manner;
- All joint activities are consistent with IRS direction;
- Issues identified by our partner organizations are consistently surfaced and addressed;
- Contacts with local Congressional offices (Congressional Affairs Program) for non-case, general tax administration activities are handled efficiently;
- Major data exchanges with the states are managed consistently.

In order to achieve these objectives it is essential that the IRS Governmental Liaisons (GLs) be the primary point of contact with these entities. As a result, **all** such contacts need to be coordinated with the C&L field Governmental Liaisons, or national Governmental Liaison office. *(The only exception is when the IRS division relationship with the authority is related to its tax reporting responsibilities. For example, the Tax Exempt and Governmental Entities Division is the primary compliance and outreach contact for state and local governments as taxpaying entities.)*

If you are contacted directly by a government entity, please notify the C&L field GL or GLD Area Manager. The GL or GLD Area Manager will help the operating division determine how best to work with these stakeholders, and what the appropriate GL involvement should be on a case-by-case basis.

The table below helps illustrate various roles and responsibilities of Governmental Liaison and the operating divisions:

C&L Field Governmental Liaisons	C&L National Governmental Liaison Office	Operating Division's Embedded FedState Coordinator	TE/GE – Federal, State and Local Governments
<p>Coordinates activities between IRS and state and local governments and federal agencies located in the states.</p> <p>Primary point of contact for local Congressional offices (Congressional Affairs Program) for non-case, general tax administration activity.</p>	<p>Develops policy and provides oversight for the overall IRS Governmental Liaison program.</p> <p>Ensures consistency for all IRS GL activity.</p> <p>Works with ODs' embedded FedState Coordinators.</p>	<p>Coordinates GL activity within division, for example: compliance initiatives, partnering, outreach pilots.</p> <p>Works with C&L National GL office to establish strategic direction for ODs' GL activities.</p>	<p>Responsible for compliance outreach, education and enforcement contacts with state and local governments in its relationship with them <i>as taxpaying entities.</i></p>

Contact Information

C&L Governmental Liaisons are located in each state and the District of Columbia. They report to seven GLD area managers located in New York, Baltimore, Atlanta, Chicago, Dallas, Denver, and Oakland. Currently, the GLs are meeting with territory managers to explain their role and offer their assistance to the operating divisions. For

your convenience, I have attached a list of Governmental Liaisons or you may find their names and numbers at <http://notesnt4.aus.swr.irs.gov/GovtLiaison.nsf>

In order for this process to work, your cooperation is essential. Thank you in advance for your support. If you have any questions or need further clarification, please call Clare Calaby, Acting Director, Office of Governmental Liaison, at 202-622-5155.

Attachment
GL Contact List:



[Home](#) > [Government Entities](#) > [Federal, State, & Local Gov'ts](#)

Federal, State, & Local Gov'ts

Tax Information for Federal, State, & Local Governments

[New! See our Calendar of Events for 2003!](#)

FSLG is participating in a series of conferences & workshops for federal, state, and local governments around the country during the upcoming calendar year. Check our Calendar of Events for locations and dates.

[Publication 963 - Federal-State Reference Guide](#)

The 2002 revision of this publication provides state and local government employers a comprehensive reference guide for Social Security and Medicare coverage and Federal Insurance Contributions Act (FICA) tax withholding issues.

[Revenue Procedure 91-40](#)

This revenue procedure sets forth rules relating to the minimum retirement benefit requirement prescribed under section 31.3121(b)(7)-2 of the Employment Tax Regulations.

[Helpful Tip No. 1](#)

Want to visit us again? Just remember <http://www.irs.gov/govts>. It's that easy!

[Helpful Tip No. 2](#)

Are you a government employer with a technical or procedural question? Write to us!

Search IRS Site for:

Search Forms and

Publications for:

[Search Help](#)

contents

[Federal, State, & Local Gov'ts](#)
[Government Liaisons](#)
[Indian Tribal Gov'ts](#)

resources

[e-file](#)
[Forms and Publications](#)
[Where To File](#)
[Contact My Local Office](#)
[Frequently Asked Questions](#)
[Taxpayer Advocate](#)

topics

[About FSLG](#)
[FSLG Newsletter](#)
[FSLG Customer Services](#)
[Calendar of Events](#)
[More Topics ...](#)

EXHIBIT E
CODES TO IDENTIFY TE/GE ACCOUNTS
(Bold Identifies FSL Entity/Account)

1. BOD Code

- a. WI
- b. TE**
- c. LM
- d. SB

2. BOD Client Code within BOD Code "TE"

- a. B - Bonds
- b. F - FSL**
- c. I - ITG
- d. 1 - Bonds Issued by ITG
- e. 2 - Bonds Issued by FSL**
- f. 3 - Bonds Issued by EO

3. Employment Code

- a. G - State and Local Government**
- b. F - Federal Employer
- c. T - Section 218 Agreement**
- d. I - ITG

4. Filing Requirement Code

- a. 941
- b. 940
- c. etc.

"L" code means large corporation case. This code also appears in the entity of an account. If one wanted to identify large corporation TE/GE FSL accounts, he would request all accounts with the following codes:

- a. TE BOD code
- b. F BOD client code
- c. L code (i.e. Large Corp)