Tax Exempt & Government Entities

TE/GE

Advisory Committee on Tax Exempt and Government Entities (ACT)

2013 Report of Recommendations

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

2012-2013
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Mr. Ferszt is chair of the Employee Benefits and Executive Compensation Group at Tarter Krinsky & Drogin LLP. He counsels clients ranging from Fortune 100 companies to small employers on all aspects of qualified retirement plans (defined contribution and defined benefit). He also counsels tax-exempt organizations on issues involving public charities and private foundations. Mr. Ferszt served as Chair of the Tax Section of the New Jersey State Bar Association and its Employee Benefits Committee. He is also a member of the IRS Northeast Pension Liaison Group and a fellow of the American College of Trust and Estate Counsel where he serves on its Employee Benefits in Estate Planning committee. Mr. Ferszt received his Juris Doctorate from the Benjamin N. Cardozo School of Law of Yeshiva University and his Bachelor of Arts from Boston University.

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

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

Donna M. Mueller, Des Moines, IA

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

David A. Mustone, McLean, VA

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

Adam C. Pozek, Salem, NH

Mr. Pozek is a partner at DWC ERISA Consultants, LLC. He specializes in plan design, qualified-plan-related due diligence in mergers and acquisitions transactions, and corrections under the Service's Employee Plans Compliance Resolution System. Mr. Pozek is active in the American Society of Pension Professionals and Actuaries where he serves on the board of directors, executive committee and government affairs committee. He also serves as co-editor-in-chief of the Journal of Pension Benefits. Mr. Pozek is enrolled to practice before the IRS as an Enrolled Retirement Plan Agent, and he holds the professional credentials of Qualified Plan Administration (QPA), Qualified Plan Financial Consultant (QPFC), and Registered Employee Benefits Consultant (REBC).

EXEMPT ORGANIZATIONS

Eric B. Carriker, Boston, MA

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

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

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

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Ms. Gries is a partner with Clifton Larson Allen LLP where she serves a wide variety of tax-exempt organizations including public charities and private foundations, social welfare organizations, associations, credit unions, and religious organizations. She has extensive experience in unrelated business income tax planning and reporting, intermediate-sanction analysis as well as application and corporate compliance reviews. Ms. Gries is a graduate of Nettleton College in South Dakota.

Marty Martin, Raleigh, NC

Mr. Martin established the Martin Law Firm to provide legal services to nonprofit and tax exempt organizations and training for their boards and senior management. Mr. Martin is an instructor for the Duke University Nonprofit Management Certificate program and is affiliated with the North Carolina State University Institute for Nonprofits. He authors The Nonprofit Mentor blog and frequently speaks on issues related to nonprofit organizations. Mr. Martin received a Master's Degree Public Administration with a concentration in managing nonprofit and public sector organizations from the Harvard Kennedy School and a Juris Doctorate degree from the Western New England University School of Law.

Celia Roady, Washington, D.C.

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

Gary J. Young, Boston, MA

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

GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS

Robert E. Jaros, Boulder, CO

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

Lisa M. Pusich, Juneau, AK

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

Kathy Sheppard, Boston, MA

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

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

Holly Easterling, Ada, OK

Ms. Easterling is Secretary of the Department of Treasury for the Chickasaw Nation in Ada, OK, where she works directly with Governor Bill Anoatubby to ensure that the financial and strategic needs of the Tribal government are realized. She served as an elected official in the Tribe's legislature including serving as Chair of the legislature and Chair of the Finance Committee. She also served as Controller for Chickasaw Enterprises, the business division of the Chickasaw Nation, which owns and operates one of the largest casinos worldwide. Ms. Easterling graduated from Oklahoma State University with a Bachelor's degree in accounting and became a CPA in 1990.

Diane M. Gange, Sequim, WA

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

William "Yaan Yaan Eesh" Micklin, Alpine, CA

Mr. Micklin is 1st Vice President of the Central Council of Tlingit & Haida Indian Tribes of Alaska, representing over 28,000 tribal citizens. He is CEO for the Ewiiaapaayp Band of Kumeyaay Indians and Executive Director of the California Association of Tribal Governments. He is appointed to tribal advisory committees for the Internal Revenue Service, Department of Interior, and Department of Energy. Mr. Micklin graduated with a Bachelor of Arts in English Literature from the University of Washington.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

Katherine A. Newell, Princeton, NJ

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

J. Sue Painter, Seattle, WA

Ms. Painter is System Director, CIO/Treasurer of her firm, Providence Health & Services, which is a multistate not-for-profit health care system with revenues in excess of $9.1 billion. She is responsible for the issuance of over $4 billion in debt financing. Prior to joining Providence, she served as the Treasurer of the Public Utility District of Clark County. In that role she was responsible for the debt issuance of a local government issuer. Ms. Painter previously served as an investment executive with a major investment bank. Ms. Painter has a Master's of Business Administration from the University of Portland and a Bachelor of Science in Business Admin/Finance from Portland State University, OR.

Lorraine Tyson, Chicago, IL

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

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

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

This year there are six reports:

- **Employee Plans:** Analysis and Recommendations Regarding the Employee Plans Compliance Resolution System
- **Exempt Organizations:** Leveraging Limited IRS Resources in the Tax Administration of Small Tax-Exempt Organizations
- **Federal, State and Local Governments:** Leveraging Internal Controls of State and Local Governments to Improve Tax Compliance
- **Federal, State and Local Governments:** Government Levy Processing Improvements
- **Indian Tribal Governments:** Supplemental Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members
- **Tax Exempt Bonds:** A Roadmap To Arbitrage Requirements For Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

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

Each year, approximately one-third of our 21 members complete their term, although this year we have fewer departures than normal. We thank them for their wisdom and sharing of their unique insights during their service. They are:

- Karen A. Gries
- Adam C. Pozek
- Celia Roady

In 2012-2013, we continued to work with our colleagues at the Service to accomplish the goals of the ACT within the very limited resources currently available to the Service.

The ACT wishes to acknowledge and express our ongoing gratitude for the Service's willingness to look to the ACT for its insights. Specifically, we would like to thank the Service's leadership for their ongoing support of our activities. We also wish specifically to thank TE/GE leadership for their assistance over the past year.

Further, we wish to specially thank the employees of TE/GE for their ongoing dedication. The members of the ACT recognize that the Service continues to dedicate significant resources to the ACT, even in light of very significant constraints on its operations. However, the insights provided by the ACT reports would not be possible without the Service's greatest strength – its dedicated employees – and their willingness to work in a collaborative and open manner with the ACT.

Lastly, in that this report also concludes my term on the ACT, I include a few personal notes of appreciation. First, I would like to thank our Vice Chair, and my friend and colleague, Adam C. Pozek, for his wisdom and leadership as well as all the members of the ACT with whom I have had the pleasure of serving over the last three years. Second, I congratulate the incoming Chair, Stephen L. Ferszt, and Vice Chair, Katherine A. Newell, on their upcoming leadership of the ACT for the 2013-2014 year. Finally, I would like to express my personal appreciation to Bobby Zarin and her team for their invaluable management of the ACT process that has made my two years as Chair a very enjoyable experience.

David N. Levine
ACT Chair
2012-2013

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Employee Plans: Analysis and Recommendations Regarding the Employee Plans Compliance Resolution System

Stephen L. Ferszt, Esq.
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Adam C. Pozek, ERPA

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I. Executive Summary

The Employee Plans Compliance Resolution System is a program created by the Internal Revenue Service that allows sponsors of qualified retirement plans, 403(b) plans, Simplified Employee Pension Plans and Savings Incentive Match Plan for Employees Individual Retirement Accounts to voluntarily correct various types of tax qualification errors. EPCRS, the most recent version of which was published in IRS Revenue Procedure 2013-12 in December 2012, has been in place in some form or fashion since the early 1990s. Although the program did not consolidate the various voluntary correction options under its current moniker until 1998, components of EPCRS have existed under several names since 1991.

In the more than two decades since its creation, EPCRS has evolved and matured due in large part to the Service's commitment to the program, the dedication of the Service personnel charged with its administration and a robust and open dialogue with the practitioner community. More than 33,000 voluntary correction applications have been submitted through the program since its inception, with nearly 7,000 coming in fiscal year 2011.

As is the case with a successful program in any organization, there is a risk that the strength and knowledge gained through years of maturation can give way to slower ongoing adaptation and more clearly defined parameters. While both can be positive, it is important that they not occur at the expense of the fluidity that contributed to the initial success.

After several discussions with the Service, the Employee Plans subgroup of the ACT elected to undertake a critical review of EPCRS, including both technical and operational aspects, with the goal of identifying those aspects that have helped to make the program so successful as well those that must continue to evolve to ensure that success continues for years to come.

The EP Subcommittee surveyed and interviewed members of the practitioner community to solicit their input. This undertaking was supported and encouraged by the management and staff of Employee Plans. In particular, the EP Subcommittee would like to acknowledge the support and leadership provided by Rob Choi, Director of Employee Plans. We also appreciate the time and cooperation from Joyce Kahn, Acting Director, Employee Plans Rulings and Agreements, Monika Templeman, Director, Employee Plans Examinations, Mark O'Donnell, Director, Customer Education and Outreach, and Yan Mak, Manager, Employee Plans Voluntary Compliance.

Through their assistance, the EP Subcommittee was provided with the opportunity to speak openly and candidly with all the Voluntary Correction Program Managers and Coordinators, as well as other staff pertinent to the project. Indeed, we were also able to collect valuable feedback from nearly half of those who comprise the Service's voluntary correction function. Both groups offered positive commentary about the program, and also made numerous suggestions as to how the program might continue to improve.

Based on the results of our research, the EP Subcommittee is making recommendations that fall into three general categories:

- Internal controls
    - Institutionalize the culture of correction for future generations of Voluntary Compliance (VC) staff.
    - Maximize VC resources to ensure that the more complex cases are directed to those with the backgrounds and experience to most efficiently resolve them.
- Procedural changes
    - Facilitate more cost effective correction by plan sponsors by further streamlining the submission process, creating additional *de minimus* thresholds and expanding the use of reasonable estimates when actual data is not available.
- Additional substantive corrections
    - Address errors for which the practitioner community would like added clarity.

Section II of this report provides a concise overview of EPCRS, and Section III briefly reviews the history of EPCRS. Section IV provides additional details regarding the manner in which the EP Subcommittee conducted its research. Our recommendations are detailed in Section V and summarized in Section VI. The Appendices include the numerical results of our practitioner survey as well as an organizational chart of the VC functional area.

II. Introduction

Employers who sponsor retirement plans, or "plan sponsors," are responsible for compliance with a number of complex laws and rules in order to maintain the tax qualification of the retirement plans. Plan qualification is crucial to viability of retirement benefits offered by plan sponsors. One method of promoting ongoing compliance and continued qualification of retirement plans is to offer a means for plan sponsors to correct a variety of plan failures discovered through routine administration. The EPCRS is that method.

EPCRS enables plan sponsors to correct many compliance issues through several voluntary processes prior to an IRS audit. These processes encourage plan sponsors to initiate their own review of the plan and its operation for compliance with qualification requirements. EPCRS also encourages negotiated settlements in the audit process to protect the retirement benefits offered under qualified retirement plans.

EPCRS comprises three programs: the Self Correction Program, the Voluntary Correction Program and the Audit Closing Agreement Program. These programs are fully described in Revenue Procedure 2013-12, §1.03 and summarized as:

Self-correction

- Available only for operational failures; where the plan sponsor has failed to follow the terms of the plan.
- Correction is made without filing a formal submission or without paying a fee to the IRS.
- Plan sponsor must be able to demonstrate practices or procedures designed to correct the failure and to administer the plan in compliance with the plan document and the governing law.
- Available to plan sponsors of a "qualified plan" or a 403(b) Plan. Also available to a SEP, or a SIMPLE IRA Plan if established by a document approved by the IRS.
- In the case of a qualified plan that is the subject of a favorable determination letter (or an advisory opinion letter for a prototype or volume submitter plan) from the Service or in the case of a 403(b) Plan, the plan sponsor may correct significant operational failures if corrected within two years of the end of the plan year in which the operational failure occurred.

Voluntary Correction Program

- Available on a much broader scale than SCP; covers corrections of operational, plan document, demographic and employer eligibility failures. Intent is to receive a "compliance statement" wherein the IRS approves of a method to correct the identified failure.
- Available to plan sponsors of a qualified plan, 403(b) plan, SEP or SIMPLE IRA Plan.
- Requires filing on specified forms and payment of fees.
- Special procedures for anonymous submissions and group submissions.
- Available to a plan sponsor only if filed before being notified of an audit.

Audit Closing Agreement Program

- Available to a plan sponsor when the plan is audited by the IRS.
- Closing agreement is a negotiated correction of an identified failure.
- Requires payment of a sanction for the failure that may vary depending on the severity and nature of the plan failure.

III. History

EPCRS was established by Revenue Procedure 98-22 and was a consolidation of several employee plans correction programs. The goal of consolidation under the umbrella of EPCRS was to establish consistency, end-to-end accountability, and uniformity in employee plans corrections with the overall purpose of maintaining the tax-favored status for retirement benefits offered by plan sponsors of qualified plans.

Since 1998, EPCRS and its programs have been updated and restated in multiple issuances of Revenue Procedures. Most importantly the primary goal of voluntary correction is to encourage compliance with applicable federal tax laws in a manner that provides a value-added service to the plan sponsor and protects the plan participants. The general principles underlying EPCRS were most recently restated in Revenue Procedure 2013-12, §1.02 as:

- Sponsors and other administrators of eligible plans should be encouraged to establish administrative practices and procedures that ensure that these plans are operated properly in accordance with the applicable requirements of the Internal Revenue Code of 1986, as amended ("Code").

- Sponsors and other administrators of eligible plans should satisfy the applicable plan document requirements of the Code.

- Sponsors and other administrators should make voluntary and timely correction of any plan failures, whether involving discrimination in favor of highly compensated employees ("HCE"), plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer. Timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment.

- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the Service, thereby reducing employers' uncertainty regarding their potential tax liability and participants' potential tax liability.

- Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly.

- Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation.

- Administration of EPCRS should be consistent and uniform.

- Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.

On December 31, 2012, the most recent guidance for EPCRS (primarily VCP) was issued in Revenue Procedure 2013-12, which is generally effective April 1, 2013. However, plan sponsors may elect to apply its provisions as of its issuance date. In this report, the EP Subcommittee will take note of areas where the issuance of Revenue Procedure 2013-12 is relevant to its study and findings concerning SC or VCP. The most significant changes contained in Revenue Procedure 2013-12 include:

- Allowing for 403(b) operational plan failure corrections in the same manner as those allowed for qualified plans (with the exception that 403(b) failures occurring prior to January 1, 2009 must comply with Revenue Procedure 2008-50).
- VCP is available for a 403(b) plan sponsor to correct a failure to timely adopt a written plan.
- New forms (8950 and 8951) are required for VCP filings.
- Appendices have been substantially revised and consolidated.
- Availability of reduced VCP fees under certain criteria in cases of late adoption of proposed amendments, multiple failures, and late adoption of a written 403(b) plan.
- Reduced Audit CAP sanctions for certain late amender failures.
- In keeping with various VCP processing reforms within the Service, VCP submissions must be mailed to the IRS Service Center in Covington, KY.

Overview of the Voluntary Correction Process

The operation of VCP has both a centralized component and a decentralized component. The Employee Plans Voluntary Compliance Manager oversees five VC groups which are located in different regions of the country. Each group consists of a Group Manager and VC specialists who handle VC application cases. Some groups also have a Group Coordinator assisting in the review of cases. The EP VC Manager also oversees three Program Coordinators who work on broad VC policy issues. Program Coordinators serve as a resource to the groups and support consistency among the groups.

VC applications are received in one centralized location (Covington, KY, previously Washington D.C.) where they are screened for basic filing compliance. The application may be immediately returned to the submitter for lack of payment of the filing fee. All others are screened by technical correction specialists who may issue approvals in specific types of cases, or reject if clearly ineligible for VCP. All other applications are forwarded to one of five VC groups located in different areas of the country for further review.

The distribution of applications across the five VC groups is primarily based on the case load in each office. Applications are distributed when a Group Manager indicates that the office can accept additional cases. Distribution is not done by matching the region of the applicant to the regional location of the VC group office or by subject matter or type of application.

Once received in a VC group office, the application is assigned according to complexity of the application and the level of expertise of the VC specialists within the group. Some categorization of cases may occur during the central screening process, but cases may also be categorized at the VC group level. Some cases with straight forward qualification failures offering approved correction methods—as described in Appendices A and B—may be closed with little or minimal contact with respect to the applicant. These cases also do not require review by the Group Coordinator.

Cases of greater complexity require review by the Group Coordinator prior to closure. These cases may also involve review by the Group Manager and/or be brought before the Program Coordinators.

Closing letters, whether or not the application is approved, are prepared by the VC specialist. Standardized letters are often saved on SharePoint software available on the IRS internal IT network. However, each VC Group may also have its own set of customized closing letters. All closing letters bear the signature of the Group Manager.

To promote continuity between VCP and Audit CAP programs a Central Coordination Committee meets periodically to discuss complex cases and policy issues. The CCC is composed of a VC Manager, VC Program Coordinators, VC Group Managers and Group Coordinators, as well as Audit Cap Coordinators.

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IV. Due Diligence

Selection of EPCRS Project

This project was selected to examine ways to strengthen and promote voluntary compliance. Plan sponsors utilizing SCP and VCP protect retirement benefits offered by qualified plans. Increased utilization of SCP and VCP also facilitates more efficient use of IRS resources.

The EP Subcommittee examined whether the program could be strengthened by broadening the eligibility base and simplifying or streamlining the submission process. The EP Subcommittee also looked at ways to simplify corrections, while also encouraging flexibility in approving more complex corrections.

We reviewed internal resources and processes of VCP. This included reviewing staff training opportunities; coordinating opportunities across groups; databases for closure examples; and coordination across all areas of EPCRS. Attention was also given to understanding the structure of the positions within VCP and the workflow processes.

The EP Subcommittee conducted its review by employing surveys of practitioners and VC staff. The practitioner survey was distributed through numerous channels. There was strong participation from the practitioner community, including many who provided comment. The EP Subcommittee members obtained additional feedback from over 20 responders who agreed to be interviewed and who had substantial experience with EPCRS.

Rob Choi, Director, Employee Plans, made staff from across EPCRS available to the EP Subcommittee. Open and informative discussions with staff and managers were conducted at ACT meetings and via telephonic interviews.

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V. Recommendations

A. Enhancement of Internal Controls

Voluntary Compliance Process Enhancements

In the 2011-2012 EP Subcommittee project, we focused on the role of internal controls review in Employee Plans' examination activities and how they can be relevant to the day-to-day administration of employee plans. After completing the in-depth review of VC materials provided to us by VC staff, evaluating the results of our internal and external surveys regarding the VC process, and conducting one-on-one interviews with VC stakeholders, we believe that the VC function could be enhanced by the following internal controls processes.

1. Maximizing Voluntary Compliance's Human Capital

Throughout our process, a repeated comment we received and witnessed first-hand is that there is a significant depth of institutional knowledge and intellectual capital in the VC function. However, as the VC program has evolved and as generational shifts have occurred within the Service, it has become clear that there are concerns both internally and externally regarding the institutional knowledge and culture of the VC process –there are concerns that VC has moved away from a goal of finding practical and reasonable solutions. These concerns were manifested in a number of ways –anonymous survey responses from VC staff reflecting their concerns about the evolution of the program as well as practitioner community commentary regarding the inconsistency and/or inflexibility of the program with respect to complex or "non-cookie cutter" cases. Given the significant depth of knowledge and skill in the VC function, we recommend that the following processes be implemented:

2. Written Training and Outreach Material

VC already produces a significant volume of educational materials – both for internal and external consumption. Given that these materials are generally not taxpayer specific, we believe that utilizing a common set of materials that would be used both internally and externally for training and outreach would both increase efficiency in light of the Service's ongoing fiscal constraints and would help bring VC and the stakeholder community closer together in their understanding of the program, thus engendering increased efficiency and utilization of the program. For example, as part of our research, we were provided with internal VC training materials explaining what steps the Service looks for to determine that a plan has adopted processes to prevent the recurrence of a failure. Sharing this same information with the stakeholder community could potentially reduce the amount of correspondence needed to review EPCRS filings. As such, having a process of utilizing the same materials may help advance the goals of the EPCRS program.

3. Training Programs

Although the significant volume of existing training materials is very helpful, it is essential for a "culture of correction" to be a core principle of the VC program. Notably, throughout our review process, we saw numerous examples where written materials could be interpreted (and had been interpreted by practitioners) as more rigid than the more flexible positions expressed by VC staff when similar questions were asked. As such, the role of training new VC staff, especially those coming from a background in the examination function - which is the background of many in VC - on this culture of correction is essential to avoid a literal reading of written materials resulting in the evolution of a more rigid program. Below we suggest a number of steps that could be taken to establish a culture of correction:

a) New Hire Training

A formal process for training individuals hired into VC should be implemented. While in-person training is preferable, we recognize the Service is facing significant fiscal limitations, and as such, video conferencing style training should be considered so "face to face" education about VC's mission and culture of compliance can be shared. This training should specifically highlight VC's goal of reaching an accommodation with taxpayers – including through the use of closing agreements where VC does not necessarily provide a solution – that achieves a protection of plan participants and beneficiaries while also encouraging employer participation in the voluntary retirement system. As such, new hires should be inculcated with a perspective that VC is intended to help keep plans within guidelines and reasonable, practical solutions which reflect real-world realities should be considered with an open mind. Further, given the evolution of the program, we recommend that early VC leadership – from Joyce Kahn, an early leader of the VC program, to long-tenured agents and VC coordinators – be recorded and these videos highlighting the ethos and evolution of the program be made an ongoing core part of new VC hire training. Adopting such an approach allows for internal consistency in message as the program and staffing continues evolving.

b) Ongoing Training Programs

We applaud VC's efforts to maintain training materials but have heard repeatedly that actual training is limited. We recommend more formalized ongoing training be implemented on a routine, scheduled basis. A refresher on the culture of correction and the topics of new hire training (which should be reinforced to existing VC staff as part of a roll out of a new hire training program) should be a starting point for each training session. Doing so will help instill and preserve a resolution oriented culture.

For example, some of the written materials provided to the EP Subcommittee can be easily read to indicate that the "standard form" corrections processes in Appendix A of EPCRS are the "strongly preferred" or even "exclusive" correction methods even though the newest version of EPCRS specifically rejects this position. The stakeholder community has explicitly pointed to this inconsistency in their discussions with us. Ongoing training can prevent any similar misunderstandings from becoming institutionalized.

We also encourage VC to consider alternative methods of training beyond the standard deck of slides presentation with examples. In prior years, we have recommended that Employee Plans consider the implementation of clinics in various cases, although we also recognize that such implementation raises a number of operational and fiscal challenges for the Service that makes such an implementation difficult. As such, we recommend that VC consider a "role playing" type of internal clinic where non-VC staff who have non-Service experience with the VC program play the role of outside practitioners in hypothetical submissions modeled on complex actual cases that have been made anonymous to help facilitate consistency across the VC program as a whole and to highlight the practical considerations both the Service and practitioners face.

We recognize that each of these recommendations will require both human capital and other Service resources. We suggest that given the recent decline in receipts under the EPCRS program and the potential cost efficiencies that could speed the VC process, these training activities might actually result in increased overall efficiency and productivity through the program.

c) Internal Mentoring Programs

Given the great depth of human capital inside the VC program, a key recommendation is to tap this background and knowledge to facilitate the institutionalization of the culture of correction with strong background on the goals and mission of the VC program. In addition to the training, we recommend that new hires into VC be provided with mentors who are agents with long tenures in the VC program. Each agent new to the program should have two mentors – one inside his or her VC group, and one outside his or her group. Such an approach will enhance coordination across VC groups on a long-term basis and help to address concerns expressed that the groups can appear to operate in a stovepiped manner. Again, we recognize that the Service faces resource limitations, but encourage that opportunities be maximized to ensure in-person connections. For example, when selecting individuals for outreach, if it is possible to pair a mentor and a mentee for that program in an efficient manner, the program could serve both an outreach and internal training goal.

4. Coordination Across VC Groups

A common theme resounding from both our internal and external contacts is that there appears to be inconsistency among group practices – from positions on preferred correction methodologies across groups (addressed above), to formal process, such as whether "custom" or "standard form" compliance statements are used. We believe our training and mentoring recommendations can help break down these inconsistencies and strengthen the program as a whole. We also recommend that VC group practices should be peer-reviewed by other groups on a periodic basis with practices compared across groups. We do not intend to suggest that discretion be removed from the highly experienced VC Group Managers, but rather encourage that the culture of compliance with a related process be peer-reviewed and vetted on a regular basis.

5. Coordination with Employee Plans' Examination Function

Although Employee Plans examination has a different role and function because it is not a voluntary program where taxpayers "opt-in" to the program, insights on how EP examination addresses corrections and provides flexible solutions (which were praised by a number of practitioners during our information gathering efforts) could provide additional insight.

B. Maximizing Voluntary Compliance's Technological Resources

During our interactions with VC staff, we became aware of a number of technological resources that have previously or currently existed to support the VC program's needs. Specifically, VC maintains a computer system that tracks VC submissions that, based on conversations, appears to be very limited in functionality. Further, VC maintains an internal Microsoft SharePoint site for sharing materials among groups.

With respect, to the tracking of VC submissions, we recommend that a high priority be placed on the better tracking of issues and corrections, and quantifying of submissions (including the electronic retention of materials) so as to help the VC staff review its processes as already suggested above and determine resource allocation. We strongly recommend against, however, looking to such a database to see which plans, if any, "regularly" use the program because such an approach could rapidly drive taxpayers away from the program, thus crippling its intended purposes. It was not clear to us whether the shift to processing of VCP submissions in Covington, Kentucky would lead to the integration of VCP into the MEDS electronic system, although we strongly encourage it.

With respect to the SharePoint site, we recommend it be provided with human capital resources to ensure that it is regularly updated with the materials and processes recommended above. Further, existing and future content housed on SharePoint should be reviewed periodically to ensure that the information is posted in a format that VC personnel can maximize SharePoint's search capabilities.

Although there is a cost, to both of these recommendations, we again believe these technological improvements could reduce VC's expenditures of VC staff time per submission and drive forward the consistency of the culture of correction already discussed above.

C. Intake, Assignment, and Status Update Process

Another area of potential process improvements relates to the intake, assignment, and tools available to determine the status of a case.

With the recent shift of case intake to Covington, Kentucky, and based on preliminary informal feedback on this new system received by individuals who have spoken with the EP Subcommittee, it appears that the process for reviewing new cases is being streamlined and made more efficient. However, because we are not aware of the exact tools being used, we recommend that, if not already in use, a screening process for new submissions similar to that used by Employee Plans' determination letter program be implemented when cases come in and that any preliminary grading become part of the communication to taxpayers (with relevant explanations of the process and outreach contained on the Service's www.irs.gov website). Further, periodically introducing new hires to this actual process (even if done remotely via electronic scans of filings) could help integrate new VC hires into the VC program.

During our research, while there were significant compliments on the processing of "Appendix F" (or now "Appendix C, Part II") submissions, some practitioners expressed concerns that they never knew how long a case would take to be processed before being assigned. Revealing information about case grading and by performing this grading on a centralized basis could ensure programmatic consistency across EP groups and also encourage engagement between the Service and the VC function.

A second recommendation in this area is to provide an online tool indicating which submissions are currently being reviewed, as is done to describe which determination letter filings are being reviewed (e.g., Cycle B filing received in June 2012). Such a tool would help provide clarity and engagement with the program. We note our understanding that, currently, cases beyond a very basic level (e.g., cases beyond late-amender $375 filings) are distributed randomly in bulk to VC Group Managers to review and assign. This can result in different processing times for similar cases depending on the caseload and staffing level in a specific group. We believe that further communication as to which group "owns" a case could help to address the concerns raised by practitioners that they do not understand why similar (or virtually identical cases) are moving on two completely different timeframes.

D. Procedural changes

1. Annual "standing" updates to EPCRS Revenue Procedures.

While taxpayer use of the EPCRS program has expanded significantly over the past decade, the frequency of official guidance provided by the IRS through revenue procedures addressing EPCRS has decreased. The issuance of Revenue Procedure 2013-12 in January of this year, updated the prior revenue procedure related to the EPCRS program which was issued in 2008. Additionally, Revenue Procedure 2013 states that the EPCRS revenue procedure will continue to be updated periodically (in whole or in part), including further improvements to EPCRS based on feedback that the Service receives.

Revenue Procedure 2013-12 makes significant changes to the VCP submission procedures and now applies to 403(b) plan issues. In addition, the revenue procedure lists more than 4 pages of other changes. While these enhancements were welcomed changes, we recommend that the EPCRS revenue procedure be updated regularly to provide changes more timely, and implement changes on an ongoing basis rather than in larger numbers.

For instance, the IRS issues several revenue procedures each year for complying with the EP/EO user fee program, requests for technical advice, and private letter ruling requests and requests for EP determination letters. These annual updates provide timely guidance which detail changes to submission procedures and address new items intended to conform existing procedures to new laws and regulations.

We believe an annual update to the revenue procedure for EPCRS could provide timely information that would accomplish a similar goal and, additionally, could provide enhancements or modifications to accepted correction methodologies.

Each of the revenue procedures mentioned above which are updated annually by the IRS include a Summary section which detail the changes that have been made from the prior year's revenue procedures. We recommend that an annual update to the EPCRS include a similar section describing the changes that were made from the prior year's revenue procedure to help communicate changes efficiently to tax payers. Alternatively, the IRS could publish a redlined version of the annual revenue procedure which would highlight changes from the prior year's version.

2. Revisions to VCP Fee Schedule

In order for the VCP program to be meaningful and continue to encourage tax compliance, it is important that compliance fees for VCP applications are realistic and reasonable. Currently, VCP compliance fees are generally based on the number of plan participants, and the fees are graded in eight (8) participant-count categories that increase as plan size increases. Certain discounts are allowed for corrections of minimum required distributions under 401(a)(9) and for some submissions that solely involve the correction of loan failures.

In its Practitioner Survey, the EP Subcommittee solicited input on the VCP compliance fee schedule. Approximately 80% of the respondents reported having plan sponsor clients who declined to utilize the VCP program for plan failures that did not qualify for self-correction (SCP) because the VCP filing fees were too expensive.

Many commented that the VCP fee scale could be even more graduated by plan size. Those plans whose participant count is close to the beginning of its size band are required to pay fees that are too high. The graduated fee schedule for small plans under 500 participants is particularly steep.

Discounted compliance fees could also be used for submissions that involve correction methods for operational failures that are outlined in Appendix A and B of the EPCRS revenue procedure. These fees should be justified since those specific correction methods are deemed to be reasonable and appropriate by the Service and should receive simplified and expedited processing by VC personnel. Approval for these proposed corrections should also be facilitated by using a default timeframe. Approval is deemed to be granted within 90 days of the filing date if the Service does not request any further information about the filing before that time. This discount should encourage a streamlined "safe harbor" approach to correction while differentiating those filings from other submissions that can propose alternative correction methods but would require more processing time by IRS agents and a higher compliance fee.

The EP Subcommittee also recommends that the compliance fee for some VCP applications should be based on the number of participants affected or the amount of the corrections, rather than on the number of participants in the plan. For example, the fees for loan corrections, while already discounted, could be based on the number of plan loans to be corrected rather than related to the number of plan participants. In addition, the correction of minimum distribution failures should be based on the total amount of the correction rather than a flat fee for any number of failures up to a maximum of 50.

The survey of practitioners found that the flat fees for non-amenders were perceived as realistic and reasonable. We believe there can be more instances where this flat fee may be appropriate. Compliance fees associated with corrections of small amounts for example, should also be based on the amount of the correction rather than plan size. For instance, if the total cost of the corrections is less than $5,000, a fee cap equivalent to 10% of the total correction amount would apply.

We also recommend the Service provide a discount for 501(c)(3) nonprofit organizations, similar to the discount provided by the Department of Labor (DOL) for such organizations which file under the Delinquent Filer Voluntary Compliance Program.

3. Enhancement and Expansion of SCP

With respect to significant and insignificant operational failures, SCP is only available to qualified plans and 403(b) plans. A Plan Sponsor that has established compliance practices and procedures may, at any time without paying any fee or sanction, correct insignificant operational failures under a qualified plan, a 403(b) Plan, a SEP, or a SIMPLE IRA Plan. In the case of a qualified plan that has received a favorable determination letter from the Service, or in the case of a 403(b) plan, the plan sponsor generally may correct significant operational failures without payment of any fee or sanction if the correction is made by the last day of the second plan year following the plan year for which the failure occurred.

a) Extension of the SCP correction period for significant operational failures

The EP Subcommittee recommends that the correction period for significant operational should be extended. Through its practitioner survey, we received significant feedback supporting the expansion of allowable SCP corrections. Indeed, Section 1101 of the Pension Protection Act of 2006 cloaked the Secretary of the Treasury with full authority to establish and implement EPCRS and allow for continued updates with respect to the program's improvement. This authority includes extending the duration of the self-correction period under the SCP for significant compliance failures. To date, no extension of the self-correction duration for significant compliance failures has been granted.

The 2008 ACT report recommended the expansion of the SCP program through the extension of the correction period for significant operational failures to include the last day of the third plan year following the plan year for which the failure occurred. The EP Subcommittee reaffirms the recommendations of the 2008 ACT report and supports the extension of this correction period for an additional year – at least for operational failures and correction methods contained in Appendices A and B of Revenue Procedure 2013-12. Further, the EP Subcommittee recommends that significant operational failures described in Appendix C of Revenue Procedure 2013-12 should be eligible for an automatic one year extension of the SCP correction period if a notice of self-correction is filed with the Service prior to the end of the SCP correction period as more fully set forth in the revenue procedure.

b) ERPA assistance with SCP corrections

The EP Subcommittee believes that ambiguity exists with respect to the SCP, which is a deterrent to plan sponsors' utilization of the program. This is especially the case with sponsors of small plans.

One source of ambiguity is the determination of whether an operational failure is significant or insignificant. This determination is dependent on many subjective factors. The plan sponsor must use judgment when using SCP to correct failures and cannot be certain that the Service will agree with its determination and correction of the failure until the plan is subject to an audit.

An additional source of ambiguity is the lack of clarity related to the required documentation for SCP corrections. The Service has not formally suggested or required a format, or specific content, for documentation of SCP corrections.

The EP Subcommittee reviewed various comments received from the practitioner survey and the internal VC survey, which clearly indicate that plan sponsors generally prefer to use SCP rather than VCP – especially if the correction at issue is eligible for self-correction. However, plan sponsors may be reluctant to make corrections, or to make full retroactive corrections under SCP if they are uncertain how to characterize their operational failures, or if they are uncertain that their corrective actions will be acceptable and properly documented to the Service under audit.

The PPA directs the Secretary of Treasury to update and improve EPCRS, giving special attention to increase the awareness and knowledge of small employers concerning the availability and use of EPCRS while taking into account special concerns and circumstances specific to small employers and plan compliance, including correction of compliance failures. The EP Subcommittee recognizes the benefits that small employers would derive from engaging the assistance of an Enrolled Retirement Plan Agent to advise on SCP errors and properly document the description of the failure and the correction method used to remedy the errors. Indeed, an ERPA would provide small employers with expert consultation and assistance by crafting and sufficiently documenting a plan's SCP correction. In this way, small employers would benefit from a cost-effective alternative in utilizing SCP and be induced to make full correction of plan failures.

The EP Subcommittee further recommends that the Service include a model template for documenting SCP errors and incorporate such a template as a new appendix in an EPCRS update. The template might include a description of the plan's established compliance practices and procedures, a description of the operational failure, an explanation of the plan sponsor's determination concerning the significance or insignificance of the failure, the applicable correction period associated with the failure, and a description of the correction method and applicable earnings calculations used to fully correct the failure.

Plan sponsors would have the option of using the template as a guideline in making and documenting SCP corrections and ERPAs would be able to use the model as a best practice in assisting plan sponsors with their corrections.

4. Pre-submission VCP Application Notification for Audit Protection

In order to encourage utilization of VCP, the EP Subcommittee recommends that the service implement a VCP pre-submission notification option for taxpayers. Taxpayers would be able to notify the IRS of their intent to file a VCP application with the Service while they prepare and finalize the VCP application. Once the pre-submission notice is given, the taxpayer would be eligible to utilize VCP with respect to plan defects that are identified in the pre-submission notice in the event of a subsequent IRS audit.

The pre-submission notification would allow time for taxpayers and their professionals to gather data to support full correction, develop a proposed correction method, and prepare the

VCP application without fear of losing the eligibility for the VCP should the plan be selected for an IRS audit while the VCP application was being prepared and finalized.

Many anonymous submissions, commonly referred to as the "John Doe" program, are filed due to concerns related to the IRS' willingness to accept the taxpayer's proposed correction method. A significant concern in utilizing the anonymous submission method is the risk that the plan will be audited before the actual VCP filing is made. To eliminate this concern for John Doe filers, these applications should be able to utilize the pre-submission notification option and benefit from audit protection with respect to any identified plan defects.

The applicable IRS compliance fee might be required to be paid when the pre-submission notice is given and the VCP filing would need to be received by the IRS within a prescribed period (three (3) to six (6) months) following the receipt of pre-submission notice by the IRS for the taxpayer to receive audit protection.

5. Reasonable assumptions for historical data

It is not uncommon for plan sponsors seeking to correct a failure to lack the necessary data to make precise calculations. This may occur following an acquisition where the failure relates to the plan of the acquired company, for which historical records were not transferred to the buyer. It may also occur when a failure is not discovered until several years going forward when records for the year(s) of the failure are either no longer available, or no longer accessible.

EPCRS does allow for reasonable estimates in certain circumstances, however, the program does not provide guidelines for the types of estimates the Service will consider reasonable, other than the calculations of investment gains.

The EP Subcommittee recommends that the Service provide direction - either through the establishment of a safe harbor or the creation of general guidelines - plan sponsors can use to make reasonable assumptions using available records when the records needed to make precise calculations are either unavailable or inaccessible. For example, the Service could specify that if records covering a certain time period (e.g., three (3) years) are available, the plan sponsor could use an average from those records to calculate the corrections for years prior to that timeframe. If records are available for a longer look-back period, then all records available should be used to determine the appropriate averages.

Providing guidance regarding reasonable estimates would facilitate expeditious correction of failures when records are missing by providing plan sponsors with greater assurance that their correction will be accepted. In addition, this type of direction would likely result in a greater percentage of VCP submissions following a consistent correction methodology, thereby allowing VC personnel to quickly complete their review of applications. At the same time, EPCRS would remain flexible for those situations in which plan sponsors and/or their representatives determine that it is impractical to remain within the newly created guidelines.

6. Missing Legacy Plan Documents/Amendments

A common problem in the mergers and acquisitions context is locating the applicable plan documentation for acquired plans and their predecessors. This is also problem for plans that rely on their third-party administrators to maintain their required plan documents and/or have changed TPAs in the past. In many instances, there is an incomplete record of prior compliance for these plans. It is our understanding that some Service personnel have taken the position that the required correction for a plan document failure in this context is to adopt all required qualification provisions separately for the period involved. For example, a legacy plan that has a 1998 determination letter, but has not been timely amended since 2000 would necessitate a separate adoption of all required amendments from 2000 to present.

In the EP Subcommittee's view, such an approach is a futile exercise with little benefit from a document compliance standpoint. Moreover, the potential time and expense for such a process, which could be substantial, might be a major deterrent to an employer (particularly small businesses) otherwise taking appropriate corrective action. To address these concerns, the EP Subcommittee recommends that for standard correction method purposes, the Service simply require that the plan sponsor have a currently compliant plan document in place to correct such a failure. This would involve the adoption of a plan document that meets the applicable requirements for the cycle in which the plan falls under Revenue Procedure 2077-44, be it an up-to-date preapproved or individually designed plan. This is a reasonable and practical approach to such a failure that should encourage voluntary compliance, but not undermine participant rights (as this would not excuse operational noncompliance during the period involved).

7. Expand availability of DOL online calculator

One of EPCRS's general correction principles is that corrective allocations or distributions in defined contribution plans should be adjusted for investment gains the participant(s) in question would have experienced if the failure had not occurred. It is not uncommon for DC plans to have investment menus that include more than 20 mutual fund options as well as managed portfolios. In addition, many DC plans allow participants to change the manner in which their accounts are invested on a daily basis.

These factors cause the calculation of precise investment returns for each participant to be an extremely lengthy and costly process. Indeed, if the plan changed service providers during the period of the error, the calculations are even more complex. For plan sponsors who engage outside service-providers to perform these calculations for them, that time translates into additional fees. Both anecdotal feedback from the practitioner community as well as the

ACT Practitioner Survey indicate that professional fees related to correction are often a significant barrier to correction.

EPCRS currently allows plan sponsors to determine investment gains related to plan corrections using the DOL Voluntary Fiduciary Correction Program Online Calculator (http://www.dol.gov/ebsa/calculator); it is only permitted however, when it is not feasible to precisely determine the actual rates of return. In other words, it is unclear whether the Service would allow use of the DOL calculator simply due to the fact that the cost of precise calculations would be significantly higher, even when participant records are readily available.

The EP Subcommittee recommends that the Service modify EPCRS to clarify that use of the DOL online calculator - to determine investment gains applicable to corrective allocations and distributions - is a "safe harbor" earnings calculation method for participant-directed defined contribution plans. Doing so balances the need to make participants whole in a fair and reasonable manner with the needs of the plan sponsor to make correction in a cost-effective manner.

To prevent potential concealment of investment gains by using actual returns when the market is down contrasted with use of the online calculator when then market is up, the Service could require, that as a condition of the safe harbor, that one method or the other (e.g., actual or online calculator), is used consistently for all years being corrected.

8. Create a *de minimus* contribution exception

EPCRS considers certain exceptions to full correction when the amount of the correction is *de minimus*. For example, Section 6.05(5) of Revenue Procedure 2013-12 provides that corrective distributions of $75 or less need not be made if the costs of doing so would exceed that amount. On the other hand, plan sponsors are generally not required to seek the recovery of overpayments of $100 or less. There is no similar *de minimus* threshold for corrective allocations.

It is not unusual for corrective allocations in defined contribution plans to typically generate small balances for participants who do not otherwise maintain account balances in the plan. Since it is commonplace for plan service providers to base their fees, in part, on the number of participants with account balances in the plan, the creation of small balances can serve to increase fees which are passed along to participants. Where former participants cannot be located, the fees associated with locater services are normally charged to their accounts. In other words, the corrective allocations of small balances often do not end up conferring any economic benefit on the participants and result primarily in increased fees.

However, EPCRS does include a limited correction in which corrective allocations are not required to be made to participants affected by a failure. For instance, the One-to-One Correction Method specifies that corrective allocations need only be made on behalf of those non-highly compensated employees (NHCEs) affected by the failure who remain employed on the date correction is made.

The EP Subcommittee recommends that the Service establish a *de minimus* threshold of $75 that applies to all corrective allocations. To the extent such a correction would require the allocation of an amount equal to $75 or less to a participant who does not otherwise have a balance in the plan, that amount would not be allocated to the participant in question, but would instead be added to the amount that is allocated to the other plan participants. Rather, the *de minimus* amounts would not reduce the amount of the correction that the plan sponsor is required to make, but rather, it would limit the allocation to participants with balances in the plan.

9. Electronic submission

In today's highly technological corporate climate, plan records are now stored electronically, and preparing a VCP submission has become an electronic process. Indeed, the Service provides fillable PDF forms that must accompany the VCP submission. The forms and supporting documentation required by Revenue Procedure 2013-12 are prepared electronically and then printed and assembled for submission to the Service.

The EP Subcommittee believes that without the ability to file electronically, resources and costs are unnecessarily expended. For instance, paper VCP submissions make it more difficult for the Service to manage when the application requires review by agents in different locations. Moreover, use of paper reduces processing efficiency, extends the time in which a case is closed, and requires that the Service expend limited resources to respond to inquiries regarding the status of pending reviews.

In light of these limitations, the EP Subcommittee recommends that the Service create an online system that allows for electronic submission, assignment and tracking of VCP applications. Such a system might resemble EFAST2, which includes a combination of both government forms and separate attachments that service providers can upload. Implementing an electronic platform for VCP submissions would also allow plan sponsors and their representatives to subscribe to automatic e-mail updates each time the status of an application changes.

For example, automated e-mails might be generated for a number of pre-determined events, such as the following:

- Receipt at time of submission, in lieu of current Appendix E Acknowledgement Letter.
- Assignment to reviewing agent, including the name and contact information.

- Request for additional information, including a secure link to obtain the details of the request.

- Issuance of compliance statement, including a secure link to obtain an electronic copy of the statement.

Additionally, an online system would require authentication to ensure access limited to authorized parties. As an initial step, the Service might consider implementing an online VCP filing system that would be limited to those corrections utilized by the streamlined schedules currently included in Appendix C.

E. Substantive Corrections

The EP Subcommittee's recommendations regarding permitted corrections addresses (i) failures for which additional corrections should be permitted under SCP; (ii) additional standard corrections; and (iii) non-qualification related failures that can also be addressed under VCP. Moreover, these recommendations also address the corrections for which input was requested in Revenue Procedure 2013-12.

1. Additional SCP Corrections

The SCP has become a valuable tool for plan sponsors and administrators to self-correct failures without the need for formal IRS involvement or approval. The EP Subcommittee believes that SCP may be reasonably extended to include certain additional failures for which the permitted correction is well-established and within the stated principles underlying SCP.

a) Section 72(p) Deemed Distribution Loan Failures

Currently, under EPCRS, Code section 72(p) failures can only be corrected under VCP and Audit CAP. The EP Subcommittee believes that the scope and parameters of the permitted correction process is sufficiently well-established to allow the waiver of the deemed distribution requirement for noncompliant loans to be corrected under SCP in certain circumstances. Specifically, self-correction would be appropriate under the following:

- The reformation of loan terms that do not comply with section 72(p)(2)(A), (B) or (C) in the manner permitted under Sections 6.07(2)(b) or (c) of Revenue Procedure 2013-12 (as applicable); and

- The reinstatement of defaulted loans to the extent and in the manner permitted under Section 6.07(3) of Revenue Procedure 2013-12.

However, to implement this in a practical and measured manner, the EP Subcommittee recommends that such correction only be available if the errors qualify for correction as insignificant failures under Section 8 of this revenue procedure. This would permit diligent plan sponsors and administrators to correct insignificant loan failures in an efficient and compliant manner without the need for incurring the time and expense of a filing a VCP submission.

b) Retroactive Amendments Correcting Operational Failures

Revenue Procedure 2013-12 only permits the following operational failures to be corrected through *retroactive plan amendment* under SCP:

- Inclusion of ineligible employees and the exclusion of eligible employees by an amendment.
- Hardship withdrawals and loans under a plan that does not allow for such withdrawals and loans by an amendment adding the feature.
- Code §401(a)(17) failures under a defined contribution plan by amendment adding comparable allocations for the other eligible employees for the year involved.

In each instance, the permitted retroactive amendment provides (i) a more expansive application of the plan, (ii) corrects the operational error in a manner that avoids the reduction of benefits, and (iii) favors plan participants.

The EP Subcommittee recommends that correction by retroactive amendment should be allowed under SCP in any circumstance in which such a correction would be favorable to participants and, if applicable, maintain assets in plan solution, and not merely in the circumstances noted above. For example, this would allow an employer to correct elective deferrals or matching contributions in excess of plan limits by retroactive amendment of the corresponding plan provisions (e.g., an amendment which aligns the plan's definition of compensation with the compensation calculated in operation).

Correction by retroactive amendment would also allow otherwise legally permissible in-service or other distributions that were not in keeping with plan terms to be corrected by adding the option to the plan (similar to what is currently allowed for hardship withdrawals and loans). Lastly, it would enable a plan sponsor to correct Roth contributions under a plan that did not allow for such simply by amending the plan retroactively to add this feature.

In our view, expanding the permitted retroactive amendment corrections in this manner should not lead to unnecessary abuse or misuse of SCP. First, the requirement under SCP that a plan have established internal controls reasonably designed to promote and facilitate compliance would still apply. Second, EPCRS already provides that any permitted retroactive amendment corrections under SCP must separately comply with the requirements of Code sections 401(a), including the nondiscrimination rules and anti-cutback rules. Third, such corrections must generally comply with any otherwise applicable correction principles under Section 6 of EPCRS. Finally, similar to the currently permitted retroactive amendment corrections, any such amendments would, to be acceptable under SCP, have to be submitted as part of determination letter application in the plan's next on-cycle year.

In sum, the parameters proposed herein will likely ensure that any expanded retroactive amendment corrections available under SCP, will not undermine the principles underlying EPCRS. Rather, in many instances, availability of the proposed corrections will provide plan sponsors with additional options to self-correct plan failures in an efficient, cost effective manner while benefitting plan participants and eliminating the time and expense involved in preparing and filing a VCP submission. Indeed, given the increasing budgetary constraints facing the Service, such a change will help conserve IRS resources.

c) Time required for SCP correction of certain § 415(c) violations

Revenue Procedure 2013-12 provides clarification related to § 415(c) violations that are eligible for correction under SCP. Specifically, the revenue procedure clarifies that a plan which allows for elective deferrals and non-elective employer contributions (that are not matching contributions) should not be treated as failing to have established practices and procedures to prevent the occurrence of a § 415(c) violation in the case of a plan under which excess annual additions § 415(c) are regularly corrected by the return of elective deferrals to the affected employee within two and a half (2½) months after the end of the plan's limitation year.

While the EP Subcommittee believes that this clarification to the revenue procedure provides adequate guidance, we also believe that the 2 ½ month period required for the return of excess annual additions is problematic.

The large majority of plan sponsors do not determine the amount of their discretionary non-elective employer contributions within 2 ½ months after the end of their tax year and often take additional time – the due date of their tax return – to finalize such amounts. In addition, employee stock ownership plans, which commonly contribute generous employer contributions and have special rules under § 415 may need to obtain their company's annual valuation prior to the value of annual additions can be determined.

The EP Subcommittee recommends that the 2 ½ month period should be extended to the later of this date, or the due date for which the employer's tax return (including any extensions) for the tax year that the non-elective employer contributions are deducted.

2. Additional Standard Corrections

The correction methods that the Service has deemed to be "reasonable and appropriate," provide valuable guidance as to how the specified errors can be corrected in a manner acceptable to the Service for purposes of SCP or otherwise. The EP Subcommittee submits that the common failures and standard corrections listed below would also be a worthwhile addition to the appendices.

a) Section 401(k)/(m) Safe Harbor Notice Failure

In general, IRS regulations require that a plan providing for safe harbor matching or non-elective contributions in accordance with Code section 401(k)(12), and if applicable, Code section 401(m)(11), must provide notice containing specified information, to eligible employees within a reasonable period of time prior to commencement of their eligibility, and each plan year thereafter. Given the widespread use of "safe harbor" contributions, there has been considerable concern with respect to the correction required for a failure to provide this notice.

It is the EP Subcommittee's understanding that VC personnel currently require that plan procedures be revised to ensure that notice is provided to all participants going forward where affected individuals are informed about the matching contribution (if applicable) and have a reasonable opportunity to participate fully in the plan. Under these circumstances, if participants were not harmed by the failure to provide notice, the EP Subcommittee believes that this current requirement is a reasonable and appropriate correction and recommends that it be included as a standard correction method in a future EPCRS update.

The same standard correction method should also be available where the required notice has not been provided in a timely manner. Thus, all that should be required under these circumstances is that the annual notice be provided on time on a prospective basis since reissuance of the current year's notice would be of little or no benefit to participants.

b) Benefit Suspension Notice Failure

In general, the benefit payments to a participant of a qualified defined benefit plan can be suspended upon rehire, or while working after reaching the plan's normal retirement age, without the need for making an actuarial adjustment to the participant's accrued benefit for the period of reemployment. This can occur where the plan document provides for such a suspension of benefits and the required notice is furnished to the participant.

Here, a common failure occurs when plan sponsors suspend benefits of rehired retirees per plan terms without providing the required suspension notice. In general, if the notice is not provided, the affected participant's benefit must be actuarially adjusted for the delay. Thus, an appropriate correction would be to actuarially adjust the participant's benefit for any periods for which the notice was not given. However, the EP Subcommittee submits that this should not be the only correction available where an affected participant has otherwise been informed of the suspension (e.g., through the SPD). Thus, it should be sufficient in these circumstances to correct such a failure by (1) revising the plan's procedures to ensure that the required notice is provided going forward for future rehires, (2) providing the required notice to any affected participant whose benefits are currently under suspension, and (3) paying to each affected participant (in one lump sum) 50% of the improperly suspended benefit payments (with interest).

In the EP Subcommittee's view, the untimely issuance of the notice should not prejudice any rights a participant may otherwise be entitled to under a plan since, at any time, the participant can legally pursue claims with respect to the suspension. Thus, failure is similar to the failure to provide a section 401(k) safe harbor notice to participants who have otherwise been informed of their participation rights. However, because a full actuarial adjustment would otherwise be normally required, we recognize that something more should be required for correction, which is the impetus for the lump sum make-up payment requirement outlined above. In sum, the EP Subcommittee believes that the foregoing is a reasonable and appropriate correction that could be included as a standard correction method in a future EPCRS update. The same standard correction approach should also be applied to late suspension notices since the considerations are the same.

c) Failure to Suspend Employee Contributions Following a Hardship Withdrawal

The section 401(k) regulations provide that a withdrawal will be treated as made on account of a hardship only if the withdrawal is (1) on account of an immediate and heavy financial need of the employee and (2) necessary to satisfy that need. For a plan that uses the "deemed" rules to meet the second requirement, an employee must be suspended from making employee contributions under the plan (and any other plan of the employer) for six months following the withdrawal.

It is the EP Subcommittee's understanding that, a reasonable and appropriate correction for a failure to implement the required suspension is to (1) refund any elective contributions made under the plan during the required suspension period (adjusted for earnings) and forfeit any associated matching contributions (adjusted for earnings) and (2) implement the remainder of the suspension period, if applicable. Since many plans use the "deemed" rules, this correction should be included as a standard correction method in a future EPCRS update.

d) Missed Compensation Items Under a 401(k) Plan

It is not uncommon for components of compensation to be excluded (e.g., bonus, overtime, commission, etc.) in applying participant deferral and/or after-tax contribution elections under section 401(k) plans. It is unclear whether the failure to include such amounts can be corrected in the same manner as other elective deferral/contribution failures addressed in Revenue Procedure 2013-12. In the EP Subcommittee's view, this failure is akin to a failure to implement an employee election, the standard correction method for which is to multiply the employee's missed deferral/contribution election by the employee's plan compensation for the period involved and contribute the applicable percentage thereof (50% for missed deferrals; 40% for missed after-tax contributions), with lost earnings. The EP Subcommittee recognizes that VC personnel currently take the position that this is an acceptable correction method for missed compensation in the elective deferral/contribution context. However, the EP Subcommittee recommends that this correction method be explicitly recognized as a standard correction for missed compensation failures in a future EPCRS update.

e) Special Rule for Brief Exclusion from Elective Deferrals and After-Tax Employee Contributions

A commonplace error arising under retirement plans is the improper exclusion of an otherwise eligible employee. Given the frequent occurrence of this error, the IRS has provided a recommended correction method.

When an employee is improperly excluded under a traditional 401(k) plan, the methodology of correction is applied by making a qualified non-elective contribution equal to the missed deferral opportunity. The missed deferral is the actual deferral percentage for the employee group (HCE or NHCE) to which the employee belongs multiplied by the employee's compensation for the portion of the plan year in which the employee was improperly excluded. The missed deferral plus any other deferrals the employee made during the taxable year cannot exceed the 402(g) limit, or any plan limit. The employer will also need to include earnings with the corrective contribution.

However, if the employee was improperly excluded for a brief period of time – less than three months and the employee has at least nine months in which to defer – during the plan year, the employer does not need to make a QNEC to correct the missed deferral. Nevertheless, the requirement that the employee has "at least 9 months" of the plan year remaining to defer salary is an inflexible condition, and renders the exception procedurally impractical.

For example, if the improper exclusion is discovered anytime following the first three months of a plan year – for plans that follow calendar years, on or after April 1 – this condition of the safe harbor cannot be satisfied, and an otherwise eligible employee will not be afforded the opportunity to contribute to the plan. Moreover, given that an employer or its plan administrator will not likely have occasion to review elective deferrals prior to a reporting event – the end of the first quarter, or coincident with the preparation of 5500s – there is little, if any, opportunity to discover the failure within the prescribed time frame.

For these reasons, the EP Subcommittee recommends that a practicable time frame of six months, or even three, should be implemented to render this correction workable. A reduced time frame of six or three months would provide employees with greater flexibility in making up missed elective deferrals discovered by employers or plan administrators later in the plan year.

3. Additional Non-qualification Related Failures Addressable under VCP

Section 1101 of the PPA generally provides that the Secretary of Treasury has the authority to expand EPCRS to waive income, excise or other taxes and penalties in appropriate circumstances. Therefore, the EP Subcommittee proposes the following circumstances where a waiver would be appropriate.

a) Section 457(b) Plans of Tax Exempt Employers

Revenue Procedure 2013-12 provides that the IRS will continue to accept applications for eligible Code section 457(b) governmental deferred compensation plans on a provisional basis, using similar standards, outside of EPCRS. For the first time, the revenue procedure also provides that the IRS may consider a submission for tax exempt entity 457(b) plans, but that option is only to be available in extremely limited circumstances (e.g., where the plan is set up to benefit NHCEs and operated similar to a qualified plan). The EP Subcommittee recommends that the EPCRS should be expanded to allow the submission of such plans under EPCRS on the same basis as governmental 457(b) plans.

Similar to governmental plans, tax exempt plans are subject to the rules of section 457(b), which require strict compliance in form and operation. Thus, the 457(b) plans of tax exempt employers are subject to the same general form and operational compliance obligations as tax qualified plans. While the EP Subcommittee recognizes that there may some reluctance to extend EPCRS to plans that generally cover only management or highly paid employees, it is worth noting that the Service has already established separate correction programs for non-qualified arrangements under Code section 409A. Indeed, a Code provision that is intended to be considerably more punitive than Section 457(b). The EP Subcommittee takes the position that it would now be appropriate to place tax exempt section 457(b) plans on the same footing as their governmental plan counterparts by providing them with the same opportunity to correct operational and documentary failures.

Given the nature of these programs and the small number of participants that they typically cover, we recognize that the current VCP fee structure may not be appropriate since the primary purpose of this fee schedule is to provide a lower fee for smaller plans and encourage their usage of VCP. As an alternative, it may make sense to establish an enhanced fee schedule in these circumstances. The EP Subcommittee proposes a schedule that is no more than twice the established applicable fee. This type of fee schedule would provide sponsors of tax exempt section 457(b) plans with a fair approach that takes into account the substantial contribution credit limits under these plans (which do not apply to section 409A-covered arrangements) and would still be in keeping with the overall objectives of EPCRS to facilitate compliance under covered arrangements.

b) Delinquent Forms 5500-EZ and 5310-A filings

(1) Form 5500-EZ

The Service automatically exempts a plan administrator from late filing penalties under the Code for delinquent Form 5500 filings made under the DOL's DFVCP. However, this relief does not apply to plans for which a filing fee is not required under Title I of ERISA (plans that file the Form 5500-EZ) since the DFVCP does not extend to these plans and similar relief has not otherwise been established by the Service for such plans.

Generally, filers for these plans are smaller, less sophisticated employers who tend to rely heavily on their plan providers in meeting their reporting obligations or otherwise). The purpose of the DFVCP (and the tandem Service relief provided in Notice 2002-23) is to allow past filing failures to be corrected at a small cost and thereby encourage plan administrators to comply fully with the underlying reporting requirements despite past failures. Extending similar relief to Form 5500 filers not covered by the DFVCP would place these filers on the same footing and thereby encourage reporting compliance for all filers on equal terms.

Therefore, the EP Subcommittee recommends that VCP be expanded to include taxpayer relief from penalties arising from the late filing of Form 5500-EZ or any other Form 5500 filing, similar to the relief available in DFVCP eligible filings. Indeed, penalty relief, sanction amounts and other requirements might be separately addressed within the VCP thereby expanding VCP in a way that is consistent with previous EPCRS expansions to cover non-section 401(a) programs used by smaller employers, such as SIMPLE IRAs and SEPs.

With respect to the filing/correction process, the EP Subcommittee envisions that, similar to DFCVP, more than one late or missed filing may be included in one VCP submission. Any missed filings would then be required to accompany the submission. Further, the EP Subcommittee recommends implementing a fee structure for such filing consisting of a small, uniform dollar amount similar to what is currently required for late interim amendments or missed determination letter amendments. While it is possible to devise a graduated fee schedule similar to that contained in the DFVCP, we believe that a simple fee structure would be more in keeping with the current VCP fee schedule. A simplified fee structure would also be more practical when compared against late filing penalties and the time and effort it would take for reviewing agents to monitor compliance with such a schedule.

(2) Form 5310-A

Currently, there is no relief available in the case of a failure to file Form 5310-A, a required actuarial statement concerning mergers, spinoffs and other similar plan transactions, which carries a $25 per day, or $15,000 maximum penalty. This filing is not limited to smaller plans and it is a one-time filing that only arises under certain triggering plan transactions. Similar to "top hat" statements for ERISA-covered nonqualified deferred compensation plans, this filing requirement is easily overlooked by otherwise diligent human resources personnel and their advisers. Thus, as remedied under the DFVCP for missed "top hat" statements, the EP Subcommittee recommends that VCP also be expanded to include relief from penalties arising from the late filing of Form 5310-A. This proposal is consistent with our previous recommendation to expand the VCP to delinquent Form 5500-EZ filings and may perhaps be added to the VCP using a similar fee schedule as discussed in Section 3.b.(i) above.

(3) Section 430 Funding Elections

In general, defined benefit plan sponsors must make elections regarding certain actuarial assumptions and prefunding balances to be used in the Plan's annual actuarial valuation for purposes of the Code section 430 minimum funding standards. These elections must be made in writing and provided to the plan's actuary in order for the actuary to certify the annual Form 5500 SB and Form 5500 MB. For example, the regulations require that the employer's election as to the use of a plan's prefunding balance be made no later than 9 ½ months after the end of the plan year to which the election relates.

If not timely made, such an election will not take effect, which may cause the plan to fail to meet minimum funding standards for the year and give rise to a Code section 4971 excise tax. For example, if a plan sponsor wished to elect to use a portion of the plan's prefunding credit balance to meet its funding obligation for the plan year (rather than make a contribution), but failed to make the election in writing within the required timeframe, a funding deficiency would technically result.

In the view of the EP Subcommittee, the failure to timely make such an election does not give rise to an actual funding deficiency and, therefore, should be correctable through VCP. We believe that providing for correction of such late elections under VCP would be in keeping with the spirit of PPA section 1101. Therefore, we recommend that VCP be expanded to allow for a plan sponsor to obtain a waiver of the section 4971 excise tax for a plan that would otherwise have met the minimum funding standards but for a late election. In our view, this defect is similar to a plan sponsor's failure to timely adopt a required interim amendment and, therefore, we recommend that the same VCP fee should apply for such a failure.

(4) Prohibited Transaction Excise Taxes

EPCRS does not currently provide for any waiver or reduction of prohibited transaction excise taxes under Code section 4975. In our view, there are two possible situations in which nonexempt prohibited transactions could generally be addressed under VCP. The first would involve prohibited transactions, which occur as part of an operational failure under a tax qualified plan. For example, the payment of impermissible plan expenses might constitute both an operational failure and a prohibited transaction under Code section 4975(c). An additional scenario might involve prohibited transactions for IRAs and the resulting loss of tax exempt status (with immediate taxation) for such arrangements in certain circumstances. While the EP Subcommittee recognizes that most IRAs are not part of an employer-sponsored arrangement and are therefore outside the current scope of EPCRS,we believe that this approach would be an appropriate extension of EPCRS since EP otherwise has ruling authority for IRAs.

In many instances, the transactions involved are inadvertent and the associated excise taxes, including the possible loss of exempt status, excessive. The EP Subcommittee recommends that the Service expand VCP to permit:

- The waiver/reduction of excise taxes for non-egregious prohibited transactions that occur as part of an operational failure.
- The waiver/reduction of excise taxes for non-egregious prohibited transactions under an IRA.
- The continued recognition of the tax exempt status of an IRA that would otherwise lose such status due to a non-egregious prohibited transaction.

Expanding VCP in this way would allow the Service to provide excise tax relief and allow taxpayers to avoid an unwarranted loss of exempt status and immediate taxation.

While it may not be possible to limit eligibility to minor or insignificant prohibited transactions, we believe that the use of such a standard in this context will likely embroil the Service in unnecessary disputes over whether a particular transaction qualifies as “minor or significant” in a particular case. Limiting the exclusion to egregious situations would be easier to administer, especially since Revenue Procedure 2013-12 already contains separate rules and guidelines for egregious qualification failures.

The EP Subcommittee recognizes that there are some circumstances in which permitting a waiver or reduction of prohibited transaction excise taxes would be inappropriate. Thus, from a policy standpoint, it would make sense to automatically exclude any transaction that constitutes fiduciary self-dealing within the meaning of Code Section 4975(c)(1)(E) and (F) - regardless of whether the prohibited transaction would otherwise be considered egregious). It would also be inappropriate to render this relief available for prohibited transactions where the applicable excise taxes are waived pursuant to the DOL’s Voluntary Fiduciary Correction Program (e.g., late participant contributions and participant loans). Indeed, such relief is expressly addressed in a separate program.

4. Comments on Revenue Procedure 2013-12 Issues

Revenue Procedure 2013-12 requests comments on certain issues relating to automatic enrollment and escalation, safe harbor notices, and Roth contributions. The EP Subcommittee views on these issues are set forth below.

a) Automatic Enrollment/Escalation Failures

Comment is requested on the appropriate correction for a failure to implement a plan's auto enrollment and, if applicable, auto escalation provisions, including a plan that contains a qualified automatic contribution arrangement (QACA) within the meaning of Code sections 401(k)(12) and 401(m)(13)).

(1) Automatic Contribution Arrangements (ACAs)

The Service currently takes the position that auto enrollment failures for non-safe harbor plans can be corrected as follows:

For an eligible employee who has been provided with the plan's enrollment materials, the missed deferral opportunity is based on the plan's automatic enrollment percentage. However, for an eligible employee who was not offered an opportunity to enroll, the failure is to be treated as an impermissible employee exclusion, the missed deferral opportunity for which is to be based on the plan's applicable ADP.

While the EP Subcommittee agrees that the foregoing corrections are reasonable and appropriate for the failures involved, we recommend that plan sponsors also have the option to correct an enrollment failure by using the automatic enrollment percentage in lieu of the ADP. We recognize that using the ADP as a proxy for the missed elective deferrals of excluded employees under a non-automatic enrollment plan is a simple, practical method that avoids the need to determine what an employee may have otherwise elected in a manner that will also avoid the need to rerun an ADP test.

However, where the plan directs that a non-electing participant contribute at a specified percentage, it should also be reasonable and appropriate for an employer to use the default percentage in determining an excluded employee's missed deferral opportunity. Since the ADP is simply an average for all eligible employees within the same compensation group, it is generally no more an accurate estimate of what the employee may have elected than the automatic contribution percentage . At the same time, allowing the use of the ACP would be more in keeping with plan terms and allow plan sponsors to effectuate correction immediately—especially for failures discovered mid-year–rather than wait until year-end to determine the applicable ADP.

In the EP Subcommittee's view, the same rationale also extends to safe harbor plans (within the meaning of Code Section 401(k)(12)) with an automatic contribution feature. While the standard correction outlined in Appendix A to Revenue Procedure 2013-12 for excluded employees under such a plan is reasonable and appropriate, use of the default deferral percentage is, for the reasons outlined above, equally reasonable and appropriate, especially under a plan that meets the safe harbor rules by use of non-elective contributions.

In sum, the EP Subcommittee recommends that use of ADP be recognized as an acceptable correction for remedying missed deferrals of excluded employees under an ACA. In addition, because of the increasing use of ACAs, we also recommend that the accepted VC correction methods for ACA contribution failures (described above), as so modified, should be established as a standard correction for such errors.

(2) Qualified Automatic Contribution Arrangements

The standard correction for an improperly excluded employee under a QACA is to determine the missed deferral opportunity by using three (3) percent for the initial period and the required annual increments under the plan thereafter. The EP Subcommittee agrees that this is a reasonable and appropriate correction, especially since the initial default percentage under a QACA will, given the qualified default contribution percentage limits in section 401(k)(13)(C)(iii), often result in that percentage. For reasons involving cost, many employers will prefer to use three (3) percent where the plan's initial default percentage is higher. However, there may be employers who prefer to use the plan default. To avoid any uncertainties as to whether this would be an acceptable correction, the EP Subcommittee recommends that this approach should be recognized as an acceptable approach for standard correction purposes.

(3) Automatic Escalation Arrangements

In general, a central tenet of EPCRS is that correction of an operational failure places affected participants in the position they should have been had the failure not occurred. In the EP Subcommittee's view, the failure to implement an automatic escalation provision for a participant is, in substance, no different than the failure to implement an automatic contribution election, and therefore, should be correctable in the same fashion. This would mean that for a participant who has either (i) affirmatively elected automatic escalation or (ii) been enrolled automatically and has been informed of the automatic escalation, a reasonable and appropriate correction might be 50% of the missed deferral opportunity. However, the missed deferral opportunity here should be based on the amount by which the affected participant's elective deferrals would have increased had the automatic escalation been applied in accordance with plan terms.

In regard to dealing with excluded employees under a plan with an automatic escalation provision, there is a certain amount of unfairness in requiring that an employer provide a makeup for an automatic escalation provision that the excluded employee was never aware of and which he/she never had an opportunity to consider. Thus, the EP Subcommittee believes that it would be reasonable and appropriate to treat such a failure similar to ACA eligibility failures as the missed deferral opportunity can be determined by simply using the applicable ADP and eliminate the need to apply any automatic escalation. However, we are not recommending that this be extended to QACAs since the automatic escalation provisions are an integral part of QACA status under Section 401(k)(13). Instead, the standard correction currently contained in Revenue Procedure 2013-12 for such failures should continue to apply.

b) Failure To Provide Safe Harbor Notices

Revenue Procedure 2013-12 also requests comment on correcting a failure to provide timely annual notices under (i) Code sections 401(k)(12) and 401(m)(11) for safe harbor plans, (ii) Code sections 401(k)(13) and 401(m)(12) for QACAs, and (iii) Code section 414(w) for an eligible automatic enrollment arrangement. As described above in Section 4.a., the EP Subcommittee is separately recommending that the Service implement a standard correction for missed safe harbor plan notices where participants otherwise have an opportunity to make plan contributions – that is, provide the required notice on a prospective basis to affected participants. We recommend that the same rationale applies to the annual notices required for QACAs and EACAs.

For example, if the affected individuals have otherwise been informed concerning automatic enrollment (and, if applicable, the automatic increase of their contribution percentage) and have a reasonable ongoing opportunity to change their participation, under such circumstances, it is hard to envision that any harm or disadvantage would result from the plan sponsor's failure to issue the required annual notice. Thus, the EP Subcommittee believes that a reasonable and appropriate correction for such a failure would be to issue the required notice to affected participants on a prospective basis. Moreover, a similar approach would apply where the notice was not timely provided. In these circumstances, a reasonable and appropriate correction may be to require that the annual notice should be provided on a timely basis in the future since reissuance of the current year's notice would be of no benefit.

c) Roth Contribution Failures

Comment is requested with respect to reasonable and appropriate methods for correcting a failure to implement a participant's Roth election, including a failure to inform eligible employees of the availability of making Roth contributions. Comment is also requested on allowing corrective contributions to be treated as Roth contributions and the application of a gross-up.

(1) Missed Roth Contribution Election

The only standard correction available for Roth contributions under Revenue Procedure 2013-12, addresses improperly excluded employees and provides that the lost contribution opportunity is to be corrected via a pretax QNEC. While the EP Subcommittee believes that this would be a reasonable and acceptable method for correcting a missed Roth contribution election, it should not be the only acceptable correction available in this context.

As noted above, a key correction concept is to place an affected participant in the position they would have been had the failure not occurred. Thus, it would logically follow to devise a correction method that allows the corrective contribution for the lost contribution opportunity to be treated as a Roth contribution. However, as reflected in the standard correction for missed after-tax contributions, there is currently no standard correction method under which the make-up contribution can be treated as an after-tax contribution, presumably because correction is being made by an employer contribution.

Another reasonable and appropriate method to accomplish the foregoing would be to allow the plan sponsor to provide the affected participant with an election to reclassify the corrective contribution as a Roth contribution for the affected plan year. However, given the recent expansion of in-plan Roth rollovers, this reclassification may be rendered moot as this recent expansion may provide a simple, convenient way to allow participants to convert any corrective contributions to Roth status.

In regard to allowing such a correction under VCP, the correction would need to be consistent with the statutory framework for Roth contributions and the amount involved would have to be treated/reported as taxable W-2 wages – the process for which could be based on that established for in-plan Roth rollovers. There is also the issue of whether to allow an election regarding the year of inclusion. Thus, similar to the current option for allowing employers to elect to include deemed loan distributions as taxable income in the year of correction, it may be reasonable to allow either the employer to provide (or the participant to elect) to have the amount involved included in income in the correction year or the year in which the contribution was missed (if still open for statute of limitations purposes). A major drawback to this is the income tax statute of limitations, which is generally three years. One possible way to address this, in a way that would avoid abuse, would be to limit usage of the prior year option to missed Roth contributions occurring in the three calendar years preceding the calendar year in which correction occurs – which, while perhaps a viable option in individual cases, would seem to be unnecessarily complex for general guidance.

However, the EP Subcommittee does not believe that it would be appropriate under EPCRS to require an employer gross-up where the corrective contribution is included in income in the year of correction rather than year of the failure. The time and effort that would be required to determine any gross-up could be substantial, as it would require an examination of each individual tax circumstances for the two different years. Such a process may also lead to costly and unnecessary disputes over what (i) could be requested as proof of loss and (ii) would be an appropriate gross-up in any particular instance. Instead, the tax implications should simply be a factor for a participant to consider in deciding what to elect, as the participant can avoid immediate taxation by electing pre-tax treatment of the corrective contribution. In short, as is the case with deemed distributions for loan defaults where no gross-up is required, an employer gross-up should not be required where a participant elects to treat a corrective allocation as a Roth contribution in the year of correction.

(2) Roth Eligibility Failure

The request for comments on a Roth eligibility failure focuses on whether an elective process would be a sufficient correction method or whether some additional corrective contribution would be appropriate to reflect that the participant's decision might have been affected by the availability of Roth contributions. For the reasons explained below, the EP Subcommittee submits that the elective process outlined in Section 4. d.(i) above, would be a more suitable correction method for a Roth eligibility failure than to provide an additional separate contribution make-up for such a failure (similar to what is currently done for after-tax contributions generally).

While Roth contributions are after-tax, the EP Subcommittee does not believe that the established correction process for after-tax contributions is compatible with Roth contributions. Thus, unlike employee contributions (which are subject to separate ACP testing), Roth contributions are bundled with an employee's pre-tax deferrals in applying the ADP test, if applicable. In addition, the annual 402(g) limit applies to both Roth and pre-tax contributions, while after-tax contributions are not subject to the 402(g) limit). Thus, the maximum amount of Roth contributions that a participant can make will be directly affected by the amount of pretax deferrals made by a participant, which is typically not case for after-tax contributions.

Under these circumstances, it is difficult to envision on what basis a separate corrective contribution for missed Roth contributions would be easily and readily computed. Of course, an employer could, in appropriate circumstances, use a separate ACP analysis strictly for Roth elections as basis for a correcting a Roth eligibility failure. However, given the time and expense of doing so and the individual nature of Roth elections, given tax and related considerations, the EP Subcommittee does not believe that such an approach would be an appropriate standard correction. Instead, the application of a standard correction percentage (as currently outlined in Section .05(3) of Appendix A) in tandem with an election to treat the make-up as a Roth contribution, would be a more effective approach for correcting a Roth failure in a meaningful manner, which would allow the participant to take advantage of the Roth feature.

d) Worker Re-Classification Correction Methods

In recent years, the Service has developed, and continues to expand, a voluntary worker classification settlement program. Given the potential impact that correction under this program may have on continued qualification for the plans of participating employers, the EP Subcommittee recommends that VC focus on reasonable and appropriate corrections for affected plans that facilitate usage of the settlement program to prevent undercutting the program.

VI. Conclusion

This year, the EP Subcommittee reviewed the technical and operational aspects of EPCRS's voluntary correction features as most recently updated in Revenue Procedure 2013-12. Through the use of surveys and telephonic interviews with members of the practitioner community, including candid discussions with IRS personnel, the EP Subcommittee collected meaningful feedback concerning potential enhancements to the voluntary correction functions available under EPCRS that would reinvigorate the program.

After evaluating the collective results of the feedback received from the practitioner community and IRS personnel, the EP Subcommittee has compiled the following recommendations, which fall into three general categories consisting of internal controls, procedural changes and additional substantive corrections.

<u>Summary of Recommendations</u>

Internal Controls

1. The IRS should enhance the VC process by:

   - Maximizing VC's human capital by fostering and maintaining a culture that is flexible and solution-minded especially when faced with complex or "non-cookie cutter" cases through the use of:

     - A common set of educational materials to be used both internally and externally to bridge the gap between VC and the taxpayer community.

     - Training and mentoring of VC new hires in a manner consistent with a flexible, solution-minded approach to avoid literal reading of written materials and prevent the evolution of a more rigid program.

     - Formal, ongoing training on a routine, scheduled basis to instill and preserve a flexible, resolution-oriented culture within VC while considering alternative methods of training beyond the standard "deck of slides" presentation and examples.

   - Creating consistency with respect to correction methodologies across VC groups with periodic peer review.

   - Implementing greater communication and coordination with Employee Plans' examination function to share insights on correction methods and flexible solutions available.

- Maximizing VC's technological resources by more effective tracking and quantifying of VC submissions, including the electronic retention of materials to reduce VC's expenditures of staff time per submission and promote consistency of a culture of correction as outlined above.

- Continuing to improve the streamlined process for reviewing new cases and implementing an online tool to inform the taxpayer community which determination letter cycles are under review.

Procedural Changes

2. The IRS should issue an annual update to the revenue procedure for EPCRS, which would serve to provide the taxpayer community with timely information, detailed enhancements and/or modifications to standard correction methodologies.

3. The IRS should revise the current VCP fee schedule to encourage increased tax compliance for smaller plans by adding additional graduated bands with respect to plan size and allow for more instances where a flat fee may be utilized.

4. The IRS should implement discounted compliance fees for:

    - Submissions that involve corrections for operational failures outlined in Appendix A and B of EPCRS.

    - The number of plan participants affected, or the number of corrections for loan or minimum distribution failures.

    - 501(c)(3) non-profit organizations, similar to the discount provided by the DOL under the DFVCP.

    - Plan sponsors that can demonstrate that their plans had been administered using significant internal controls related to the plan defect being corrected.

5. The IRS should implement a pre-submission VCP application notification for audit protection, including John Doe filers. Taxpayers would be able to notify the IRS of their intent to file a VCP application while preparing and finalizing the submission. Once the pre-submission notice is given, the taxpayer would be eligible to utilize VCP with respect to plan defects that are identified in the pre-submission notice in the event of a subsequent IRS audit.

6. The IRS should establish a safe harbor or create general guidelines that allow for reasonable estimates and assumptions when taxpayer records are needed to make precise calculations and are either unavailable or inaccessible.

7. The IRS should only require plan sponsors to have a current compliant plan document (in accordance with Revenue Procedure 2007-44) on file when missing legacy plan documents and amendments.

8. The IRS should modify EPCRS to clarify that use of the DOL online calculator is an approved safe harbor earnings calculation method for participant-directed defined contribution plans when determining investment gains applicable to corrective allocations and distributions.

9. The IRS should establish a *de minimus* threshold of $75 that applies to all corrective allocations.

10. The IRS should create an online filing system that (1) allows for electronic submissions, assignment and tracking of VCP applications, and (2) generates automatic email updates with respect to status of application changes.

Additional Substantive Corrections

11. The IRS should expand the SCP to include the following additional failures:

    - Section 72(p) deemed distribution loan failures.

    - Retroactive amendments correcting operational failures.

12. The IRS should add the following proposed standard corrections to EPCRS appendices:

    - Section 401(k)/(m) Safe Harbor Notice Failure.

        - Current correction that plan procedures be revised on a prospective basis where affected individuals are informed about the matching contribution and have a reasonable opportunity to participate fully in the plan.

    - Benefit Suspension Notice Failure.

        - In addition to the current correction, plan procedures should be allowed to be revised on a prospective basis for future rehires and provide the required notice to any affected participant whose benefits are currently under suspension.

    - Failure to Suspend Employee Contributions Following a Hardship Withdrawal.

        - Plans that use the “deemed” rules should be allowed to correct by (1) refunding any elective contributions made under the plan during the required suspension period and forfeit any associated matching contributions, and (2) implement the remainder of the suspension period, if applicable.

- Missed Compensation Items Under a 401(k) Plan.
    - Allow this failure to be corrected in the same manner as other elective deferral/contribution failures addressed in Revenue Procedure 2013-12.

13. The IRS should expand EPCRS to allow for waivers of income, excise or other taxes and penalties in the following circumstances under VCP:

    - Allow the submission of tax exempt entity 457(b) plans on a similar basis as governmental 457(b) plans (using an enhanced fee schedule) and provide such plans with the same opportunity to correct operational and documentary failures.

    - Include taxpayer relief from penalties, similar to the relief available in DFVCP eligible filings, arising from the late filing of Form 5500-EZ, all other Form 5500s and Form 5310-A. A fee structure may be implemented that is similar to the fee schedule currently in place for untimely interim amendments.

    - Non-egregious prohibited transactions that occur as part of an operational failure, under an IRA, or the continued recognition of the tax exempt status of an IRA that would otherwise lose such status due to a non-egregious prohibited transaction.

14. The IRS should modify the timeframe of the "nine month rule" to six (6) or three (3) months in the standard correction for improperly excluding otherwise eligible employees with respect to elective deferrals and after-tax employee contributions.

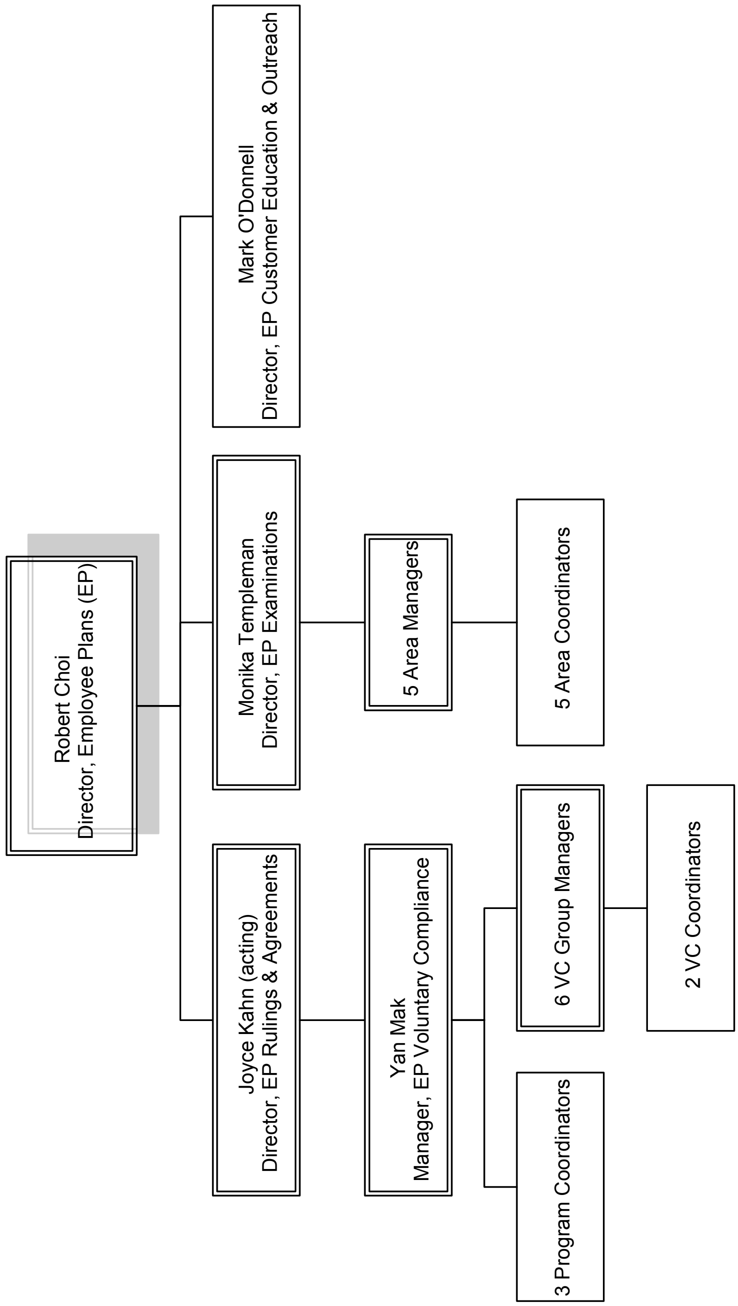
15. The IRS should permit the use of ADP as an acceptable correction for remedying missed deferrals of excluded employees under an ACA.

16. The IRS should allow taxpayers to correct the failure to implement an automatic enrollment provision in the same manner as an automatic contribution election.

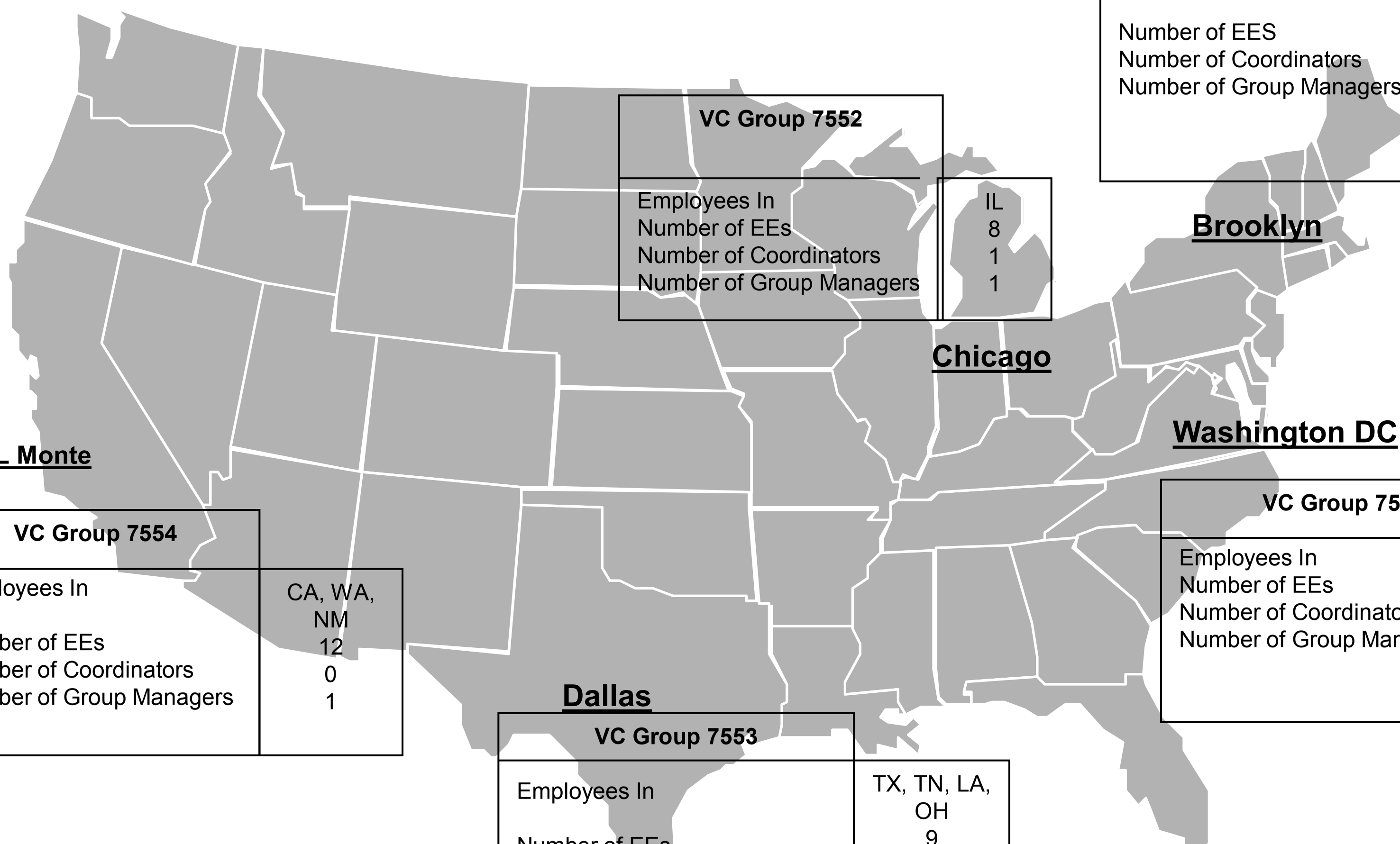
17. The IRS should implement an additional method for correcting a missed Roth contribution election and a Roth eligibility failure by allowing the plan sponsor to provide the affected participant with an election to reclassify the corrective contribution as a Roth contribution for the affected plan year.

18. The IRS should continue to focus and direct its resources towards expanding its voluntary worker classification settlement program. Considerable attention should be made with respect to appropriate corrections for affected plans that facilitate usage and prevent undercutting of the program.

Appendix A: EPCRS Positions



Appendix A (cont'd): Dispersion of VC Groups...



VC Group 7551	
Employees In	NY, PA, FL, GA, NC, MD,AL, NJ
Number of EES	8
Number of Coordinators	0
Number of Group Managers	1

VC Group 7552	
Employees In	IL
Number of EEs	8
Number of Coordinators	1
Number of Group Managers	1

VC Group 7553	
Employees In	TX, TN, LA, OH
Number of EEs	9
Number of Coordinators	1
Number of Group Managers	1

VC Group 7554	
Employees In	CA, WA, NM
Number of EEs	12
Number of Coordinators	0
Number of Group Managers	1

VC Group 7559	
Employees In	DC
Number of EEs	6
Number of Coordinators	0
Number of Group Managers	1

Appendix B.

ACT Practitioner Survey

SurveyMonkey

1. In the last 3 years, how many times have you assisted a client in correcting a failure under SCP?

	Response Count
	224
answered question	224
skipped question	6

2. Please provide comments regarding your experience with the SCP Program, highlighting positives as well as areas for improvement.

	Response Count
	167
answered question	167
skipped question	63

3. In the last 3 years, how many times have you submitted a correction using VCP?

	Response Count
	226
answered question	226
skipped question	4

4. Did you find the VCP process to be:

	Strongly Agree	Agree	Neither Agree Nor Disagree	Disagree	Strongly Disagree	Rating Average	Response Count
Efficient	13.4% (29)	**42.1% (91)**	19.0% (41)	20.8% (45)	4.6% (10)	3.39	216
Intuitive	7.0% (15)	**34.0% (73)**	33.5% (72)	18.1% (39)	7.4% (16)	3.15	215
Timely	6.5% (14)	**31.3% (67)**	26.2% (56)	24.3% (52)	11.7% (25)	2.97	214
Flexible	9.3% (20)	**36.7% (79)**	27.0% (58)	21.9% (47)	5.1% (11)	3.23	215
						answered question	**217**
						skipped question	**13**

5. With regard to the VCP program's flexibility, over the last three years, I have found the program to be:

	Response Percent	Response Count
More flexible	27.2%	58
The same	**57.7%**	**123**
Less flexible	15.0%	32
answered question		**213**
skipped question		**17**

6. For those clients with a failure that is not eligible for correction under SCP who choose not to file their correction under VCP, which of the following best describes the reason?

	Strongly Agree	Agree	Neither Agree Nor Disagree	Disagree	Strongly Disagree	Rating Average	Response Count
Filing fees	**43.4% (85)**	36.2% (71)	9.7% (19)	8.7% (17)	2.0% (4)	4.10	196
Complexity	16.9% (32)	**36.0% (68)**	24.9% (47)	18.0% (34)	4.2% (8)	3.43	189
Limits on the program's flexibility	10.8% (20)	**39.2% (73)**	29.0% (54)	16.1% (30)	4.8% (9)	3.35	186
Lack of a clear correction methodology (please explain below)	7.0% (13)	20.9% (39)	**41.7% (78)**	25.1% (47)	5.3% (10)	2.99	187
Concern that what the IRS would require for correction would be too costly/complicated	**41.4% (82)**	40.4% (80)	10.6% (21)	6.1% (12)	1.5% (3)	4.14	198
Fear of the IRS	25.9% (50)	**31.6% (61)**	22.8% (44)	12.4% (24)	7.3% (14)	3.56	193
Other	21.3% (16)	18.7% (14)	**54.7% (41)**	4.0% (3)	1.3% (1)	3.55	75
						Other or additional explanation:	76
						answered question	**201**
						skipped question	**29**

7. What do you consider to be the most positive aspects of the VCP program?

	Strongly Agree	Agree	Neither Agree Nor Disagree	Disagree	Strongly Disagree	Rating Average	Response Count
Reasonable fees	6.6% (14)	24.1% (51)	**33.0% (70)**	28.8% (61)	7.5% (16)	2.93	212
Efficiency of process	8.1% (17)	**32.2% (68)**	26.1% (55)	29.4% (62)	4.3% (9)	3.10	211
Timeliness of response	5.2% (11)	22.7% (48)	28.4% (60)	**31.3% (66)**	12.3% (26)	2.77	211
Timeliness of closure	7.0% (15)	26.5% (57)	**29.8% (64)**	27.4% (59)	9.3% (20)	2.94	215
Flexibility of correction methodology	9.0% (19)	31.3% (66)	**35.1% (74)**	20.4% (43)	4.3% (9)	3.20	211
Knowledgeable agents	9.5% (20)	36.5% (77)	**41.2% (87)**	10.0% (21)	2.8% (6)	3.40	211
						answered question	**217**
						skipped question	**13**

8. Have you used the Streamlined VCP process (Appendix F)?

	Response Percent	Response Count
Yes	**78.4%**	**174**
No	21.6%	48
answered question		**222**
skipped question		**8**

9. Please rate the following aspects of the Streamlined VCP process:

	Excellent	Good	Average	Poor	Very Poor	Rating Average	Response Count
Ease of use	**44.9% (79)**	38.6% (68)	12.5% (22)	0.6% (1)	3.4% (6)	4.21	176
Timeliness of response	32.0% (56)	**33.7% (59)**	23.4% (41)	7.4% (13)	3.4% (6)	3.83	175
Timeliness of closure	**33.1% (58)**	30.9% (54)	24.0% (42)	8.6% (15)	3.4% (6)	3.82	175
						Comments:	42
						answered question	**176**
						skipped question	**54**

10. List up to 3 additional corrections you would like to see added to the program.

	Response Percent	Response Count
1.	**100.0%**	**136**
2.	61.8%	84
3.	35.3%	48
answered question		**136**
skipped question		**94**

11. Would you be interested in speaking to a member of the ACT about your experience with EPCRS?

	Response Percent	Response Count
Yes - Please provide your contact information below (your name will not be used)	20.4%	42
No, thanks	**79.6%**	**164**
Contact information:		42
answered question		**206**
skipped question		**24**

Appendix C.

Internal VC Survey

SurveyMonkey

1. How many years have you worked in VC?

	ResponsePercent	ResponseCount
Less Than 2 Years	13.0%	3
2-5 Years,	30.4%	7
5-10 Years,	21.7%	5
10 or More Years	**34.8%**	**8**
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

2. How many years have you worked for the Service?

	ResponsePercent	ResponseCount
Less Than 5 Years	17.4%	4
5-10 Years,	4.3%	1
10-15 Years	13.0%	3
15 or More Years	**65.2%**	**15**
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

3. On average, how many cases do you work on per year? Please briefly describe:

	ResponseCount
	21
AnsweredQuestion	**21**
SkippedQuestion	**2**

4. Of the cases you see, what percentage fit into corrections that you would consider to be "standard" or "preapproved" (for example, as described in Appendix A of Revenue Procedure 2008-50)?

	ResponsePercent	ResponseCount
1-25%	17.4%	4
26-50%	**47.8%**	**11**
51-75%	21.7%	5
76-100%	13.0%	3
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

5. Are there particular failures and corrections that you would recommend for a streamlined application procedure? Please briefly describe:

	ResponseCount
	15
AnsweredQuestion	**15**
SkippedQuestion	**8**

6. Over the past several years, do you think that the VC program's permitted correction methodologies for non-standard submissions are more or less flexible than in past years?

	ResponsePercent	ResponseCount
Significantly More Flexible	0.0%	0
More Flexible	**45.0%**	**9**
Not Changed	40.0%	8
Less Flexible	0.0%	0
Significantly Less Flexible	15.0%	3
If you chose any option other than "not changed", please explain any reasons that might explain this change:		10
	AnsweredQuestion	**20**
	SkippedQuestion	**3**

7. There are sufficient training opportunities and resources for evaluating, resolving and processing VC cases?

	ResponsePercent	ResponseCount
Strongly Agree	13.0%	3
Agree	**34.8%**	**8**
Neither Agree nor Disagree	26.1%	6
Disagree	13.0%	3
Strongly Disagree	13.0%	3
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

8. Please briefly describe what additional training opportunities and/or resources you would like to see for VC?

	ResponseCount
	20
AnsweredQuestion	**20**
SkippedQuestion	**3**

9. Are there adequate opportunities to coordinate and communicate with program coordinators, group managers and/or VC coordinators on individual VCP submissions?

	ResponsePercent	ResponseCount
Yes	**73.9%**	**17**
No	26.1%	6
	Please briefly describe:	11
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

10. Do you feel there is consistency in the correction methodologies applied across groups and the VC program as a whole?

	ResponsePercent	ResponseCount
Strongly Agree	0.0%	0
Agree	30.4%	7
Neither Agree nor Disagree	26.1%	6
Disagree	**34.8%**	**8**
Strongly Disagree	8.7%	2
	Please briefly describe:	15
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

11. Do you feel there is consistency in the processing procedures applied across groups and the VC program as a whole?

	ResponsePercent	ResponseCount
Strongly Agree	0.0%	0
Agree	**39.1%**	**9**
Neither Agree nor Disagree	26.1%	6
Disagree	21.7%	5
Strongly Disagree	13.0%	3
	Please briefly describe:	12
	AnsweredQuestion	**23**
	SkippedQuestion	**0**

12. What changes or improvements to the VCP correction methodologies would you like to see and why? Please briefly describe:

		ResponseCount
		15
	AnsweredQuestion	**15**
	SkippedQuestion	**8**

13. What changes or improvements would you like to see made to the internal VC processing procedures? Please briefly describe:

		ResponseCount
		18
	AnsweredQuestion	**18**
	SkippedQuestion	**5**

14. What qualification failures present the most challenges resolving under VCP? Please briefly describe:

		ResponseCount
		17
	AnsweredQuestion	**17**
	SkippedQuestion	**6**

15. What position do you hold in VC (Optional):

	ResponsePercent	ResponseCount
Coordinator/Manager	15.0%	3
Revenue Agent/Tax Law Specialist Who Is Not a Coordinator or Manager	**85.0%**	**17**
	AnsweredQuestion	**20**
	SkippedQuestion	**3**

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Exempt Organizations: Leveraging Limited IRS Resources in the Tax Administration of Small Tax-Exempt Organizations

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2013

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I. Executive Summary

In an era of competing and challenging budgetary priorities and constraints, the IRS Exempt Organization Division (IRS) is charged with overseeing and regulating approximately 1.5 million tax-exempt organizations EOs). These EOs range from the very small, all-volunteer grassroots organizations to very large and sophisticated organizations with thousands of employees and millions or billions of dollars in annual revenues and total assets.[1] For the calendar year 2012, IRS statistics from the Annual Masterfile Extracts indicate there were 294,019 Form 990 filers; 223,348 Form 990-EZ filers; and 98,948 Form 990-PF filers.[2]

This report was written against the backdrop of continuing resolutions and then sequestration with its mandatory cuts rather than an approved congressional budget. This budgetary environment affects the IRS in a myriad of ways. The ACT's report was prompted in part by this budgetary environment and the ACT's desire to suggest ways that the IRS may leverage its resources in regulating EOs, in particular the very small and smaller EOs. Consequently, the ACT attempted to minimize the budgetary impact of its recommendations. However, some of the ACT's recommendations would, if implemented, have a budgetary impact on the IRS. On balance, the ACT believes the benefits to the IRS, state charity regulators, the public, and the nonprofit sector outweigh the fiscal burdens which these recommendations may prompt.[3]

The ACT believes there are two facets to leveraging IRS resources to oversee and provide for the tax administration of these smaller EOs. First, the IRS must determine how best to deploy its internal human, financial, and technological resources over which it has direct management oversight and control. Second, the IRS must consider how to facilitate and encourage external resources over which it may have influence to support and advance the IRS oversight and tax administration of the exempt sector. This ACT report addresses three areas in which the IRS can leverage internal and external resources: (a) the Form 990-EZ filing requirements; (b) IRS customer education and outreach; and (c) IRS information sharing with state charity regulators.[4]

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[1] For purposes of this report, the IRS Tax Advisory Committee for Tax Exempt and Government Entities (ACT) uses the term *very small* to include EOs with annual revenues of less than $50,000 which meet their annual IRS filing requirement by submitting Form 990-N electronically. The term *smalle*r includes EOs with annual revenues of less than $200,000 and total assets of less than $500,000 which satisfy their annual IRS filing requirement by filing Form 990-EZ. Large or *larger* organizations have annual revenues and/or total assets in excess of the Form 990-EZ filing threshold and must file IRS Form 990.

[2] This data was derived from the IRS SOI Tax Stats- Annual Extract of Tax-Exempt Organization Financial Data, http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data (last accessed April 17, 2013)

[3] The ACT is also mindful that given the current budgetary constraints, it may not be feasible for the IRS to undertake any significant budget initiatives.

[4] These issues are not new to the ACT. The 2005 ACT report included recommendations about filing thresholds (lowering the Form 990-EZ thresholds and reinstating the $5,000 filing threshold); education and outreach (requiring additional contact information on the Form 1023 and Form 990 including email addresses; expanding FAQs on the EO website; leveraging existing internal and external information outlets to better educate charities regarding ongoing compliance obligations;

The ACT's specific recommendations include the following:

A. The IRS should require more information from 990-EZ filers without changing the filing thresholds.

- The IRS should retain the existing filing threshold for Form 990-EZ.[5]
- The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable:
  - Schedules F (activities outside the United States);
  - I (grants);
  - J (compensation);
  - L Parts III and IV (transactions with interested persons);
  - M (noncash contributions); and
  - R (related organizations).
- The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

B. The IRS should enhance its Customer Education and Outreach.

- The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing smaller EOs. This should include the creation of prominent links beginning with the IRS main web landing page at IRS.gov and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the website. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.

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providing links to information on EO workshops and partnering with umbrella organizations); and sharing more information with the states. *See generally* ACT Report, "Project Improve" ["Informative Materials Prescribe Responsibilities and Obligations Very Early"] – Recommendations to Enhance the Compliance of Newly Formed Charities (June 8, 2005), http://www.irs.gov/pub/irs-tege/p4344.pdf (last accessed Mar. 31, 2013).
The 2006 ACT report recommendations included accommodating the reporting needs of the states as long as they do not adversely affect the IRS's primary mission or unduly burden filers; requiring all 501(c) organizations, including organizations below the $25,000 filing threshold, to complete a Form 990 core form and noting that a core form with schedules may make a Form 990-EZ unnecessary; and removing statutory limits on mandatory electronic filing and phasing in mandatory electronic filing. *See* ACT Report, "Policies and Guidelines for Form 990 Revision" (June 7, 2006), http://www.irs.gov/pub/irs-tege/tege_act_rpt5.pdf (last accessed Mar. 31, 2013).
We gratefully acknowledge the work and recommendations from these earlier ACT members.

[5] Two ACT members disagree and believe the filing threshold should be reduced. *See infra* note 44.

- The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborating entities. The adoption of a "train the trainer" model is an important consideration in this regard.
- The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

C. The IRS should enhance its information sharing with state charity regulators.

- The IRS should continue working with state charity regulators to clarify the Pension Protection Act of 2006 strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.
- The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

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II. Introduction

The IRS's tax administration of very small and smaller EOs is particularly challenging for several reasons. The first is the sheer number of such EOs. Recent IRS Statistics of Income studies indicate for the 2010 tax year that more than 69 percent of EOs with IRS filing requirements (about 642,000 organizations) had gross receipts and total assets below the Form 990 filing threshold of gross receipts of $200,000 or more or total assets of $500,000 or more.[6] The second is the difficulty in reaching and maintaining contact with these organizations. Many lack a regular place of business and are staffed by volunteers who turn over frequently. The third is their inability to secure competent internal bookkeeping staff or outside tax advisors. This makes them prone to tax mistakes arising from a lack of information about their responsibilities under the tax laws, including basics like how to maintain adequate books and records.

Challenges exist for smaller EOs as well. Some organizations, particularly those run solely by volunteers, may have difficulty preparing and filing even the Form 990-EZ, which is a much simpler form filed by eligible organizations with gross receipts of less than $200,000 and total assets of less than $500,000. Having to pay an outside Form 990 return preparer or travel to attend a tax conference may put a serious dent in these organizations' budgets, diverting funds that—in the view of smaller EOs—are far better spent on mission-related activities. Many smaller EOs feel strongly that they are working very hard to "do good" and should not be burdened by what appears to be unnecessary paperwork or expected to take time to attend educational programs. These well-intentioned organizations simply want to be free to do their good work with as little administrative burden as possible.

At the same time, it is clear that not all very small and smaller EOs seek to "do good." State charity regulators see many EOs created and run by opportunistic individuals who use a charitable mission as a cover for fundraising efforts that at best yield pennies on the dollar to the charity and at worst are a cover for blatantly fraudulent activities. State charity regulators have identified certain "causes" particularly susceptible to this type of abuse. They include so-called *badge organizations*, which solicit funds purportedly on behalf of police or fire organizations and often intimidate people into contributing by fostering a belief that failure to contribute may jeopardize their right to public protection.

The IRS devotes extensive resources to customer education and outreach, but faces substantial challenges when reaching out to very small and smaller EOs. Even though these EOs are exempt from tax, they are subject to many legal requirements imposed by tax laws. Their

[6] Some EOs, such as churches, do not have IRS filing requirements. Data for tax year 2010 is incomplete since some returns with extensions were not due until 2012 and such data is not included in the totals listed above. Based on available data for tax year 2010, of the 642,000 organizations with gross receipts and total assets below the Form 990 filing threshold, some 236,000 filed Form 990-EZ and some 407,000 filed Form 990-N.

failure to understand and comply with these requirements can place their very existence in jeopardy. There is no more compelling illustration of this than the cumulative revocation of the tax exemption of approximately 40,000 EOs which failed to file IRS Form 990 series returns for three consecutive years following the new filing requirement imposed by the PPA and which subsequently have filed seeking reinstatement of their exempt status.

The PPA included a new Form 990-N filing for organizations whose gross receipts and total assets are below the Form 990-EZ filing threshold and provided for automatic revocation for failure to file Form 990 series returns for three consecutive years. Based on the number of EOs that have applied for reinstatement, it appears that many of the automatic revocations were of EOs no longer in existence, but there was a significant number of currently operational EOs that lost their exemptions as well. The fallout from the Form 990-N automatic revocation adversely impacted these EOs and put a very serious drain on IRS resources.

IRS resources can be leveraged by partnering with state charity regulators, who share oversight of EOs and have many overlapping concerns about the effective use of EO resources in pursuit of their missions. With the PPA, Congress greatly expanded the IRS's authority to share enforcement information with the states. However, only three state charity regulators have taken advantage of information sharing because of PPA limitations on how shared information can be received and used. Further, state enforcement referrals to the IRS have not been as robust as they could be because of differing IRS and state enforcement objectives.

For these reasons it is critical for the IRS to have in place an appropriate and balanced program for the tax administration of smaller EOs which leverages resources external to the IRS as much as possible. In this era of budget cuts, the ACT believes the IRS should take additional appropriate measures to leverage its resources in the tax administration of smaller EOs. This ACT report approaches this topic from three perspectives:

- examining the Form 990-EZ filing thresholds,
- identifying ways to better reach and educate small EOs, and
- exploring options for achieving greater mutual information sharing with state charity regulators.

The discussion below explores and offers recommendations in each of these areas.

III. History

A. History of EO Reporting Requirements

1. Background

For tax years 1941 through 1967 most organizations exempt from federal taxation under Section 501(a) filed a Form 990. There was no short-form alternative to Form 990. A one-page Form 990-SF (Short Form) was introduced for the 1968 and 1969 tax years. This form could be completed by EOs with not more than $10,000 in both gross receipts and total assets. In lieu of completing the full Form 990, these EOs were required to complete only certain lines of Form 990 and could leave the remaining lines blank for tax years 1970 through 1975. In 1976 this threshold was increased to include EOs with not more than $25,000 in gross receipts.

2. IRS/State Compact for a Uniform Form 990

In 1980 the IRS formed a subgroup of the Tax Forms Coordinating Committee to initiate and review all IRS forms. This committee included state charity regulators and charitable group representatives to establish a uniform Form 990 that could be used by the federal government and the states in order to keep the Form 990 revisions intact. The subgroup would recommend any future changes to the form. At that time it was estimated by the Urban Institute's National Center for Charitable Statistics that $100 million to $125 million was being expended by charities on the preparation of separate federal and state forms. At the urging of the National Association of Attorneys General and the National Association of State Charity Officials, more than half of the 39 states that had filing requirements agreed to use the new Form 990 to satisfy those requirements.

On April 28, 1981, the states and the IRS entered into an agreement that the revised Form 990 would become the basic reporting document for exempt organizations reporting funds from the public.[7] Under this agreement, the subcommittee was to determine what information was essential for disclosure of fiduciary responsibilities and public scrutiny of EOs.[8]

The use of a uniform Form 990 provided extensive savings in data processing costs to the states and accounting costs to the EO community. Accordingly, this cooperative effort in creating a uniform Form 990 greatly enhanced the ability of the IRS and state charity regulators to obtain necessary information on the activities of EOs. Since 1981 Form 990 has been

[7] This agreement came as a result of a special study commissioned in 1975 by Congress and the Department of Treasury. The Commission on Private Giving and Public Needs is better known as the Filer Commission.
[8] On April 28, 1981, at a public IRS hearing, then Commissioner Roscoe Egger announced the IRS's agreement with substantially all of the states with reporting requirements that a uniform Form 990 had been agreed to. *See* IRS News Letter, Vol. 5, No. 4 (July/August 1981).

accepted by many states in partial satisfaction of state filing requirements, and subsequent changes to Form 990 have reflected states' needs as well as federal initiatives.[9]

3. History of the Form 990-EZ

The IRS continued with various modifications of the thresholds and content of Form 990 during the tax years 1976 through 1989. In tax year 1989 Form 990-EZ was first introduced. EOs could file Forms 990-EZ if their annual gross receipts were less than $100,000 and their total assets were less than $250,000. EOs generally were exempt from Form 990/990-EZ filing requirements if their annual gross receipts were normally not more than $25,000. These filing requirements continued through tax year 2007.

In response to public comment that smaller organizations did not have sufficient resources to complete the full Form 990, the IRS redesigned the Form 990 for tax year 2008 to minimize the filing burden for these smaller organizations in two significant ways:

- The IRS established a transition period (2008-2010) during which Form 990-EZ filing thresholds were initially increased (see below) and resulted in more organizations being eligible to file Form 990-EZ;[10] and
- The IRS did not redesign Form 990-EZ or increase reporting by Form 990-EZ filers. Although certain redesigned Form 990 schedules also applied to the Form 990-EZ, the IRS was careful only to require reporting of information that Form 990-EZ filers were required to report prior to the redesign.

The number of EOs voluntarily filing Forms 990 was larger during the phase-in period.[11] This may be because some organizations knew they would have to file Forms 990 at some point. Some organizations may have wished to present the details contained in their Forms 990 to the public, to meet state filing requirements or to satisfy the requirement of funders such as federated fundraising campaigns. During the period for tax years 2008 through 2010 the filing threshold was phased in and reduced from requiring EOs with gross receipts of less than $1,000,000 and total assets of less than $2,500,000 to the current filing threshold of

[9] *See* "*Advisory Committee for Tax Exempt and Government Entities (ACT), Report of Recommendations*" (June 2006), "Policies and Guidelines for Form 990 Revision," Part IV a., at 8.

[10] Tax year 2008: In lieu of completing full Forms 990, filers could file Forms 990-EZ if their annual gross receipts were less than $1 million and their total assets were less than $2,500,000; organizations continued to be exempt from Form 990/990-EZ filing if their annual gross receipts were normally not more than $25,000.
Tax year 2009: In lieu of completing full Forms 990, filers could file Forms 990-EZ if their annual gross receipts were less than $500,000 and their total assets were less than $1,250,000; organizations continued to be exempt from Form 990/990-EZ filing if their annual gross receipts were normally not more than $25,000.
Tax years 2010 to present: In lieu of completing the full Forms 990, filers can file Forms 990-EZ if their annual gross receipts are less than $200,000 and their total assets are less than $500,000. Organizations are exempt from Form 990/990-EZ filing if their annual gross receipts are normally not more than $50,000, but must file Forms 990-N.

[11] In tax year 2008 53% filed the 990 and tax year 2009 36% filed the 990.

gross receipts of $200,000 and total assets of $500,000. For the 2010 tax year, 17 percent of EOs eligible to file Forms 990-EZ nonetheless filed Forms 990.[12]

Currently, only limited financial data is required to be presented in Form 990-EZ. The filing does not contain the same transparency concerning governance and management disclosures as Form 990.

Form 990-EZ contains various triggering questions which determine whether an organization must file one or more of the following Schedules:

- Schedule A – Public Charity Status and Public Support
- Schedule B – Schedule of Contributors
- Schedule C – Political Campaign and Lobbying Activities
- Schedule E – Schools
- Schedule G – Supplemental Information Regarding Fundraising or Gaming (Parts II & III)
- Schedule L – Transactions with Interested Persons (Parts I & II)
- Schedule N – Liquidation, Termination, Dissolution or Significant Disposition of Assets
- Schedule O – Supplemental Information

A limited number of EOs whose income and assets are within the Form 990-EZ filing threshold are statutorily prohibited from filing Forms 990-EZ and must file Forms 990. These include a sponsoring organization of donor-advised funds and a controlling organization of one or more controlled entities as described in section 512(b)(13). In addition, an organization is required by Treas. Reg. § 1.6033.2(c) to file a series Form 990, 990-EZ, or 990-N if exempt status has not yet been recognized by the IRS.

B. Education and Outreach

The IRS devotes extensive resources to customer education and outreach. The IRS has developed numerous publications, a website, web-based materials, an EO Update, and videos to provide information for applying for and maintaining tax-exempt status.[13] The IRS collabo-

[12] Tax year 2010 is the most current year for which the ACT has data.
[13] The IRS Exempt Organization Division's primary web landing page is located at http://www.irs.gov/Charities-&-Non-Profits (last accessed Mar. 23, 2013). As this report was being drafted, this page was improved and modified as part of the continuing upgrades by the IRS Exempt Organization Division's Customer Education and Outreach.

rates with academic institutions to conduct workshops and training programs specifically for small and medium-sized 501(c)(3) EOs.[14]

Yet, the IRS faces substantial challenges in reaching out to the very small and smaller EOs. These organizations are often overseen by volunteers, with high turnover among board members and officers. This turnover creates disruption in terms of knowledge of reporting requirements and often loss of required documentation, e.g., Form 1023 and its related determination letter and Form 990.

The challenge the IRS faces in reaching out to smaller EOs was brought sharply into focus following the enactment of the PPA. Prior to the PPA, EOs with revenue of less than $25,000 were not required to file any documents with the IRS (other than Forms 990-T and 990-PF and forms such as those pertaining to employment tax) after filing their Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (Form 1023) and receiving recognition of their exempt status.

The PPA required all EOs to file annual Form 990, Form 990-EZ or Form 990-N (e-postcard) notices. Failure to file a return for three consecutive years resulted in an automatic revocation of the organization's tax-exempt status by law. Because very small EOs with less than $25,000 in revenue previously had not been required to file annually, the IRS did not have current mailing addresses for EOs in many instances.

Between 2007 and 2010 the IRS engaged in extensive outreach and communications to the exempt sector through multiple means to reach EOs potentially subject to automatic revocation. The IRS mailed information to EOs for which it had valid mailing addresses. It posted information on the IRS website and updates on EO Update. The IRS reached out to the exempt sector through state charity regulators, state and national membership associations, academic institutions, and professional entities such as accounting and law firms. The IRS engaged the general public through the national, state, and local news media, as well as online and print media primarily focused on the exempt sector.

The great majority of EOs fulfilled their filing requirements mandated by the PPA. However, approximately 500,000 organizations failed to file and their exemptions were revoked as required by statute. Many of these organizations are believed to be no longer operating or in existence. The IRS currently simply does not have information to make this determination. To date approximately 40,000 organizations whose exempt statuses were revoked as required by the PPA have submitted Forms 1023 seeking reinstatement of their exempt status.

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[14] *See*, Academic Institutions Initiative, http://www.irs.gov/Charities-&-Non-Profits/Academic-Institutions-Initiative-%E2%80%93-Exempt-Organizations-Partners-with-Academic-Institutions-Training-Non-Profit-Sector-Leaders (last accessed Mar. 23, 2013).

C. Information Sharing with State Charity Regulators

1. IRS information sharing with state charity regulators under the Tax Reform Act of 1969

The specific functions of the IRS and state charity regulators are distinct. The IRS accomplishes its mission through the enforcement of federal tax laws. State charity regulators have common law *parens patriae* oversight over public charities and they apply state nonprofit corporation, consumer protection, trust, and charitable solicitations laws. However, the goals of state and federal regulatory schemes often overlap. Both state and federal regulators have material concerns about ensuring against excess compensation, private inurement, waste, fraud, conflicts of interest, and other abusive practices. They share similar concerns about the efficient and effective use of EOs' resources in pursuit of their missions.

Consistent with these shared concerns, the Tax Reform Act of 1969 added Section 6104(c).[15] This Section required the IRS to disclose final denials and revocations of tax-exempt status and final notices of deficiency regarding Chapter 42 Excise Taxes to state charity regulators and state tax officials. The disclosure provisions were intended to facilitate effective enforcement of state common law and statutory requirements regarding organizations described in Section 501(c)(3) as charities. Consequently, state charity regulators were able to compare IRS disclosures with their existing state case files and ongoing state investigations and to determine if EOs should have notified the states concerning the disposition of EO charitable assets upon termination.

2. Protection of taxpayer information under the Tax Reform Act of 1976[16]

Prior to 1977 tax information was considered a public record and open to inspection under Treasury regulations approved by the president or under presidential order. After the Watergate hearings there was increased congressional and public concern about the widespread misuse of tax information by government agencies for purposes unrelated to tax administration. The Privacy Act of 1974 embodied the principle that information collected by the government should only be used for the purpose for which it was collected.[17]

This concern culminated with the enactment of Section 6103 as part of the Tax Reform Act of 1976.[18] Congress sought to end highly publicized attempts to use the IRS for political purposes and to regulate the flow of tax data from the IRS to state governments. Accordingly, Section 6103 eliminated much of the executive discretion concerning the disclosure of returns or return information by mandating that tax returns and return information were confi-

[15] Pub. L. No. 91-172, 83 Stat. 523 (1969).
[16] This Section about the Tax Reform Act of 1976 borrows heavily from IRS Pub. No. 4639, "Disclosure and Privacy Law Reference Guide," pp. 1-1, and 1-7 through 1-10.
[17] 5 U.S.C. § 552a (1974).
[18] Pub. L. No. 94-455, 90 Stat. 1520 (1976).

dential and not subject to disclosure, except in the limited situations delineated by the Internal Revenue Code.

The Tax Reform Act of 1976 created a comprehensive statutory scheme for the disclosure and use of tax returns and return information. The four basic parts to this statutory scheme are:

- The general rule of Section 6103(a) made tax returns and return information confidential except as expressly authorized in the Code.[19]
- The exceptions to the general rule outlined permissible disclosures.[20]
- Technical, administrative, and physical safeguard provisions prohibited recipients of returns or return information from using or disclosing the information in an unauthorized manner and established accounting, recordkeeping, and reporting requirements to assist in congressional oversight.[21]
- Criminal penalties were imposed, including a felony for the willful, unauthorized disclosure of returns or return information, and a civil cause of action was provided for the taxpayer whose information has been inspected or disclosed in a manner not authorized by Section 6103.[22]

Significantly, Section 6103 did not affect the provisions of Section 6104 providing for IRS disclosure of information about exempt organizations to state charity regulators and state tax officials until 30 years later when Congress amended Section 6104(c) as part of the PPA in 2006.

3. IRS information sharing with state charity regulators after 2006

In 2006 the PPA incorporated the tax return confidentiality provisions of Section 6103 as a prerequisite for substantially expanding the types of information the IRS could share with state charity regulators. State charity officials were permitted to receive both examination and determination information much earlier in the process.[23] Under amended Section 6104(c), the IRS was now authorized to share with state charity regulators:

- information about EOs applying for tax-exempt status under Section 501(c)(3) from the initial application through proposed refusals to grant such status to final approval or denial;

[19] Definitions of key terms such as return and return information are located in Section 6103(b).
[20] I.R.C. §§ 6103(c)–(o).
[21] *Id.* § 6103(p).
[22] *Id.* §§ 7213 (criminal penalty for unauthorized disclosure) & 7431 (civil damages provision).
[23] Prior to enactment of the PPA, the IRS was only permitted to disclose to state charity regulators information concerning final denials and revocations of tax-exempt status and final notices of deficiencies.

- information about EOs that have been proposed for revocation of exempt status;
- information about EOs for which a proposed Chapter 42 notice of deficiency is issued through the final notice of deficiency or final resolution; and
- proposed and final Chapter 42 notices of deficiency for disqualified persons.

The IRS can share information about certain proposed revocations and proposed denials before an administrative appeal is made and a final revocation or denial issued. The IRS also is authorized to disclose final revocations and final denials issued after any administrative appeal has been concluded for any EO.

The IRS Determination Office in Cincinnati issues monthly reports to state charity regulators who have information sharing agreements. These reports show EOs which have applied for Section 501(c)(3) status within each state and the status of their applications. The IRS can provide participating states with a copy of the application before the IRS takes any action on it. For proposed revocations and notices of deficiency, the IRS prepares a package containing the 30-day letter to the EO and the revenue agent's report, which explains in detail the factual and legal positions of the EO and the IRS.

State charity regulators would welcome receiving information which is available under the PPA and would enhance their oversight of EOs.[24] For example, information now available under Section 6104(c) about EOs receiving a proposed denial of Section 501(c)(3) status immediately raises state charity law issues. In addition, state receipt of the names of EOs applying for Section 501(c)(3) status would help states monitor startup entities that cease operations before the IRS responds to their Form 1023 applications. State receipt of information about EOs receiving a proposed revocation of exemption would raise immediate questions about whether those organizations' assets are being properly applied to charitable purposes as required by state law.

Because of limitations the PPA placed on how such information is received and used under Section 6103, only three state charity offices currently subscribe to the PPA information sharing regime, despite the information's usefulness to all state charity offices.[25] Most state charities agencies have no system set up to meet the safeguards required by Section 6103 and lack the resources to establish such a system.[26] For information stored on computers, made

[24] State charity regulators also would welcome receiving information they received from 1976 until the 2006 enactment of the PPA. The PPA actually decreased disclosure of information to the states because only states participating in information sharing now receive the pre-PPA notifications of final denials, revocations, and notices of tax deficiencies.
[25] As discussed earlier, although the PPA placed additional safeguards on shared information, it also expanded the type of information state charity regulators can receive to include sensitive, confidential information such as revenue agents ' reports regarding proposed revocations and notices of deficiencies.
[26] Although only three state charity regulators have signed up for information sharing about EOs since the PPA mandated Section 6103 safeguards in 2006, over 250 other state and federal entities (which are subject to Section 6103 safeguards that have been in place since 1976) receive taxpayer information from the IRS, and virtually all use computer systems to process the data.

available on computer networks, or otherwise stored or transmitted electronically, Section 6103 requires an extensive safeguard system to protect IRS information from unauthorized access and disclosure detailed in over 128 pages in IRS Publication No. 1075. Thus, state charity regulators participating in information sharing limit their receipt of information to paper documents to avoid the substantial burdens of maintaining safeguards required for the maintenance of electronic data, which includes a required audit of the statewide data center.[27]

Further, Section 6103(p)(4) requires state regulators to return or destroy IRS documents which they do not use in judicial proceedings. State charity regulators have expressed concerns that these requirements conflict with state statutes requiring the retention and public inspection of public records.[28] The IRS asserts that these state laws are preempted by the Supremacy Clause of the United States Constitution and that Section 6103 effectively will become meaningless if the information is subject to the vagaries of 50 varying state public disclosure statutes.[29]

Although there is no case law squarely on point, there is strong support for the IRS's contention that such state laws are preempted.[30] The Supreme Court has held that state laws are preempted when they pose such substantial obstacles that they prevent the attainment of congressional objectives.[31] Accordingly, state public record laws compelling public disclosure of information shared with state charity regulators pose obstacles which prevent attainment of congressional objectives to safeguard taxpayer information under Section 6103. Reviewing courts likely would find such state laws preempted.

For the first time, the PPA subjected state charity regulators to the same criminal penalty provisions of the Internal Revenue Code that recipients of tax information have been subject to since the enactment of Section 6103 in 1976. Sections 1224(b)(5) and (6) of the PPA amended Section 7213(a)(2), making it a criminal offense for any state official to willfully

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[27] In order to receive such paper documents, state charity regulators are required to maintain them with strict confidentiality. When the IRS makes a disclosure to a state charity office, a regulator must review the data, log the receipt of the information, and place the data in a file secured by at least two physical barriers (e.g. locked doors and cabinets). See the October 28, 2011, letter from the National Association of Attorneys General to the Senate Finance Committee urging that Congress amend the provisions of Sections 6103, 6104 and 7213 to enable state charity regulators to more freely use information shared by the IRS (the NAAG letter). (Appendix A)
[28] *See* the NAAG letter (Appendix A).
[29] U.S. CONST. art. VI, cl. 2.
[30] *Compare State v. Howard*, 92 Wash. App. 1018 (1998) (after detailed analysis of Supreme Court preemption standards and the legislative history of Section 6103, court held that Section 6103 did not preempt state court authority to order taxpayer to sign a consent form authorizing release of her federal tax returns), *with Yorkshire v. I.R.S.*, 829 F. Supp. 1199, 1202-03 (C.D. Calif. 1993) (requirements under Section 6103(e)(1) that corporate tax returns be made available to 10 percent shareholders preempted any state constitutional right to privacy afforded corporations).
[31] *Arizona v. United States*, 132 S. Ct. 2492, 2507 (2012); *Crosby v. Nat 'l Foreign Trade Council,* 530 U.S. 363, 373 (2000).

disclose information shared by the IRS under Section 6104(c) in a manner unauthorized by the Internal Revenue Code.[32]

Information obtained from the IRS cannot be disclosed except as authorized by the Internal Revenue Code. Section 6104(c)(4) permits disclosure of tax information in the context of a state judicial or administrative proceeding implicating state charity law issues. This allows disclosures to a court, to an administrative body, or to the EO or its counsel as part of the proceeding. Although the term *proceeding* has been broadly construed, certain disclosures are not permitted, including disclosures to the EO prior to a proceeding or to an expert witness to prepare for a proceeding. After the IRS has disclosed information pursuant to Section 6104(c)(5), state charity regulators then must notify the IRS before subsequently disclosing that same information in a state judicial or administrative proceeding so that the IRS can ensure that a state's disclosure will not seriously impair federal tax administration.

State charity regulators have expressed concerns that after the IRS's initial disclosure to a state charity regulator, Section 6104(c)(5) theoretically permits the IRS to apply a stricter standard before permitting state disclosure in a state's judicial or administrative proceeding. In that event, states risk spending time and resources on developing a state law case only to be told by the IRS that they cannot proceed. In conversations with IRS officials, however, they indicated these state concerns are unfounded because the IRS has not been confronted with this issue while implementing Section 6104(c)(5). By applying the "impair federal tax administration" standard prior to initially disclosing information to participating state agencies, they indicated the IRS likely would simply decline to disclose potentially problematic information to the states.

4. IRS efforts to provide disclosure alternatives

The practical barriers to information sharing posed by the PPA prompted the IRS to help state charity regulators explore ways to obtain the same taxpayer information from EOs and other sources. State use of such independently verified information does not violate PPA safeguard provisions, because information provided directly to state charity regulators by EOs is not considered tax information subject to Sections 6103, 6104, and 7213. Thus, there are no restrictions on use by state charity regulators of information obtained from the EO, including placing it on a state network computer.[33]

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[32] State charity regulators believe that application of such criminal penalties to state charity regulators under the PPA is unnecessary compared to other federal-state information sharing regimes which do not utilize criminal penalties (*e.g.*, Federal Trade Commission/state information sharing under 15 U.S.C. § 464(f), 16 C.F.R. § 4.11(c)). There were no disclosure restrictions in IRS information sharing about final confidential IRS actions affecting EOs under Section 6104(c) from 1976 to 2006. As stated in the NAAG letter: "We see no reason why IRS notices of refusals to grant tax-exempt status, proposed revocations of exempt status, or proposed deficiency taxes for prohibited transactions under chapters 41 or 42, such as intermediate sanctions, taxes on self-dealing transactions and similar matters . . . should be subject to the same criminal penalties . . . applicable to individual and corporate income tax return information." (Appendix A)

[33] Similarly, at the ACT's suggestion, the IRS recently modified its website to encourage private complainants referring

In order to obtain information from a target EO, state charity regulators must rely upon an independent source, such as a telephone directory or advertisement, as the ostensible basis for contacting the EO and requesting any recent communication to or from the IRS. However, state charity regulators have expressed concerns that such an inquiry might pose ethical dilemmas for state charity regulators.[34] When a target EO inevitably asks why state charity regulators are seeking information about the EO's correspondence with the IRS, state regulators will be prohibited by Section 6103 from disclosing that their inquiry was premised on the information received from the IRS, and that prohibition may conflict with state regulators' obligation under state bar codes to disclose that information in order not to mislead.[35]

5. IRS sharing of state law violations with state charity regulators under the PPA

The PPA modified Section 6104(c)(2)(D) and for the first time authorized the IRS on its own initiative (and regardless of whether it initiated an examination) to disclose returns or return information of any Section 501(c)(3) organization to state charity regulators if the IRS determines that its information may be evidence of noncompliance with state laws. However, because of limited staff resources, the IRS currently does not routinely examine its cases for state law violations or regularly communicate with state charity regulators about applicable state law standards.

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cases to the IRS to share information about those complaints with state enforcement authorities, because such information received directly from complainants is not return information subject to Section 6103. *See,* IRS Complaint Process for Tax Exempt Organizations, http://www.irs.gov/uac/IRS-Complaint-Process-For-Tax-Exempt-Organizations (last accessed Apr. 14, 2013).

[34] However, state charity regulators can disclose the secondary sources they used to verify the information.

[35] Although courts would likely find that Section 6103 preempts any state ethical obligation to disclose shared information (see discussion at footnote 31, *supra*), state charity regulators have expressed qualms about placing themselves at risk of violating state ethics codes and other state laws until they have the protection of definitive judicial precedent that such state obligations are preempted by Section 6103.

IV. Due Diligence

A. EO Reporting Requirements

The ACT reviewed the current Form 990-EZ, its instructions and predecessor versions of the form. The IRS provided historical information about the form and statistical data regarding the number of Forms 990-EZ filed annually. The IRS also provided a comparison of information reported and schedules to the Form 990 and Form 990-EZ.

The ACT interviewed IRS officials and staff about issues, challenges, and concerns associated with the Form 990-EZ filing. These issues included errors commonly found in the forms and transparency issues concerning the Form 990-EZ.

The ACT obtained information from members of NASCO[36] about general issues concerning the Form 990-EZ, including input on the transparency provided in the Form 990-EZ filing and state filing requirements which cannot be satisfied by the Form 990-EZ.[37]

The ACT interviewed various practitioners with significant experience with the Form 990-EZ and compliance reporting. The practitioners represent a wide variety of large and small charitable organizations. The group included both legal and accounting professionals who answered a series of questions about the current Form 990-EZ and offered input on potential changes to the filing.

B. Customer Education and Outreach

The ACT interviewed representatives from various stakeholder groups to obtain opinions and suggestions pertinent to customer education and outreach.[38] The ACT interviewed members of the IRS leadership and the Customer Education and Outreach staff in the Exempt Organizations Division, as well as several tax professionals and policy analysts who focus on exempt organizations and representatives of small EOs. [39]

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[36] NASCO is made up of state charity regulators, including Attorneys General, Secretaries of State, and Commissioners of Consumer Affairs, whose responsibilities include oversight of tax-exempt entities. That oversight includes administering state registration and reporting requirements, and ensuring that charitable assets are appropriately managed, charitable fiduciaries fulfill their duties of loyalty and care, donor intent is fulfilled, and fraudulent fundraising is remedied.

[37] The ACT gratefully acknowledges state charity regulators from the following state agencies who provided feedback for this project. They included regulators from California Attorney General's Office, Connecticut Attorney General's Office, Hawaii Attorney General's Office, Massachusetts Attorney General's Office, Michigan Attorney General's Office, Nebraska Attorney General's Office, New Hampshire Attorney General's Office, New York Attorney General's Office, North Carolina Secretary of State's Office, Ohio Attorney General's Office, Oregon Attorney General's Office, and Virginia Office of Charitable and Regulatory Programs.

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

[39] The questions varied depending on the interviewee but generally covered the following: (1) How do small and midsized nonprofits learn about IRS changes affecting them? What and/or who are a nonprofit's primary source(s) of information about IRS issues? (2) What, if any, IRS educational resources do the small and midsized nonprofits use? Do nonprofits engage in annual training for staff and board members? (3) In general, how do you find IRS instructions on completing

The ACT reviewed the results of a survey and focus group interviews that the IRS conducted in 2010 and 2011 to obtain information from representatives of small to midsize EOs regarding the resources they use to learn about and comply with IRS requirements for tax exemption. The survey, which was conducted by telephone, entailed a nationally representative sample of approximately 1,200 EOs stratified by type of 990 filer (i.e., 990-N, 990EZ, 990). Ten focus groups were conducted, eight in person and two by telephone, with each group comprising representatives of organizations with less than $200,000 in gross receipts and less than $500,000 in assets.

While both the IRS's and ACT's data collection efforts focused on IRS consumer education and support, they are distinguishable in several respects. First, the ACT's interviews targeted a select group of EO stakeholders most of whom were tax professionals and industry experts. By contrast, the survey and focus groups targeted representatives of EOs only. Second, the ACT relied on a convenience sample of interviewees. The IRS survey and focus groups followed standard social science principles for sampling and interviewing. Finally, the ACT conducted its data collection shortly after the IRS unveiled a major revision of its website and sought information about the utility of the website for purposes of consumer education and support. The IRS survey and focus groups were conducted before the IRS website was revised.

The ACT reviewed existing IRS educational materials including the website, web-based educational materials and tools, and videos. In addition, an ACT member consulted with interested participants from NASCO about general issues concerning (1) how state charity regulators attempted to find and communicate, both directly and through representative interest groups, with very small EOs subject to potential revocation under the PPA; and (2) the extent to which state charity regulator websites included links to the IRS website.

C. Information sharing with state charity regulators

The ACT interviewed former and present IRS staff about the history, purpose, and implementation of the PPA's information sharing provisions under Section 6104(c). A member of the ACT surveyed interested NASCO participants about:

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forms accessible? If not, how might the IRS improve its ability to educate a nonprofit on how to complete the necessary forms? (4) What information does your nonprofit want to receive from the IRS? In what format(s) does the nonprofit prefer to receive information from the IRS? (5) What are your nonprofit's barriers to receiving IRS resources and training? (6) What recommendations do you have for the IRS in how best to leverage its resources in reaching out to small and midsized nonprofits?

Using a publicly available IRS database, the ACT identified organizations whose tax-exempt status was revoked for failure to file a Form 990 for three consecutive years but subsequently regained their exempt status. From among these organizations, the ACT selected eight as a convenience sample based largely on availability of their contact information. Five organizations responded, but only four agreed to be interviewed.

- issues concerning the nature, effectiveness, and usefulness of information sharing under Section 6104, both prior to the PPA and after the PPA;
- IRS information sharing about noncompliance with state laws;
- factors influencing their decisions to refer cases to the IRS; and
- factors affecting their sharing of information about IRS referrals with other state charity regulators.[40]

[40] *See supra* note 37.

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V. Conclusion

A. EO Reporting Requirements

The ACT received a wide range of responses to its questions regarding the Form 990-EZ filing threshold. The responses fell into three general categories. Some felt very strongly that the Form 990 is too complex for smaller organizations and the filing threshold should be increased to allow more organizations to file the Form 990-EZ.

Another group felt—equally strongly—that the Form 990-EZ allows smaller organizations to avoid disclosing information relevant to the IRS, state charity regulators, donors, media, and the public. It recommended that the filing threshold be lowered or the Form 990-EZ be eliminated altogether.

The third group felt on balance that the existing filing threshold is appropriate. Some commentators in the third group suggested that additional information could be added to the Form 990-EZ to enhance disclosure without raising the filing threshold.

The arguments supporting each of these positions are described below along with ACT's own view on the subject.

1. Increase the 990-EZ Filing Threshold

Advocates of increasing the Form 990-EZ filing threshold have a consistent rationale—the Form 990 is too complex and burdensome for smaller organizations to complete without paid professional help which will take away funding otherwise available for mission purposes. These commentators are in general agreement—while it is possible for a smaller organization to file a complete and accurate Form 990-EZ without professional assistance—this is not the case with the Form 990.

Based on their experience, many advocates for increasing the Form 990-EZ filing threshold believe a significant number of Form 990-EZ filers are staffed by volunteers and do not have the type of complex operations warranting Form 990 filing. They believe the Form 990-EZ, if completed accurately, provides an appropriate level of disclosure for smaller EOs. Advocates generally proposed relatively modest increases to the Form 990-EZ filing threshold, noting that even a small increase in the Form 990-EZ filing threshold will be helpful in relieving what they view as an unnecessary burden on smaller EOs. At the high end, some commentators proposed doubling the current filing threshold to allow Forms 990-EZ to be filed by organizations with gross receipts of less than $400,000 and total assets of less than $800,000.

Issues relating to the Form 990 were the subject of hearings at the Oversight Subcommittee of the House Ways and Means Committee on July 25, 2012. At that hearing one witness testified about the Form 990 and Form 990-EZ and suggested increasing the Form 990-EZ filing threshold to less than $1 million in gross receipts and less than $3 million in total assets. The witness testified:

> The Redesigned 990 overly burdens small charities and small non-501(c)(3) exempt organizations. In my experience, reporting organizations whose budget is on average under $1,000,000 of revenue per year are not able to self-prepare the Form and are unlikely to have access to paid or volunteer professional preparers who are well-versed in the Form's intricacies. The present threshold at which the Form 990 is required (and the Form 990-EZ may not be used) for most filers: gross receipts for the year less than $200,000 and gross assets at year end of less than $500,000 – should be altered. To more closely tailor the reporting burden to the size of the these organizations, my recommendation would be to allow exempt organizations with gross receipts for the year less than $1,000,000 and gross assets at year end of less than $3,000,000 to file a Form 990-EZ, modified in key ways, in lieu of the 990. Many will argue that this would exclude too many organizations from the full blown reporting of the Form 990, but I believe the response to that would be to utilize the Form 990 Core Form for most of these filers and modify the reach and extent to which the full Form's ancillary Schedules are required. The full blown Form 990 is too comprehensive for most of the sector's small organizations.[41]

2. Decrease the Form 990-EZ Filing Threshold

Advocates of decreasing the Form 990-EZ filing threshold or eliminating the Form 990-EZ altogether generally approach the issue from a consumer protection standpoint. They observe that Form 990 and Form 990-EZ each have a function separate and apart from IRS tax administration, which is to provide meaningful information about EOs to donors, state charity regulators, the media, and the public. One commentator observed a good case could be made that mandatory disclosure is more warranted for smaller EOs than it is for larger ones because smaller ones are less likely to have marketing staffs, brochures, or websites to provide donors and grant-makers with information about the organizations. In this regard, the commentator argued there is no reason why someone who decides to give $100 to a smaller charity should receive less information than someone who donates $100 to a large charity. Both donors will make better decisions if they have more rather than less information.

Advocates of decreasing the Form 990-EZ filing threshold were not sympathetic to the argument that this would impose an undue burden on smaller EOs. One commentator noted nobody ever suggests smaller EOs should receive free utilities simply because they are small, and characterized as "nonsense" any suggestion they should be spared accounting and legal

[41] Testimony of Eve Borenstein Before the Subcommittee on Oversight, House Ways and Means Committee (July 25, 2012), http://waysandmeans.house.gov/uploadedfiles/borenstein_testimony_7.25.pdf (last accessed Mar. 31, 2013).

expenses that simply reflect normal compliance costs. In this regard, the commentator noted "mom-and-pop" restaurants are expected to be in full compliance with the same food-handling laws as large national restaurant chains and expressed the view that filing the required tax disclosure forms is simply a cost of being in the nonprofit business for all EOs, small and large alike.

A final point made by advocates of decreasing the Form 990-EZ filing threshold is there are numerous examples of smaller EOs that are used to hide abuse. The ability of these smaller EOs to complete the Form 990-EZ rather than the more comprehensive Form 990 can help these organizations hide their tracks. State charity regulators and commentators also note that many smaller, all-volunteer organizations lack adequate internal controls and good governance processes and therefore would benefit from the accountability of having to file the more comprehensive Form 990. In this regard, one commentator noted a plausible case can be made that allowing smaller organizations to file the Form 990-EZ increases compliance burdens by providing state charity regulators and the media with less information to use in identifying abuse and wrongdoing by smaller EOs. Advocates of this position believe any increase in the Form 990-EZ filing threshold will only work to the detriment of donors, grantmakers, state charity regulators, the IRS, media, and the public.

State charity regulators who rely on the Form 990 and Form 990-EZ for their own regulatory purposes share this point of view.[42]

3. Retain the Existing Form 990-EZ Filing Threshold

Advocates of retaining the existing Form 990-EZ filing threshold argue that the current approach strikes the right balance in terms of requiring an appropriate amount of information without imposing an undue burden on smaller exempt organizations. They agree there is a legitimate need to avoid burdening smaller organizations and believe that the Form 990-EZ, if properly prepared, provides adequate information to address the needs of the IRS, donors, state charity regulators, media, and the public.

4. The ACT's View

In many respects the ACT's discussion of this issue reflected the diverse views of the various commentators. Some ACT members felt the Form 990-EZ should be abolished altogether or the filing threshold reduced in the belief that organizations incapable of filing a complete and

[42] State charity regulators would also favor lowering the filing threshold for the Form 990-N since that postcard return does not even require basic reporting of gross receipts and total assets. Indeed, many states require all EOs to file Form 990, Form 990-EZ, or state forms requiring at least rudimentary financial information, because they do not consider the Form 990-N to provide an adequate measure of disclosure.

accurate Form 990 should not be in business. There was also recognition that the job of state charity regulators would be easier if all organizations were required to file Form 990.[43]

Other ACT members were sympathetic to the challenges facing smaller and frequently all-volunteer exempt organizations trying to accomplish missions which they deem of critical importance in meeting their community's needs and the significant difficulties in meeting an IRS Form 990 filing requirement. These ACT members argued that the Form 990-EZ provides an appropriate vehicle for smaller organizations to meet their public disclosure requirements. If anything, they felt that the Form 990-EZ filing threshold should be increased, although perhaps not as dramatically as some commentators have advocated.

In considering this issue, the ACT was also mindful that changes to the Form 990-EZ filing threshold or the information required on the Form 990-EZ could impose significant administrative burdens on the IRS. In the ACT's view, these administrative burdens must be weighed as well, particularly at a time when IRS resources are severely constrained.

After a thorough discussion of all aspects of this issue, a majority of the ACT reached a consensus in favor of retaining the existing Form 990-EZ filing threshold.[44] While it is appropriate for the IRS to consider increasing the Form 990-EZ filing threshold from time to time, the ACT sees no compelling reason for increasing it at this point in time, particularly since the threshold was significantly increased just a few years ago.

In reaching its view that the existing Form 990-EZ filing threshold should be retained, the ACT recognized that the Form 990-EZ does not require as much information and therefore does not provide the same degree of transparency as the Form 990. The effect is to limit the information about smaller organizations that is available to the IRS, state charity regulators,

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[43] Some state charity regulators require all EOs to file a Form 990 irrespective of size to comply with state requirements.

[44] Two ACT members disagree with the recommendation in this section. In their opinion the burdens imposed on the IRS by this proposed recommendation, in particular the burdens associated with modifying the Form 990-EZ (*see* fn 64, *infra*) outweigh the benefits to the IRS and the public. In their opinion it is at best an interim recommendation likely yielding only marginal results largely unknown to both the IRS and the ACT as suggested in the recommendation itself.
They agree the burden on current Form 990-EZ filers may be overstated because of the number of eligible 990-EZ filers who nevertheless file a Form 990 whether required by state charity officials or funders or simply because they choose to do so because of their enhanced transparency to the public and its value to the EO. Further, as expressed in the report, there is significant potential for abuse by smaller exempt organizations which file either the 990-N or 990-EZ with the less than full disclosure contained in the Form 990. For hundreds of thousands of exempt organizations this means either limited or no public transparency or scrutiny as a means to leverage external resources which advance the IRS and state regulatory tax administration goals and benefit all involved in the EO sector.
These ACT members believe there is far less burden and far greater benefit to the IRS and others by simply reducing the filing threshold for the Form 990, but differ on the threshold and their rationale. One ACT member favors lowering the filing threshold for the Form 990-EZ to the pre-2008 level, which was gross revenues of less than $100,000 and total assets of less than $250,000.
Another ACT member recommends that the IRS use a single standard Form 990 core form for all exempt organizations with accompanying schedules determined by the EO's response to the core form's questions. Standardizing on a single core form alone will yield significant benefit to the IRS, state charity officials, and the EO sector. A standard Form 990 core form should be accompanied by mandatory e-filing phased in over several years to permit the very small organizations to adjust. See Epilogue, *infra.*

donors, media, and the public. For smaller organizations, a majority of the ACT nevertheless believes that the current Form 990-EZ filing threshold strikes an appropriate balance between the IRS's need for sufficient information to carry out its regulatory functions, to provide a meaningful level of transparency and public accountability, and to minimize unnecessary tax administration burdens on smaller organizations.

The ACT determined that some of the concerns expressed by the various stakeholders could be addressed, at least in part, by expanding the information required for Form 990-EZ filers. For this reason the ACT felt it was appropriate for the IRS to consider the possibility of revising the Form 990-EZ accordingly. We understand that making such changes could require significant IRS resources. The information gathered for this project did not allow us to make an informed judgment regarding whether the administrative cost to the IRS of making such changes is outweighed by the greater resulting transparency provided to the various stakeholders, including the IRS, state charity regulators, donors, media, and the public.

The ACT also lacked information to estimate the number of Form 990-EZ filers impacted by some of these changes and was therefore unable to determine the extent to which these changes would increase the burdens on smaller organizations. Both of these factors would be important in applying an appropriate cost-benefit analysis. Accordingly, while the ACT recommends that the IRS consider potential changes to the Form 990-EZ in the areas identified below, we recognize that the ACT currently does not have enough information to make a concrete recommendation for change.

The ACT suggests two types of potential changes to the Form 990-EZ for IRS consideration. The first is for Form 990-EZ filers to provide certain requested information on the applicable Form 990 schedule rather than on Schedule O, which will make this information more readily accessible to Form 990-EZ readers. The ACT concluded there will be greater transparency if applicable Form 990-EZ filers were required to file several additional schedules. These schedules include:

- Schedule F, which provides information on activities outside the United States and would be particularly relevant to U.S. Friends organizations as well as other small exempt organizations formed to raise money for activities conducted outside the United States;
- Schedule I, which provides information on grants for those Form 990-EZ filers that make grants rather than (or in addition to) conducting direct program activities. This information is currently required to be included on the Form 990-EZ Schedule O;
- Schedule J for Form 990-EZ filers with officers, directors and key employees earning $150,000 or more;

- Schedule L, Parts III and IV, which provides information on grants made to, and business transactions with, interested persons;
- Schedule M, which provides information on noncash donations; and
- Schedule R, which provides information on related organizations.

We recognize that the changes described above might be applicable to a limited group of Form 990-EZ filers which should be taken into account by the IRS in considering these additions to the Form 990-EZ. In the ACT's view, none of these Schedules are likely to be required by most 990-EZ filers, which is probably why the IRS does not currently require them.

However, for those few 990-EZ filers that have activities outside the United States (Schedule F) or pay more than $150,000 in compensation to officers, directors or key employees (Schedule J), the information on the applicable Schedules would provide an important window into a type of activity that one would not commonly expect of a smaller EO. In this regard, the ACT believes it is possible that making these changes may impose little or no burden on most Form 990-EZ filers, and an appropriate burden for those organizations whose activities are covered by the Schedules. However, we also recognize, as noted, that making these changes may impose a significant burden on the IRS which must be taken into account, particularly during this time of resource constraints.

Finally, the ACT suggests that the IRS consider the possibility of requiring all Form 990-EZ filers to answer certain questions that are currently found on the Form 990 but not on the Form 990-EZ. These include certain questions from the Form 990 that the ACT believes might provide an additional level of transparency that would be particularly relevant to the IRS, state charity regulators, the media, and/or the public. In the ACT's view, questions of particular relevance include:

- whether the organization has and complies with a conflict-of-interest policy (Form 990 Part VI, items 12a-c);
- how many board members are independent (Form 990 Part VI, items 1a and b);
- whether there has been a significant diversion of funds (Form 990 Part VI, item 5); and
- whether the organization follows appropriate practices in setting compensation (Form 990 Part VI, items 15a and b).

In making this suggestion, the ACT is mindful that the IRS is undertaking a governance study of a statistically valid sample of Section 501(c)(3) and Section 501(c)(4) EOs to determine whether governance practices might be useful indicators of tax compliance.[45] The results of this study may help inform an IRS determination of whether it would be appropriate to add some governance questions to the Form 990-EZ and, if so, which questions would be the most appropriate.

5. Recommendations

- The IRS should retain the existing filing threshold for the 990-EZ.[46]
- The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable: Schedules F (activities outside the United States); I (grants); J (compensation); L, Parts III and IV (transactions with interested persons); M (noncash contributions); and R (related organizations).
- The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

6. Epilogue

While this report was in the drafting process, there were three noteworthy events relating to the Form 990 which the ACT believes have the potential to help the IRS EO Division further leverage both internal IRS and external resources.

First, the Aspen Institute released a report which makes the case that providing information through *open data* will unleash the collective ability to assist the IRS and state regulators, increase transparency, spur innovation, and help to understand the full potential of the Form 990 data to governments, the public, and the nonprofit sector. This report offered three primary means to accomplish this objective which are not mutually exclusive: (1) legislative mandate, (2) IRS initiative, and (3) third party platform development.[47]

Second, after the Aspen Institute's report and consistent with *open data*, the IRS released Statistics Of Income data in a downloadable space-delimited ASCII file format, which can be downloaded and electronically imported into commonly available software like Microsoft Excel and Access. Currently, the data released provide more information for a limited number of EOs than has been previously available from the IRS, including other SOI data already available on the IRS website. The data is open to the public, though not always in a format

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[45] *See*, "IRS Exempt Organizations FY 2012 Annual Report and FY 2013 Workplan" at 10, http://www.irs.gov/pub/irs-tege/FY2012_EO_AnnualRpt_2013_Work_Plan.pdf (last accessed Mar. 31, 2013).
[46] Two ACT members disagree and believe the filing threshold should be reduced. *See supra* note 44.
[47] *See generally*, "Information for Impact: Liberating Nonprofit Sector Data," Beth Simone Noveck and Daniel L. Goroff (The Aspen Institute, Jan. 2013), http://www.aspeninstitute.org/sites/default/files/content/docs/events/psi_Information-for-Impact.pdf (last accessed Mar. 26, 2013).

which opens up easily for uses with typical consumer software programs. It is available at no cost.[48] The IRS is to be commended for releasing more data in an electronic format which leverages both IRS and external resources.

Finally, the Department of the Treasury released explanations for its recommendations to make Form 990 e-filing mandatory for EOs.[49] Reasons given for these recommendations include:

- improved quality of data used by the IRS for tax administration;
- timeliness of public disclosure for return data;
- more accurate and complete data;
- donors' use in making more informed contribution decisions and by others to understand the exempt sector;
- creating information tools and services useful to the sector;
- usefulness to state and local regulators, charity watchdog groups, charitable beneficiaries and the press; and
- lower processing costs than paper returns.[50]

The Treasury Department's recommendations directly speak to how Form 990 e-filing will leverage IRS, state charity regulators, and external resources, and benefit the public and others in the EO sector when fully deployed.

The ACT applauds these initiatives.

B. Customer Education and Outreach

While the IRS devotes considerable resources to customer education and outreach, reaching small and midsize EOs is an ongoing challenge. The interviews the ACT conducted generat-

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[48] *See* "SOI Tax Stats – Annual Extract of Tax-Exempt Organizational Data," http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data (last accessed Apr.12, 2013). Some of this data is released in a.dat format which is not easily accessible to the occasional user. The IRS is encouraged to release data in multiple formats which result in data which is easily accessible to occasional users and their consumer based software.

[49] This recommendation is consistent with and complements the 2012 ACT recommendation that "[t]he IRS should expedite the internal processes and commit the necessary resources (human, financial, and technological) to transform the Form 1023 into an interactive web-based Form e-1023 that can be filed electronically and stored, transmitted, and disseminated in an electronic database format. This information will serve as the electronic gateway for IRS knowledge about tax-exempt organizations." *See* "Exempt Organizations: Form 1023 Updating It for the Future," Advisory Committee for Tax Exempt and Government Entities (ACT) "Report of Recommendations" (June 2012, http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf (last accessed Apr.12, 2013).

[50] *See* "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (Department of the Treasury, Apr. 2013), at 174, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf (last accessed Apr. 12, 2013).

ed various suggestions for addressing this challenge. The ACT recommends the following to strengthen customer education and outreach.

1. IRS Website

A key finding from the IRS survey and focus groups was that the IRS website is the most important resource for small and midsize EOs for compliance information. Since this research was conducted, the IRS redesigned its website and unveiled it in late 2012.

In general, the individuals we interviewed for this report described the new website as complicated and time-consuming to use. In particular, the redesigned website removed from the IRS's primary landing page (IRS.gov) the prominent and direct link to the IRS Exempt Organization's website and information portal for charities and nonprofits.[51] Practitioners found removal of this link to be a significant loss in terms of the accessibility of the EO informational portal. They also commented on the disruption and difficulties in finding information as a result of this redesign.

The consensus among EO representatives was that the new IRS website was not accessible for volunteers and staffs with limited time to devote to tax-related matters. For individuals who go to the website only periodically, one interviewee stated that "they are likely to be frustrated in their efforts to navigate the site and may well decide that they lack the time to find the information that they are seeking." Some commented that the current site seems more oriented to tax professionals. While the current site offers content and tools like easy-to-download checklists and flow charts for tax compliance, they are not easily found or accessed.[52]

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[51] The EO Division does not have direct control over the IRS.gov landing page and, therefore, cannot make changes to this site on its own initiative. The ACT's recommendations for representative changes would apply only to those web resources which the EO Division can modify directly.

[52] For example, see "SOI Tax Stats – Annual Extract of Tax-Exempt Organization Financial Data", http://www.irs.gov/uac/SOI-Tax-Stats-Annual-Extract-of-Tax-Exempt-Organization-Financial-Data (last accessed Apr. 17, 2013). In order to obtain calendar year 2012 IRS statistics from the IRS Annual Masterfile Extracts about the numbers of Form 990 filers, Form 990-EZ filers, and Form 990-PF filers (see footnote 2, supra), one must click on the list and description of all available fields to download a Microsoft Excel 97-2003 file which opens easily in a Windows environment. Contained in this downloadable Excel file are the total numbers for 2012, as well as descriptions of other data items found on the various Forms 990. This file download did not contain a comparable listing for the number of 990-N filers. Contained on this page also is a section "Exempt Organization Returns Filed in Calendar Year 2012" with hypertext links to Form 990 Extract 2012, Form 990-EZ Extract 2012, and Form 990-PF Extract 2012, but no comparable Form 990-N Extract 2012 file. These files were not downloadable as an Excel spreadsheet program. Efforts to download and review information from these files were unsuccessful in securing the information in a format which opened up in a Windows or Excel format. The file first was downloaded as a Zip directory containing a file with .dat extension. When opened, Windows first prompted a warning message and then indicated Windows could not open the file. If the user does attempt to open the file, they are directed to find this file format on the web or from a list.
Reviewing the IRS SOI Tax Stats – Charities & Other Tax-Exempt Organizations Statistics web page, provides statistical tables for various Form 990 filers, except for Form 990-N. See, http://www.irs.gov/uac/SOI-Tax-Stats-Charities-and-Other-Tax-Exempt-Organizations-Statistics (last accessed April 17, 2013). Clicking on the hypertext link titled Snapshot of Charities & Other Tax-Exempt Organizations ' Statistics, the reader is taken to a PDF file which contains information that is current through 2008. See, http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf (last accessed April 17, 2013).

The ACT recommends that the IRS return the link to the Exempt Organization Division's Charities and Nonprofit page on its main web landing page (IRS.gov) and continue its efforts in revising its website to improve its accessibility to individuals engaged in managing small EOs. While EO Division's main landing page contains references and links on the left side of its main page to several topics to include the A-Z Index, Search for Charities, Calendar for Events, Charity and Nonprofit Audits, Free e-Newsletter, Online Training, and Life Cycle, many of its subsidiary pages and other primary categories of organizations do not.[53] For its subsidiary pages, the IRS should create similar links and hypertext which easily lead the reader to these or related sources and available educational materials like Stay-Exempt consistently throughout the website to enable a user to more easily navigate the site from every page. With the exception of a single tab which returns to the main IRS web page, the IRS should consider using the remaining tabs across the top of EO pages as another additional means to index and assist users seeking information about EOs. In some instances, it would be beneficial to add more descriptive information about what is available on the website.[54] This may be especially helpful to the non-professional users. Other primary pages might have direct hypertext links to take a user directly to the resource.[55] The IRS should also consider linking to non-IRS sources like YouTube and providing downloadable PDF files for its web pages and information contained on them.[56] Finally, for the web pages over which EO exercises control, the ACT recommends creating an Internet-based suggestion box link for visitors to EO's web pages to report problems or issues with the website and to offer suggestions on how to improve it.

Common interest networks are an inherently efficient and effective means of transmitting information and are relied upon by EOs for guidance to understand and access IRS resources. The IRS currently reaches smaller EOs by identifying and collaborating with gateway hubs such as state nonprofit associations, funding organizations like foundations, and other EO common interest groups through its Stakeholder Liaison program.[57] As it continues to up-

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The IRS Exempt Organization Division does not own these web pages.

[53] See, Tax Information for Charitable Organizations, http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations, last accessed April 17, 2013.

[54] For example, see Statistical information page, http://www.irs.gov/Charities-&-Non-Profits/Statistical-Information-About-Tax-Exempt-Organizations, last accessed April 17, 2013.

[55] For example, see Webinars for Exempt Organizations, http://www.irs.gov/Charities-&-Non-Profits/Webinars-for-Exempt-Organizations, last accessed April 17, 2013.

[56] For example, see Questions about annual reporting requirements for EO, http://www.irs.gov/Charities-&-Non-Profits/Questions-about-the-Annual-Reporting-Requirements-for-Exempt-Organizations, last accessed April 17, 2013. Having PDF files for this information facilitates electronic downloads which can then be transmitted as attached. They can also be printed out and used as training handouts by others.

[57] Over the years, the IRS has sought the assistance of affinity and industry groups to help solve administrative issues that have arisen in the interpretation of the Code or issues in protracted litigation. For example, under the Code, integrated auxiliaries were not required to file Forms 990 because they were principally engaged in religious activities. Former Treas. Reg. § 1.6033-2(g)(5)(ii). The IRS determined that independent social service agencies of a church did not meet the definition of a church, a convention of churches or an integrated auxiliary and were required to file Form 990 information returns. Since a majority of church conferences were supporting and carrying out their religious missions through these enti-

grade its website, the ACT recommends the IRS use this program to systematically map and encourage affiliate organizations (e.g., national and state associations, law firms, accounting firms) to create links to relevant IRS websites and encourage their members to subscribe to EO Update.

2. IRS Academic Institutions Initiative

The IRS Academic Institutions Initiative collaborates with academic institutions nationwide to provide training to small and midsize nonprofits. The host academic institution provides the training site, logistics, and local marketing efforts. The IRS provides the trainers and all participant materials at no cost to these institutions.[58] Since 2010, the EO has held 85 workshops in 28 states and trained approximately 10,000 participants.[59] Interviewees generally referred positively to the activities of universities, colleges, and other types of educational providers to offer such programs to small EOs.[60]

The IRS presenters are the primary reason for the Academic Institutions Initiative's success. Their participation is voluntary and in addition to their regular IRS duties and responsibilities.[61] These day-long sessions are highly interactive. Some interviewees had either attended or served as instructors in these programs. There was a general consensus that these programs were informative, very inexpensive, and well attended. Interviewees also indicated a desire to see greater availability of such programs.

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ties, they sued the IRS to obtain the right not to file the returns. *See*, *e.g*., *Lutheran Children & Family Servs.*, 758 F.2d 1228 (8th Cir. 1985); *Tenn. Baptist Children's Homes Inc. v. United States*, 604 F. Supp. 210 (M.D. Tenn. 1984), *aff 'd* 790 F.2d 534 (6th Cir. 1986). Because a number of these cases were arising with conflicting results in the various federal circuit courts of appeals, the IRS called together leaders of the major religious denominations to see if a solution could be found under the existing law. Working with these denominations, the IRS developed a definition of an integrated auxiliary that was affiliated with a church or a convention or association of churches and that was internally supported by those denominations rather than the public. The IRS and affinity groups solved the issue without further litigation and costs. This reconsideration and consultation with the religious community resulted in Treas. Reg. § 1.6033-2(h) defining affiliated organizations under the integrated auxiliary rules.

[58] For example, the" Exempt Organizations Participant Text" provides a core curriculum with an easily understandable outline of issues affecting small and medium-sized exempt organizations. The chapters address tax-exempt status; jeopardizing 501(c)(3) status; unrelated business income; gaming activities; employment issues; recordkeeping, Form 990; audit, compliance and complaint processes; and required disclosures. Regrettably, however, this manual could not be located as a downloadable PDF file on the IRS website through a search by its title, catalog number 88908P, or Training 4325-002 (Rev. 10-2008) (last attempted Apr. 12, 2013). All of these designations are on the manual hard copy.

[59] Initially, the IRS self-produced these workshops by working directly with a contractor. In 2010 the IRS began collaborating with academic institutions which hosted the workshop. In 2010 the IRS provided 21 workshops—18 self-produced and 3 in collaboration with academic institutions. In 2011 the IRS held 28 workshops—17 self-produced and 11 with academic institutions. In 2012 all 36 workshops were held in collaboration with academic institutions.

[60] An ACT member participated in the 2009 IRS focus group discussions prior to the launch of this Initiative and then chaired the Initiative's third training session. This multisite, multiday program resulted in the training of more than 600 participants.

[61] To become a member of the EO Presenters Cadre, an IRS employee submits an application in response to an open announcement. IRS employees go through a competitive selection and vetting process in addition to the training they receive. Presenters also are evaluated by the workshop participants.

The ACT recommends the IRS continue these collaborative programs and look to build residual capacity in the collaborating institutions through this initiative. One way for the IRS to build on the successful Academic Institutions Initiative is to create a "train the trainer" program.[62] The IRS could work through these academic institutions, nonprofit associations, and other service providers to train individuals about IRS requirements for EOs. Providing a certification and credentialing program similar to the Enrolled Agents program would provide a level of quality control and an incentive for these institutions to work with EOs in their communities.[63]

There are many associations and organizations with their own ongoing training programs and resources. The IRS should collaborate with these organizations' training resources and make IRS resources available to them as a component of their annual training. In particular, this could be achieved through collaborations with these organizations by co-creating reusable web-based training available to both the IRS and the training entities.

3. Prompts for Educational Opportunities

Many very small and smaller exempt organizations are overseen by volunteers. Because turnover among board members is high, these organizations often lack board members who are a reliable source of knowledge regarding tax compliance matters. While the IRS provides a wide range of educational materials regarding compliance issues, voluntary board members are not necessarily oriented to seeking and reviewing such materials. Interviewees suggested that the IRS should take advantage of opportunities to reinforce to individuals serving on the boards of the very small and smaller exempt organizations the availability of educational materials from the IRS and the importance of reviewing them. The ACT recommends the IRS take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices.

The application process of completing the IRS Form 1023 provides an excellent opportunity to provide information about what it means to start and operate an EO. Each applicant could be asked on the current accompanying checklist whether it had reviewed certain IRS materials prior to completing its application (e.g. Stay Exempt or other specific IRS web-based resources and materials).[64] Simply adding a question to this checklist alerts and directs the ap-

[62] The ACT recognizes that there are many restrictions which prevent the IRS from partnering with for-profit entities, yet public-private collaborations are a means used to leverage public resources in many contexts. The ACT encourages the IRS to explore avenues by which the IRS might leverage its resources through these providers.
[63] While mindful that this may be a resource-intensive suggestion at this time, the ACT believes that the benefits outweigh the burdens. Creating the equivalent of the EO Presenter Cadre in these participating institutions over time will leverage EO's educational outreach significantly.
[64] Changes to IRS forms (e.g., Forms 1023 and 990) impact both the IRS and the sector. For the IRS this consists at a minimum of implementing, overseeing, and administering the changes in computer systems and programming. Neither Form 1023 nor Form 990 undergoes frequent and significant modifications. If implemented as a stand-alone project, the ACT believes the benefits outweigh these burdens by increasing awareness of and leveraging access to IRS-created educational materials. As the IRS upgrades and moves to implement electronic filing and forms, the ACT believes these changes can

plicant to these specific web-based IRS educational materials, thereby likely increasing their usage.[65] For applicants who choose to review these educational materials, it enhances the Form 1023 application's educational purposes which are already an integral part of the application process.[66] Given high turnover among board members incorporating a similar question on the Form 990 about board governance education and orientation may encourage the use of IRS educational resources. At a minimum the IRS should continue to provide and highlight prominently displayed links and references to specific educational materials in its communications, forms, and instructions with references to IRS materials.

Finally, the IRS performs audits, surveys, compliance checks, and studies as a part of its ongoing regulatory and information gathering needs. The IRS should include questions about current and emerging education practices and opportunities as part of its ongoing regulatory activities. Questions should consider both IRS and non-IRS educational opportunities and materials.

4. Recommendations

- The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing small exempt organizations. This should include the creation of prominent links beginning with the IRS main web landing page and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the site. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.
- The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborating entities. The adoption of a "train the trainer" model is an important consideration in this regard.

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be integrated easily into the overall design and implementation with minimal burdens. Similarly, we believe the benefits to the sector outweigh any actual or perceived burden. Many very small and smaller EOs do not avail themselves of professional advice often for budgetary reasons. For them, access to a publicly available resource created by the IRS may be the most significant, if not only, access to credible educational materials and information about their legal and tax requirements. Directing an applicant to specific IRS resources at their inception during the one-time Form 1023 application provides an early introduction and awareness to the legal and regulatory tax regime for exempt organizations with lasting benefits to the applicant, the public, and the IRS.

[65] During the drafting of this report, the ACT reviewed an Interactive Form 1023. This form is a web-based, interactive, and downloadable PDF file. As applicants complete each field they are provided with integrated electronic hypertext links to additional IRS reference materials and explanations to assist them in completing this form. The form will permit an applicant to link automatically to and complete any required schedules with links to reference materials. When completed, the applicant will download, print, and mail a completed Form 1023 paper form to the IRS. It is anticipated the Interactive Form 1023 will serve as an interim step toward the full deployment of electronic data base Form e-1023 outlined in the 2012 ACT recommendations. *See* "Report of Recommendations" at 69-122 (June 6, 2012), http://www.irs.gov/pub/irs-tege/tege_act_rpt11.pdf (last accessed Mar. 26, 2013).

[66] *See*, the 2012 ACT report, *supra*.

- The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

C. Information Sharing with State Charity Regulators

1. State Charity Regulator Participation in IRS Information Sharing Under the PPA

The IRS has shown remarkable resilience in seeking to educate state charity regulators about information sharing constraints under the PPA in the face of substantial state reticence to deal with previously described PPA burdens. After the passage of the PPA, IRS staff worked with NASCO to provide information concerning the PPA's requirements to NASCO members. IRS staff gave presentations at several NASCO conferences to inform state charity regulators about the procedures for receiving authorized information and the safeguard requirements of Section 6103(p)(4). The IRS's designated EO Federal/State Liaison has worked tirelessly to educate participating state agencies in the mechanics of PPA participation, provide assistance with the safeguard procedure report, and link state officials with appropriate IRS officials conversant in necessary information technology and security issues. The IRS organized an informative teleconference with NASCO members to explain the information-sharing process and standards. Finally, the IRS initiated collaborative discussions with state charity regulators through an ongoing NASCO/IRS working task force to develop a pragmatic approach for taking advantage of what is presently available under the PPA.[67]

The ACT commends the IRS for this approach. Increased state PPA participation in information sharing will enhance IRS/state enforcement coordination while leveraging limited IRS and state resources.[68] The IRS should continue collaborating with state officials to devise solutions to PPA implementation barriers while avoiding unintended consequences such as state law barriers that limit or nullify their effectiveness. Further, the IRS should continue its efforts to communicate clear, straightforward road maps to the states on how best to implement the information sharing process and to overcome the deterrent effect from the PPA's complex, daunting labyrinth of requirements (e.g., sharing standards and processes such as safeguards for maintaining electronic data). IRS communication about workable processes can only encourage participation by nonparticipating states while facilitating more effective, beneficial participation by those states already participating in PPA information sharing.

[67] The teleconference call and the working task force have also served to educate state charity regulators about inaccuracies in the NAAG letter (Appendix A). *See, e.g.*, *supra* text accompanying notes 29-31.
[68] To the extent that PPA impediments have been overcome, it is in states ' best interest to participate in PPA information sharing, even though salutary legislative changes could streamline the PPA to more efficiently meet its goals. *See supra* note 29. It would appear not to be in states ' best interests to decline to participate in a workable information sharing scheme while awaiting possible congressional action to improve that scheme, thus allowing perfection to be the enemy of the good.

Information sharing benefits the IRS as well. There are important synergies among the IRS and state charity officials that can only be fully realized through robust information sharing and coordinated enforcement efforts. Information sharing enhances states' ability to exercise their state law responsibilities by working more cooperatively with the IRS to oversee EOs and ensure the proper administration of charitable assets.[69]

The IRS has limited resources to police the sector. In calendar year 2011 the IRS processed 798,903 EO returns. In fiscal year 2012 the IRS audited or examined 10,743 EO and related taxable returns or approximately one percent.[70] Collaboration leads to enhanced and more efficient collective enforcement efforts by the IRS and state charity regulators. Information sharing leverages IRS resources by allowing state charity regulators to pursue cases which the IRS may lack the resources or authority to undertake. This includes the diversion of charitable assets by EOs in their respective jurisdictions where charitable assets are required to be deployed for the benefit of the public.

The IRS is to be lauded for collaborating with NASCO and recently achieving a major breakthrough which will make IRS/state information sharing significantly more workable under the PPA.[71] The IRS has obtained approval to provide letters to participating states authorizing disclosure of information to EOs as a routine, early part of the information sharing process, thus removing states' concerns about not revealing the basis for their inquiries to EOs. The IRS can issue a blanket approval letter under Treas. Reg. 301.6103(p)(2)(B)-1 allowing state disclosure of information to an EO as part of the paper work-around process, thereby facilitating a state's efforts to obtain copies from target EOs of materials the IRS has provided to state charity regulators under Section 6103. This significant development is generating a great deal of interest among state charity regulators who had previously been reticent about participating in information sharing. IRS issuance of such letters to state charity regulators will remove two significant barriers to state participation in information sharing by:

- removing state concerns about seeking information from a target EO without being able to disclose that the inquiry resulted from information received from the IRS; and

[69] The ACT does not recommend that the IRS expand its information sharing with state charity regulators to include state law violations, as permitted by Section 6104(c)(2)(D). Although referrals of state law violations would assist both the IRS and state charity regulators in prioritizing and leveraging their limited enforcement resources, they would also impose additional burdens on the IRS, which the ACT believes cannot be justified as leveraging already limited IRS resources. The burden would be especially disproportionate in light of the fact that only three states ' charity regulators have signed up for information sharing. In order to educate IRS staff about the vagaries of 50 state laws, the benefits of state law referrals would likely be outweighed by the burdens of learning a host of state law issues important to state charity regulators which may have no counterpart in the Internal Revenue Code, such as governance issues, *cy pres* issues triggered by an EO's radical change of charitable purpose, violation of charitable trusts such as restrictions on endowment funds, and deceptive fundraising practices.

[70] *See, IRS Data Book 2012*, at 33. http://www.irs.gov/pub/irs-soi/12databk.pdf (last accessed Apr 21, 2013)

[71] IRS staff broke this positive news to the NASCO working group during a teleconference call on April 11, 2013.

- reducing the likelihood that the target EO would respond by misrepresenting that it never provided the relevant information to the IRS.

Another promising avenue of IRS/state collaboration to make IRS/state information sharing more workable under the PPA is the IRS's ongoing review of various states' civil investigation demand (CID) statutes to determine if they constitute administrative proceedings during which state charity regulators can disclose information received from the IRS to a target EO under Section 6104(c)(4).[72] Under Section 6104(c)(4), the IRS must evaluate which state law processes are "similar to . . . tax administration proceedings under Section 6103(h)(4)" which Section 6103(h)(4) further defines as "administrative proceeding[s] pertaining to tax administration." Such administrative proceedings include examinations (or audits) under Section 7602. Examinations can include taxpayer conferences and a formal review of a taxpayer's books and records to determine tax liability. Examinations can also include compelled document production and compelled testimony under oath. State CID statutes are similar to examinations under Section 7602 because they authorize state attorneys general to issue pre-lawsuit subpoenas compelling depositions and document production in order to investigate potential violations of state charity law.[73]

IRS review will determine which state CID statutes provide for administrative proceedings where state charity regulators can disclose information received from the IRS to a target EO under Section 6104(c)(4). An IRS determination that a state's CID proceedings constitute administrative proceedings under Section 6104(c)(4) will remove state concerns about not revealing the basis for state inquiries to target EOs and will compel EO representatives to respond under oath about their communications with the IRS.

2. Enforcement Referrals by State Charity Regulators to the IRS

The IRS has taken an active role in educating state charity regulators about the process for state referrals of complaints to the IRS and the substance of IRS compliance and examination issues. The IRS has also encouraged state charity regulators to make referrals directly to a designated EO Fed/State liaison. State charity regulators are often the eyes and ears of the IRS on the front lines in regulating EOs and they annually refer many significant cases of abusive practices to the Exempt Organizations Division.

Survey responses of state charity regulators varied widely regarding whether, when, and to what extent they make enforcement referrals to the IRS and what criteria they apply in making such referral decisions. However, there are several consistent themes in their responses. They are more likely to make referrals to the IRS when their state agencies lack sufficient resources to conduct an investigation or prosecution or where state remedies are limited by a

[72] *E.g.*, Mass. Gen. Laws. ch.12, § 8H.
[73] Such CID statutes are essentially a civil equivalent to a pre-indictment criminal grand jury process.

charity's presence in other states. State charity regulators are also more likely to make referrals to the IRS when there are no significant state issues to pursue.

State charity regulators also reported that they are less likely to make referrals if IRS enforcement might interfere with donor intent or where state charity regulators are seeking restitution payable by the EOs' officers to the EO as a remedy for wrongful inurement. Such restitution remedies can be compromised if the IRS is seeking payment of penalties for excess benefit transactions from those same officers, thus offsetting the officers' financial ability to pay restitution to the harmed EO.

There could be improved IRS/state communication and coordination regarding state referrals of potential enforcement matters to the IRS, to help both the IRS and states prioritize their limited resources.[74] State charity regulators report that both the IRS and state charity regulators unwittingly waste resources and duplicate efforts when they are investigating the same EOs. In addition, the IRS prefers receiving state referrals earlier in the evolution of a case.

Further, the state perception is not always justified that the IRS offsets potential state restitution remedies by requiring payments to the IRS for excess benefit transaction penalties. The IRS sometimes obtains remedies requiring officers to pay restitution to EOs which is consistent with state charity regulators' goals.

Thus, the ACT recommends that the IRS expand its education of state charity regulators about IRS compliance and examination functions, with a particular focus on IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies such as penalties and restitution. Such state education efforts could foster an increase in state referrals to the IRS while helping state charity regulators clarify and integrate the sometimes conflicting enforcement goals of the IRS and the states.

The ACT also recommends that the IRS encourage states to share information about their IRS referrals with other states through the IRS web site and other means. As described above, information provided by complainants directly to state charity regulators is not considered tax information subject to Sections 6103, 6104, and 7213, whereas Section 6103 prohibits the IRS from disclosing complaint information provided by one state charity regulator to other state charity regulators.

3. Recommendations

- The IRS should continue working with state charity regulators to clarify PPA strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.

[74] The need for improved IRS/state coordination is a function of the limitations of the PPA. It is not a reflection of the IRS's excellent efforts to encourage state referrals and to process such referrals rapidly after it receives them.

- The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

D. Summary of ACT Recommendations

The IRS should require more information from 990-EZ filers without changing the filing thresholds.

1. The IRS should retain the existing filing threshold for Form 990-EZ.[75]
2. The IRS should consider the possibility of requiring Form 990-EZ filers to file the following schedules, if applicable:
   - Schedules F (activities outside the United States);
   - I (grants);
   - J (compensation);
   - L, Parts III and IV (transactions with interested persons);
   - M (noncash contributions); and
   - R (related organizations).
3. The IRS should consider the possibility of adding governance questions to the Form 990-EZ after it has an opportunity to consider the findings of the governance study which will evaluate whether particular governance practices may be useful indicators of tax compliance.

The IRS should enhance its Customer Education and Outreach.

4. The IRS should continue to revise its website and improve its accessibility to individuals engaged in managing small exempt organizations. This should include the creation of prominent links beginning with the IRS main web landing page (IRS.gov) and the addition of links that visitors can use to report problems and that offer visitors guidance for navigating resources available on the site. The IRS should also encourage state charity regulators and affiliate organizations to create links to the IRS website.
5. The IRS should continue to support its Academic Institutions Initiative and other collaborative educational programs and look to build residual capacity in the collaborat-

[75] Two ACT members disagree and believe the filing threshold should be reduced. *See supra* note 44.

ing entities. The adoption of a "train the trainer" model is an important consideration in this regard.

6. The IRS should take additional steps to encourage and facilitate the use of ongoing educational opportunities as an integral component of good board-governance practices. These steps should include adding prompts to checklists that direct consumers to available educational resources for good governance.

The IRS should enhance its information sharing with state charity regulators.

7. The IRS should continue working with state charity regulators to clarify PPA strictures on IRS sharing of confidential information and to assist in overcoming obstacles to state PPA participation in IRS information sharing.
8. The IRS should encourage increased enforcement referrals from state charity regulators by (a) educating them about IRS enforcement priorities and the processes and criteria the IRS applies for determining appropriate remedies and (b) encouraging them to share information about their IRS referrals with other states.

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Appendix A. National Association of Attorneys General Letter to the Senate Finance Committee Urging that Congress Amend the Provisions of Sections 6103, 6104, and 7213 of the Internal Revenue Code

National Association of Attorneys General

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October 28, 2011

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate

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

via fax

Dear Chairman Baucus and Ranking Member Hatch:

Re: Pension Protection Act of 2006 Provisions Regarding Information

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

I. INTRODUCTION

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

II. BACKGROUND INFORMATION

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

[1] See STATE ATTORNEYS GENERAL POWERS AND RESPONSIBILITIES (Emily Myers &Lynne Ross, eds., 2007).

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

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

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

III. THE PENSION PROTECTION ACT OF 2006

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

[2] Federal treasury regulations also require private foundations to provide their IRS Forms 990PF to state attorneys general in their state of domicile or registration.
[3] Public Law No. 109-280 (Aug. 17, 2006).

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

IV. EXPLANATION OF THE PROBLEM

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

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

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

1. When the IRS makes a disclosure to the state charity office, an official reviews the data, logs the receipt of the information, and must place the data in a file secured by a least two barriers (doors, cabinets, etc).

2. In order to take investigatory or enforcement action, however, the state charity official must then rely upon an independent source, such as a telephone directory or advertisement, as the ostensible basis for contacting the subject charitable organization and requesting any recent communication to or from the IRS. Following this sort of procedure does not violate the safeguard provisions at issue because

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

[5] Other than on unrelated business income, charities are exempt from income tax under IRC § 501(c)(3).

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

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

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

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

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

We see no reason why IRC notices of refusals to grant tax-exempt status, proposed revocations of exempt status, or proposed deficiency taxes for prohibited transactions under chapters 41 or 42, such as intermediate sanctions, taxes on self-dealing transactions and similar matters involving public charities and foundations, should be subject to the same criminal penalties and security procedures applicable to individual and corporate income tax return information. This is all extremely valuable and important information that allows state charity officials to fulfill their statutory mandate. The safeguard requirements have proven unsuccessful and unworkable, however, and even the three states that have attempted to "play by the rules" feel as if the information obtained directly from the affected charity is akin to fruit of a poison tree.[6]

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

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

Sincerely,

John W. Suthers
Colorado Attorney General

David Louie
Hawaii Attorney General

Luther Strange
Alabama Attorney General

John J. Burns
Alaska Attorney General

Tom Horne
Arizona Attorney General

Dustin McDaniel
Arkansas Attorney General

Kamala Harris
California Attorney General

George Jepsen
Connecticut Attorney General

Joseph R. "Beau" Biden III
Delaware Attorney General

Lenny Rapadas
Guam Attorney General

Lawrence Wasden
Idaho Attorney General

Lisa Madigan
Illinois Attorney General

[6] Recently proposed IRS regulations (IRS REG-140108-08) will not address any of the substantive issues presented.

Tom Miller
Iowa Attorney General

Jack Conway
Kentucky Attorney General

Douglas F. Gansler
Maryland Attorney General

Bill Schuette
Michigan Attorney General

Jim Hood
Mississippi Attorney General

Steve Bullock
Montana Attorney General

Catherine Cortez Masto
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New Jersey Attorney General

Eric Schneiderman
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Wayne Stenehjem
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Scott Pruitt
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William J. Schneider
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Jon Bruning
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Guillermo Somoza-Colombani
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Greg Phillips
Wyoming Attorney General

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Federal, State and Local Governments: Leveraging Internal Controls at State and Local Governments to Improve Tax Compliance

Robert E. Jaros
Lisa M. Pusich
Kathy M. Sheppard

2013

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Table of Contents

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I. Executive Summary

A. Purpose

The purpose of the ACT/FSLG Subcommittee (Subcommittee) report is to identify how the IRS can leverage internal controls at the state and local government level to better identify fraud, work collaboratively with these entities on fraud issues, and ultimately improve tax administration and compliance. The report also includes recommended updates to the FSLG Fraud Job Aid, a training outline for a possible webinar and other guidance on combating fraud to be offered by FSLG and National Association of State Auditors, Comptrollers and Treasurers to the state and local governments.

B. Report Summary

This report includes background on internal controls, fraud, waste, and abuse in governments, a summary of survey on internal controls of state and local governments, and recommendations for consideration by the IRS.

C. Recommendations

1. Update the Fraud Job Aid or the instructions for using it to include the extent of internal controls and the size of the entity in the risk assessment of the entity to be audited
    - **Extent of Internal Controls –** The IRS could identify the extent of internal controls at the entities to be audited and adjust their audit scope accordingly. The IRS should consider using The Fraud Job Aid for entities with little or no internal controls and conduct more fieldwork on fraud for these entities. For entities with strong internal controls, the IRS should consider relying on these internal controls and reduce the fraud detection scope of the audit.
    - **Size of Entity –** The IRS could consider additional procedures regarding fraud for smaller entities, which typically have fewer internal controls and greater incidence of fraud than larger entities.
2. Develop and conduct training on internal control and fraud
    - **IRS Webinar –** This could include an IRS webinar for its agents to address items in the Fraud Job Aid. The webinar could identify the benefits of conducting a risk assessment in performing audits. In addition, the webinar could highlight relatively inexpensive steps smaller organizations can take to protect against fraud.

- **Reach out to national associations such as NASACT and the Government Finance Officers Association to offer joint training on internal control and fraud –** The Subcommittee could assist the IRS in setting up this joint training on internal control and fraud to reach state and local governments. Stronger internal control leads to fewer instances of fraud and better tax administration and compliance.

II. Introduction

Governments are susceptible to fraud from employees, contractors, and benefit recipients. The Federal Government has recognized the cost of fraud and abuse, and President Obama signed the Improper Payments and Elimination and Recovery Act in 2010. Further, FSLG issued the Fraud Job Aid and guidance in 2012 to assist field specialists to better identify and report fraud.

A. Fraud and Abuse in Governments

Governments are susceptible to fraud committed by employees, contractors, and benefit recipients. Employee fraud most often involves bribery and asset misappropriation including billing and skimming schemes. Bribery can involve invoice kickbacks and bid rigging to win a contract even when the contractor did not make the lowest or best bid. Employees can bill shell companies or make personal purchases. Employees can also skim receipts when collecting fees from the public.

Contractor fraud most often involves procurement and billing schemes. A contractor can bill the government for incomplete work or inflate the cost of labor or supplies. One of the largest areas of contractor fraud is for Medicare/Medicaid, where healthcare companies can overestimate clinical costs, ask for reimbursement for tests and procedures that were never performed, or otherwise attempt to defraud the government.

Benefit recipients of food stamps, school lunches, supplemental security income, unemployment insurance, and other government programs can claim that they are eligible when, in fact, they are not.

B. Improper Payments Elimination and Recovery Act

In an effort to reduce wasteful payments by $50 billion in 2012, President Obama signed the Improper Payments and Elimination and Recovery Act in 2010. The Act and subsequent executive orders and directives included the following:

1. Identification of high-priority programs, the development of supplemental measures of payment error for high-priority programs;
2. Public website to track progress in reducing improper payments. See www.PaymentAccuracy.gov;
3. Pursuit of tough penalties on contractors for failing to timely disclose credible evidence of significant overpayments received on government contracts;
4. Expansion of the use of payment recapture audits;

5. Establishment of a Do Not Pay List, a single source through which all agencies can check the status of a potential contractor or individual; and
6. Annual risk assessment conducted by Federal agencies, and if a program is found to be susceptible to significant improper payments, then agencies must measure improper payments in that program.

State and local governments have been affected by IPERA, as the federal agencies generally hold the state and local governments responsible for the administration of federal programs.

C. Fraud Job Aid

FSLG issued the Fraud Job Aid and guidance in May 2012. The purpose of the Fraud Job Aid was to provide guidance to Field Specialists to identify potential fraudulent activities and to develop fraud referrals as necessary. The identification, development, and prosecution of criminal tax cases are a critical part of tax administration and compliance.

III. History

A. Report on Occupational Fraud

Every two years, the Association of Certified Fraud Examiners publishes a report to the nations. The latest such report is the "Report to the Nations on Occupational Fraud and Abuse 2012 Global Fraud Study," available at www.acfe.com. Occupational fraud is defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.

Key findings in the Report on Occupational Fraud included:

1. Survey participants estimated that the typical organization loses five percent of its revenues to fraud each year. The median loss caused by the occupational fraud cases was $140,000. More than one-fifth of these cases caused losses of a least $1 million.
2. Asset misappropriation schemes were by far the most common type of occupational fraud, comprising 87 percent of the cases reported; they were also the least costly form of fraud, with a median loss of $120,000. Financial statement fraud schemes made up just eight percent of the cases, but caused the greatest median loss at $1 million.
3. Occupational fraud is more likely to be detected by a tip than by any other method. The majority of tips reporting fraud come from employees of the victim organization.
4. There are three broad types of fraud identified in the Report:
    - Corruption
    - Asset Misappropriation
    - Financial Statement Fraud

The Subcommittee notes that State and local governments are susceptible to the first two types of fraud, but generally not financial statement fraud. Although there have been cases of fiscal mismanagement leading to municipal bankruptcies, it does not appear that financial statement fraud was involved. To address budget shortfalls, certain state and local governments have passed statutes/ordinances that require a divergence from Generally Accepted Accounting Principles issued by the Government Accounting Standards Board. These divergences are disclosed in the state and local comprehensive financial report. With the scheduled implementation of GASB statements 67 and 68 on pension plans and reporting, there is the possibility of *more* divergences from GAAP and the potential risk of financial statement fraud.

- Occupational fraud is a significant threat to small organizations. The smallest organizations suffered the largest median losses. These organizations typically employ fewer anti-fraud controls than their larger counterparts, which increases their vulnerability to fraud.

- The presence of anti-fraud controls is positively correlated with significant decreases in the cost and duration of occupational fraud schemes. Victim organizations that had implemented any of 16 common anti-fraud controls experienced considerably lower losses and time to detection than organizations lacking these controls.

B. Internal Control

1. Committee of Sponsoring Organizations

"Internal Control – Integrated Framework" prepared by the COSO of the Treadway Commission defines internal control as a process to achieve the following objectives:

- Effectiveness and efficiency of operations
- Reliability of Reporting
- Compliance with applicable laws and regulations

Internal control is a continuous built-in component of operations that occur throughout an entity's operations and on an ongoing basis. It is a process and a means to an end, not an end in itself. Employees make internal control work. The responsibility for good internal control rests with all managers, not just the auditors and accountants. Internal control provides reasonable assurance, not absolute assurance that all organizational objectives will be met. Factors outside the control or influence of management can affect the entity's ability to achieve all of its goals. Internal control should benefit the entity and it should be cost effective.

Internal control consists of five integrated components:

- Control Environment – The set of standards, processes, and structures that provide the basis for carrying out internal controls across the organization.
- Risk Assessment – Involves a dynamic and iterative process for identifying and assessing risk from external and external sources to the achievement of the entity's objectives.
- Control Activities – Actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various states within business processes, and over the technology environment. They may be preventive or detective in mature. Segregation of duties is a typical control activity.
- Information and communication – Information is necessary for the entity to carry out internal control responsibilities in support of the achievement of its objectives. Man-

agement uses relevant information from both internal and external sources to support the function of other components of internal control. Communication is the continual process of sharing and obtaining necessary information.

- Monitoring – Monitoring should assess whether each of the five components of internal control are present and functioning. Monitoring should also ensure that findings of audits and other reviews are promptly resolved.

Internal control is a multidirectional, iterative process in which each component influences other components. The components apply to all entity sizes, types, and government bodies. Each organization may choose to implement internal control differently due to the size, complexity and degree of centralization. No single method of internal control is universally applicable.

In 2011, COSO issued an update entitled "Internal Control – Integrated Framework" that included the five components of internal control listed above and set out seventeen principles representing the fundamental concepts associated with each component. All seventeen principles apply to each category of the objective, as well as to individual objectives within a category. See http://www.coso.org/ic-integratedframework-summary.htm.

2. States and Other Guidance

The National Association of State Controllers Internal Controls Information Sharing Group developed an Internal Control Guide, nineteen internal control questionnaire documents for functional areas such as budgets, capital assets, payables, receivables, etc.), internal control glossary, sample template for state agencies' assessment of risk and internal controls, advisory controls for A-87 compliance, and Information Classification Guide. This information is available, free of charge, on the NASC website:
http://www.nasact.org/nasc/committees/multistate/index.cfm#Resource.

As noted on the website, the NASC Internal Control Questionnaires were developed by governmental financial managers, accountants and auditors and their design is inherently focused on government operations. These ICQs are tools that will help entities quickly, efficiently and effectively assess the control environments in which they are administered. These ICQs, as they are published, cover a wide range of governmental operations. For users, these tools represent a starting point, and should be evaluated for application under the user's unique circumstances, making changes and additions as may be required.

GFOA does not have comparable free guidance on internal control on its website. Instead, the GFOA offers a book entitled "Evaluating Internal Controls – A Local Government Manager's Guide." The present price of the book is $28.00. See http://www.gfoa.org/

3. Occupational Fraud and Internal Control

a. Summary

As noted in the Report on Occupational Fraud, the presence of anti-fraud controls is positively correlated with significant decreases in the cost and duration of occupational fraud schemes. Victim organizations that had implemented any of 16 common anti-fraud controls experienced considerably lower losses and time to detection than organizations lacking these controls. These anti-fraud controls include:

- External Audit of financial statements
- Code of Conduct
- Internal Audit/Fraud Examination Department
- External Audit of Internal Control
- Management Certification of financial statements
- Independent Audit Committee
- Management Review
- Employee Support Programs
- Hotline
- Fraud Training for Employees
- Fraud Training for Managers/Executives
- Anti-Fraud Policy
- Formal Fraud Risk Assessment
- Surprise Audits
- Job Rotation/Mandatory Vacation
- Rewards to Whistleblowers

b. Smaller Entities

There is a dramatic disparity in the implementation of controls between companies with over 100 employees and those with 100 or fewer employees. For example, 91.4 percent of large organizations had an external audit compared with 55.7 percent of small organizations. In addition, 85 percent of large organizations had an internal audit/fraud examination department compared with 31.6 percent at small organizations. This is consistent with the survey of state and local governments conducted by the Subcommittee.

Several of the 16 anti-fraud controls would not provide an appropriate cost/benefit balance for smaller organizations. However, other anti-fraud measures could be implemented at a marginal cost and could greatly increase the ability to prevent and detect fraud. These include:

- Code of conduct
- Fraud training programs
- Management review

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IV. Due Diligence

The Subcommittee reviewed material on occupational fraud and internal control, conducted a survey, and analyzed the results.

A. Materials on Occupational Fraud and Internal Control

The Subcommittee utilized the following data sources to conduct this analysis:

1. Fraud Job Aid – Federal, State & Local Governments - IRS
2. Guidance for the Fraud Job Aid - IRS
3. Internal Control – Integrated Framework – December 2011 – COSO
4. Internal Control Guidebook and other materials – NASC Internal Controls Information Sharing Group
5. Report to the Nations on Occupational Fraud and Abuse 2012 Global Study – Association of Fraud Examiners
6. Survey of state and local governments conducted by the Subcommittee
7. Improper Payments and Elimination and Recovery Act

B. Survey

The Subcommittee conducted a survey of state and local governments to determine the use of internal control, identify their practices regarding fraud prevention, and receptiveness to training and outreach that the IRS could develop and provide to these governments on best practices for fraud prevention and detection. The Subcommittee developed a survey to determine the use of internal controls in state and local governments. The Subcommittee distributed the survey through NASACT. The Subcommittee also sent the survey to local governments through the GFOA. There were 58 responses, including 26 states and 32 local governments that responded to the survey. The Subcommittee did not survey federal agencies.

C. Survey Results

The highlights of the survey are as follows:

1. States are more likely to have an internal control statute/ordinance in place than local governments – 75 percent of states had an internal control statute versus 20 percent for local governments.
2. States are more likely to have an internal control plan in place than local governments – 75 percent for states versus. 30 percent for local governments.

3. States are more likely to have an internal control policy than local governments – 93 percent for states versus 47 percent for local governments.
4. States are more likely to identify fraud than local governments – 75 percent for states versus 42 percent for local governments. This should be interpreted with caution, as the higher identification of fraud by states may due more to the better detection systems rather than an indication of more cases of fraud.
5. States are more likely to conduct a risk assessment than local governments – 78 percent for states versus 58 percent for local governments.
6. States are more likely to have internal audit function and internal auditor than local governments – 80 percent for states versus 65 percent for local governments for an internal control function and 70 percent for states versus 50 percent of local governments for an internal auditor.
7. States are more likely to offer training on internal controls for their entity than local governments – 85 percent for states versus 68 percent for local governments. About 30 percent of states conduct training for business partners versus five percent for local governments.
8. States are more likely to have a public hot line to report fraud, waste or abuse of public resources – 65 percent of states versus 42 percent of locals.

D. Conclusions and Implications for FSLG

1. IRS can leverage entity's internal control.

   Effective internal control in state and local governments result in better operational efficiency, compliance with laws, more accurate reports and better tax administration. FSLG can leverage the internal controls of these entities to better identify fraud, work collaboratively with these entities on fraud issues, and ultimately improve tax administration.

2. In general, local governments are at a greater risk of experiencing fraud than State governments.

Most state governments have internal control statutes that require the state to have internal controls in place to achieve the above objectives. In contrast, most local governments do not have internal control ordinances requiring the use of internal controls. This difference means that local governments are more susceptible to fraud. In the Report to the Nations, it was noted that small organizations (those with fewer than 100 employees) are the most common victims of fraud while larger organizations have fewer cases of fraud. While there are several factors involved, there appears to be a clear correlation between the use of internal controls and fraud – the more that internal controls are in place, the lower the fraud, while organizations that have little or no internal controls experience higher rates of fraud.

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V. Conclusion

FSLG requested input to offer improvement and/or enhancement with employment and income tax administration and compliance for state and local governments by reviewing and suggesting revisions to the FSLG Fraud Job Aid.

Additionally identifying needs of State and Local Governments for improved identification and prevention of fraud, and suggesting training and outreach materials to meet any gaps was determined to be a complementary objective. The Subcommittee will provide suggestions to the IRS from a governmental taxpayer's perspective.

Summary of Recommendations

A. Update the Fraud Job Aid or the instructions for using the Aid to include the extent of internal controls and the size of the entity in the risk assessment of the entity to be audited

- **Extent of Internal Controls** - The IRS could identify the extent of internal controls at the entities to be audited and adjust their audit scope accordingly. The IRS should consider using The Fraud Job Aid for entities with little or no internal controls and conduct more fieldwork on fraud for these entities. For entities with strong internal controls, the IRS should consider relying on these internal controls and reduce the fraud detection scope of the audit.
- **Size of Entity** - The IRS could consider additional procedures regarding fraud for smaller entities, which typically have fewer internal controls and greater incidence of fraud than larger entities.

B. **Reach out to national associations such as NASACT and GFOA to offer joint training on internal control and fraud** – The Subcommittee could assist the IRS in setting up this joint training on internal control and fraud to reach state and local governments. Stronger internal control leads to fewer instances of fraud and better tax administration and compliance.

C. Develop and conduct training on internal control and fraud

- **IRS Webinar** - This could include an IRS webinar for its agents to address items in the Fraud Job Aid. The webinar could identify the benefits of conducting a risk assessment in performing audits. In addition, the webinar could highlight relatively inexpensive steps smaller organizations can take to protect against fraud.

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VI. Special Thanks

- Phyllis A Burnside, Group Manager, Compliance and Program Management
- Paul Marmolejo, Director Federal State and Local Governments
- Laura Hostelly, Program Manager, Field Operations, Reviews, and Enforcement
- Jo Ann Lacey, Internal Revenue Agent, Federal State and Local Governments
- Jim Maslanka, Senior Program Analyst, Field Operations, Reviews and Enforcement
- Scott Olsen, Department of Assistance Bureau Director, Office of the Comptroller of the Commonwealth of Massachusetts
- Kathleen Rodegeb, Supervisory Internal Revenue Agent, Federal State and Local Governments
- Carol Walters, Management and Program Analyst, Federal State and Local Governments
- National Association of State Controllers, Auditors and Treasurers assisted with the distribution of surveys to the States, specifically Kim O'Ryan, Association Director, and Lori Slagle, Finance Manager
- National Government Finance Officers Association assisted in the distribution of the survey to the local governments, specifically Susan Gaffney, Director, Federal Liaison Center

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Appendix A: Internal Controls Survey

ACT INFORMATION SURVEY REQUEST – INTERNAL CONTROLS

Hello NASACT / GFOA members and friends – we, Lisa Pusich (AK), Robert Jaros (CO), and Kathy Sheppard (MA) are members of the Advisory Committee on Tax Exempt and Government Entities of the Internal Revenue Service. We are conducting this survey to gather data on two distinct business topics that government entities manage: the ongoing management of Internal Controls and the handling of IRS Levies. While this is not an IRS survey and no personal information will go to the IRS, the summary results will be very helpful to IRS FSLG (Federal, State, and Local Government) in developing outreach and educational tools and materials.

The survey is meant to be answered by someone that manages/oversees internal controls for your entity. Please feel free to share the survey link with the appropriate person that manages or receives IRS levies. It should take about 15 minutes to respond.

General

1. Name of your entity

2. Type of government (examples: state, county, local, authority)

3. Entity size – Budget FY11 (all fund types – budgeted, capital, federal, trust, fiduciary)

- 3a. < $10,000,000
- 3b. $10,000,000 – < $50,000,000
- 3c. $50,000,000 – < $100,000,000
- 3d. $100,000,000 – < $1,000,000,000
- 3e. $1,000,000,000 or greater

Internal Control Questions

4. Is your department or office responsible for internal control oversight in your governmental entity? Y/N

4a. If not, please identify oversight agency, department, office. (Comment field)

5. Is there an Internal Control Statute in place? Y/N

5a. If so, what year was it enacted? (Comment field)

5b. If not, how are Internal Controls managed? (Comment field)

6. Do you have an Internal Control Policy?

7. Do you have an Internal Control Plan?

7a. If not, are there plans to develop one in the next 12 -18 months?

8. Do you offer training on internal controls?

8a. For your agency? Y/N

8b. For the entity? Y/N

8c. For your business partners? Y/N

9. For those with a robust Internal Control Program (or are striving to have one) can you please list the top 3 benefits this program offers/produces.

10. Has there been any case of fraud identified in your entity in the last 5 years?

10a. If so, can you provide a summary of the event(s) and how uncovered?

Please note: We are <u>not</u> asking for names or dates. The events that have occurred and you share here may offer insights or warning flags to help another entity mitigate a possible future fraud.

11. If a fraud is identified is there a standard notification process?

11a. If yes – to whom?

(i) Federal entity

(ii) State entity

(iii) Other

12. Has there been a risk assessment performed for your entity?

13. Do you have an Internal Auditor or Internal Audit Function in your entity?

14. Do you have a public Hot Line to report Fraud, Waste or Abuse of public resources?

15. The IRS FSLG (Federal, State, Local Governments) may be offering a Webinar on the topic of Fraud Detection and Prevention. How likely is it that you or your staff would participate?

15a. Very likely

15b. Somewhat likely

15c. Unlikely

15d. Not sure

16. Please provide comments on the areas of interest or focus for further IRS webinars.

17. Name(s) of individual completing the survey

I/C name

18. Position/title of individual(s) completing the survey

I/C Email Address

I/C Phone Number

19. What tax reporting issues are foremost on your agenda for the upcoming year?

Possible Issues (not in any order and not limited to): TIN Matching – Electronic Filing – Electronic Form Distribution – Tax Advantage Bond Issuance and Post-Issuance Compliance

Optional respondent information - Add here

(Comment sections can hold up to xxx characters??)

Glossary of Terms:

Fraud – An intentional deception that drains value from the organization. All organizations are subject to fraud risks. Large frauds have led to the downfall of entire organizations, massive investment losses, significant legal costs, incarceration of key individuals, and erosion of confidence in capital markets.

Internal Audit Function – As defined by the Institute of Internal Auditors, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Internal Control – Internal control is broadly defined as a process designed to provide reasonable assurance regarding the achievement of the entity's objectives in the following categories: a) Effectiveness and efficiency of operations; b) Reliability of financial reporting; and c) Compliance with laws and regulations. An organization is a living entity which changes over time. As a result, the organization's mission, goals and objectives must be regularly evaluated and periodically revised. Policies and procedures should be revised to mitigate risk and eliminate redundancy. They must also be communicated internally and externally, as necessary.

Internal Control Plan (ICP) – An internal control plan is a description of how an entity expects to meet its various goals and objectives by using policies and procedures to minimize risk. The plan should be reviewed and updated as conditions warrant, but at least annually. An effective ICP is a high level, entity-wide summarization of risks and controls for all of its business processes and is supported by lower level detail

Internal Control Policies and Procedures – The entity's policies and procedures provide the detail for the internal control plan. It is important that they be reviewed in conjunction with the plan. It is not uncommon for the detailed policies and procedures to be modified due to changes in personnel, audit or quality assurance recommendations, etc. As these modifications occur, the entity's documentation should be updated to reflect them.

Risk Assessment – A risk assessment is a process to identify and analyze factors that may affect the achievement of a goal. In general, risk factors may include the control environment, size of the entity, complexity, change, and results of previous reviews/audits. It is important to remember that not all risks are equal. Some risks are more likely to occur while others will have a greater impact. For example, risks to safety or security of individuals, data or personal information could have significant consequences.

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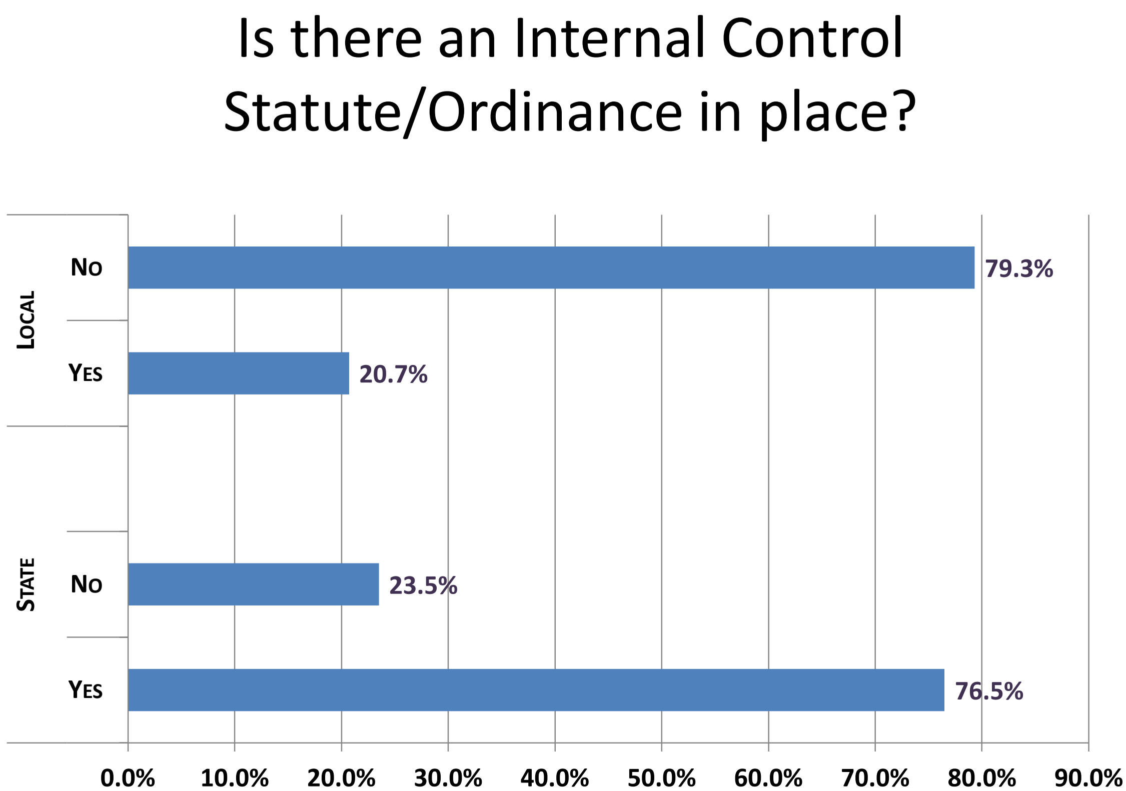
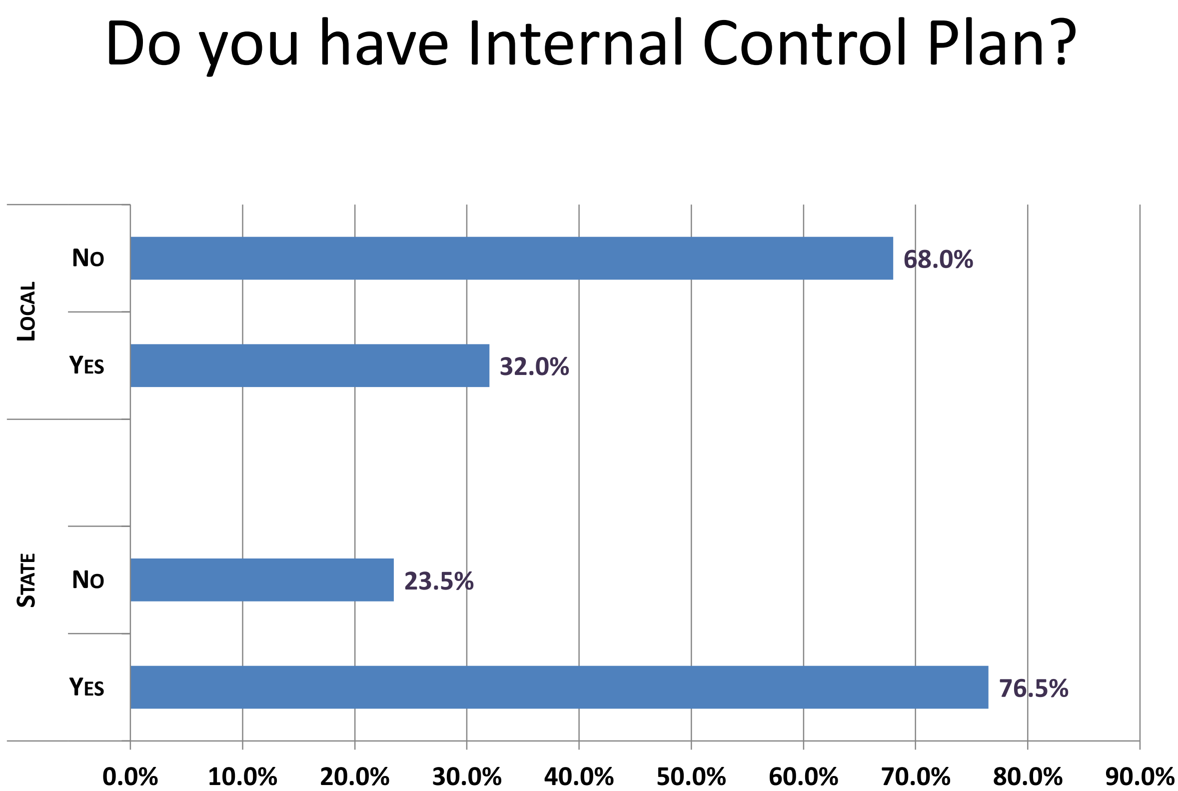
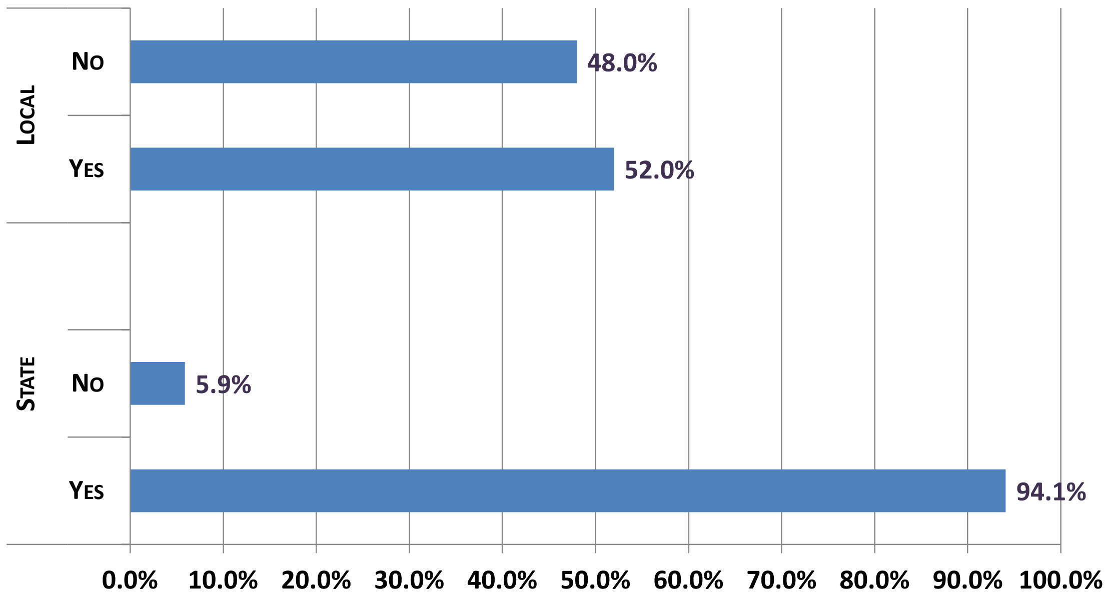
Appendix B: Internal Controls Survey Results

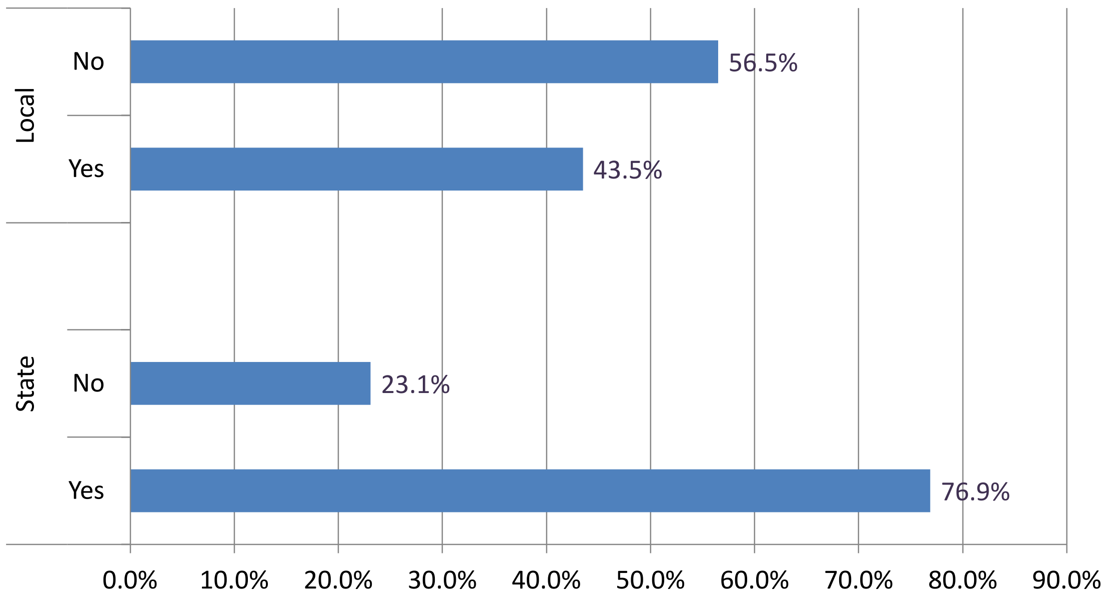


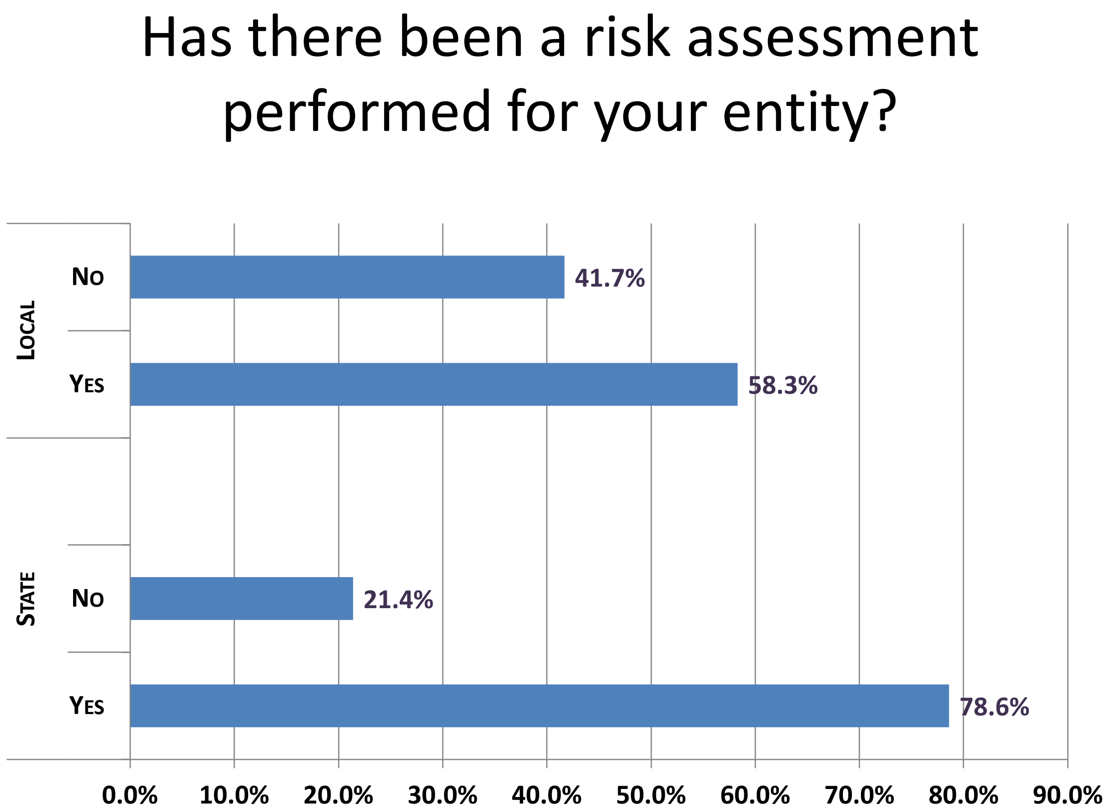

Do you have Internal Control Plan?
LOCAL
NO
68.0%
YES
32.0%
STATE
NO
23.5%
YES
76.5%
0.0%
10.0%
20.0%
30.0%
40.0%
50.0%
60.0%
70.0%
80.0%
90.0%

Do you have an Internal Control Policy?

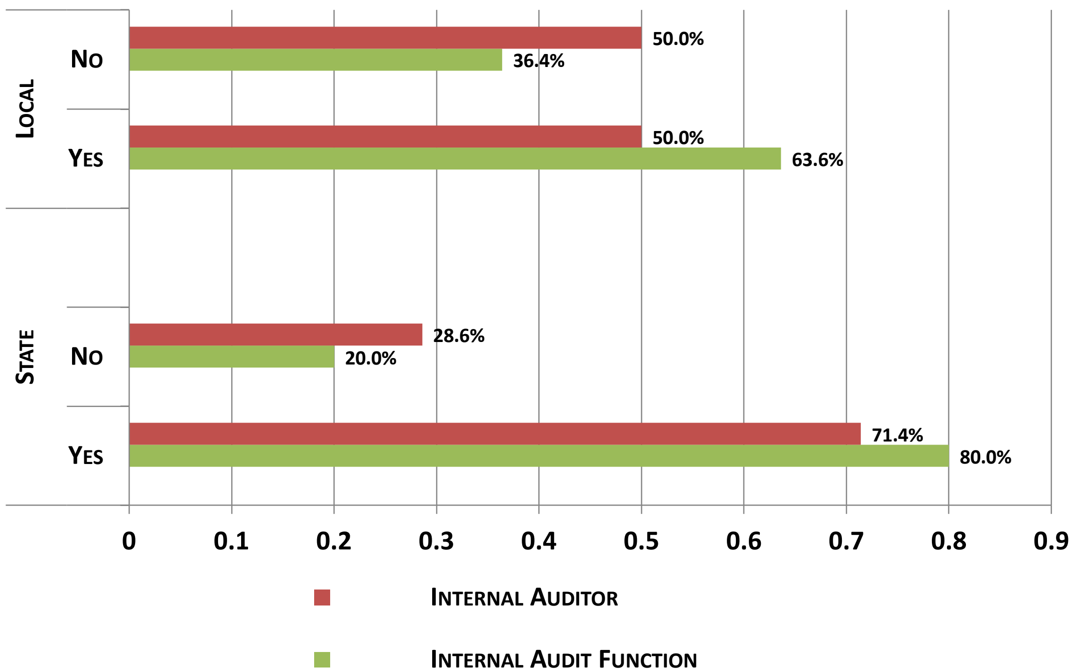


Has there been any case of fraud identified in your entity in the last 5 years?

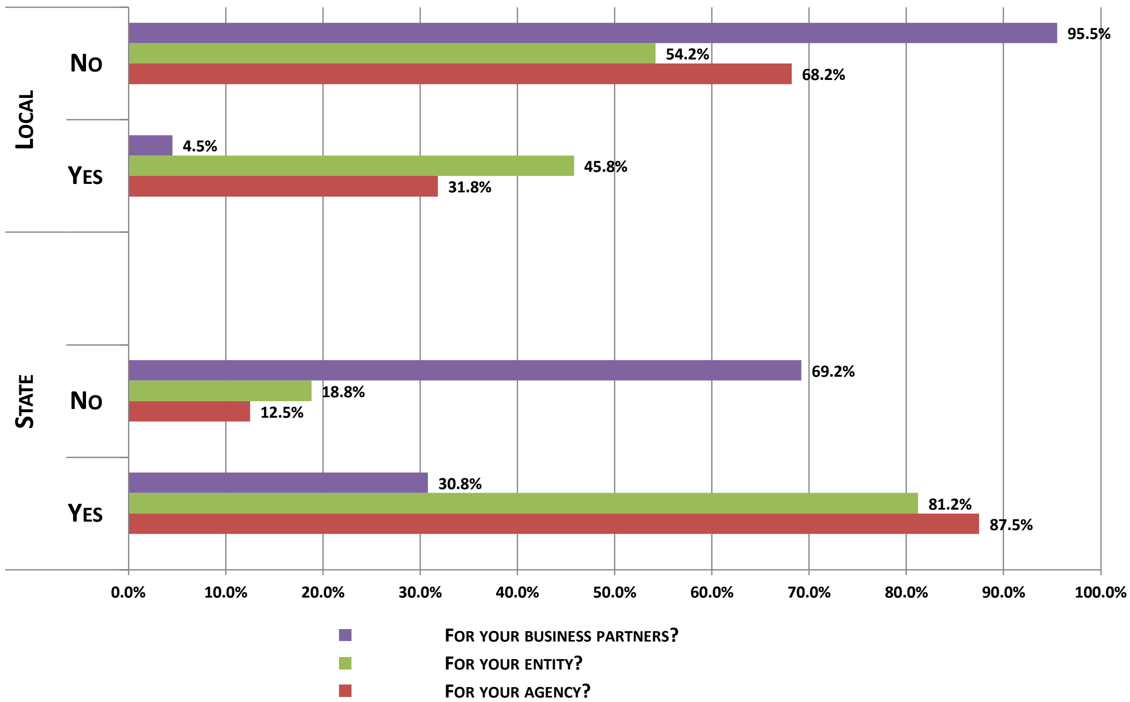



Has there been a risk assessment performed for your entity?
LOCAL
NO
41.7%
YES
58.3%
STATE
NO
21.4%
YES
78.6%
0.0%
10.0%
20.0%
30.0%
40.0%
50.0%
60.0%
70.0%
80.0%
90.0%

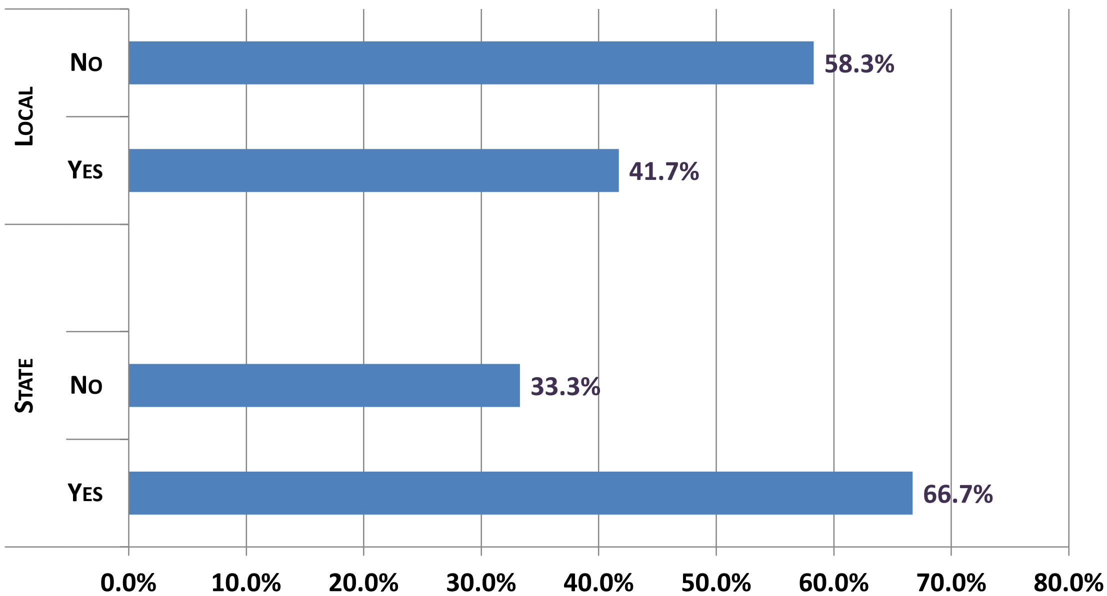
Do you have an Internal Auditor and/or Internal Audit Function in your entity?



Is There Training Offered on Internal Controls?



Do you have a public Hot Line to report Fraud, Waste or Abuse of public resources?



Appendix C: Proposed Suggestions for Fraud Job Aid

Initial Interview Questions to Detect Potential Fraud

SUBCOMMITTEE COMMENT: The IRS should consider having "sub" job aids that focus on specific areas included in the initial interview questions. The Agent could then use these sub job aids to explore further into the area in question.

1. What is the oversight model for your agency, department or commission?
   - If there is board or commission oversight there should be follow-up about its composition and review of meeting schedules and minutes.
2. Has the taxpayer (TP) discovered or suspected any embezzlement or other illegal fiscal schemes being perpetrated by any employees or vendors or elected or appointed officials in the current, prior and/or subsequent years?
3. If the answers to any part of question #1 are yes, what actions, if any, were taken against the individuals or businesses involved?
4. Have any employees been terminated for embezzlement or mismanagement of funds in the year under exam or in either the prior or subsequent years? If so, please provide information.
5. Did any employees suddenly resign or were asked to resign? If so, why.
6. Has the TP undergone any inquiries or investigations by local, state or federal government agencies? If so, please explain and provide any reports relevant to the inquiries or investigations.
7. Is the TP involved in any litigation in the year under audit or in any prior or subsequent year?

SUBCOMMITTEE SUGGESTION: The Subcommittee suggests that the IRS consider presenting the questions in the following order: 7, 10, 8, 6, 11, 5, 4, 2, 3, and 9.

8. What measures and safeguards does the TP implement to prevent fraudulent schemes within the entity?
9. Are there any vendors who are employees or family of employees? If so, please list.

10. Internal Control Evaluation Questions (Sample – not all inclusive)

    - Separation of Duties among personnel in various functions (i.e. Accounts Payable (A/P), Cash Receipts/Disbursements, Bank Reconciliation, Accounts Receivable, Human Resources (hiring), Payroll, etc.).

    - Who requests and approves the vendors, bid process, etc.

    - Credit Card Process (i.e. who is issued credit cards, the approval, review and payment process, etc.)

11. Have Internal and/or External Auditors determined any problem areas? If so, explain. What corrections were made?

Procedures to Identify Potential Fraud

1. Research the government entity (GE) on the internet (website, articles, etc.) and through Accurint and the Federal Audit Clearinghouse (results of audits of entities that receive federal grant monies)

2. Conduct internal research including:

    - Inspect and analyze multiple years' returns

    - Review IRPTR data and analyze information return filings for patterns of non-compliance or inconsistencies

    - Review audit history and results

    - Review timeliness of filing tax and information returns

    - Review timeliness of deposits and payment of balances due

    - Utilize Package Audit Lead Sheet for these steps (WP 33.501)

3. Interview the taxpayer

    - Include questions for detecting potential fraud (see the questions on page 2 to incorporate into the initial interview)

    - Identify parties responsible for initiating and approving transactions, for setting up vendors or making payments, and for reconciliation of book and/or bank records.

4. Evaluate internal controls – be alert for unusual processes, such as re-routing of transactions for approval, for limited secondary review or payment outside the normal manner

5. Request, review and comment on all audit reports, including, but not limited to:

   - Internal and external reports
   - Certified audit reports
   - Compliance audits
   - Internal controls audits
   - State controller audits, etc.
   - Carefully review footnotes for concerns or problems, as well as large, unusual and questionable (LUQ) items in the financial statements themselves.

6. Request and review Taxpayer's books and records, including, but not limited to:

   - Chart of accounts
   - Trial Balance (adjusted and unadjusted)
   - Adjusting and reversing journal entries
   - General ledger
   - Look for LUQs (e.g., cash account(s), miscellaneous expense account, etc.)

7. Examine TP's Accounts Payable records

   - Sample invoices and contracts to verify that vendor exists and that expenses are business related and not personal expenses of employees
   - Ensure that contracts are valid

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Federal, State and Local Governments: Government Levy Processing Improvements

Robert E. Jaros
Lisa M. Pusich
Kathy M. Sheppard

2013

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Table of Contents

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I. Executive Summary

The ACT/FSLG Subcommittee conducted a survey with state and local government entities to identify their administration of Internal Revenue Service levies. In particular we were interested in the volume of levies the IRS administers, whether there is follow-up necessary with the IRS to impose the levy, if the levy form instructions are sufficient, how many different locations within the IRS are involved in the levy process, whether a centralized IRS function would be of assistance, and whether they would be interested in IRS training on this topic.

Under the present practice, after diligent efforts to collect from the taxpayer, local IRS tax offices issue notices of levy to the State and Local Governments (as employer or payer) on individual and/or corporate taxpayers, who are employees and/or vendors of the entity. The government entities offset payroll and vendor payments up to the amount of the IRS levy, and remit the amount to the designated IRS office.

As a result of the survey, the Subcommittee has identified a taxpayer burden to State and Local Governments regarding the present IRS practice of sending and collecting levies. To lessen that burden and hopefully provide some efficiency in the levy process, we propose process improvement opportunities. The IRS should consider:

1) the establishment of a central/designated location, or clearing house, for a governmental entity to remit levy payments, make inquiries or seek clarification on the levy process and release of the levy;

2) an Electronic Fund Transfer method for governmental entities to remit levy; and

3) Improve communication on levies by publishing on the web a collection of frequently asked questions where entities could go to for answers for common questions regarding the implementation of the levy and by conducting webinars on levies.

The Subcommittee believes the recommendations presented provide the IRS with some process improvement opportunities which benefit all involved parties.

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II. Introduction

The Subcommittee is aware that this particular topic is not within the direct control of Federal, State and Local Governments; however, it is under the Service as a whole and does impact governmental entities served by FSLG. Therefore, the Subcommittee thought this topic was worthy of discussion and consideration by the Service. There is room for improvement to lessen the burden on the governmental entity and also streamline and improve processes by the IRS which in the end would be a benefit.

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III. History

Per the IRS web page at IRS.gov, "A levy is a legal seizure of your property to satisfy a tax debt."

The total number of levies issued by the IRS in 2012 and 2011 were 2,961,162 and 3,748,884 respectively.

This information is provided per the 2012 IRS Data Book (http://www.irs.gov/pub/irs-soi/12databk.pdf).

Generally, there are two types of levies that the IRS serves to State and Local Governments. The form 668-A, Notice of Levy, is served on the taxpayer's Vendor/Bank. The form 668-W, Notice of Levy on Salary, Wages and Other Income, is served on the employer. The IRS makes a determination when serving the levy which form (668-A or 668-W) to use based upon the property being levied. Form 668-A is used to levy other property that a third party is holding. For example, this form is used to levy bank accounts and business receivables due and payable to the taxpayer. Form 668-W is used to levy an individual's wages, salary (including fees, bonuses, commissions, and similar items) or other income. Other income is generally income owed the taxpayer as the result of personal services in a work relationship. The IRS issues a form 668-D, Release of Levy/Release of Property from Levy, to release either levy.

There are three levy electronic payment programs:

1. The Federal Payment Levy Program – This program began in July 2000 and allows the collection of overdue taxes through the levy of federal payments from Federal Management System. This is only a program for federal entities to take advantage of and would not include state and local governments to remit levy collections.

2. State Income Tax Levy Program - This program is where an individual state tax refund may be taken to satisfy the IRS levy. Individual states may participate in this program and the SITLP listing is matched against a listing of federal tax delinquent accounts. If there is a match, the state issues a notice to the taxpayer advising of the levy of the taxpayer's individual income tax refund.

3. Social Security Administration Levy - This program is where the IRS Wage and Investment Division set up the levy process with the Social Security Administration for sending the levy payment to the IRS through Electronic Federal Tax Payment System or the Intra-government Payments and Collection System. The IRS sends the Social Security Administration a paper levy and the Social Security Administration sends an electronic payment through EFTPS/IPAC and notifies the debtor of the levy on the

debtor's social security payment. This levy program is not a submission available for state and local governments as it only involves federal entities.

If the governmental entity is not utilizing any of the three levy payment programs described above, the governmental entity would remit levy payments through a manual warrant/check process, and no electronic means of payment is available. This is the payment method that applies to most state and local governments. Since there are multiple IRS payment locations for levy activity, the governmental entities must have multiple vendor records for each payment location to issue a hardcopy payment for the levy activity.

IV. Due Diligence

Payment processing for IRS levies issued by Automated Collection Services campus employees is centralized to some degree at seven separate campus addresses. See a listing of the ACS campuses in Appendix A. An ACS campus employee is typically the first IRS worker assigned an account for levy action. Once the ACS has exhausted all known income resources of the taxpayer, and full collection of the levy amount has been unsuccessful, a Revenue Officer is assigned to the account for additional collection efforts. Nationwide there are currently 5,031 Revenue Officers who issue levies from 431 different IRS posts of duty. Therefore, governmental entities are receiving levies from multiple IRS locations and are required to remit the funds levied to the address of the assigned IRS official. Release of those levies is also controlled by the assigned IRS official.

A form 668-A levy served on the State or Local Government is deemed to be satisfied when the governmental entity surrenders the property to the IRS. For example, if the full amount of the levy is paid, the State or Local Government would no longer have an obligation to the IRS.

The term of a 668-W levy differs depending upon whether it is served on an employer or a vendor. A 668-W levy served on salary and wages per Internal Revenue Code (IRC) section 6331(e) shall be continuous from the date the levy is first made until the date the levy is released per IRC section 6343. The levy also attaches to obligations existing at the time the levy is received for payments owed the taxpayer for payments in the future. Therefore, if this is a levy on an employee's wages, it will remain in place until an official release (form 668-D) is received. For income due a debtor/vendor, the levy will remain effective only for those amounts currently owed the taxpayer at the time the levy is received. However, if a 668-A or 668-W is received to be applied against payments to a vendor, the governmental entity must remit all obligations for payment to the vendor at the point in time received and may apply to future payments, if fixed and determinable, until the levy is satisfied or a release of levy (form 668-D) is received. Obligations are in existence when the liability of the obligor is fixed and determinable, even though the right to receive payment is deferred to a later date, per Treasury Regulation Section 301.6331-1(a)(1). This would include, for example, a right to receive future payments under a trust or contract, provided the right to receive such payments was not contingent upon the performance of future services.

The IRS has some processes in place to allow for bulk levy payments transmissions, but none of these allow for payments directly through EFTPS. These bulk levy payment transmissions include:

1) Federal Payment Levy Program Payments – Levy payments are received from the Treasury Offset Program;

2) State Income Tax Levy Payments – Levy payments received from individuals states on behalf of the taxpayers; and

3) Social Security Administration Levy – Levy payments received from the SSA benefits of taxpayers.

The Subcommittee surveyed state and local governments to obtain additional information regarding the IRS levy process. Contacts at the National Association of State Comptrollers were used to submit the survey to their State Government members. The Association of Governmental Accountants was contacted to submit the survey to their local government members. There were a total of 59 respondents to the survey. See Appendix B for a copy of the survey questions.

Survey Summary:

1. The volume of levies received annually by the entities that responded to the survey varied drastically. There were reported as few as one to as many of 1,100.

2. There were only 17 “no” responses to the question on whether there is a need to have direct communication with the IRS issuing office when a levy is received. The “yes” respondents mentioned that clarification was sought in the following areas:

   a. How should the levy be handled?

   b. If there are multiple levies, what order should they be processed?

   c. Is the levy a one-time levy or a continuing levy?

   d. What is the time period in which the funds should be attributed to the levy?

   e. What is the balance of the levy?

3. There were several respondents that stated the instructions were not sufficient to accurately apply the levy. Many of the same questions in item 2 above were mentioned in the responses.

4. The number of IRS locations that the state and local governments are dealing with in the administration of the levy range from two to eleven.

5. When asked whether it would be beneficial to remit levy payments to a single location, 100 percent of those responded “yes.”

See Appendix C for Survey Results.

V. Recommendations

1. Centralization of levy activity for a governmental entity should be considered.

The survey asked the respondents whether they thought it would be beneficial to remit all levy payments to a single location. All of the state and local governments that responded to the survey stated, yes. A central levy depository should be established by the IRS. This would simplify the payment process as all levies would go to one address. This would reduce the number of vendor record files maintained by the governmental entity.

Creation of a central levy hotline in which specific questions regarding the levy could be asked and answered would also be beneficial. The survey asked whether the instructions associated with the particular levy were sufficient to accurately apply the levy. States and Local governments responded no in 30 percent and 12 percent respectively. Therefore, there is a lack of understanding of the instructions to apply a levy. In addition, this levy hotline or some type of on-line inquiry system could provide information regarding the remaining unsatisfied balance of a particular levy.

A central point of contact for levy release would be beneficial to governments. There have been instances when a governmental entity received a release of levy, but subsequently, the IRS agent identified on the original levy called to inquire why no further levy payments had been received. The governmental entity informed the agent that a release of levy had been received. The agent informed the governmental entity that they are the only agent allowed to release that particular levy. Perhaps if the government had a central contact for all levies and the release of the levy this type of mix up would not occur.

2. Electronic Payment

Many organizations have initiatives moving towards an electronic means for payments and receipts for reasons of efficiency. In addition, the IRS EFTPS system over the years has also increased their mandate the use of electronic submissions of tax payments. The electronic payment initiatives are very prevalent and will likely continue to be a process improvement for governmental entities.

The IRS should consider the use of EFTPS or another electronic portal for the electronic payment of levies by governmental entities. This would result in the IRS receiving the levy funds in a more timely manner, and provides the governmental entity some confirmation of receipt of payment for their records.

Allowing payment by electronic means would also remove the requirement to mail personal information on a separate document or the check stub, including the individual name and tax identification number of the garnished individual/entity. This would further protect against identify theft.

3. Communication Improvements

a. Frequently Asked Questions

IRS should provide a repository of FAQs on the levies and how the levies should be implemented by specific type. In addition, how the levy should be imposed when the vendor has a continuing contract with the entity should be explained.

Levy instructions should be expanded upon to explain in more detail how the levy should be put into place and the duration of the levy. This should also be explained as regards an employee levy versus a vendor levy. In addition, situations where the IRS has worked with the taxpayer to come up with an installment payment plan, the implementation of that plan, whether it is based upon each payment made or a monthly payment amount, should be clearly explained. It should be clear to the governmental entity receiving the levy on whether it is a one-time levy or a continuing levy.

b. Increase Educational Outreach to Governmental Entities

The IRS should consider additional educational outreach on how to apply levies for employees and vendors. The Subcommittee concluded that the majority of the information available on the IRS web page at IRS.gov regarding levies is directed at the individual whose wages/property is being levied by the IRS and not necessarily directed at the governmental entity that will be imposing that levy upon their employees or vendors.

Webinar training or Computer Based Training available on the internet IRS page could be provided. Many respondents to the survey were interested in additional outreach and training on this topic.

VI. Conclusion

The Subcommittee believes the recommendations identified above would be beneficial to the governmental entities and to the IRS as a whole. Having a web page with FAQs available would be a cost saver for governments and the service by eliminating the need to answer individual inquiries directly. The governments could go to go this location and see if their question has already been addressed. This would also ensure consistency in the answers provided and certainly save the IRS time in addressing questions as calls/inquiries are received. Both entities (governments and the IRS) could benefit from a centralized processing format. Governments will be able to have one contact location for those unique questions and one location to go for balance verification and release information. Allowing electronic payments in the submission of levy activity would speed up the receipt funds within the IRS and also the governments would have immediate confirmation of receipt for their records. Educational outreach to governments is always beneficial to ensure proper compliance and consistency in the information provided. Consideration to implement the changes is greatly appreciated.

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VII. Special Thanks

- Phyllis A Burnside, Group Manager, Compliance and Program Management
- Paul Marmolejo, Director Federal State and Local Governments
- Laura Hostelly, Program Manager, Field Operations, Reviews, and Enforcement
- Jim Maslanka, Senior Program Analyst, Field Operations, Reviews and Enforcement
- Scott Olsen, Department of Assistance Bureau Director, Office of the Comptroller of the Commonwealth of Massachusetts
- National Association of State Controllers, Auditors and Treasurers assisted with the distribution of surveys to the States, specifically Kim O'Ryan, Association Director, and Lori Slagle, Finance Manager
- National Government Finance Officers Association assisted in the distribution of the survey to the local governments, specifically Susan Gaffney, Director, Federal Liaison Center

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Appendix A. ACS Campus Locations

Service Center Addresses for Collection Operations

BOD	Service Center	Address
SBSE	**Brookhaven BSC-01** CT (06), MA (04), ME (01), NH (02), NY (11, 13, 14, 16), RI (05), VT (03)	P.O. Box 480, Stop 660 Holtsville, NY 11742-0480
SBSE	**Memphis MSC-03** AL (92), AR (71), GA (58), IA (42), IL (36, 37), IN (35), KS (48), KY (61), LA (72), MI (38), MN (41), MO (43), MS (64), ND (45), NE (47), NJ (22), OH (31, 34), OK (73), PA (23, 25), SD (46), TN (62), TX (74, 75, 76), WI (39), WV (55)	P.O. Box 69, Stop 811 Memphis, TN 38101-0069
SBSE	**Ogden OSC-04** AK (92), AZ (86), CA (33, 68, 77, 94, 95), CO (84), HI (99), ID (82), MT (81), NM (85), NV (88), OR (93), UT (87), WA (91), WY (83)	P.O. Box 9941, Stop 5500 Ogden, UT 84409
SBSE	**Philadelphia PSC-05** DC (78), DE (51), FL (59, 65), MD (52), NC (56), SC (57), VA (54), Puerto Rico (66) and International (98)	CSCO Stop 4-N31.142 Philadelphia, PA 19255-0030
W&I	**Andover ANSC-08** AK (92), AZ (86), CO (84), CT (06), DC (78), DE (51), HI (99), ID (82), IL (36, 37), MA (04), MD (52), ME (01), MT (81), ND (45), NH (02), NJ (22), NM (85), NV (88), OR (93), RI (05), SD (46), TN (62), UT (87), VT (03), WA (91), WI (39), WY (83)	310 Lowell Street Stop 830 Andover, MA 01810
W&I	**Atlanta ATSC-07** AL (63), FL (59 ,65), GA (58), KY (61), LA (72), MS (64), NC (56), SC (57), TX (74, 75, 76), VA (54)	PO Box 47421, Stop 74 Doraville, GA 30362
W&I	**Kansas City KCSC-09** AR (71), CA (33, 68, 77, 94, 95), IA (42), IN (35), KS (48), MI (38), MN (41), MO (43), NE (47), NY (11,13,14,16), OH (31, 34), OK (73), PA (23, 25), WV (55)	Stop P-4 5000 P.O. Box 219236 Kansas City, MO 64121-9236

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Appendix B. Survey Questions

LEVY QUESTIONS (59 Responded to survey)

1) How many levy requests from the IRS do you receive, on average, in a year? (Include all levies received including levies for employees and for vendors) - *Open-Ended Response*

2) When a levy is received, is there a need to have direct communications with the IRS issuing office?(No – 17)
   If you answered Yes. Can you provide comments as to the type of information or instruction you sought through this contact (please do not include any taxpayer specifics) - *Open-Ended Response*

3) Are the instructions associated with the particular levy sufficient to accurately apply the levy?
   If no, please describe where additional clarity is needed. Include the form number of the levy and provide some examples where additional instructions are needed. - *Open-Ended Response*

4) Do you routinely remit to multiple IRS locations?
   If yes, how many different IRS locations are you dealing with? - *Open-Ended Response*

5) Would it be beneficial to remit all levy payments to a single location?
   If possible, for follow-up discussion, Please provide contacts for levy processing through employee payroll as well as vendor payments. - *Open-Ended Response*

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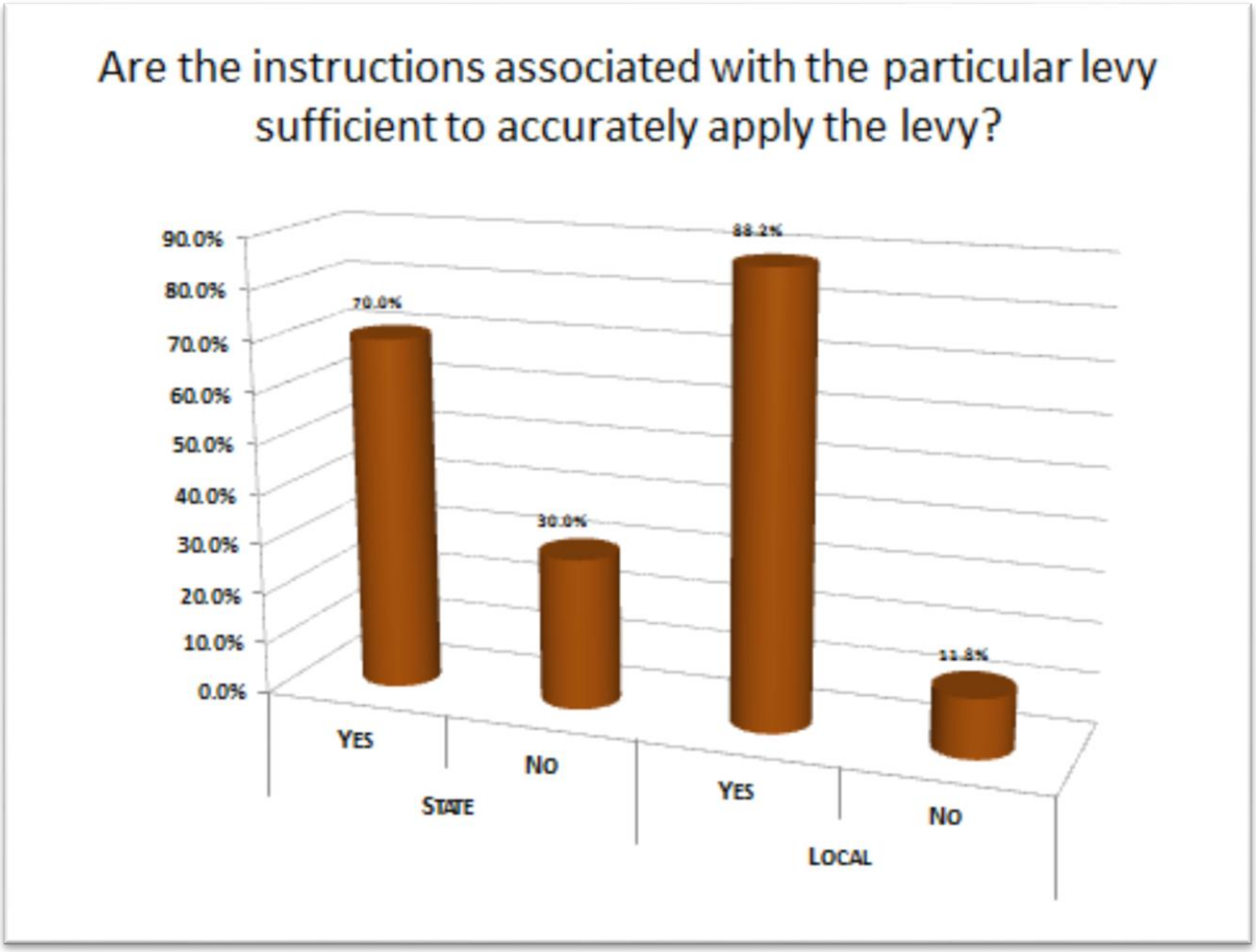
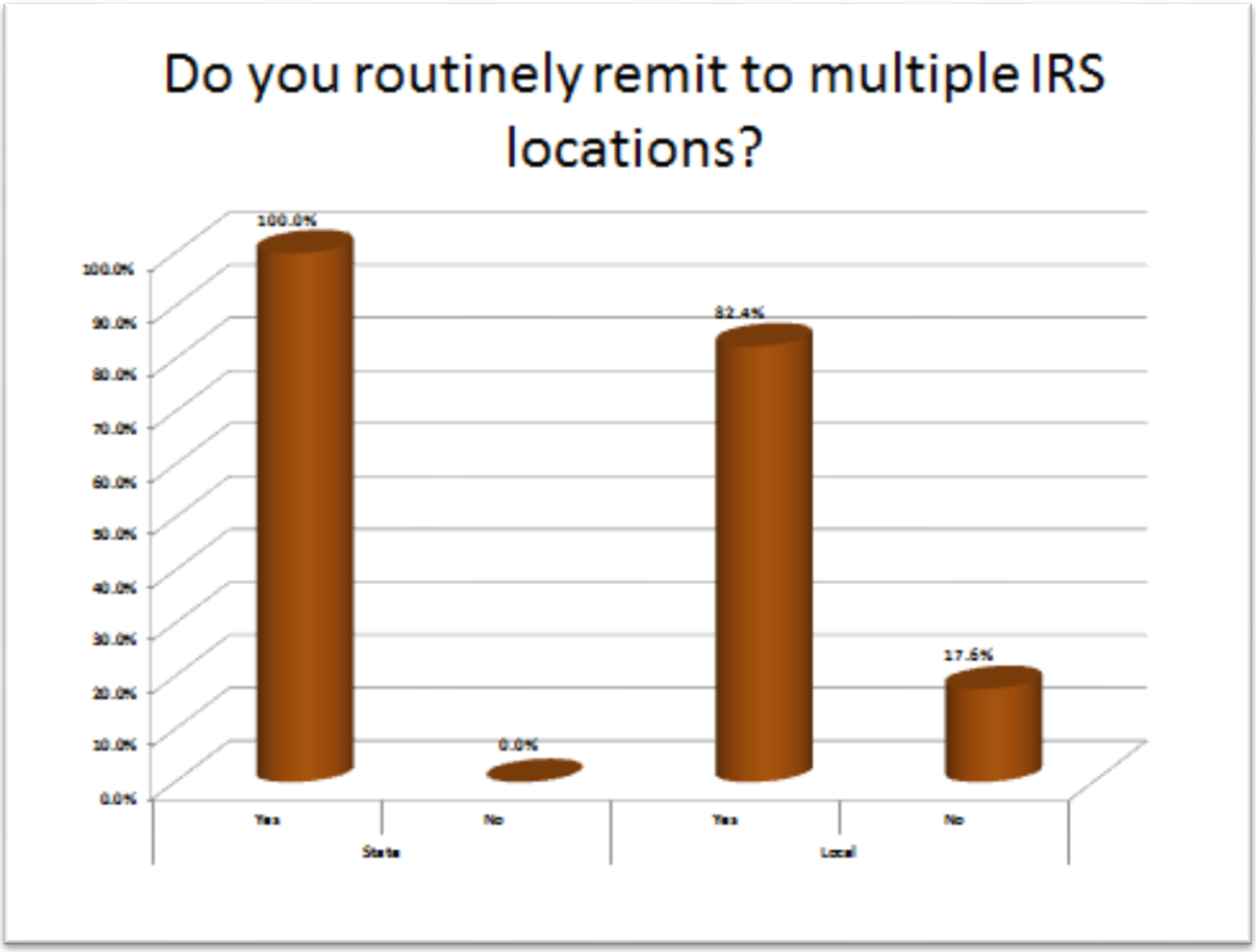
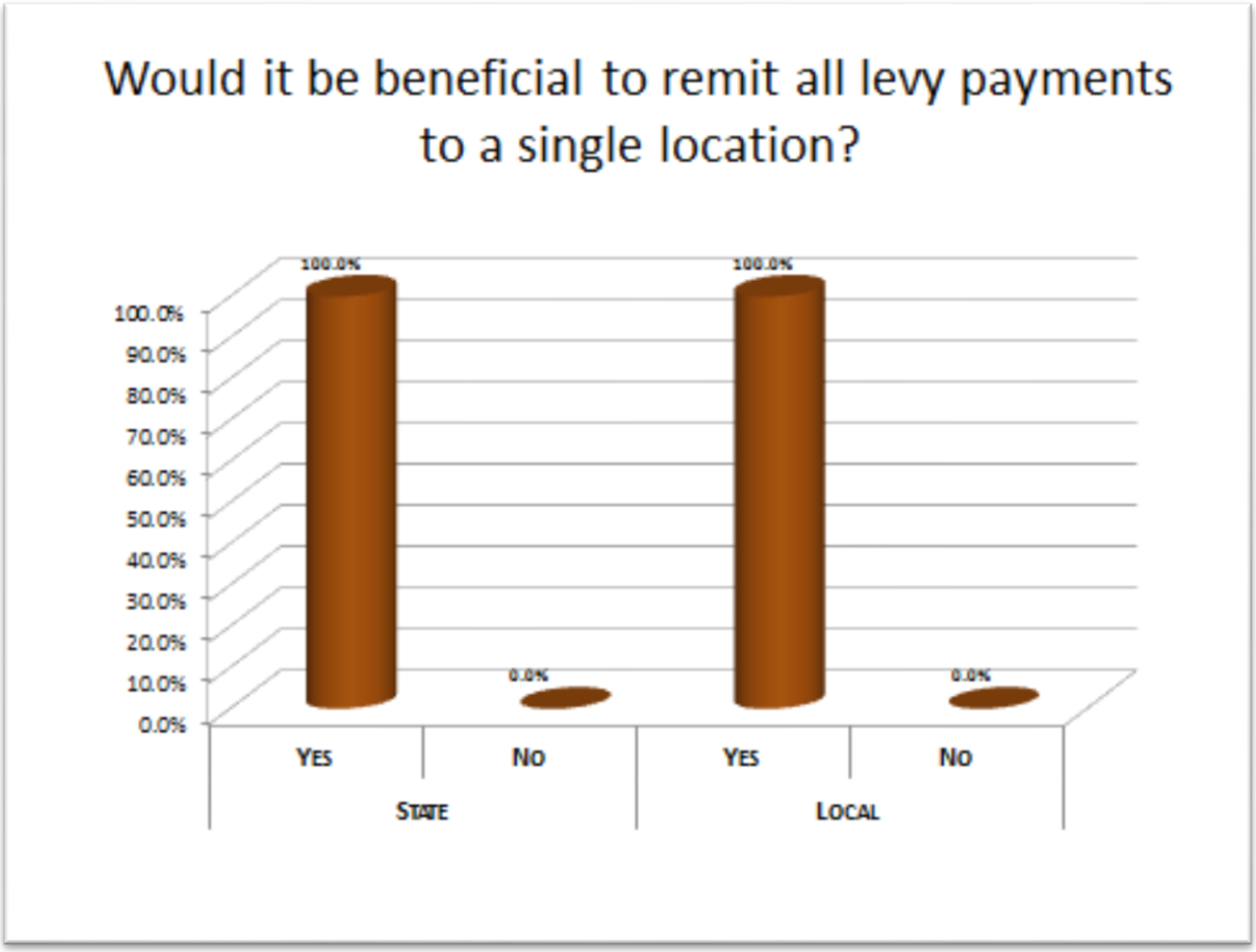
Appendix C. Survey Results




Do you routinely remit to multiple IRS locations?
100.0%
82.4%
17.6%
0.0%
Yes
No
Yes
No
State
Local


Would it be beneficial to remit all levy payments to a single location?
100.0%
0.0%
100.0%
0.0%
100.0%
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
YES
NO
YES
NO
STATE
LOCAL

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

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

Holly Easterling
Diane Gange
Will Micklin

2013

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Table of Contents

I. Executive Summary

There is a sound policy and tax administration basis for either expanding the existing general welfare doctrine as it applies to tribes, or developing a discrete administrative exemption applicable only to tribal governments and their members. The United States has made a commitment to protect tribes as separate sovereigns. One expression of that commitment is the federal decisional rule that federal laws should not be interpreted to invade upon a tribe's internal affairs. Federal supremacy does not apply to Indian tribes.[1] Accordingly, administration of the general welfare exclusion with respect to tribal programs should acknowledge a tribe's role and authority to determine what is necessary for the general welfare of its members. Any guidance under the general welfare exclusion must be designed to be consistent with federal law and policy and must reflect the sovereign status of tribes, the federal trust relationship, and the federal policy of self-determination.

The General Welfare Exclusion (GWE) continues to be an important issue in Indian Country. Indian Tribal governments are sovereign governments with inherent responsibilities to their citizens. It has always been a Tribal tradition and cultural practice to care for their citizens and to provide for their general welfare. Tribal government programs and services exist to address the needs of tribal communities without creating an ancillary tax burden for the recipient who received the service or benefit.

With the release of proposed guidance in December of 2012, in response to tribes' request for clarity and consistency on the GWE's application to Indian tribal government programs, the ACT felt compelled to address the Notice in the following ways:

- Discuss the need for a general welfare exclusion based on tribal community need determined by Indian tribal governments that is rooted in tribal sovereignty and the federal trust responsibility;
- Provide assistance to tribes in structuring their tribal programs and services to meet the exclusion based on the proposed revenue ruling as described in Notice 2012-75;
- Recommend actions by the Service and Department of Treasury.

[1] Robert Clinton, There Is No Federal Supremacy Clause for Indian Tribes, Arizona State Law Journal, 2002, at 235-252.

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II. Introduction

This ACT Report is an extension of the ACT 2012 Report that addressed the controversy between tribes and the Internal Revenue Service (IRS) involving GWE policy that determines the taxation of payments or benefits provided by tribal governments to their tribal citizens as either an exclusion from gross income or taxable income. Tribes have disputed the criteria used by the IRS to determine the cognizable general welfare need and asserted broader definition of need uniquely applicable to tribes and tribal citizens, which is informed by the federal trust responsibility and federal self-determination policy.

The controversy arises not as part of an IRS initiative to seek out non-compliance, but commonly in the context of informational exams of tribes by IRS Indian Tribal Government (ITG) field agents. The exams, however, often easily become burdensome requests for production of tribal records that tax the resources of a tribe. The lack of clear GWE policy guidelines that speak to its application to tribes and tribal citizens, and the lack of IRS ITG training for its field agents that results in varying determinations from tribe to tribe and region to region, adds to the controversy. The ACT 2012 Report made recommendations to clarify the imprecise administrative rule of exclusion.

The 2012 ACT Report advances recommendations for a tribal government determined "General Welfare Doctrine" (GWD) which provides that payments made by an Indian tribal government under its legislatively provided social benefit program for promotion of tribal citizens' general welfare are excludable from gross income.

The 2012 ACT Report further recommends a broader definition of a cognizable need determined by a tribal GWD is needed due to unique cultural and economic needs of tribes.

The 2012 ACT Report addressed the further complication that the administrative exemption under the General Welfare Doctrine has evolved largely from rulings related to benefits provided by state and local governments to their citizens. This Report examines the paradigms established in federal Indian policy that primarily balance the interests of federal and state governments in reaching decisions on disputes involving Indian tribes rather than examining tribes' inherent sovereignty and the federal trust responsibility to tribes. The Report asserts the relationship of state governments to its citizens does not provide a meaningful or instructive model in determining the relationship of a tribal government to its tribal citizens and whether tribal programs serve the "general welfare" of tribal citizens uniquely characterized as tribal "community need" and, as such, are exempt from taxation.

The ACT Report examines the tribal trust assets (land, resources, and certain tribal funds) communally held, which favor any distribution of derived proceeds to tribal citizens to be excluded from taxation pursuant to common law precedent and doctrines, and according to the federal trust responsibility to preserve and protect the trust asset from diminishment, such as from taxation. The ACT Report examines the federal trust responsibility that is also meant to preserve and protect trust assets, and is also intended to preserve and protect Indian culture and tradition. The ACT Report describes the harm arising from the inappropriate and inconsistent application of the GWE policy upon the traditions, customs and practices of Indian tribes.

The ongoing controversy compelled the IRS to publish a notice of a proposed GWE guidance[2] as safe harbor provisions for a modified GWE policy, with comments from tribes due on June 3, 2013. The ACT Report describes the concern of tribes that the application of the IRS proposed GWE guidance to tribal programs lacks clarity, consistency and certainty, and the absence of any deference to Indian tribal governments in the policy.

The ACT Report is meant to advance the further modification of the IRS proposed GWE policy, to improve its administration by the IRS ITG, and to promote the consultation between the IRS and tribes. The ACT Report does not purport to represent the divergent views and interests among the 566 federally recognized tribes. The ACT report cannot reasonably present all of the possible concerns about or solutions to the controversy. The ACT report will do the following:

A. Present a statement of the GWE policy;
B. Present a brief history of the GWE policy and it's administration in Indian Country;
C. Describe proposed GWE guidelines;
D. Examine a GWE exclusion based on Indian tribal governments definition of tribal community need;
E. Examine the application of the proposed GWE guidance;
F. Propose best practices for tribal compliance with GWE guidance; and
G. Make recommendations with the following key provisions:
    1. Deference to an Indian tribal government determination of a tribal GWD;
    2. Deference to an Indian tribal government's GWD determination of tribal community need;
    3. Modify the definition of payment for services to exclude ceremonial activities and non-business assistance;
    4. Standards for rebuttable presumption for an Indian tribal government's GWD determinations of exclusion from income;
    5. Voluntary compliance, safe harbor and rebuttable presumption as a part of the Service's GWE guidelines.
    6. Develop a definition of reasonably calculated instead of lavish or extravagant that is appropriate for Indian tribes, and standards for implementation;
    7. Establishment of a Department of Treasury STAC;

[2] Notice 2012–75, page 715. Application of general welfare exclusion to Indian tribal government programs.

8. Revisions to improve the safe harbor provisions of the IRS proposed GWE guidelines;
9. More and improved training of IRS ITG field specialists; and
10. Collaboration to develop best practices.

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III. The Indian Tribal Government Role in Establishment of a Tribal General Welfare Doctrine, the Determination of a Tribal Community Need, and the Government-to-Government Relationship

A. History of the Tribal General Welfare Exclusion

The GWE is an administrative rule of exclusion that provides that payments made by federal, state, local and Indian tribal governments under a legislatively provided social benefit program for promotion of the general welfare are excludable from gross income. For several years, a growing focus of IRS audits of tribal governments involved whether benefits provided by Indian tribes to their members were excludable under this doctrine or subject to tax as gross income. Because the administrative exemption evolved largely from rulings related to benefits provided by state and local governments to their citizens, tribal governments felt that IRS interpretations of tribal general welfare programs, in meeting the exclusion, failed to recognize the unique relationship between tribes and their citizens. Indian tribes are neither states, nor part of the federal government, nor subdivisions of either. Tribal governments have a very different relationship and role with respect to tribal citizens than state and local governments have to their citizens. Because tribal property (land, resources, and certain tribal funds) is held communally, decisions about allocation of resources are vested in the tribe's government. And, historically, the tribe's government is meant to ensure that the resources of the tribe are preserved for the members, that culture and tradition is maintained and fostered, and that the individual needs of the members are met from these resources.

In response to tribes' request for clarity on the scope of the application of the GWD, on November 2011, IRS announced a broad-based consultation with Tribal leaders on the issue and called for written comments from tribes on their benefits programs, particularly in the areas of education, housing, cultural and elders. Treasury and IRS hosted various meetings and general consultations and two Congressional hearings focused on this topic. Many tribes and tribal organization submitted comments.

The 2012 ACT report of the Indian Tribal Government Committee presented tribal perspective on the lack of clarity of the General Welfare Doctrine, presented a survey of the comments received in response to Notice 2011-94 and provided a sampling of tribal programs and services that serve the general welfare of the tribal citizens and tribal communities. Among other recommendations of the report, the first was that a process be developed which would permit tribes to take affirmative steps to structure their general welfare programs through an IRS voluntary compliance program implementing the safe-harbor guidelines that also establishes a rebuttable presumption of Indian tribal government compliance and shifts the burden of proof to the IRS to prove the particular tribal program has not met the general welfare exclusion guidelines.

A proposed revenue procedure was issued on December 5th, 2012, providing Safe Harbor provisions for certain tribal programs.

B. The Proposed Guidance

On December 5, 2012, the IRS issued Notice 2012-75, a proposed revenue procedure that "clarifies" how the general welfare exclusion applies to tribal government programs. In doing so, the IRS first re-stated the general doctrine and its three-part test that is still generally applicable to all forms of government assistance. Under the three part-test, a general welfare payment is excludable if: (1) the payment is made by a governmental unit or entity or pursuant to a government program; (2) the payment is made for the general welfare (i.e., on the basis of individual or family need, and not every citizen regardless of need); and (3) the payment does not represent compensation for services.

In addition to reiterating the traditional doctrine, Notice 2012-75 offers Indian Tribal Governments a safe harbor with respect to over 20 different types of social programs (specified in the notice and discussed in later sections of this report) under which IRS will presume that the program is administered on the basis of need, and meets the second requirement, even though it is made available equally to every tribal member. Safe harbor, in the context of this guidance, means that if the conditions under the guidance are met, payments made under the program will be excluded from taxation and no information reporting will be required related to those payments. Under Notice 2012-75, these specified programs include educational assistance of various types, housing assistance in several forms, a wide spectrum of elder programs, medical assistance, including nonprescription drug subsidies and travel subsidies, and cultural programs. In order to qualify for the safe harbor, however, the tribe's program would have to meet six procedural requirements, including the promulgation by the tribe of written eligibility guidelines, the content of which could be determined by the tribe so long as all members are treated equally and there is no discrimination in favor of members of the tribe's governing body.

The IRS solicited tribal comments on this proposed guidance over an extended period of time that will end on June 3, 2013. Submissions were not available for review and inclusion in this report at the time of writing, however, members of the ACT ITG were able to solicit feedback from a variety of avenues and have included some of these comments and concerns in Section VI of this report.

C. A GWE Based on an Indian Tribal Government Definition of Tribal Community Need

The Advisory Committee on Tax Exempt and Government Entities (ACT) 2012 Report[3] recommended modification of the IRS GWE policy as applied to Indians. The ACT 2012 Report recommended the IRS (1) "develop an administrative tax exemption that takes into account the unique circumstances of tribes and their sovereign authority over internal affairs, while at the same time promoting effective tax administration"[4] and (2) accept a tribe's determination of "general welfare" for payments made or benefits provided pursuant to a legislatively provided social benefit program intended for the promotion of general welfare complies with the need basis for exclusion from income for the individual tribal citizen.[5]

The IRS GWE policy provides for an administrative exemption evolved largely from rulings related to benefits provided by state and local governments. There exist few rulings specific to the application of the GWE tribal citizens and none to tribal authority GWE determinations. IRS rulings in the form of Private Letter Rulings or Technical Advice Memoranda are non-precedential and technically cannot be relied upon by any other taxpayer or tribe. A lack of training for IRS field agents has resulted in inconsistent GWE determinations. While some auditors have required a showing of individual financial need to support a GWE, published rulings on state/local government programs do not require a showing of individual financial need to support a GWE (see, e.g., Rev. Rul. 57-102; TAM 200035007), while some IRS Indian Tribal Government (ITG) field agents have required such a showing.[6]

The IRS and issued Notice 2011-94 on November 15, 2011, to invite comments describing actual or proposed Indian tribal government programs that provide GWE eligible benefits to members and the tribes' views on application of the exclusion to these programs and benefits.

In December 2012, the IRS published a notice of proposed GWE guidelines[7] for a revenue procedure that would provide safe harbors under section 61 of the Code for applying the general welfare exclusion to Indian tribal government programs. The proposed GWE guidelines do not contemplate deference to the role of a tribal government's legislative act to establish a tribal general welfare doctrine that determines a cultural or community basis for need as a broader definition of cognizable need unique to tribal governments and their tribal citizens. Existing IRS rulings support a broader interpretation of need not limited to an expression of individual, financial need. See, e.g., Rev. Rul. 57-102; TAM 200035007 (financial need is

[3] Pearson, Micklin and Easterling, ACT ITG, Indian Tribal Governments: Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members, 2012.
[4] Id, at 26.
[5] Id, at 43.
[6] Wendy S. Pearson, TREASURY'S COMMENT PROJECT ON THE GENERAL WELFARE DOCTRINE OF TAX EXEMPTION, http://www.wspearson.com/includes/pdf/TaxTribalWelfarePymtGWDApril12.pdf
[7] Notice 2012–75, page 715. Application of general welfare exclusion to Indian tribal government programs.

not the measure). IRS rulings also show a community may be a legitimate beneficiary of social benefit programs without a showing of individual need. See, *e.g.,* Rev. Rul. 76-373.[8]

Instead, the proposed GWE guidelines rely solely upon the individual need definition of Internal Revenue Code (Code) Section 61, which provides that, except as otherwise provided by law, gross income means all income from whatever source derived, and tribal income not otherwise exempt is includable in the gross income of the Indian tribal citizen when distributed or constructively received by them. Rev. Rul. 67-284.[9] The proposed GWE guidelines offers safe harbor exceptions beyond low income determinations, however, these are in line with the non-tribal development of the GWE[10] and do not address inherent tribal government authority over internal relations and cultural distinctions. Failure to do so perpetuates the cultural and economic harm arising from the imposition of individual need as the sole basis for GWE determinations.

Tribal leaders have expressed deep dissatisfaction with existing IRS GWE policy.[11] Tribal leaders' concerns with the proposed GWE guidelines are not due to the IRS until June 3, 2013, which is too late for consideration by the ACT in this Report. ACT representatives interaction with tribal leaders and taxation and law professionals engaged by them, although anecdotal, has helped to inform this Report, and has confirmed our analyses and conclusions.

Accordingly, and notwithstanding the fact that the proposed GWE guidelines offer significant additional exceptions without income tests as safe harbor protections in GWE determinations for tribal citizens, the ACT concludes the IRS should acknowledge the role of tribal governments as limited inherent sovereigns with the authority to legislatively determine a general welfare standard for their tribal citizens. Further, the IRS should accept a tribally determined community need as the need basis in GWE determinations. Tribal leaders recognize, as does the ACT, IRS deference to tribal governments in this matter is (1) a bedrock principle that tribes govern their internal relations, and addressing community need is at its heart, and (2) if not reformed, GWE policy strikes at the heart of tribal culture and economy.

1. <u>Tribal General Welfare Doctrine Determination of Community Need</u>. The Act recommends the IRS modify its GWE proposed guidelines to include a tribal government's payments or benefits provided to its tribal citizens as a community need if provided through a tribal general welfare doctrine and defined therein as a cognizable general welfare need, and that is not provided as pay for services outside of a non-business or cultural activity.

The limitation of IRS GWE policy to individual means testing significantly harms tribal culture and tradition. Justifications for need sufficient for exclusion under GWE policy should

[8] 1976-2 C.B. 16.
[9] 1967-2 C.B. 55.
[10] ACT 2012 Report, p. 5-13.
[11] Id, p. 22-24.

include individual issues such as financial, health, education, and employment status, but also community characteristics such as high unemployment rates, lack of access to capital or disproportionate poverty levels. Need is cultural, such as programs that restore, protect, promote and extend tribal cultural heritage. Programs that supplement or supplant federal funding or work towards the same goals of federal policy (even in the absence of federal funding) should qualify. Payments or benefits received pursuant to cultural programs should not constitute compensation for services when governmental assistance is tied to community service or job training programs.[12] Payments made to individuals within the context of cultural ceremonies, or for the reasonable costs of assistance when provided by another, who is not in the business of providing such assistance, should not constitute compensation for services.

Community need rather than individual need should be the primary focus of tribal GWD programs. The IRS GWE policy should defer to each tribal government's GWD policy, including the standard for community need and implementing programs. Community need defined by a tribal GWD is the exercise of tribal self-determination, and as such should be construed broadly to protect tribal culture and traditions, the internal tribal economy and role of traditional tribal leaders in satisfying community need.

Individual means testing is destructive to tribal culture and values, and is contrary to federal Indian policy of tribal self-determination and limited inherent tribal sovereignty that reserves unto tribes only the regulation of tribal affairs.

Accordingly, IRS modifications to the GWE policy must be broad to protect tribal community priorities and must give substantial deference to the discretion of tribal governments and their legislative policy making process in the development and implementation of a tribal GWD.

The ACT's recommendation for IRS deference to limited inherent tribal government authority to allow for a tribe to promulgate a tribal general welfare doctrine is based upon the history of federal Indian policies and doctrines established by common law precedents applicable to GWE policy. The policies, and the doctrines of implied exemption, instrumentality, and tribal sovereignty are herein examined in preparation for a discussion of federal taxation of tribal citizens and a concluding discussion of the harm the IRS GWE policy has caused to tribal social, cultural and economic values and opportunity.

2. <u>Federal Indian Policies</u>. Tribes' economic and political dependency on the federal government occurred as a result of transactions whereby tribes conveyed, by treaty or by sword, their ancestral lands, its resources, and their friendship to the federal government, who became their trustee through the exchange. The federal trustee responded by often re-trading the deal, sometimes rescinding the bargain, and, almost without exception, defaulting on the

[12] Pearson, at 1.

terms and conditions of the agreement, while exercising dominion over their trust beneficiaries through mostly failed federal Indian policies. One example is the Northwest Ordinance of 1787[13], which provided that "[t]he utmost good faith shall always be observed towards the Indians [and] their land and property shall never be taken from them without their consent …"; however, northwest Indian tribes today hold a fraction of their lands promised to them forever in 1787.

The first federal Indian policy era was the sovereign-to-sovereign period (1776-1820s). The second was removal (1830s-1880s). The third was the reservation period (1880s-1930s). The fourth was assimilation and allotment (1880s-1930s). The fifth was the Indian New Deal (1930s-1940s). The sixth was termination (1950s-1970). The seventh policy era, the tribal self-determination period, began in 1970 and has continued to the present day.

Federal Indian policy during the reservation period reserved or established Indian lands in remote areas, with few opportunities to influence events that controlled tribal destinies or to establish economies external to tribal lands. Tribes had little to no opportunity to inform the rules that governed them, and instead were left to regulate their social and internal relations[14] through inherent sovereignty that pre-dated the U.S. Constitution.[15]

The well-documented consequence of such policies is that a majority of tribal citizens today suffer from abject poverty and compare unfavorably to all ethnicities and their demographics in the United States. The 2010 centennial U.S. Census shows the median income of American Indian and Alaska Native households was $35,062. This compares with $50,046 for the nation as a whole. The percent of American Indians and Alaska Natives that were in poverty in 2010 is 28.4 percent. For the nation as a whole, the corresponding rate was 15.3 percent.[16]

The federal trustee's responsibility, deriving from the imposition of limitations on tribes' inherent sovereignty and their corresponding dependency on the United States for protection,[17] compels the IRS to respect the retained sovereignty and the tribal culture in the promulgation of polices and rulings effecting tribes and tribal citizens. Accordingly, the imposition of any tax policy, including the GWE, must consider its effect on the federal policies that implement the trust responsibility if contradiction of these federal policies is to be avoided. Inherent tribal sovereignty is not so limited as to preclude IRS deference to tribal governments and their establishment of a tribal general welfare doctrine and a standard for community. The IRS notice of proposed GWE guidelines is an important step, and complies with the current federal Indian policy requirement for tribal consultation as implemented by Executive Order

[13] Ordinance of 1787: The Northwest Territorial Government (July 13, 1787), printed in Organic Laws of the United States, Vol. 1 U.S.C. xxv, at xxxvii (1964).
[14] U.S. v. Wheeler, 98 S.Ct. 1079, 55 L.Ed.2nd 303, 435 U.S. 313.
[15] Talton v. Mayes, 163 U.S. 376 (1896).
[16] 2010 American Community Survey for the American Indian and Alaska Native alone population, US Census 2010.
[17] American Indian Law Deskbook, University Press of Colorado, 1993.

13175, *Consultation and Coordination with Indian Tribal Governments*. However, to stand within the modern federal Indian policy of self-determination, the IRS should defer to tribal government GWD's and accept a tribal community need standard. The ACT recommends consideration of several common law doctrines as examples of similar determinations that led to similar decisions, and assist in a showing that the IRS is not precluded from deference to tribal government GWE determinations. These doctrines and foundational rulings were not decided on GWE cases or facts. Nevertheless, they constitute example and instruction for modification of GWE policy within the boundaries of modern federal Indian policy.

3. Implied Exemption Doctrine. The IRS acceptance of a tribal government determined GWD for tribal community need should be viewed as an implied exemption derived from acts, treaties, the federal trust responsibility, and tribal policies.

The foundational example of implied exemption is in *Squire v. Capoeman*[18] wherein the U.S. Supreme Court decision turned on the Indian land's protected status in holding that the proceeds from a sale of standing timber growing on trust land allotted to Indians pursuant to the General Allotment Act[19] were not subject to federal income taxation. The Court relied on the Act's purpose of preserving value for the landowners.[20] "It is unreasonable to infer that, in enacting the income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would, in the words of the court below, be "at the least, a sorry breach of faith with these Indians."[21]

The *Big Eagle v. United States*[22] decision also turns on implied exemption from tax by finding immunity from direct taxation is indicative of the congressional goal to provide Indians a protected economic base and that trust income earned from exempt land was exempt from federal taxation because Congress' purpose was "to protect the property so that it will adequately serve the needs of the ward and finally bring him to a state of competency and independence. This chance is encouraged, if not guaranteed, by tax exemption."[23]

Consider that payments or benefits provided by an Indian tribal government to its tribal citizen is funded from a tribe's trust resources. Tribal government resources represent the undivided trust assets of any tribe owned by all tribal citizens. To tax their proceeds when provided through a tribal general welfare program decreases the value of that which is intended to be a protected economic base exempt from taxation.

[18] 351 U.S. 1 (1956).
[19] 25 U.S.C. §§ 331 et seq. (1964).
[20] Richard L. Perez, Indian Taxation: Underlying Policies and Present Problems, 59 Cal. L. Rev. 1261 (1971).
[21] 351 U.S. at 10.
[22] 300 F.2d 765 (Ct. Cl. 1966).
[23] ld. at 771-72.

In *Shepard v. United States,*[24] the court ruled, "the government's fiduciary undertaking to its Indian wards, set out in treaties, statutes, and case law, is remembered."[25]

4. Instrumentality Doctrine. In declaring, "the power of taxing [a federal instrumentality] by the states may be exercised so as to destroy it,"[26] Justice Marshall founded the instrumentality doctrine protecting against the taxation, and potential control of one government's functions by another.[27]

The subsequent court decisions held taxes that directly interfere with governmental functions are illegal if the imposition of a pure financial burden on the federal government or its agent is generally too remote an interference with the governmental policy to be invalid.[28]

In narrowing the instrumentality doctrine[29], the courts decided the federal government's intention is to have a particular activity performed, and the governmental policy does *not* depend on the enterprise making a profit. "There is ordinarily no need to protect federal policy by invalidating such a tax because the courts can prevent a destructive effect when the situation arises…In cases involving Indian interests, however, fundamentally different ground rules apply. The purpose of the federal policy *is* profitability of the enterprise, and the measure of the federal policy's success is the degree of economic improvement in the Indian's position. Thus, a tax directly interferes with the central policy goal."[30]

While court decisions in *Thomas v. Gay* (1898)[31] and *Oklahoma Tax Commission v. Texas Co., 1* (1949)[32] failed to recognize the unique nature of Indian cases in the area of the instrumentality doctrine, in 1961 the Supreme Court returned to the special instrumentality doctrine issues involved when dealing with federal functions whose success depends upon *profitability,* as distinguished from those projects only collaterally interested in financial considerations in deciding *Federal Land Bank v. Board of County Commissioners.*[33]

The instrumentality doctrine as an implied exemption from tax is appropriate for Federal Indian policy because success of the tribal economy depends upon the maximum profitability and maximum value to the tribe and its tribal citizens. "Providing economic aid to Indians is

[24] 162 F. Supp. 313 (E.D. Wis. 1958).
[25] 162 F. Supp. at 315.
[26] McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 427 (1819).
[27] See McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 429-35 (1819). See also sources cited note 63 infra.
[28] See, e.g., Taber v. Indian Terr. llluminating Co., 300 U.S. 1, 3-4 (1936).
[29] Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939).
[30] Perez, p. 1276.
[31] 169 U.S. 264 (1898),
[32] 336 U.S. 342 (1949).
[33] 368 U.S. 146 (1961). See also Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95 (1941), in which the Court held that Congress could exempt a purchase by the Federal Land Bank from a state sales tax. In response to the state's argument that Congress could immunize only the bank's activities as a depository and fiscal agent of the federal government, and not the lending function or activities incidental thereto, the Court said that the bank also performed a governmental function by providing low-interest loans. Since the bank's ability to provide low-interest loans depended on minimization of costs, Congress was constitutionally authorized to immunize the bank from state taxation. Id. at 102-03.

also a governmental function; in fact, it is uniquely governmental, as has been recognized by those courts that have discussed the United States obligations to the American Indian."[34]

If held to the instrumentality doctrine, the IRS could echo Justice Holmes' answer to Justice Marshall, "The power to tax is not the power to destroy while this Court sits," by its accepting that a tax on a tribal citizen's general welfare benefits should not stand due to its destructive effects on tribal culture and economy. Tribal leaders in IRS GWE listening sessions have testified to the harm caused by IRS GWE determinations on tribes and tribal citizens, which tribal leaders will emphasize in their written comments in response to the proposed GWE guidelines notice due by June 3, 2013. This Report also addresses this harm in the section entitled, "Harm from Existing IRS GWE Policy." However, entering into a discussion of harm, this Report will continue its development of doctrine and taxation issues.

5. Tribal Sovereignty Doctrine. In *McCulloch v. Maryland*[35] Justice Marshall declared the power to tax an attribute of sovereignty. In the case Daniel Webster argued that, "An unlimited power to tax involves, necessarily, a power to destroy."[36] In the IRS imposition of its GWE policy, it is the tribal sovereign that is subject to such destruction. The tribal sovereign doctrine by its application protects against an incautious and potentially ruinous GWE policy, and is sufficient reason for IRS deference to tribal government GWD policy and community need standards.

Court rulings informing the tribal sovereignty doctrine has been uneven in the years between the Marshall trilogy and today. In the "Marshall trilogy," the Supreme Court established the doctrinal basis for interpreting federal Indian law and defining tribal sovereignty:

a. *Johnson v. McIntosh* (21 U.S. 543 (1823)): the tribes' power to dispose of their land required Congressional consent.
b. *Cherokee Nation v. Georgia* (30 U.S. 1 (1831)): Indian tribes were merely "domestic dependent nations" existing "in a state of pupilage, and their relation to the United States resembles that of a ward to his guardian."
c. *Worcester v. Georgia* (31 U.S. 515 (1832)): the states are excluded from exercising their regulatory or taxing jurisdiction in Indian country.

The Marshall trilogy developed three bedrock principles: (1) by virtue of aboriginal political and territorial status, Indian tribes possessed certain incidents of preexisting sovereignty; (2) such sovereignty was subject to diminution or elimination by the United States, but not by

[34] Perez, p. 1279.
[35] 17 U.S. (4 Wheat.) 316, 428-29 (1819).
[36] 17 U.S. 327

the individual states; and (3) the tribes' limited inherent sovereignty and their corresponding dependency on the United States for protection imposed on the latter a trust responsibility.[37]

Two anchor points stand between the original Constitutional tribal federal policy and modern federal tribal policy, which are foundational US Supreme Court decisions in Indian law. The latter is Justice Hugo Black's decision in *Williams v. Lee*[38] as a foundational case in support of the Indian sovereignty doctrine and inherent tribal sovereignty that reasserted the principles of the former foundational decision, *Worcester v. Georgia* (1832).[39] The Indian sovereignty doctrine presumes tribes possess inherent sovereignty over their lands and citizens unless Congress acted to reverse the attributes of that sovereignty by legislation or by treaty.[40] [41]

In *Johnson v. M'Intosh* (1823)[42], the Court recognized Indian tribes as separate sovereigns with inherent sovereignty but concluded that this sovereignty was diminished as a result of European discovery of the land.[43] The Court later came to describe Indian nations as "domestic dependent nations," comparing the relationship between tribes and the federal government to the relationship between a ward and its guardian.[44]

Cherokee Nation v. Georgia (1831)[45] has formed a basis for the ideas that Congress has broad power to legislate on behalf of tribes and the Court has little power to review Congress's acts so long as they are rationally tied to Congress's obligation towards Indians. See, e.g., *Washington v. Confederated Bands & Tribes of the Yakima Indian Nation*[46], finding statute creating checkerboard state and tribal jurisdiction on reservation constitutional because it is rationally tied to the interest of protecting Indians.

Despite some limitations placed on the Indian sovereignty doctrine by the U.S. Supreme Court that limited inherent tribal sovereignty[47], in 1941 Felix Cohen's "The Handbook of Federal Indian Law" (1941)[48] re-affirmed the Indian sovereignty doctrine[49] and was applied in *Williams v. Lee*.[50]

37 American Indian Law Deskbook, University Press of Colorado, 1993.
38 358 U.S. 217 (1959).
39 31 U.S. (6 Pet.) 515 (1832).
40 Dewi Ioan Ball, Williams v. Lee (1959) – 50 Years Later, Michigan State Law Review, Vol. 2010:391, p. 391.
41 Williams v. Lee, 358 U.S. 217, 223 (1959).
42 21 U.S. (8 Wheat.) 543 (1823).
43 Id. at 587; see also Cherokee Nation v. Georgia, 30 U.S. (5 Pet.) 1, 17–18 (1831) (affirming divestiture of Indian tribes' sovereign rights to convey lands and enter into treaties with foreign nations).
44 See id., 30 U.S. at 17.
45 30 U.S. 1 (1831)
46 439 U.S. 535 (1974)
47 Johnson v. M'Intosh, 21 U.S. (8 Wheat.) 543 (1823); Cherokee Nation v. Georgia, 30 U.S. (5 Pet.) 1 (1831); Worcester v. Georgia, 31 U.S. (6 Pet.) at 515; aka, the Marshall trilogy.
48 Felix S. Cohen, Handbook of Federal Indian Law (1941) 123.
49 Ball, p. 393.
50 Williams, 358 U.S. at 219 n. 4, 223.

The principles of *Worcester v. Georgia* in 1832 were the foundation for the *Williams v. Lee* decision in 1959, which affirmed territorial sovereignty and prohibit state law in the reservations even if the states' interests were important.[51] These seminal decisions, 127 years apart, should inform the IRS that its GWE policy should respect and, therefore, defer to a tribal government GWD policy based upon tribal community need rather than individual need or income suited to non-tribal individuals.

The ACT 2012 Report described in some detail tribes cultural emphasis on community, the cultural values expressed in giving to support the community need, and the cultural role of relations and tribal leaders integral to assessing and satisfying the community need. The practices are fundamental to a tribe's culture as well as to its traditional internal economy. The cultural and economic attributes are inseparable from each other in practice, and are fundamentally incompatible with non-tribal culture that emphasizes the individual. Accordingly, the application of individual need-based GWE standards to tribal practices based on community need is ill conceived and unsuitable, and can only result in harm to the tribal culture, economy and Indian tribal government.

In *Williams v. Lee* the court supported "the right of reservation Indians to make their own laws and be ruled by them."[52] This decision was based on the presumption that tribes had inherent sovereignty over the lands and people in the reservation unless Congress acted to reverse the attributes of that sovereignty by legislation or by treaty.[53] The ruling is a predecessor decision to the tribal self-determination era [Worcester] in building a bridge to carry tribal policy from [Worcester] over the gulf of the termination era to the modern era of federal Indian law.[54] The termination era meant "full assimilation and termination of the special legal status of tribes."[55] *Worcester v. Georgia* and *Williams v. Lee* meant "continued respect for the ability of Indian peoples to govern themselves."[56]

David H. Getches argued wrote that "[i]n its bellwether Williams decision, the Court vindicated tribal sovereignty in a modern context" and "confirmed the modern Court's adherence to foundation principles"[57] of federal Indian law. Charles F. Wilkinson wrote that the Williams case as the one that "opened the modern era of federal Indian law."[58] The decision served to settle unsettled law and foreshadowed the self-determination period of federal Indian policy.

[51] Canby, supra note 12, at 243-44.
[52] 358 U.S. 217, 220 (1959) at 220.
[53] 358 U.S. 217, 223 (1959).
[54] Id.
[55] Id.
[56] Id.
[57] David H. Getches, Conquering the Cultural Frontier: The New Subjectivism of the Supreme Court in Indian Law, 84 CALIF. L. REV. 1573, 1589 (1996).
[58] Charles F. Wilkinson, American Indians, Time, and the Law 1 (1987).

The instruction of *Williams v. Lee* for the purposes of the GWE policy discussion is in its application to the sovereignty doctrine. The court held in favor of the tribal sovereignty doctrine wherein "state courts have no jurisdiction over a civil action involving an Indian on a reservation unless Congress so authorizes,"[59] overturning the rationale used by the Arizona Supreme Court (the lower court), which ruled that states had jurisdiction in the reservation unless federal authority existed to prohibit state law.[60]

The IRS GWE policy that does not allow for a tribal government GWD policy or a tribal community need standard is analogous to the lower court rationale in *Williams v. Lee*, in that unless Congress affirmatively acts to expressly deny IRS jurisdiction over tribal GWD policies and tribal citizens, then the IRS possesses such jurisdiction sufficient to determine a tribal citizen is eligible for a GWE exception only as an individual based upon IRS determinations of individual need. The ACT recommends the IRS accept that a tribal citizen's eligibility for a GWE exemption from tax should be determined on the basis of a tribal community need as determined by their culture and a tribal GWD policy adopted by a tribe unless and until the Congress affirmatively acts to expressly deny this inherent right of a tribal sovereign to regulate its internal relations. The tribal sovereignty doctrine and the modern federal Indian policy of tribal self-determination speak against the IRS's argument that all tribal citizens are indistinguishable from non-tribal individuals who are subject to a tax on all income regardless of source unless an express exemption from tax is acquired or a low income test is satisfied.

By the principles of the Williams decision, known as the 'infringement test' by the Williams Court, tribes retain sovereignty in the reservation until either Congress took it away or it was proved that state authority did not infringe on tribal government and only then would state authority be applicable inside the reservation.[61] "[T]his test precludes state interference with tribal self-government no matter how important the state's interest may be."[62] Philip P. Frickey wrote that the tribal sovereignty doctrine "could be dislodged only by agreement or statute, not by judicial decision."[63] Hugo Black wrote that "[i]f this power is to be taken away from them, it is for Congress to do it."[64]

Dewai Ball wrote[65] that, "This line of thinking adopted by the Supreme Court Justices linked in with the general assessment of the powers of the tribe undertaken by Felix S. Cohen in 1941. In an attempt to reconcile the development of Supreme Court case law and divergent Federal Government policies from 1832, Cohen, in a seminal passage of his work, defined the powers of the tribe as:

[59] Warren Papers, Certiorari to Supreme Court of Ariz., supra note 27, at 2.
[60] Ball, p. 396.
[61] Williams v. Lee, at 220.
[62] Canby, supra note 12, at 243-44.
[63] Frickey, supra note 15, at 29.
[64] Williams, 358 U.S. at 223.
[65] Ball, p. 402-403.

> [T]he whole course of judicial decision on the nature of Indian tribal powers is marked by adherence to three fundamental principles: (1) An Indian tribe possesses, in the first instance, all the powers of any sovereign state. (2) Conquest renders the tribe subject to the legislative power of the United States and, in substance, terminates the external powers of sovereignty of the tribe, e.g., its power to enter into treaties with foreign nations, but does not by itself affect the internal sovereignty of the tribe, i.e., its powers of local self-government. (3) These powers are subject to qualification by treaties and by express legislation of Congress, but, save as thus expressly qualified, full powers of internal sovereignty are vested in the Indian tribes and in their duly constituted organs of government.[66]

"Therefore, the tribes had authority, power and sovereignty, termed inherent sovereignty, over all lands and people within the reservation unless authority was explicitly withdrawn, divested or annulled by a clear and plain act of Congress or by treaty.[67] In addition, Cohen's definition of tribal powers was a reminder to the United States government and the United States Supreme Court that the tribes had always had inherent sovereignty over lands and people within those lands. Moreover, the Williams Court ruled that tribal authority was concomitant with territorial sovereignty."[68]

The tribal sovereignty doctrine was again revitalized in 2013 with the enactment of the Violence Against Women Reauthorization Act (VAWA) of 2013 as Pub.L. 113-4 on March 7, 2013. VAWA expands the modern tribal jurisdiction doctrine to tribal court jurisdiction over non-Indian individuals who are consensual residents of a tribe's territory. VAWA advances tribal sovereignty in the modern self-determination era of federal Indian policy.

The ACT recommends the IRS carefully consider the Tribal leaders comments from 2011[69] to the present that have vehemently opposed IRS GWE jurisdiction and supported IRS deference for tribal government authority to develop and implement a tribal GWD policy and tribal community need standard. Tribal culture will allow no other course for tribal leaders than to unquestioningly seek IRS deference to tribal government determinations of tribal community need under a tribally determined GWD.

Invitation is clearly made by tribal leaders to the IRS to participate in the modern federal Indian policy of self-determination and acknowledge the tribal sovereignty doctrine in its application of a modified GWE policy.

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[66] Cohen, supra note 10, at 123.
[67] See id.
[68] See Williams, 358 U.S. at 223.
[69] ACT 2012 Report, p. 22-24.

Also as to the later discussion of harm, Bethany Berger's history[70] of *Williams v. Lee* is illustrative of the Indian policy debate between Indians and non-Indians over the General Welfare Doctrine as a struggle over Indian sovereignty and jurisdiction, and the resulting collateral damage to Indian people and their culture, which is addressed later in this section.

6. Federal Taxation of Tribal Citizens. Internal Revenue Code (Code) Section 61 provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Tribal income not otherwise exempt is includable in the gross income of the Indian tribal citizen when distributed or constructively received by them. Rev. Rul. 67-284.[71]

Justification for the exercise of federal power of taxation over Indian tribes is most often premised on the Duro opinion[72], while forgetting *Elk v. Wilkins*[73], and its reliance on Indian citizenship effected through the Indian Citizenship Act of 1924.[74] However, granting American citizenship to Indians as individuals does not diminish the sovereignty of Indian tribes as Indian tribal governments nor does it diminish the relationship of tribal citizens to their Indian tribal government. The Constitution's Indian Commerce Clause recognizes tribal sovereignty,[75] which is clearly expressed in the Crow Dog decision[76] in its holding that the treaty was protection of the Sioux Nation rather instead of a promise to supply federal governance for Lakota Indians as individuals. Clearly, the grant of citizenship to individual tribal citizens of Indian tribes does not affect the separate sovereign status of Indian tribes.[77] "Just as the United States cannot unilaterally co-opt the sovereignty of Canada by granting American cit-

[70] Bethany Berger, Williams v. Lee and the Debate over Indian Equality, Michigan Law Review, Vol 109: 1463, June 2011, p. 1463.
[71] 1967-2 C.B. 55.
[72] Duro v. Reina, 495 U.S. 676 (1990).
[73] 112 U.S. 94 (1884). Indians were not part of the American people at the time the U.S. Constitution was drafted or when the 14th Amendment definition of citizenship was adopted.
[74] Indian Citizenship Act of 1924, ch. 233, 43 Stat. 253 (1924) (codified at 8 U.S.C. § 1401(b)): (b) a person born in the United States to a member of an Indian, Eskimo, Aleutian, or other aboriginal tribe: Provided, That the granting of citizenship under this subsection shall not in any manner impair or otherwise affect the right of such person to tribal or other property. In a recent article, Professor Robert Porter has questioned the constitutionality of the Indian Citizenship Act of 1924. Robert B. Porter, The Demise of the Ongwehoweh and the Rise of the Native Americans: Redressing the Genocidal Act of Forcing American Citizenship Upon Indigenous Peoples, 15 HARV. BLACK LETTER L.J. 107, 135–38 (1999) (focusing on the lack of Indian consent). Significantly, although the Indian Citizenship Act of 1924 conferred United States citizenship, it did not confer state citizenship. Since the Supreme Court held in Elk v. Wilkins, 112 U.S. 94 (1884), that the citizenship clause of the Fourteenth Amendment did not apply to Indians, there is perhaps no justifiable explanation for treating tribal Indians as citizens of a state. Frank Pommersheim, Coyote Paradox: Some Indian Law Reflections from the Edge of the Prairie, 31 ARIZ. ST. L.J. 439, 472–73 (1999). The citizenship statutes, themselves, continue to draw a distinction between natural born citizens, and Indians born in the United States whose citizenship depends on naturalization. Compare 8 U.S.C. § 1401(a) (2000), with § 1401(b) (2000). Perhaps federal Indian law distinctions are more understandable if one assumes that Indians are citizens of the United States and their tribes, while state citizens are citizens of United States and their states. This distinction would go far to explain to the American public why state law does not apply to Indians in Indian country. Nevertheless, a series of cases, commencing with post-World War II voting rights cases, simply assumed that Indians were citizens of the states in which they reside, often citing the Fourteenth Amendment without noting the Elk v. Wilkins holding. E.g., Harrison v. Laveen, 196 P.2d 456, 458 (Ariz. 1948); Goodluck v. Apache County, 417 F. Supp. 13, 15 (D. Ariz. 1975); Acosta v. San Diego County, 272 P.2d 92, 97 (Cal. Ct. App. 1954). These cases went far toward blurring the citizenship and, ultimately, jurisdictional boundaries that had been part of the original baseline understanding of the tribal relationship. Nevertheless, since federal policy has involved states in aggressively providing certain services to Indians, such as public educational services, denying Indians state citizenship on the basis of the limited grant of the Citizenship Act of 1924 would have the unfortunate result of denying Indians the right to vote for important municipal and school board authorities who are responsible for providing them important governmental services. Denial of state citizenship also would affect the ability of parties to invoke the federal diversity of citizenship jurisdiction set forth in 28 U.S.C. § 1332 where tribal Indians constitute parties to the litigation.
[75] U.S. CONST. art. I, § 8; U.S. CONST. art. I, § 2.
[76] Ex parte Crow Dog, 109 U.S. 556 (1883).
[77] Clinton, at 249.

izenship to Canadian citizens, so the involuntary grant of United States citizenship to Indians did not justify any enlargement of federal sovereign powers of the Indian tribes.[78]

For individual Indians, there are some specific exceptions to taxation. Specific statutory exclusions as express exemptions from taxation for individual Indians include income from the exercise of fishing rights[79] and receipt of per capita distributions of certain funds held in trust by the Office of Special Trustee (BIA).[80] A common law exclusion applies to income of an Indian allottee derived directly from his/her trust land.[81] Specific types of income are exempt by treaty.

The conclusion that individual Indians may be subject to federal income taxes is premised upon the broad language imposing the federal income tax on individuals,[82] which tax is applied to all income from whatever source it may be derived, unless specifically exempted by law.[83] A Congressional Research Service Report[84] declares an individual's status as an Indian or his status as a tribal member alone has no bearing on whether the individual's income is subject to federal taxation[85] absent a statute or treaty provision evincing a clear intent from Congress to exempt.[86] In *Choteau v. Burnet Osage* mineral royalties were subject to federal income tax based on the language of the Osage Allotment Act.[87] The Court noted that the legislation of the allotment era was sufficient to show the intent of Congress was to gradually impose both the privileges and responsibilities of property on non-competent Indians.

The federal tax status of Indian-related income is determined according to whether Congress intended to include such income within the broad provisions of the Internal Revenue Code.[88] Congressional intent is often deemed controlling because neither the principle that taxes that frustrate federal policy are invalid nor the tribal-sovereignty principle deny the United States the power to tax Indian-related income.[89]

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[78] Clinton, at 251.
[79] 26 U.S.C. § 7873
[80] 25 U.S.C. §§ 1401-1408.
[81] Squire v. Capoeman, 351 U.S. 1 (1956).
[82] I.R.C. § 1 (tax imposed on all individuals, trusts, and estates).
[83] Id. § 61 ("[...]gross income is all income from whatever source derived[...]").
[84] Yule Kim, CRS Report for Congress, Federal Income Taxation of Indian Tribes and Members, October 26, 2007, Order Code RL34220.
[85] Choteau v. Burnet, 283 U.S. 691, 694 (1931). See alsoRev. Rul. 67-284, 1967-2 C.B. 55.
[86] Superintendent of Five Civilized Tribes v. Comm'r, 295 U.S. 418, 420 (1935). See also Squire v. Capoeman, 351 U.S. 1, 6 (1956) (reaffirming the proposition that Indians are citizens and, when in the ordinary affairs of life not governed by treaties or remedial legislation, are subject to federal taxation like other citizens unless an exemption to the tax laws is "clearly expressed" by Congress); Rev. Rul. 67-284, 1967-2 C.B. 55.
[87] 34 Stat. 539.
[88] INT. R.Ev. CooB OF 1954, § 61. For cases construing income statutes in Indian-related cases, see Superintendent of Five Civilized Tribes v. Commissioner, 295 U.S. 418 (1935) (income from investment of funds earned from use of restricted land subject to federal income tax); Choteau v. Burnet, 283 U.S. 691 (1931) (royalty income from oil and gas lease subject to federal income tax); Shepard v. United States, 162 F. Supp. 313 (E.D. Wis. 1958) (basis of property for federal income tax purposes is the fair market value on the date of termination of the exemption).
[89] Congress is not prohibited from imposing a tax that might damage another of its policies, and Congress has the right to govern Indians. Thomas v. Gay, 169 U.S. 264, 274 (1898).

However, as discussed in the instrumentality doctrine section above, the decision of *Thomas v. Gay* (1898)[90], reasoning that persisted through *Oklahoma Tax Commission v. Texas Co., 1* (1949)[91], and which decisions failed to recognize the unique nature of Indian cases in the area of the instrumentality doctrine, was in 1961 returned by the US Supreme Court to the special instrumentality doctrine issues involved when dealing with federal functions whose success depends upon *profitability,* as distinguished from those projects only collaterally interested in financial considerations via the decision in *Federal Land Bank v. Board of County Commissioners*.[92]

The restored instrumentality doctrine, informed by the Big Eagle[93] decision discussed in the implied exemption doctrine section above, permits the reconciliation of otherwise conflicting policies in determining Congressional intent to subject Indian-related income to federal taxation.

Nor is the decision in *Superintendent of Five Civilized Tribes v. Commissioner* (1935)[94] dispositive, as expressed by Richard Perez[95], "since subsequent cases have chosen not to follow the Superintendent dictum when the reasons for an Indian tax exemption have been compelling. *Squire v. Capoeman*[96] and *Shepard v. United States*[97] both found implied exceptions for the treatment of Indian income for capital gains purposes. In Squire the court explained the reason for finding an implied exemption:

> We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens. We also agree that, to be valid, exemptions to tax laws should be clearly expressed. But we cannot agree that taxability of respondents in these circumstances is unaffected by the treaty, the rust patent or the Allotment Act. . . To tax respondent under these circumstances would, in the words of the court below, be "at the least, a sorry breach of faith with these Indians."[98]

"In *Nicodemus v. United States*,[99] rents derived from tax free Indian land were held not to be subject to federal income taxation even though they were *not specifically excluded by treaty*

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[90] 169 U.S. 264 (1898),
[91] 336 U.S. 342 (1949).
[92] 368 U.S. 146 (1961). See also Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95 (1941), in which the Court held that Congress could exempt a purchase by the Federal Land Bank from a state sales tax. In response to the state's argument that Congress could immunize only the bank's activities as a depository and fiscal agent of the federal government, and not the lending function or activities incidental thereto, the Court said that the bank also performed a governmental function by providing low-interest loans. Since the bank's ability to provide low-interest loans depended on minimization of costs, Congress was constitutionally authorized to immunize the bank from state taxation. Id. at 102-03.
[93] Big Eagle v. United States, 300 F.2d 765, 769 (Ct. Cl. 1962).
[94] Superintendent of Five Civilized Tribes v. Commissioner, 295 U.S. 418, 420 (1935).
[95] Perez id. At 1288-1289.
[96] 351 U.S. 1 (1956). See text accompanying note 41 supra.
[97] 162 F. Supp. 313 (B.D. Wis. 1958). See text accompanying note 45 supra,
[98] 351 U.S. at 6-10. See also United States v. Hallam, 304 F.2d 620, 622-23 (lOth Cir. 1962) (income from the sale of minerals from restricted lands was not subject to federal taxation).
[99] 132 F. Supp. 608 (D. Idaho 1955).

or statute. [emphasis added] The court answered the government's contention that Indians are to be included within the scope of the Internal Revenue Code by stating:

> [T]his Court, having no exact rule to follow . . . is of the opinion that taxation of income from trust property as in the present case, would be in violation of the government's agreements with the Indians . . . and . . . this court should not permit an injustice such as this .... [100]

> "Nicodemus ruled that to tax the income at issue would be inconsistent with the history of the dealings, the treaties and agreements the United States made with the vanquished Indians prior to the passage of this act [I.R.C.]. . . If they may now be taxed, then the obligation which the government has assumed in reference to these Indians may be entirely defeated because it cannot be questioned that if the income tax is assessed against them, and is not paid, it would become a lien upon their lands and would not be "free of all charge or incumbrance whatsoever."[101]

In *Commissioner v. Walker*[102] the court ruled that "[i]f, under the law, the income of an organization is exempt from taxation, it does not follow that the income received by an employee as compensation from such organization is also exempt from taxation."[103] This rule is not appropriate to the relationship between a tribal government and its tribal citizen, which is dissimilar to the relationship between tax-exempt organizations[104] and their employees or shareholders. Tribes are distinct from exempt organizations in that exempt organizations non-profit goals are not intended to benefit their employees and shareholders, while tribal governments serve the interests of their tribal citizens, and federal Indian policy and programs, promised by the federal governments' trust responsibility, and intended to serve its trust beneficiaries. GWE exemptions are, therefore, appropriate under the implied exemption doctrine and tribal sovereignty doctrine as a responsibility of the federal government's trust responsibility, and to disallow it would violate the instrumentality doctrine due to the consequent harm.

7. <u>Harm from Existing IRS GWE Policy</u>. Finally, we must look at the particular harm to Indian culture, economy and government by application of the IRS existing GWE policy. We have discussed the instrumentality doctrine that prohibits harm to federal policies and programs by taxation of tribes or tribal citizens. Attention must be turned as well to the resulting

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100 132 F. Supp. at 611.

101 Id. at 610. See also Big Eagle v. United States, 300 F.2d 765, 771 (Ct. Cl. 1962), which stated that the spirit of Squire v. Capoeman, 351 U.S. 1 (1956), requires not extending the language of the federal income tax law, broad as it is, to trust-land income of a noncompetent Indian, even though there is no "definitely expressed exemption in the tax law. . . ." But see Superintendent of Five Civilized Tribes v. Commissioner, 295 U.S. 418,420-21 (1935).

102 326 F.2d 261 (9th Cir. 1964).

103 Id. at 264.

104 See Int. Rev. Code of 1954, §§ 501 (exempt organizations), 503 (requirements for exemption).

harm to Indian culture, economy and government caused by this GWE policy. An illustration of such harm is best understood in, once again, the case of *Williams v. Lee*, wherein the imposition of tax and its effects "struck at the heart of the Navajo economy and culture."[105] In this same way the IRS GWE policy strikes at the heart of tribal government, economy and traditional Indian culture today.

Berger[106] writes that "concealed by the Court's opinion are the reasons why Williams struck at the heart of Navajo concerns about outside control. The central fact for the Williams family, and the chief concern of ordinary Navajos, is not mentioned in the decision: on filing the suit, Mr. Lee had part of their sheep herd seized as security against the eventual judgment. Sheep were the economic mainstay of the Williams family and of most ordinary Navajos. They were deeply connected to Navajo culture and domestic relations. When the Apache County Sheriff took the sheep, it became a powerful symbol of why tribal institutions were necessary to protect the choices of the Navajo people about how to live their lives."

A traditional and customary practice of giving and a careful attention to satisfying the tribal community need continues to be a mainstay of tribes today. Whether a tribe has little or much to share, it is shared. These practices are deeply connected to tribal culture and domestic economy, and carried out as a traditional function by tribal leaders on behalf of the tribal government. When the tribal government decisions implementing their tribal GWD are not respected by the IRS, the cultural role of tribal leaders in the maintaining the general welfare of their tribal citizens is diminished. When the value of the trust asset is diminished by imposition of a GWE tax, the promised protections of the federal trust responsibility and tribal doctrines are thwarted. When traditions and customs are questioned and diminished, the hearts of Indian people are pushed toward the ground. The IRS GWE policy strikes at the heart of tribal institutions and culture, and the choices of the Indian people about how to live their lives. This harm could not be greater.

The Navajo struggle in 1959 represented the struggle of Indian peoples for sovereignty.[107] The Navajo never questioned the need to struggle against the imposition of a foreign state jurisdiction on their tribal lands. Today, no tribal government questions why they fight so vehemently against the imposition of an unmodified IRS GWE policy. Tribal leaders have testified in tribal consultation sessions that the IRS GWE policy diminishes customary practices and disrupts inter-woven tribal economies. Berger wrote of the Navajo determination to "insist that respect for tribal status was necessary to ensure equal treatment and dignity in the modern era."[108]

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[105] Id, p. 1465.
[106] Berger, at 1467.
[107] Id.
[108] Berger, at 1466.

The ACT 2012 Report detailed the deep cultural significance of the traditional and customary practices of giving to meet the community need, not the individual need, and the integral role of tribal leaders in this practice.[109] The Report also described the many tribal GWD programs implemented by tribes, as an integral part of their cultural practices for the purpose of fulfilling their tribal community needs.[110]

Berger's conclusion is telling, suggesting that the [Justice] decision in "*Williams v. Lee* and the self-determination movement that followed it represent a choice by American Indians to insist that *respect for tribal status* was necessary to ensure Indian equality in the modern era. This history and its results provide an important lesson today as federal Indian policies are increasingly attacked as fundamentally inconsistent with fairness and equality." [emphasis added]

8. <u>A Reasonable Modification</u>. A reasonable modification of the IRS proposed GWE guidelines that respects tribal government sovereignty and tribal culture would fulfill the purpose and goals of the modern federal Indian policy of self-determination.

The IRS should, therefore, accept that an Indian tribal government definition of community need is warranted, and consult with Indian tribes to develop reasonable means to review and accept as a rebuttable presumption in favor of tribal GWD policies with a tribally defined community need that makes eligible tribal member payments or benefits for exclusion from tax under a modified IRS GWE policy. The ACT recommends this modified IRS GWE policy would expand the safe harbor method described in the December 2012 GWE guidelines notice to provide Indian tribal governments the option to participate in a voluntary compliance program with the Service's Indian Tribal Government (ITG) office.

[109] ACT Report 2012, at 30-37.
[110] Id., at 22-26.

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IV. Best Practices

A. The GWE Safe Harbor in Application

Notice 2012-75, Application of the General Welfare Exclusion to Indian Tribal Government Programs That Provide Benefits to Tribal Members, was issued December 5, 2012. The opinion of the ACT is that there will be many comments, concerns and requests, in addition to the ones presented in this report, which will result in modification(s) beneficial to tribes in broadening the exclusion and/or providing more clarity to the guidance as it is written. Nevertheless, Indian Tribal governments may rely upon the the revenue procedure in its proposed form currently and in taxable years for which the period of limitation on refund or credit under I.R.C. Section 6511 has not expired. In this regard, the ACT would like to discuss the proposed guidance with the intent of helping tribes structure their tribal welfare programs to meet the existing criteria and safe harbors for exclusion.

Tribal programs are often developed with a mission to provide for a need of the community, not just an individual. In the guidance, the IRS has provided that if a program is designed meeting the General Criteria in Section 5.02(1) and is specifically included in Section 5.02 (2) then during a compliance check or examination the IRS will "conclusively presume that individual need is met for each tribal member, spouse, or dependent of a tribal member receiving the benefit." Thus, upon substantiation, no further testing of the program will be completed and all benefits provided to the Tribal citizen under this program will be considered exempt from income under the general welfare exclusion.

Tribes therefore must have procedures in place to meet the general criteria. This section of the report provides explanations of the general criteria and examples of procedures that will assist tribes in setting up programs so that the general welfare exclusion applies. Also included are examples of programs addressed in 5.02 (2) and how policies and procedures can be implemented to insure compliance.

1. Section 5.02 (1) General Criteria for Exclusion

a. The benefit is provided pursuant to a specific Indian Tribal government program:

> When developing a general welfare program where Tribal citizens will be receiving either payments or services the program must be "pursuant to a specific Indian tribal government program". The appropriate governing body of the Indian tribal government should approve the program by affirmative tribal government action. This approval must be formalized by resolution/motion/policy development or any other specific means typical to that governing body and be properly documented.

b. The program has written guidance that specifies how individuals may qualify for the benefit:

Programs must have written policies and procedures. These policies should address the nature of the program, how the program meets a need of the Tribe as a whole, who is eligible and how benefits will be paid. These policies and procedures need to be approved by the appropriate governing body. This requirement is no different than similar requirements under federal/state funding programs where polices are required to determine eligibility. Once policies and procedures are in place the program must be operated accordingly.

c. The benefit is available to any tribal member who satisfies the program guidelines:

All tribal citizens who meet the criteria of eligibility must have benefits of the program made available. For instance, if a program is designed to provide a form of assistance to Elders on the reservation or in the service area, then every Elder meeting the criteria must be treated equally. In this example it would be allowable however for Elders outside the reservation or service area not to be granted the same benefit.

d. The distribution of benefits from the program does not discriminate in favor of members of the governing body of the tribe:

In order for a program to qualify under the General Welfare exclusion benefits must be made available to all citizens who are eligible and the eligibility criteria cannot be limited to members of the governing body. For example, a policy to pay for housing repairs limited to only members of the governing body would not be eligible. However, if a program was designed to pay for housing repairs for all Elders, then those on the governing body who are Elders could qualify for the benefit and it would qualify under the exclusion.

e. The benefit is not compensation for services:

Benefits must be paid to address a need either of the community or individual for it to qualify under the exclusion. A payment to a tribal citizen for services rendered will be considered income to the citizen and must be properly reported. A tribe may have a program to provide meals to Elders, the benefit to the Elder receiving the meals is not income under the General Welfare exclusion, however, the amount paid to the person who delivered the meals is taxable as it is compensation for the service performed (the delivery of the meals).

f. The benefit is not lavish or extravagant:

In both Section 5.03 and as discussed in the next section of our report, the Service will be looking at General Welfare expenses and determining if these are "lavish or extravagant". Though this term is not defined in the current guidance, in other IRS guidelines the term has been defined. IRS Publication 463 (Travel, Entertainment, Gift, and Car Expense) defines what Lavish or extravagant is not. "An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances." Additional language throughout the code discusses necessary and ordinary as a measurement of "lavish or extravagant". Necessary defined as "helpful and appropriate" while ordinary is defined as "common and accepted in your trade or business". Unfortunately, the interpretation of what is helpful, common, and not lavish or extravagant can vary from Tribe to Tribe and circumstance to circumstance. With the difficulty of definition, IRS should rely on tribes to know what is appropriate for their citizens. Lavish or extravagant should not be determined with the same means as federal programs and poverty guidelines. Tribes also need to be reasonable with their expectations of what might constitute lavish or extravagant.

2. Section 5.02 (2) Defined Areas

a. Housing programs:

Providing Tribal citizens with opportunities for a decent home and suitable living environment is a need felt by all Tribal governments. Many tribal programs help their citizens eradicate substandard housing and increase the availability of affordable rental housing and home ownership opportunities. In order to address this need, tribes establish various housing projects that address the specific needs of their community. This will vary from tribe to tribe based on the demographics of their citizens and location. Though many housing programs administered with federal funding have income criteria and thus quite clearly fit the "traditional" definition of general welfare, as tribes become more successful, expanded programs paid with tribal funds permit a higher standard in providing for housing needs of the community. The safe harbor provisions include tribal government programs that provide assistance in making mortgage or rental payments, enhance habitability of housing, provide basic housing repairs, and assist with the paying of utility bills.

Samples of programs that would fall under the Safe harbor for Housing:

The Tribe establishes a program providing basic housing repairs and rehabilitation to tribal citizens' homes on the reservation, service area or within the defined tribal boundaries.

- The governing body must approve the program.

- Policies and procedures must be written discussing eligibility and how payments will be paid out. In this example, the Tribe could limit the services to families with children and Elders who live on the reservation or in the service area.
- Payments for repairs should be made to the contractor thus no funds are actually received by the citizen.
- The repairs must be reasonable and necessary, not lavish.

b. Education programs:

Tribes recognize that educating their citizens is one of their major priorities. Education promotes the general welfare of the Tribe and its citizens. Scholarships awarded to a Tribal student for tuition, books, and fees have always been excluded from income under section 117. Tribes have also recognized the need to provide additional assistance to its students in order for them to be successful in their educational pursuits. Other assistance may include tutors, computer equipment, allowances for room and board, and supplies.

Samples of programs that fall under the Safe harbor for Education:

- Assistance provided to a post-secondary student to assist with living expenses while attending an accredited college or university, vocational or technical education, or other alternative education are now not included in gross income.
- The funds must be given in accordance with a policy in place and approved by the governing body that specifically outlines the program and explains how a person qualifies. An example may be the Tribes policy is to pay a student $1,500 per quarter toward living expenses.
- The student is eligible as long as he/she is continuing in school and maintaining a passing grade.
- The allowance must be reasonable (not lavish).
- Amounts may be set and paid regularly to the student and must be used to pursue his/her education.

Another important program provided by many Tribes is to provide backpacks and school supplies, school clothes, or computer equipment to school-aged citizens. All students in the service area may be eligible for this assistance, whether or not there is a financial need. In the past there has been concern whether these programs would create reportable income to the family. Clarified by the issued guidance, if a policy is in place and approved by the Tribal council that specifically outlines the program, explains how a person qualifies (e.g., a tribal citizen in the service area, under the age of 19) then the value of this benefit is not reportable income.

Job placement, training, and assistance are also included in the guidance. Approved tribal programs paying for job counseling, placement, or training is not considered income to the recipient. As well as paying for actual training, assistance provided to Tribal Citizen's to insure their success in this area such as transportation assistance, travel, clothing, etc. are also not income (e.g., the Tribe may assist a Tribal citizen with a clothing allowance for specific clothes needed in a new trade or appropriate for an interview).

c. Elder and disabled programs:

It has always been a culturally important aspect of Tribal life to honor and care for tribal Elders. Every tribe wants to protect the health and welfare of its Elders. Assistance provided varies greatly from Tribe to Tribe based on the needs of its own Tribal Elder population. The IRS has specifically identified as Safe Harbor programs assistance for Elders and disabled population for providing meals through home delivered meals or at a community center, home care, local transportation assistance, travel expenses for medical care and to attend educational, social, or cultural programs offered by the tribe or another tribe, and improvements to adapt housing to meet special needs.

Samples of programs that would fall under the Safe harbor for Elder and disabled programs:

- The governing body of the Tribe can approve a program and written policies where meals are delivered to Elders on a weekly basis.
- Eligibility for the program can include all Elders within the service area regardless of income.

The Tribe may find there is a need among the Elder population for transportation services to and from the Tribal center for social activities. A program of this nature can enhance cultural competency, increase social activities and reduce isolation for the Elders. A written policy addressing how a citizen is eligible (must be an Elder on the reservation or in the service area as an example) should be approved. These services will not be taxable to the Tribal citizen. However persons paid to transport the Elders will be compensation as a fee for providing a service.

d. Other Qualifying Assistance:

The Guidance provides for other types of assistance to be included as part of the Safe Harbor programs. These other services include, transportation costs to public facilities, cost of transportation and temporary meals/lodging while a citizen, spouse, or dependent is receiving medical care away from home, assistance to individuals in exigent circumstances, pay costs for temporary relocation or shelter for individuals displaced from their home, emergency assistance for individuals stranded off reservation, and reimbursement of the cost of nonprescription drugs.

Examples of programs falling in the safe harbor for this category are:

- As part of a tribe's health program, benefits could be extended to include assistance provided to the citizen and its' dependents while away from home for a medical situation.
- The tribe's program could include paying for a hotel, meals, and transportation (bus, gas, rental car, etc.) while away. The cost of these services will not be taxable to the Tribal citizen or it's family.

Tribes can also design written programs that provide for emergency assistance to a Tribal citizen if stranded off reservation. The program can provide for transportation back to the reservation or if necessary room and meals until transportation can be arranged. Costs of these arrangements must be reasonable, and cannot be lavish or extravagant.

Recent interpretations of the Affordable Care Act, determined that cost of non-prescription drugs was not exempt to tribal citizens under the Act's medical exemption. However, the safe harbor in the GWE guidance specifically allows tribes to pay for non-prescription drugs and have that tax-exempt to the citizen. Tribes can develop a program to pay for over the counter smoking cessation drugs, vitamins, and other related items where they see a need in their community.

e. Cultural and Religious Programs:

In receiving responses on General Welfare issues, the tribes felt quite strongly about payments for cultural and religious programs being exempt from any form of taxes. Tribes are highly dedicated to preserving their culture and teaching the traditions to all generations. Therefore providing resources in order for citizens to attend tribal functions, ceremonies, and educational events is paramount. It is also culturally significant for tribes to pay for funeral and burial expenses of its citizens.

Examples of programs falling in the safe harbor of cultural and religious programs are:

- The Tribe may create a written program where it pays for transportation, food, and lodging to a cultural activity or event hosted by the Tribe or other tribes.
- The program can provide the transportation (citizens take a tribal bus) or it can provide financial resources for the citizen for their own transportation.
- The program may also provide resources so a citizen can attend tribal events such as a traditional foods dinner, basket weaving classes, and dance or language workshops.

Tribes may also choose to have a program that pays for or reimburses tribal citizen's families for funeral or burial costs. These costs can include actual burial costs (e.g., cremation, cemetery plots, headstones, death certificates, etc.) or can include the costs of memorial dinners, celebrations of life, or similar bereavement events. Policies are best written when costs are paid directly to a third party such as a funeral home but also can also be reimbursed to the citizen's family when paid in advance (with receipts provided). Costs of meals or events may be paid directly to the citizen's families.

3. Section 5.03

The IRS in its guidance also provided that some benefits paid by a tribe would not be considered compensation when those benefits are provided under a tribal program and have cultural significance. It is customary for tribes to provide a cash honoraria or other form of gift to recognize participation in a cultural, religious, or social event. If these benefits are not lavish or extravagant, the Service will presume that individual need is met and not treat this as compensation for services. For example, if a Tribal spiritual leader is paid $100 to perform a blessing for a new facility, this would not be considered compensation for service but a benefit under the general welfare exclusion.

It is important to note that some programs are already exempt from taxation due to Congressional legislation or prior revenue rulings. If payments are made to or on behalf of a tribal citizens these payments remain nontaxable and the GWE guidance does not supersede this determination.

Below is a list of exclusions that are not affected by the recently released general welfare guidance (Notice 2012-75):

Statutes

- Section 117 – Qualified Scholarships
- Section 139 – Disaster Relief Payments
- Section 139A – Federal Subsidies for Prescription Drug Plans
- Section 139D – Indian Health Care Benefits

IRS Guidance

- Relocation payments (*e.g.*, Revenue Ruling 98-19)
- Replacement housing benefits (*e.g.*, Revenue Ruling 74-205)
- Training for unemployed or underemployed (*e.g.*, Revenue Ruling 68-38)
- Disaster relief for necessary expenses (*e.g.*, Revenue Ruling 76-44)
- Grants to increase Indian entrepreneurship and employment (*e.g.*, Revenue Ruling 77-77)
- Programs not covered under Notice 2012-75 but based on individual need, such as financial (*e.g.*, Private Letter Ruling 200336030) or educational (Technical Advice Memorandum 200035007)

B. Tribal Programs which are not a specific Safe Harbor program

There are many areas of need outside those "safe harbor" or previously excluded programs which tribes address in providing assistance to their citizens. There are also many tribal programs which are very similar in nature but don't meet the criteria based on the narrow language of the proposed guidance. As such, the General Welfare exclusion may not automatically be presumed. Programs outside 5.02 should be developed for potential application of the GWE based on the general criteria. Section VII, Best Practices, Heading C, of this report describes how to develop a sound tribal general welfare program.

When the IRS visits a tribal government for a review or compliance check, their primary focus has been on employment tax issues (W-2s, proper payroll tax reporting, 1099s and the proper classification of independent contractors). Payments to citizens which are not reported on a W-2 or 1099 are subject to the overarching principle of IRC 61, 26 U.S.C. § 61, which generally states gross income means all income from whatever source derived and is hence, taxable unless specifically excludable. If the payment is made for something where existing guidance or legislation already exists (medical benefits to tribal citizens under the Affordable Care Act which excluded these from income, for example) then no further testing is required. If not covered under other existing guidance, a third consideration will be made as to Notice 2012-75. If the payment is made pursuant to a program that meets the general criteria in 5.02(1) and need is presumed because it is one of the safe harbor programs included in 5.02(2), no further testing is required and payments are determined to be nontaxable. Lastly, if the program is not a safe harbor program then the "Traditional General Welfare rules" will be analyzed. The following tests will be applied to determine if the benefit is taxable:

- Is the benefit a payment pursuant to a specific government program including written guidelines?
- Is there a need? In this area the Service is allowing need to be met as long as the payment is not lavish or extravagant. Lavish or extravagant will be determined on a case-by-case basis and will not be one size fits all. ITG Specialists in the field will not be able to make a final determination of lavish or extravagant without approval of the situation from the National office.
- The payment is not compensation for services.

If a benefit paid meets the above criteria, then the payment will be excluded from federal taxation and no further testing is required. If a payment fails to be excluded under any of the criteria (i.e., existing guidance, new GWE guidance, and traditional GWE) then the payment is determined taxable.

Therefore, in developing a program that is not one of the safe harbors within the guidance, tribes should make sure they follow best practices in order for the program to qualify for exemption. An example of a program matching this criterion could be a childcare program.

Child care/day care programs do not appear to be included within the scope of any of the educational safe harbors in the IRS notice. Numerous tribes provide a wellness center or health club program for their members in order to promote healthy lifestyles and reduce the incidence of diabetes or help them fight the disease if already diagnosed.

If a tribe develops a wellness program, it must be approved by the governing body and have policies and procedures stating the need of the community for such a program. The procedures also should determine who is eligible (all tribal citizens), and how payments are determined (if a wellness facility cannot be provided by the tribe, the program would pay for a monthly membership fee of the member based on certain criteria). The IRS will presume that the program is administered on the basis of need as long as the payment to the provider is not lavish or extravagant. Under this scenario, the benefit the citizen is provided (membership at a wellness center) is not taxable. If an IRS ITG specialist reviewed this program, the Tribe would need to provide the approval for the program, the policies and procedures, and documentation for the expense.

Following the same methodology, tribes should have the flexibility to meet the divergent needs of their communities and citizens while, at the same time, protecting their programs and services from taxability to the recipients.

C. Problems with narrow language in the guidance

As the guidance currently exists, there are areas that have caused either confusion among Tribes or areas where further clarification would be helpful. Here are just a few examples.

- *On or near reservation:* Tribes with no or very little reservation land have found this section problematic. Tribal government offices may reside on reservation or trust property, however, it may provide services to citizens who live within the "service area" that is not reservation or trust property. There may be questions on whether these services are subject to the safe harbor rules. Also, a definition or guidance on how the IRS interprets "near" reservation is needed.
- *Assistance to descendants:* The Guidance as it exists refers to services provided to *tribal citizens.* Some tribes provide services to descendants who based on constitutional requirements do not qualify for "citizenship" but are considered part of the Tribal community and family. Clear guidance should be provided on whether benefits paid or provided are subject to the GWE.
- *Extended families:* Tribal culture looks at a family much broader than spouse, dependents, and parents. Nieces, nephew, aunties, and uncles all play an integral part in the family. There is confusion on whether for instances if an auntie is paid for transporting a tribal citizen to medical care away from home, how would these benefits and services be handled if discovered during a review?

- *Lavish or extravagant:* There is no definition in the general welfare guidance regarding lavish or extravagant. And though as noted earlier in our report there is some definition in other parts of the code this area has the potential to cause the most questions and incorrect expectations amongst Tribal governments. There is concern that without some sort of definition or specific information this will be implemented inconsistently during audits. There is great concern that lavish or extravagant will be looked at with "global" approach rather than on a case-by-case basis. What one tribe is able to do for a citizen and does not reasonably think is extravagant may be very different in another market (housing for example) or location.
- *Housing:* The guidance refers to *assistance* of homeowner costs. What is the definition of *assistance*, is it paying a portion of a citizens rent/mortgage or if an entire amount is paid, does that still qualify? How does *lavish or extravagant* enter into this discussion? Down payment assistance is also not specifically addressed in the safe harbor provisions. Tribes have also questioned what *basic* housing repairs or rehabilitation means, and whether this includes a remodel or renovation.
- *Education:* The guidance has clarified and exempted so many items that in the past have created questions as it relates to post-secondary education. There remain questions on whether tuition and related costs of preschool or private schools for primary and secondary education would also be included and would be excludable payments. Also questioned is whether supplies or fees paid for extracurricular activities are excluded under the GWE. Distance learning and online education appear to be encompassed within the scope of "alternative education" in the tuition-related safe harbors. However, tuition payments for distance learning and online education do not qualify for an exclusion from income under Section 117 of the Code. Consequently, it may be worth clarifying that tuition payments for distance learning and online education are included within the scope of the IRS Notice.
- *Elders Programs:* The guidance allows for transportation and admission fees to attend educational, social, or cultural programs offered by the tribe or another tribe as exempt. If the program is offered by an organization that is not tribally affiliated, is there no exclusion?
- *Transportation costs:* In numerous places in the guidance, transportation costs are noted and included. However, in some cases there is very specific language (bus, taxi, or public transportation fares paid) and in other cases it is much broader (transportation costs). It would be beneficial to have a standard term used throughout the document. Limiting or having the appearance of limiting transportation to public transportation is concerning to tribes as many reservations are in remote locations and do not have public transportation available to them.
- *Nominal cash honoraria:* There has been much discussion about how the Service will apply the criteria in section 5.03 regarding payments to cultural/religious/spiritual leaders. Many Tribes question what payment to a spiritual leader (for conducting a

day long ceremony, for instance) would be considered nominal. It is important to remember that the 1099 reporting threshold ($600 in the aggregate to one recipient) is the best rule of thumb so anything under that amount shouldn't raise an issue. Additional discussion and or consideration should be given to allowing Tribes to determine nominal as long as it is not "lavish or extravagant".

D. Considerations for Tribal Best Practices

1. General considerations

Our report has discussed the implementation of the guidance and requirements for policies and procedures so that programs meet the general criteria and safe harbor programs as defined in the guidance. Some general considerations will also be helpful to tribes in further protecting their citizens from taxation of these benefits.

a. A good system of accounting, record keeping and program internal controls is a must for any payment processes the tribe administers. Records should be maintained for at least six years (in the event of an audit).
b. Consider periodic reporting (or re-application) from citizen/grantee if the program provides a recurring benefit. This will ensure they continue to meet the qualification requirements.
c. Gift cards are not the best practice. These will most likely be considered a taxable gift if not for a specific service as defined in the safe harbor programs (a gift card to pay for hotel while in another city receiving medical attention could be consistent with the guidance). When applicable provide a service, not a gift card, such as providing a meal service program rather than providing gift cards to grocery outlets. By providing a service it is apparent that the citizen received the benefit consistent with the program. It is hard to document and prove that a gift card was used to pay for the benefit of the program.
d. Facilities always prevent the benefit from looking like an "individual" benefit and therefore individual need is not spotlighted. Providing daycare at an on-site childcare facility versus paying childcare assistance payments, for instance.
e. When at all possible pay a third party provider versus paying a citizen directly. An example, for funeral benefits, it is better to pay the funeral home directly for services instead of paying the family the benefit. If paying the citizen, request documentation of expenses and "reimburse" them for actual costs. This practice assures that benefits have been received for their intended purposes.
f. The most important best practice to follow "Document, define and DO what you say you are doing." Once a tribe has its ordinance and policies and procedures in place, then it is imperative that they follow them. If program guidelines are established and inconsistently applied, or not followed at all, there is greater risk of the benefits not

qualifying for the general welfare exclusion and citizens could suffer a tax consequence.

g. Programs or assistance that requires some type of personal service on the part of the recipient (with the exception of those under guidance Section 5.03) to receive the benefit will be considered compensation, in most instances, and should be avoided.

2. Summary of IRS process for addressing taxability of tribal benefits

a. Payment to individual is discovered that is not substantiated by W-2 or 1099
b. General presumption is taxable income to individual under IRC 61, 26 U.S.C. § 61, <u>unless:</u>
c. There is existing guidance for exclusion:

Statutes

- Section 117 – Qualified Scholarships
- Section 139 – Disaster Relief Payments
- Section 139A – Federal Subsidies for Prescription Drug Plans
- Section 139D – Indian Health Care Benefits

IRS Guidance

- Relocation payments (*e.g.*, Revenue Ruling 98-19)
- Replacement housing benefits (*e.g.*, Revenue Ruling 74-205)
- Training for unemployed or underemployed (*e.g.*, Revenue Ruling 68-38)
- Disaster relief for necessary expenses (*e.g.*, Revenue Ruling 76-44)
- Grants to increase Indian entrepreneurship and employment (*e.g.*, Revenue Ruling 77-77)
- Programs not covered under Notice 2012-75 but based on individual need, such as financial (*e.g.*, Private Letter Ruling 200336030) or educational (Technical Advice Memorandum 200035007)

d. If there is no existing guidance, does the payment qualify as a Notice 2012-75 safe harbor?
   - Benefit is provided pursuant to a specific Indian tribal government program
   - Program has written guidelines that specify how individuals may qualify for the benefit
   - Benefit is available to any tribal member who satisfies the program guidelines
   - Distribution of benefits from program does not discriminate in favor of members of the governing body of the tribe
   - Benefit is not compensation for services
   - Benefit is not lavish or extravagant
   - Benefit is provided under the specific benefit programs described in section 5.02(2) of the guidance

e. If payment doesn't qualify as safe harbor, foes the payment qualify under the traditional, general criteria?
    - Payment made pursuant to a governmental program
    - For the promotion of the general welfare (that is based on need and is not lavish or extravagant)
    - Does not represent compensation for services

f. If the payment fails #3-5 above, it will be considered taxable income to the recipient.

E. How to develop a sound tribal general welfare program (including appendices of tribal best practice in existence)

a. Benefit is provided pursuant to a specific Indian tribal government program

b. Official Tribal Government Action – Resolution, Statute, Ordinance, etc. (See example in Appendix A)

2. Program has written guidelines that specify how individuals may qualify (See examples in Appendix B)

- Describe the reason for the program
- Define the "need" being met by the program (Housing, Education, Financial, Elder, Emergency, Burial, etc.)
- Be prepared to provide substantiation of "need"
    - i. Individual or community need
    - ii. Reasonable and necessary versus lavish or extravagant
    - iii. If financial need-base program – how measured (Federal standards, Tribal Standards)

3. Benefit is available to any tribal member who satisfies the program guidelines and does not discriminate in favor of the governing body of the tribe.

a. Define the qualification process for each program

b. How will the tribe confirm the applicant meets the written criteria of the policy/program

4. Benefit is not compensation for serves

a. Personal services should not be required from tribal member to receive benefit

5. Ensure compliance with the general welfare program

a. Ensure continuing qualification of applicant

b. Ensure the program is administered consistently among tribal members

6. Ensure sound administration of the program

a. Methods of payment
b. Record keeping
c. Complaints and appeals

V. ACT Recommendations

A. IRS Deference to Tribal Government General Welfare Doctrine and Tribal Determination of Community Need; Rebuttable Presumption in Favor of Tribal General Welfare Programs; Voluntary Compliance Program

The ACT recommends the IRS defer to tribal governments in their legislative determinations of a tribal general welfare doctrine for their tribal citizens, such that payments or benefits provided to tribal citizens under a tribal GWD are a cognizable general welfare need excluded from income.

The ACT recommends the IRS modify the GWE policy to include a tribally determined community need as the general welfare need basis in GWE determinations.

The ACT recommends the IRS GWE policy exclude payments made under a tribal GWD provided for assistance of a tribal citizen by a third-party who is not in the business of providing such assistance to not be compensation for services and excluded from income.

The ACT recommends the IRS GWE policy exclude payments made to a tribal citizen within the context of cultural ceremonies to not be compensation for services and excluded from income.

The ACT recommends the IRS accept a Tribe's legislatively enacted general welfare doctrine (GWD) in the form of a resolution, ordinance, statute, memorandum of understanding, or other similar means to define the specific terms and conditions. The GWD should establish as the policy of the Tribe:

- The reason for the policy and program.
- The tribal community and/or individual need being met by the program.
- The standard for community and/or individual need.
- The qualification process for each program.
- The application process.
- The process for confirmation of initial and ongoing eligibility.
- The compliance and enforcement process.
- Periodic reporting by program participants and program officials.
- Methods of payment.
- Record keeping.
- Complaints and appeals.

The ACT recommends the IRS modify the proposed GWE policy to provide either a safe-harbor or rebuttable presumption for tribal GWD policies that presumes the tribal compliance with the IRS GWE policy and places the burden of proof to the IRS to establish the particular tribal program has not met the general welfare exclusion. Accordingly, a tribe would not be required to produce additional or substantial documents to the IRS unless evidence showing a material breach of the tribe's GWD is established.

The ACT contemplates that certain fundamental requirements for establishing a tribal general welfare doctrine and cognizable general welfare exclusion under a rebuttable presumption would be mandatory and incumbent upon the tribe to prove provided, however, that the IRS would not unreasonably withhold agreement of the community need standard and a method for administrative appeal should dispute arise. Once proved, the tribal GWD determinations of exclusion from income would not be rebuttable (except upon a showing of fraud or other extraordinary circumstances). These two non-rebuttable factors are:

- Payments are made pursuant to a tribal legislatively provided social benefit program or under a tribal general welfare doctrine (TGWD); and
- For the promotion of general welfare.

The first factor is proved by providing evidence of the tribe's legislative action, by means pursuant to an official tribal government action, approving the tribal general welfare doctrine or program. Once proved, there would be nothing rebuttable about tribe's legislative action. Tribal governments as limited inherent sovereigns possess exclusive jurisdiction to determine what programs will meet the needs of their tribal citizens.

The second factor would also be non-rebuttable. The tribe's determination of "general welfare" involves a policy expression by a sovereign by legislative action. This is a political process accountable to the tribal citizens. This serves to protect an intrinsic cultural ethos, a historic tradition, customary practices surviving from time beyond memory, and an imperative response to invasion, historic disruption of tribal communities, loss of life, land, liberty and resources.

The tribe's determination of what constitutes a tribal community need under a tribal general welfare doctrine or general welfare program in the context of that tribe's culture, tradition and history is unique and should be inherently unassailable. As such, the IRS general welfare policy should recognize the same deference to tribal governments as to state governments.

The core question of a typical GWE controversy usually arises not as to these first two factors, but as to the nature of the payment. That is, assuming the payment is not a form of compensation, is it reasonably calculated to meet a cognizable general welfare need?

The ACT recommends the IRS proposed GWE policy adopt a broader definition of a cognizable "need" than is currently envisaged by the general welfare doctrine. The existing IRS rulings support a broader interpretation of "need" that is not limited to an expression of individual, financial need. See, *e.g.,* Rev. Rul. 57-102; TAM 200035007 (financial need is not the measure). The ACT recommends the IRS general welfare policy not require a showing of individual need as unsuitable for tribal culture and governance. The ACT recommends the IRS include, as a cognizable general welfare need, the standard of the tribal community as a whole that is a legitimate beneficiary of social benefit programs. See, *e.g.,* Rev. Rul. 76-373.[111]

The ACT recommends the IRS include in its general welfare policy the role of, and deference to, tribal governments such that the IRS general welfare policy would be applied to a tribe's general welfare doctrine or program as a necessary measure to accommodate the unique circumstances, traditions, roles and functions of a tribal community.

Accordingly, a rebuttable presumption process would permit a tribe to establish the precise need it intends its program to meet (whether community need or individual need) under a tribal general welfare doctrine or program legislatively enacted, how the program is reasonably calculated to meet that need, how the program is administered to meet that need to ensure compliance, and that the actual benefit provided is reasonable and not lavish or extravagant. The rebuttable factors would, therefore, be the following:

- Proof the payment is not compensation for services rendered by the recipient, except for payments within the context of a cultural ceremony or payments for assistance provided by third party not in the business of providing such assistance; and
- Proof the payment is reasonably calculated to meet an individual or community need, as defined by the tribal government.

The ACT recommends the IRS consult with tribes to agree upon the evidentiary requirements to create a rebuttable presumption with the assistance of the recommended new tribal advisory committee/STAC.

The ACT recommends there would be a minimum necessary threshold of proof for the tribe, and once proved, the IRS could only rebut the presumption if it develops sufficient contrary evidence to rebut the probative value of the tribe's supporting documentation and data.

The ACT recommends that the GWE safe harbor policy be implemented through a voluntary compliance program. The voluntary compliance program would provide that during the ensuring 24 months period wherein the ITG and an Indian tribal government determine a TGWD complies with the Service's GWE policy guidance safe harbor provisions, the Tribe and its tribal citizens would not be subject to any penalty for the prior period or for the proceeding 24 months with respect to TGWD benefits distributed. The IRS GWE safe harbor would include a rebuttable presumption that an Indian tribal government's TGWD is in compliance with the IRS GWE safe harbor policy, and all qualifying payments the Indian tribal

[111] 1976-2 C.B. 16.

government would qualify for the general welfare exclusion if the payments are (1) made pursuant to a governmental program of the tribe; (2) for the promotion of general welfare (that is, uniquely in the case of programs of Indian tribal governments, to meet tribal community need established by the TGWD); and (3) not compensation for services (that is, uniquely in the case of programs of Indian tribal governments, except for tribal cultural, social and ceremonial activities).

The ACT recommends a program "reasonably calculated" to meet the identified need would be determined to be reasonable in amount, and not subject to a lavish or extravagant.

The ACT recommends the "lavish or extravagant" standard be replaced by a "reasonably calculated" standard for determining compliance with IRS GWE policy. The "lavish or extravagant" standard is a prejudicial term that implies the conclusion to the analysis, while the "reasonably calculated" standard appropriately applies to the test applied. The IRS does not offer a definition of "lavish or extravagant" is its publications or guides. The IRS audit guide notes that the IRS will not attempt to disallow entertainment as lavish or extravagant merely because it exceeds a fixed dollar amount or is incurred at a deluxe restaurant, hotel, nightclub, or resort establishment. The ACT recommendation is that the IRS train its ITG examiners to apply a "reasonably calculated" standard in looking for: (1) a traditional and customary tribal community need for the payment or benefit provided to a tribal citizen or lineal descendent; (2) a directly related and resulting tribal community benefit; and (3) substantiation (who, what, when, where, why, and how much).

The ACT recommends that IRS engage in consultation with tribes to determine a working definition and method of application for lavish or extravagant. Pervasive and longstanding unmet economic, educational and infrastructural needs exist throughout Indian Country for all tribes, including tribes with significant economic enterprises. Short term success is not sufficient to overcome hundreds of years of deprivation, such that currently successful tribes should not be penalized for their achievements without accounting for inherent sovereign rights and cultural, social and economic losses accumulated since first contact. As such, lavish or extravagant must be calculated on a different scale that is sensitive to tribal circumstances. Nevertheless, the tribal welfare program under this test would be one that is not intended to provide luxury not available to all tribal citizens.

The ACT recommends two factors for consultation in the matter of lavish or extravagant or, as recommended by the ACT, the reasonably calculated standard. First, the equity present in the availability of the same or similar value benefit to all tribal members should stand substantially in favor of a determination that a benefit is not lavish or extravagant. Second, a determination of the value of a real property benefit should not use the value of the same item in a non-tribal setting is equivalent. For example, a house provided to a tribal member by the tribal government on tribal lands should not be valued equivalent to a fee-property on non-tribal lands because the non-tribal property includes the value of the land parcel and the opportunity to sell the property, which is absent for a tribal house on tribal lands. Further, the nominal value of the tribal house should not be pegged to a "HUD" home allowance, which is tied to poverty level income. Doing so perpetuates the bias that Indians are only Indians when impoverished.

B. Treasury Level Advisory Committee/Undersecretary of AI/AN Affairs/Tribal Consultation Policy Amendment.

The United States has a unique legal and political relationship with Indian tribal governments, established through and confirmed by the Constitution of the United States, treaties, statutes, executive orders, and judicial decisions. In recognition of that special relationship, pursuant to Executive Order 13175 of November 6, 2000, executive departments and agencies are charged with engaging in regular and meaningful consultation and collaboration with tribal officials in the development of Federal policies that have tribal implications, and are responsible for strengthening the government-to-government relationship between the United States and Indian tribes.

The Department of Health and Human Services (HHS) has taken the lead among federal agencies in fulfilling its responsibility to comply with Executive Order 13175 by establishing the Secretary's Tribal Advisory Committee (STAC).[112]

The ACT recommends the Secretary of the Department of Treasury establish a similar STAC composed of the Treasury Secretary, the IRS Commissioner, senior Treasury and IRS officials, and representatives of tribes and national and regional inter-tribal associations throughout Indian Country.

The ACT recommends the Treasury Secretary also establish an Undersecretary for Tribal Affairs.

C. Treasury/IRS STAC

The Treasury/IRS STAC purpose would be to seek consensus, exchange views, share information, provide advice and/or recommendations; or facilitate any other interaction related to intergovernmental responsibilities or administration of Treasury/IRS programs, including those that arise implicitly under policy or rule, or explicitly under statute, regulation or executive order. This purpose would be accomplished through forums, meetings and discussions between Federal officials and elected Tribal leaders in their official capacity (or their authorized representatives) and national and regional inter-tribal associations representing member tribes.

[112] U.S. Department of Health & Human Services, IEA Tribal Affairs, www.hhs.gov, http://www.hhs.gov/iea/tribal/index.html.

The Treasury/IRS STAC should include without limitation the following core functions:

1. Identify historical, current and evolving issues effecting American Indians and Alaska Natives (AI/AN), including Tax Policy, Finance and Economic Policy.
2. Apply the trust responsibility of the United States government to tribal governments, and its responsibilities under the United Nations Declaration of the Rights of Indigenous Peoples (UNDRIP)[113], to the Treasury Department's mission to build a strong economy and create economic and job opportunities in and for Indian Country by promoting the conditions that enable economic growth and stability for tribes and on tribal lands.
3. To understand tax policy that respects AI/AN tribal government inherent rights and provides America's tribes top quality service by helping all parties understand and meet their trust and tax responsibilities and by developing standards for applying the tax law with integrity and fairness for all.
4. Propose clarifications and other recommendations and solutions to address issues raised at Tribal, regional and national levels.
5. Serve as a forum for Tribes and Treasury/IRS to discuss these issues and proposals for changes to Treasury/IRS regulations, policies and procedures.
6. Identify priorities and provide advice on appropriate strategies for Tribal consultation on issues at the Tribal, regional and/or national levels.
7. Ensure that pertinent issues are brought to the attention of Indian Tribes in a timely manner, so that timely Tribal feedback can be obtained.

The ACT recommends the Treasury/IRS STAC be comprised of the following members: one delegate (and one alternate) from fourteen federally recognized tribes (one delegate and alternate from each of twelve Bureau of Indian Affairs (BIA) regions with two delegates and alternates from Alaska and California), and one delegate (and one alternate) for twelve national or regional inter-tribal associations: National Congress of American Indians (NCAI), United South and Eastern Tribes (USET), All Indian Pueblo Council (AIPC), Inter-Tribal Council of Five Civilized Tribes (ICFCT), Arizona Inter-Tribal Council (AITC), California Association of Tribal Governments (CATG), Affiliated Tribes of Northwest Indians (ATNI), Michigan Association of Sovereign Tribes (MAST), Alaska Federation of Natives (AFN), Great Plains Tribal Chairman's Association (GPTCA), Inter-Tribal Council of Nevada (ITCN), and National Association of Financial Officers (NAFOA).

D. Treasury/IRS Tribal Consultation Policy

The ACT recommends the tribal consultation policy of the Department of Treasury and the Internal Revenue Service be amended to include the following provisions:

[113] See Official Records of the General Assembly, Sixty-first Session, Supplement No. 53 (A/61/53), part one, chap. II, sect. A., approved by the United Nations 107th plenary meeting on 13 September 2007.

> *The Department of Treasury shall adopt a policy of communication and consultation with all federally recognized American Indian and Alaska Native tribes. All Department bureaus and agencies shall comply with the policy. The policy shall provide for timely and meaningful communication and consultation with Indian tribes and shall permit elected officials and other representatives of tribal governments to provide timely and meaningful input into the development of legislation, regulations, rules, and policies on matters that significantly or uniquely affect the AI/AN tribes. The policy shall require the Department and its agencies to communicate and consult with AI/AN tribes before the Department or agency comments on legislation, or proposes or adopts regulations, rules, or policies that may materially affect AI/AN tribes.*

E. Undersecretary for Tribal Affairs

The ACT recommends the office of Undersecretary for Tribal Affairs be established to serve as the official point of contact for Tribes with the Department of Treasury and IRS. The Tribal Affairs office, to be effective, must be established within the immediate Office of the Secretary, report directly to the Secretary, and be the Department's lead office for Tribal Consultation in accordance with Executive Order 13175 - Consultation and Coordination with Indian Tribal Governments. Other duties and responsibilities of the Office of Undersecretary for Tribal Affairs should include:

- Coordination and management of tribal and native policy issues and serve as the Department's expert and informational resource to the Secretary
- Provide executive direction for the Secretary's intradepartmental council
- Collaboration and outreach to Tribes and national or regional Native associations
- Coordination of Department participation in national Tribal meetings and Tribal site visits for the Department's executive leadership
- Advice and assistance to the Department's executives and senior staff on tribal affairs
- Coordination of the Secretary's policy development for Tribes

F. More Clarity Needed – Proposed Revenue Procedure (Notice 2012-75)

We strongly recommend that the Service resolve uncertainties that have arisen since the issuance of the guidance. Narrow, undefined, and confusing language has led to some tribal leaders' opposition to the guidance. In some instances conversations with or presentations from IRS personnel on how the guidance will actually be implemented has been opposite of how it was interpreted on first read. Clarifying issues and communication on how the Service plans to implement will go far toward gaining acceptance of the guidance in its current state or until such time as other issues brought up in this report (community need and tribal sovereignty) can be dealt with.

The guidance in its current version only includes four definitions and these can easily be found in other places in the code or other federal registers. Needed are definitions for more specific terms used. We also feel that terms that could be interpreted differently by IRS and Tribal staff be more clearly defined. Tribal governments would find it helpful if terms or phrases such as 1) lavish or extravagant, 2) near reservation, 3) meals, 4) transportation, and 5) nominal just to name a few were included in a definitions section.

We also feel that using terms consistently throughout the guidance would be helpful. As an example in some areas transportation is a very general term, Section 5.02(c)(iii) "local transportation assistance" or Section 5.02(d)(ii) "pay for the cost of transportation … while the tribal member … is receiving medical care away from home." In other areas transportation is very specific, Section 5.02(d)(i) "pay bus, taxi, or public transportation fares from the Indian reservation to public facilities." These inconsistencies leave tribal governments wondering "we have no public transportation so if we pay for gas for a citizen to get to a public facility off reservation, is this still within the safe harbor?"

The ACT recommends the IRS consider adding additional programs or expanding current programs in the safe harbor provisions. Tribes in the initial comment period were apprehensive about putting forth actual programs that they wanted the Service to consider as GWE programs. In looking at the results of the guidance, many of the "asks" from Tribes concerning actual programs were addressed. Tribes now feel as though they should have included others such as daycare, down payment assistance, etc. The ACT recommends modification of the proposed guidance based on the comments and feedback to be received by the Service in June.

G. IRS To Provide Tribes Assurance About Training of Field Agents

The ACT recommends the IRS take immediate measures to provide better training to field agents to ensure tribes there will be no disconnect on the enforcement side of policies that specifically address tribal governments and their special status. Tribal governments would like to know what would be done to reduce the administrative burden in substantiating compliance with the proposed guidance where no further testing will be required. The ACT was provided little assurance of how this issue was to be addressed and when.

Tribal governments have raised alarms over several years about the dramatic increase in the number of Internal Revenue Service audits in Indian Country and how they have lacked focus, resulting at times in penalties assessed for tax enforcement that remained undefined. The ACT recommends a formal training curriculum be developed to educate IRS field agents as well as tribal administrators of GWE programs of the standard procedures that will be implemented in the event of a GWE review, exam or audit.

H. IRS Support for Tribal Best Practices

In Section IV and appendices to this Report the ACT offered recommendations for best practices by tribes in their implementation of the IRS proposed GWE guidance and requirements for policies and procedures to increase the likelihood that tribal programs meet the general criteria and safe harbor programs as defined in the proposed guidance. The ACT discussed and provided language to include in ordinances, resolutions, and policies and procedures.

The ACT recommends the IRS actively assist tribes, through direct contacts with tribes and national and regional inter-tribal organizations, in a collaboration intending to further develop best practices for tribes.

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Appendix A. Tribal Resolution Example

RESOLUTION # XX-XX

WHEREAS, the XYZ Tribe ("Tribe") was Federally acknowledged by the Secretary of the Interior of the United States of America on February 10, 1981; and

WHEREAS, the XYZ Tribal Council (the "Council") is the governing body of the Tribe, in accordance with its Constitution adopted on November 19, 1983, pursuant to the provisions of Part 81 of the Code of Federal Regulations, as such Constitution is amended from time-to-time; and

WHEREAS, the health, safety, welfare, education, and regulation of treaty fishing, hunting, and gathering practices of the Indian people of the Tribe is the responsibility of the Council; and

WHEREAS, the Tribe had determined that a community need exists and that it is in the best interest of the Tribe as a whole to provide assistance to tribal citizens in their pursuit of higher education; and

WHEREAS, Social Services department has developed the attached policies and procedures to implement this program; now

BE IT RESOLVED, that the Tribal Council formally approves the Higher Education general welfare assistance program as outlined in the attached policy.

____
Tribal Chair

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Appendix B. Program/Policy Examples

Example of Housing program: Home improvement grants to seniors. Sample qualification criteria may include:**

1) Resolution states that the safety and welfare of the Tribe's members are served by ensuring that member housing is habitable and safe for occupation; further that safe housing provides a stable environment for elderly tribal members which is necessary to their health and self-sufficiency;
2) Resolution describes general condition of senior housing on the reservation, and states that welfare program is necessary to address, for instance, a problem of substandard HUD housing;
3) Describe how the home improvement grant program is designed specifically to meet the need for improving senior, substandard housing;
4) Define Minimum Age requirement;
5) Where possible, provide the program will not make payments directly to the tribal members, but instead to the supplier/provider of services and equipment;
6) Confirm that this benefit is not paid equally to senior members (i.e. it does not look like a per capita)-only actual and substantiated home improvement costs qualify;
7) Limit the reimbursement to necessary expenses – no luxury items (however defined), for e.g.;
8) Confirm that this is not simply one of several benefits from which a member can choose from.

****THIS IS NOT AN EXHAUSTIVE LIST OF QUALIFYING CRITERIA AND IS NOT INTENDED AS TAX ADVICE – CONSULT WITH YOUR TAX ADVISOR****

Example of Elder program: Tribal elder travel policy. Sample qualification criteria may include:**

1) Approved policy states that the tribe respects and honors its elders and thus has developed a program where elders have the ability to travel to culturally significant events;
2) Approved policy states the intent of the program is to provide an opportunity for tribal elders to enhance cultural competency, promote social interaction and reduce isolation;
3) Trips may include travel to other tribes' cultural activities, ceremonies and traditional singing, drumming and dancing events that are planned by the Elder Coordinator in conjunction with recommendations from the Elder Committee;
4) Outlines how the applicant meets the qualifications of the program and what documentation is required;
5) Defines eligible travel costs that will be funded including airfare, transportation, per diem and lodging and admission fees to at-

tend educational or cultural opportunities consistent with tribal travel policies and procedures.

****THIS IS NOT AN EXHAUSTIVE LIST OF QUALIFYING CRITERIA AND IS NOT INTENDED AS TAX ADVICE – CONSULT WITH YOUR TAX ADVISOR****

Example of Cultural or Religious program: Burial supplement assistance program. Sample qualification criteria may include:**

1) Approved policy states that the burial of tribal elders is a culturally significant event and assisting the family of a tribal elder with final expenses is a defined community need;
2) Approved policy defines the minimum age requirement;
3) Describes the maximum amount that will be paid toward the final balance of the elder's burial expense;
4) Outlines how the applicant meets the qualifications of the program and what documentation is required;
5) States that benefit is payable directly to the funeral home and after all other avenues of payment are exhausted;
6) Limit the reimbursement to necessary expenses – maximum amount of benefit is a reasonable and necessary for a modest funeral service and not lavish or extravagant
7) Program is available for all tribal members who qualify and doesn't discriminate in favor of members of the governing body.

****THIS IS NOT AN EXHAUSTIVE LIST OF QUALIFYING CRITERIA AND IS NOT INTENDED AS TAX ADVICE – CONSULT WITH YOUR TAX ADVISOR****

Example of Education program: Graduation Assistance Program. Sample qualification criteria may include:**

1) Resolution or approved policy states that college graduation of a tribal member meets the needs of the tribal community by contributing to a more educated population and by permitting self-sufficiency through employment;
2) Resolution or approved policy states the intent of the program is to assist with one-time graduation expenses on a reimbursement basis;
3) Descriptions of who is an eligible student, the application process and required documents (which would include a final official college transcript and original receipts of payment for graduation-related expenses);
4) A verification process with the college/university registrar's office;
5) Definitions for the maximum benefit that is available up to a specific amount and only to the extent of actual receipts provided for necessary expenses (caps, gowns, invitations);

6) Program that, in this instance, will make payments directly to the tribal members but on a reimbursement-basis that would be similar to an accountable plan.

****THIS IS NOT AN EXHAUSTIVE LIST OF QUALIFYING CRITERIA AND IS NOT INTENDED AS TAX ADVICE – CONSULT WITH YOUR TAX ADVISOR****

Example of Other qualifying assistance program: Nonprescription Drug Cost program. Sample qualification criteria may include:**

1) Approved policy states the goal and purpose of the program, in this
   instance, to improve the health status of tribal citizens;
2) Statements that as part of its overall health program the tribe will provide reimbursement of costs for nonprescription drugs;
3) Definitions of the criteria established to qualify for the program
   a. Be an enrolled tribal citizen
   b. Has registered for benefits with the tribal health office
   c. Lives within the service area and doesn't maintain any other primary residence
4) Definitions of non-prescription drugs as over-the-counter medications, vitamin supplements and medical supplies, and equipment deemed medically necessary by a tribal healthcare provider or the tribal community health nurse;
5) Requirements for actual receipts to be submitted for reimbursement.

****THIS IS NOT AN EXHAUSTIVE LIST OF QUALIFYING CRITERIA AND IS NOT INTENDED AS TAX ADVICE – CONSULT WITH YOUR TAX ADVISOR****

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Appendix C. Recommended IRS Notice of GWE Policy Safe Harbor Guidance Through a Voluntary Compliance Program and a Rebuttable Presumption for Compliance

[*The following is an ACT recommendation for an IRS notice of GWE policy guidance*]

Implementation of General Welfare Exclusion Safe Harbor Guidance Through Voluntary Compliance Program and a Rebuttable Presumption for Compliance

I. PURPOSE AND OVERVIEW

This notice describes safe harbor methods that Indian tribal governments may use (but are not required to use) to determine Indian tribal government General Welfare Doctrine (TGWD) benefit programs that are treated as excluded from federal taxation for purposes of the General Welfare Exclusion (GWE) policy of the Internal Revenue Code (Code). Specifically, the administrative guidance in this notice, modifying and expanding on previous guidance, includes a voluntary compliance program to the safe harbor guidelines that Indian tribal governments may apply to TGWD programs to receive the rebuttable presumption of compliance with the Service's GWE policy under the revised guidance.

As described more fully below, this notice –

- Expands the safe harbor method described in the previous Notice 2012-75 to provide Indian tribal governments the option to participate in a voluntary compliance program with the Service's Indian Tribal Government (ITG) office for determining compliance with the Service's GWE policy guidance safe harbor provisions, without being subject to any penalty for the prior period or for the proceeding 24 months with respect to TGWD benefits distributed. [*a brief summary of IRS GWE policy for Indian tribal governments would follow*]

- Facilitates a transition for Indian tribal government TGWD program methods and the Service's prior GWE determination methods to the Service's GWE policy safe harbor guidance through the voluntary compliance program; and

- Provides Indian tribal governments reliance, at least through the end of 2015, on the voluntary compliance program contained in this notice and on the Service's GWE policy safe harbor guidance described in prior notices:

(1) for Indian tribal government TGWD programs reasonably calculated to meet a tribal community need, an Indian tribal government will be permitted a transition period of up to 24 months;

(2) for Indian tribal government TGWD programs, an Indian tribal government that maintains a TGWD program that is reasonably calculated to meet a tribal com-

munity need will have the rebuttable presumption of compliance with the Service's prior GWE policy;

(3) for Indian tribal government TGWD programs, an Indian tribal government that maintains a TGWD program that is reasonably calculated to meet a tribal community need will not be subject to an assessable payment or penalty under the Service's prior GWE policy for failing to document to transaction or satisfy the prior definition of need; and

(4) for all tribal citizens, a tribal citizen will not be subject to an assessable payment or penalty under the Service's prior GWE policy for a TGWD benefit if the benefit offered to that employee was reasonably calculated to satisfy a tribal community need (referred to as the Indian tribal government (ITG) need safe harbor).

This guidance is intended to encourage Indian tribal governments to continue providing and potentially to expand TGWD program coverage for their tribal citizens by permitting the Service to implement revised GWE safe harbor guidance and for Indian tribal governments to adopt reasonable procedures to comply with the Service's GWE safe harbor guidance without becoming liable for a assessment or penalty, to protect Indian tribal governments and tribal citizens from unnecessary cost, confusion, and disruption of needed TGWD programs, and to minimize administrative burdens on Indian tribal governments.

Simultaneously with the issuance of this notice, the Department of the Treasury announces:

(1) the establishment of the Treasury Secretary's Tribal Advisory Committee (STAC) to be comprised of tribal leaders from each of the 12 Bureau of Indian Affairs regions and regional inter-tribal government organizations to advise the Secretary and Service on tribal issues and to jointly develop administrative guidance on issues of concern for Indian tribal government interests;

(2) the establishment of the position in the Department of Treasury of Undersecretary for Indian Tribal Government Affairs to coordinate the STAC activities, to advance STAC issues within the Department and the Service, the implement to tribal consultation policy for the Department and Service, and to advise the Secretary on Indian tribal government issues and actions; and

(3) the consultation with Indian tribal governments for the Service's GWE policy safe harbor and voluntary compliance program for a period of 24 months to develop administrative guidance and recommendations.

This notice consists of a background section briefly summarizing the Service's GWE policy (section I); the statutory and common law framework for the inherent sovereignty of Indian tribal governments (section II); the administrative guidance issued to date for the GWE safe harbor guidance (section III); a description of the voluntary compliance program for the Service's GWE policy safe harbors available for Indian tribal governments for determining exclusion from income for purposes of federal taxation in the case of prior TGWD programs and forward-looking during the transition to the Service's revised GWE safe harbor guidelines and a series of examples illustrating how the safe harbors apply) (section IV); a description of the reliance provided to Indian tribal governments through at least 2015 (section V); and a request for Indian tribal government comments (section VI).

II. BACKGROUND

III. GWE SAFE HARBOR ADMINISTRATIVE GUIDANCE

IV. VOLUNTARY COMPLIANCE PROGRAM FOR IRS GWE POLICY SAFE HARBORS PROGRAM

V. RELIANCE PROVIDED TO INDIAN TRIBAL GOVERNMENTS THROUGH 2015

VI. SCHEDULE FOR TRIBAL CONSULTATION AND REQUEST FOR INDIAN TRIBAL GOVERNMENT COMMENTS

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Tax Exempt Bonds: A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

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J. Sue Painter
Lorraine Tyson

2013

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I. Executive Summary

While tax-exempt governmental bond issues of $100 million or more get the lion's share of the press coverage in *The Bond Buyer* and other municipal bond publications, in reality, tax-exempt governmental bond issues under $10 million comprise a supermajority of the number of all tax-exempt governmental bond issues in recent years. As reported by the IRS Statistics of Income Division, for the reporting years 2006-2010 (information most readily available as of the date of this report), the number of issues of tax-exempt governmental bonds with par values under $10 million comprised approximately 85% of the total number of all issues of tax-exempt governmental bonds in each of those calendar years.

Section 148 of the Internal Revenue Code of 1986, as amended and its regulations restrict the amount of "arbitrage" which an issuer or conduit borrower can earn and retain from investing proceeds of a tax-exempt or other tax-advantaged bond issue (the "Arbitrage Requirements"). As applied to tax-exempt bonds, "arbitrage" generally refers to the profit earned from taxable investments purchased with proceeds of bonds bearing interest at tax-exempt rates. There are two main categories of Arbitrage Requirements – yield restriction and rebate. If ***either*** the yield restriction requirements ***or*** the rebate requirements are not satisfied, tax-exempt bonds become "arbitrage bonds" and lose their tax-exempt status. Although the rebate rules have applied since the enactment of the Tax Reform Act of 1986 and the concept of yield restriction dates to the Tax Reform Act of 1969, many issuers and conduit borrowers still find the rules difficult to understand and apply.

From conversations with IRS representatives, rebate professionals and various bond counsel, the Tax Exempt Bonds Subcommittee (the "Subcommittee") of the Advisory Committee on Tax Exempt and Government Entities (ACT) has learned that smaller and infrequent issuers and smaller conduit borrowers make certain recurring errors in calculating rebate and also frequently calculate rebate, but fail to prepare a yield restriction analysis.

The Subcommittee recognizes that under current market conditions, yield restriction and payment of rebate are rare since there are few eligible investments that issuers and conduit borrowers can invest in that produce yields higher than their tax-exempt bond yields. However, the Arbitrage Requirements have continuing applicability and at some point in the future yield restriction and payment of rebate will occur more frequently. The Subcommittee has drafted proposed publications on the Arbitrage Requirements tailored to issuers of tax-exempt governmental bond issues and conduit borrowers of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount and recommends that the IRS publish these proposed IRS publications to assist such issuers and borrowers in complying with the Arbitrage Requirements.

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II. Introduction

Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and its regulations restrict the amount of "arbitrage" which an issuer or conduit borrower can earn and retain from investing proceeds of a tax-exempt bond issue (the "Arbitrage Requirements").[1] As applied to tax-exempt bonds, "arbitrage" generally refers to profit earned from taxable investments purchased with proceeds of bonds bearing interest at tax-exempt rates. There are two main categories of Arbitrage Requirements – yield restriction and rebate. If ***either*** the yield restriction requirements ***or*** the rebate requirements are not satisfied, tax-exempt bonds become "arbitrage bonds"[2] and lose their tax-exempt status.

The Arbitrage Requirements are among the most complicated rules applicable to tax-exempt bonds. Although the rebate rules have applied since enactment of the Tax Reform Act of 1986[3] and the concept of yield restriction dates to the Tax Reform Act of 1969,[4] many issuers and borrowers still find the rules difficult to understand and apply. The Subcommittee recognizes that under current market conditions, yield restriction and payment of rebate are rare since there are few eligible investments that issuers and conduit borrowers can invest in that produce yields higher than their tax-exempt bond yields. However, the Arbitrage Requirements have continuing applicability and at some point in the future yield restriction and payment of rebate will occur more frequently. The Subcommittee believes that smaller and infrequent issuers and conduit borrowers[5] would benefit from guidance on the Arbitrage Requirements directed to their circumstances.

[1] The Arbitrage Requirements also apply to bonds issued by state and local governmental issuers that are eligible for tax-advantaged treatment such as Build America Bonds and certain tax credit bonds.
[2] IRC §148(a), provides that the term "arbitrage bond" means "any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly -- (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments." IRC §148(a) further provides that a bond will be an arbitrage bond if an issuer intentionally uses any portion of bond proceeds to invest in or replace funds invested in higher yielding investments. "Higher yielding investments" are defined in IRC §148(b)(1) as any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.
[3] Pub.L. 99–514.
[4] Pub.L. 91–172.
[5] In practice, many conduit issuers require in their bond documents that the conduit borrowers assume responsibility for complying with the Arbitrage Requirements for the related tax-exempt conduit bonds. The IRS's stated position is that compliance with the Arbitrage Requirements and other tax requirements for tax-exempt conduit bonds is the responsibility of the conduit issuer. See Publication 5005 *Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds* (Rev. 4-2012).

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III. History

"Arbitrage bonds" were born with the enactment of the Tax Reform Act of 1969 (the "1969 Act")[6] which amended Section 103 of the 1954 Internal Revenue Code to make the interest on any "arbitrage bond" taxable.[7] The new provision generally defined "arbitrage bonds" as state or local government bonds which are expected, directly or indirectly, to be invested in or used to acquire, taxable investments having a "materially higher" yield over the term of the bond issue than the yield on the bonds.[8] In 1895, the U.S. Supreme Court, in *Pollock v. Farmers' Loan & Trust Company*,[9] held that interest on municipal bonds was protected from income taxation by the federal government under the Tenth Amendment.[10] Prior to the 1969 Act, the exemption from income tax on state and local government debt was unconditional, as reflected in the Revenue Act of 1913,[11] the Internal Revenue Code of 1939[12] and the Internal Revenue Code of 1954.[13]

The municipal bond market greatly expanded between 1812, when the City of New York issued the first recorded general obligation bonds,[14] and the 1960s. By 1960, $66 billion of state and local government debt was outstanding.[15] During the 1960s, policymakers began to question the loss of federal tax revenue on the profit governmental issuers earned from borrowing funds at lower tax-exempt rates through the issuance of governmental debt and investing such borrowed funds in taxable investments with higher interest rates.[16] This led to the "yield restriction" rules imposed by the 1969 Act.[17]

Pursuant to express statutory authority to prescribe regulations to carry out the new provisions,[18] the Department of Treasury (Treasury) proposed regulations which prescribed the method of computing yield and defined what constitutes "materially higher" yield. The statute provided a limited exception to treatment as "arbitrage bonds" if bond proceeds were invested only until needed for the purpose of the bonds. In interpreting this exception, the post-

[6] Pub.L. 91–172.
[7] This provision was presaged by a 1966 announcement (TIR-840, August 11, 1966), that the IRS would no longer issue favorable rulings on the tax-exempt status of municipal bonds where a substantial part of the proceeds of the issued were to be invested in taxable obligations pledged as security for the bonds. See Ritter and Miller, *infra* at footnote 16.
[8] §103(d) of the Internal Revenue Code of 1954 as added by §601 of the Tax Reform Act of 1969.
[9] 157 U.S. 429 (1895).
[10] The Tenth Amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."
[11] Ch. 16, 38 Stat. 114.
[12] Ch. 2, 53 Stat. 1.
[13] Ch. 736, 68A Stat. 3.
[14] Fahim, Mayraj. "Municipal Bonds Have Been Issued Since 1812" (March 20, 2012) available at /www.citymayors.com/finance/bonds.html. (March 20, 2012).
[15] Fahim, Mayraj, *supra* footnote 8.
[16] Ritter and Miller, 271-2d T.M. Federal Arbitrage Law (1978), p. A-1.
[17] During this period policymakers also questioned the loss of federal revenue attributable to "industrial development bonds" and the Revenue and Expenditure Control Act of 1986, Pub. L. 90-364 (1968), §107 limited the availability of tax-exemption for this category of bonds.
[18] §103(d)(5) of the Internal Revenue Code of 1954 as added by the Tax Reform Act of 1969.

1969 Act regulations developed the concept of "temporary periods" of unrestricted yield. The regulations also interpreted the related statutory exception to yield restriction for a reasonably required reserve fund with no more than 15% of bond proceeds.[19] Regulations were initially proposed in 1972[20] and were amended many times[21] until final regulations were adopted in 1979.[22] The amendments both revised original concepts[23] and responded to the types of transactions occurring in the market.[24] These regulations illustrate by their number and content the complexity inherent in the concepts related to "arbitrage bonds."

The statutory scheme was dramatically revised by the Tax Reform Act of 1986[25] which retained Section 103 to provide the basic rule for tax-exempt bonds, but added new Sections 141 through 150, which codified many of the rules set forth in existing regulations, revenue rulings and procedures but also added new rules and concepts. Pre-1986, if bond proceeds were "reasonably expected" at the time of issuance to be invested at a "materially higher" yield, the bonds were "arbitrage bonds". Section 148, as added by the Tax Reform Act of 1986, continues the "reasonable expectations" test but also defines bonds as "arbitrage bonds" if the issuer intentionally invests bond proceeds at a "materially higher" yield. Most significantly, the Tax Reform Act of 1986 extended to all types of state and local government bonds, the rebate requirement that, previously had applied only to industrial development bonds.[26]

The rebate branch of the Arbitrage Requirements is a separate and independent set of rules that must be met in addition to the "yield restriction" rules. An issuer is required to rebate to the federal government, the "arbitrage" earned from the investment of bond proceeds in investments with materially higher yields over the life of a bond issue generally at 5-year intervals.[27] Today these complex rules are still confusing to apply especially for governmental issuers of bond issues that do not exceed $10,000,000 and smaller conduit borrowers of qualified Section 501(c)(3) bond proceeds.

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[19] §103(d)(4) of the Internal Revenue Code as added by the Tax Reform Act of 1969.
[20] Prop. Regs. §103 -13; 37 Fed. Reg. 10946 (June 1, 1972).
[21] 38 Fed. Reg. 10944 (May 3, 1973) as corrected by 38 Fed. Reg. 12405 (May 11, 1973); 40 Fed. Reg. 56488 (December 3, 1975) as corrected by 40 Fed. Reg. 58656 (December 18, 1975); 41 Fed. Reg. 47682 (October 29, 1976) as corrected by 41 Fed. Reg. 51840 November 24, 1976); 42 Fed. Reg. 27610 (May 31, 1977); 42 Fed. Reg. 29517); 42 Fed. Reg 61613 (December 6, 1977); 43 Fed. Reg. 19675 (May 3, 1978); 43 Fed. Reg. 39822 (Sept. 7, 1978).
[22] T.D. 7627 (filed May 5, 1979).
[23] For example, the regulations initially proposed that yield be computed on the "investment bankers method" but changed to the actuarial or "true interest cost" method. See Ritter and Miller, page A-3, *supra* footnote 19.
[24] See Ritter and Miller, page A-2, *supra* footnote 16.
[25] Pub. L. 99-514.
[26] The Deficit Reduction Act of 1984, Pub. L. 98–369, imposed the rebate requirement on industrial development bonds. In addition, the Mortgage Subsidy Bond Tax Act of 1980 (Title XI of Pub, Law 96-499 amended by Pub. L. 96-595 (1980)), provided an option to pay all arbitrage earned on nonmortgage investments to the mortgagors as rapidly as practical or pay such arbitrage to the U.S. every 5 years. See The First Book of Arbitrage, reprinted from Continuing Professional Education Exempt Organizations Technical Instruction Program for FY 1994 Training 4277-045, page 204 available at *www.irs.gov/pub/irs-tege/part2g02.pdf*.
[27] IRC §148(f).

IV. Analysis

While tax-exempt governmental bond issues of $100 million or more get the lion's share of the press coverage in *The Bond Buyer* and other municipal bond publications, in reality, tax-exempt governmental bond issues under $10 million represent a supermajority of the number of all tax-exempt governmental bond issues in recent years. As reported by the IRS Statistics of Income Division, for the reporting years 2006-2010 (information most readily available as of the date of this report), the number of issues of tax-exempt governmental bonds with par values under $10 million comprised approximately 85% of the total number of all issues of tax-exempt governmental bonds in each of those calendar years.[28] As used in this report, the term "Smaller Issuers" refers to issuers of tax-exempt governmental bond issues and conduit borrowers[29] of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount.

In preparing this report, the Subcommittee spoke with various bond counsel and rebate professionals and obtained information from representatives of the Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division, about their experiences with the quality of compliance with the Arbitrage Requirements. The private sector professionals related that, in their experience, a majority of smaller and infrequent issuers remain unclear about their obligations with regard to Arbitrage Requirements and have difficulty understanding and applying these rules. TEB representatives confirmed this and reported that some smaller and infrequent issuers fail to complete a rebate analysis for a variety of reasons including lack of awareness that the requirement applies to their bond issues. They also reported that some of these issuers make computational errors or recognize their rebate obligation but overlook the yield restriction requirement. The most frequent errors encountered by IRS representatives are failure to:

- calculate variable bond yield correctly;
- apply the disbursement method correctly;[30]
- account for all gross proceeds subject to the rebate requirement;
- make a yield restriction analysis even if rebate is calculated;

[28] *www.irs.gov/uac/SOI-Tax-Stats-Tax-Exempt-Bond-Statistics*.

[29] In practice, many conduit issuers require in their bond documents that the conduit borrowers assume responsibility for complying with the Arbitrage Requirements for the related tax-exempt conduit bonds. However, the IRS's stated position is that compliance with the Arbitrage Requirements and other tax requirements for tax-exempt conduit bonds is the responsibility of the conduit issuer. *See* Publication 5005, Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds (Rev. 4-2012).

[30] TEB representatives report that issuers frequently use deposits (e.g., an initial investment) to and withdrawals (e.g., cash expenditures) from bond funds (the "disbursement method") in making arbitrage calculations. This approach does not comply with the method prescribed in the arbitrage regulations which define rebate as the excess of the future value of all "receipts" over the future value of all "payments" on nonpurpose investments. Treas. Reg. §1.148-3 (c). Both "receipts" and "payments" as defined in the regulations represent investment transactions and allocations of investments rather than general deposits and withdrawals.

- apply spending exceptions correctly; and
- properly value investments at the end of the computation period.

V. Conclusion

Based on the foregoing information and analysis, the Subcommittee believes that Smaller Issuers face challenges in carrying out their arbitrage compliance responsibilities with respect to tax-exempt bonds. In recent years, the IRS has encouraged issuers to adopt post-issuance compliance procedures that cover all post-issuance tax requirements including arbitrage. Recently, the IRS has revised the Form 8038-G information return for governmental bonds and the Form 8038 information return for qualified Section 501(c)(3) bonds and other private activity bonds to ask whether the issuer established written procedures to monitor the requirements of Section 148 of the Code.[31] Some of the Forms in the 8038 series ask specific questions, (i) whether the issuer has elected to pay a penalty in lieu of rebate, and (ii) (a) whether the issuer will be reimbursed from bond proceeds for prior expenditures, (b) the amount of the reimbursement and (c) the date the required official intent was adopted. The instructions for each Form 8038 that asks about written procedures simply direct the issuer to "[C]heck the box if the issuer has established written procedures to monitor compliance with the arbitrage, yield restriction and rebate requirements of Section 148" without further guidance.

As described in Part IV, Analysis, there are recurring areas of difficulty with compliance among Smaller Issuers such as lack of awareness of the yield restriction rules, failure to apply the spending exceptions to rebate correctly and failure to calculate variable bond yield correctly. Failure to apply the disbursement method correctly[32] and failure to properly value investments at the end of the computation period are other frequent errors. TEB representatives attribute frequently occurring failures to lack of policies and procedures, the assumption that a conduit borrower is obligated to fulfill the Arbitrage Requirements instead of the conduit issuer or confusing the concept of a small issuer of "bank qualified bonds" with the "$5 Million Small Issuer" exception to rebate.

The IRS has described the Arbitrage Requirements in several publications,[33] training materials and resources for professionals and in 2012, as part of its outreach efforts, conducted a telephone forum on arbitrage and rebate compliance. Generally, existing publications provide an overview of the Arbitrage Requirements and the Subcommittee believes that Smaller Issu-

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[31] Form 8038-G (Information Return for Tax-Exempt Governmental Obligations) (Rev. September 2011)(Form 8038-G"), Form 8038 (Information Return for Tax-Exempt Private Activity Bonds) (Rev. April 2011)(Form 8038"), Form 8038 -B (Information Return for Build America Bonds and Recovery Zone Economic Development Bonds) (January 2012) (Form 8038-B") and Form 8038-TC (Information Return for Tax Credit Bonds and Specified Tax Credit Bonds) (June 2010) (Form 8038-TC")also include this question. Form 8038-GC (Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales) (Rev. January 2012) (Form 8038-GC"), which applies to issues of tax-exempt governmental obligations with issue prices of less than $100,000, does not ask whether the issuer has adopted such written procedures. Copies of these forms are available under *www.irs.gov/Forms-&-Pubs* by searching current forms for 8038s.

[32] See footnote 30 *supra*.

[33] Publication 4077 Tax-Exempt Bonds for 501(c)(3) Charitable Organizations / Compliance Guide (09-2005): Publication 4078 Tax-Exempt Private Activity Bonds / Compliance Guide (09-2005): Publication 4079 Tax-Exempt Governmental Bonds / Compliance Guide (09-2005).

ers would benefit from an IRS Publication in the form of a step-by-step guide to applying the Arbitrage Requirements.

The Subcommittee recognizes that the IRS's position is that the conduit issuer is the taxpayer responsible for compliance with the Arbitrage Requirements. However, in practice, many conduit issuers require in their bond documents that the conduit borrowers assume responsibility for complying with the Arbitrage Requirements for the related tax-exempt conduit bonds. Accordingly, the Subcommittee recommends that any published guidance on the Arbitrage Requirements be directed not only to issuers of governmental bond issues under $10,000,000 in principal amount, but also to conduit borrowers of qualified Section 501(c)(3) bond issues under $10,000,000 in principal amount.

The Subcommittee also believes that Smaller Issuers would benefit from guidance in developing written policies and procedures for post-issuance compliance and guidance on whether or not to hire outside arbitrage compliance professionals. The Subcommittee recognizes that the IRS may have legitimate concerns[34] in publishing an example of written post-issuance compliance procedures set forth in Appendix B - Establishing Written Post-Issuance Compliance Procedures. However, the Subcommittee believes that a baseline model of written post-issuance compliance procedures would be especially helpful to Smaller Issuers since it would provide them a good starting point in drafting such procedures which after implementation would help them better comply with the Arbitrage Requirements (including, but not limited to, identifying critical deadlines in monitoring temporary periods, meeting spending requirements for rebate exceptions, calculating rebate and paying any rebate due).

Accordingly, the Subcommittee recommends that the IRS issue publications targeted to Smaller Issuers to provide guidance on arbitrage compliance, development of written post-issuance compliance procedures and whether or not to hire outside arbitrage compliance professionals. Suggested forms of these publications are attached as:

- Appendix A – A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers;
- Appendix B – Establishing Written Post-Issuance Compliance Procedures for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers; and
- Appendix C – Engaging An Arbitrage Compliance Professional for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds.

[34] For example, the IRS could encounter difficulties in an exam if an issuer asserts that it implemented and followed the published model procedures as a defense to an adverse determination from the IRS on its tax-exempt bonds.

Appendix A

[Proposed IRS Publication]

A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

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A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

I. Introduction

The Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division, offers specialized information and services to the municipal finance community. Municipal bonds provide tax-exempt financing for the furtherance of governmental and qualified purposes including constructing hospitals, recreational and cultural facilities, schools, water infrastructure, road improvements, as well as facilities and equipment used in providing police, fire and rescue services.

This IRS Publication, A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers, is a guide for smaller and infrequent issuers of tax-exempt governmental bonds and smaller conduit borrowers of qualified Section 501(c)(3) bonds to the yield restriction requirements and rebate requirements of Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and applicable Treasury Regulations. As used in this Publication, "Smaller Issuers" refers to issuers of tax-exempt governmental bond issues and conduit borrowers of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount.

The information provided in this IRS Publication does not include any special rules that may apply to bond pools, Build America Bonds, tax credit bonds or private activity bonds other than qualified Section 501(c)(3) bonds. In addition, the information is intended primarily as a basic guide and does not necessarily address all questions or issues that may arise in complying with the Arbitrage Requirements for all types of issues.

This Publication provides information about the specific rules described herein. It does not address the other federal tax requirements that must be met in order for bonds to bear tax-exempt interest. IRS Publication 4079, Tax-Exempt Governmental Bonds and IRS Publication 4077, Tax-Exempt Bonds for 501(c)(3) Charitable Organizations provide a general overview of federal tax rules that apply post-issuance to governmental bonds and qualified Section 501(c)(3) bonds respectively. All applicable federal tax law requirements must be met during the life of tax-exempt bonds to ensure that interest earned by tax-exempt bondholders is not subject to federal income taxes.

TEB also provides detailed information on specific provisions of the tax law through IRS publications (available online) and through outreach efforts as noted on the TEB website at www.irs.gov/Tax-Exempt-Bonds.

Readers of this Publication should consult their own counsel for legal advice on whether the Arbitrage Requirements are met with respect to a particular issue of bonds.

II. The Arbitrage Requirements Generally

Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and its regulations restrict the amount of "arbitrage" which an issuer or conduit borrower can earn and retain from investing proceeds of a tax-exempt bond issue (the "Arbitrage Requirements").[1] As applied to tax-exempt bonds, "arbitrage" generally refers to profit earned from taxable investments purchased with proceeds of bonds bearing interest at tax-exempt rates. There are two main categories of Arbitrage Requirements – yield restriction and rebate. If ***either*** the yield restriction requirements ***or*** the rebate requirements are not satisfied, tax-exempt bonds become "arbitrage bonds"[2] and lose their tax-exempt status.

Yield restriction. Section 148(a) of the Code generally provides that bonds are arbitrage bonds if the issuer expects to invest or actually invests all or a portion of the bond proceeds at a yield that is materially higher than the bond yield. Exceptions under Section 148(c) of the Code and related regulations permit unrestricted investment during certain temporary periods, in a reasonably required reserve fund, of a "minor portion" or in certain tax-exempt investments. In other words, in these instances the issuer can invest bond proceeds in investments with yields materially higher than the bond yield. If no exception permits unrestricted investment, the relevant bond proceeds must be "yield restricted" (i.e., used to make investments with yields not materially higher than the yield on the bonds or, in limited circumstances, the issuer may instead remit yield reduction payments to the federal government). However, any arbitrage that the issuer earns in these instances must be rebated to the federal government unless a specific exception to the rebate requirement applies.

Rebate. Section 148(f) of the Code generally provides that arbitrage must be paid to the federal government as rebate unless a specific exception to the rebate requirement applies to the bond issue. Otherwise, the bonds become "arbitrage bonds." *If exceptions to rebate apply, the "yield restriction" rules must still be satisfied.*

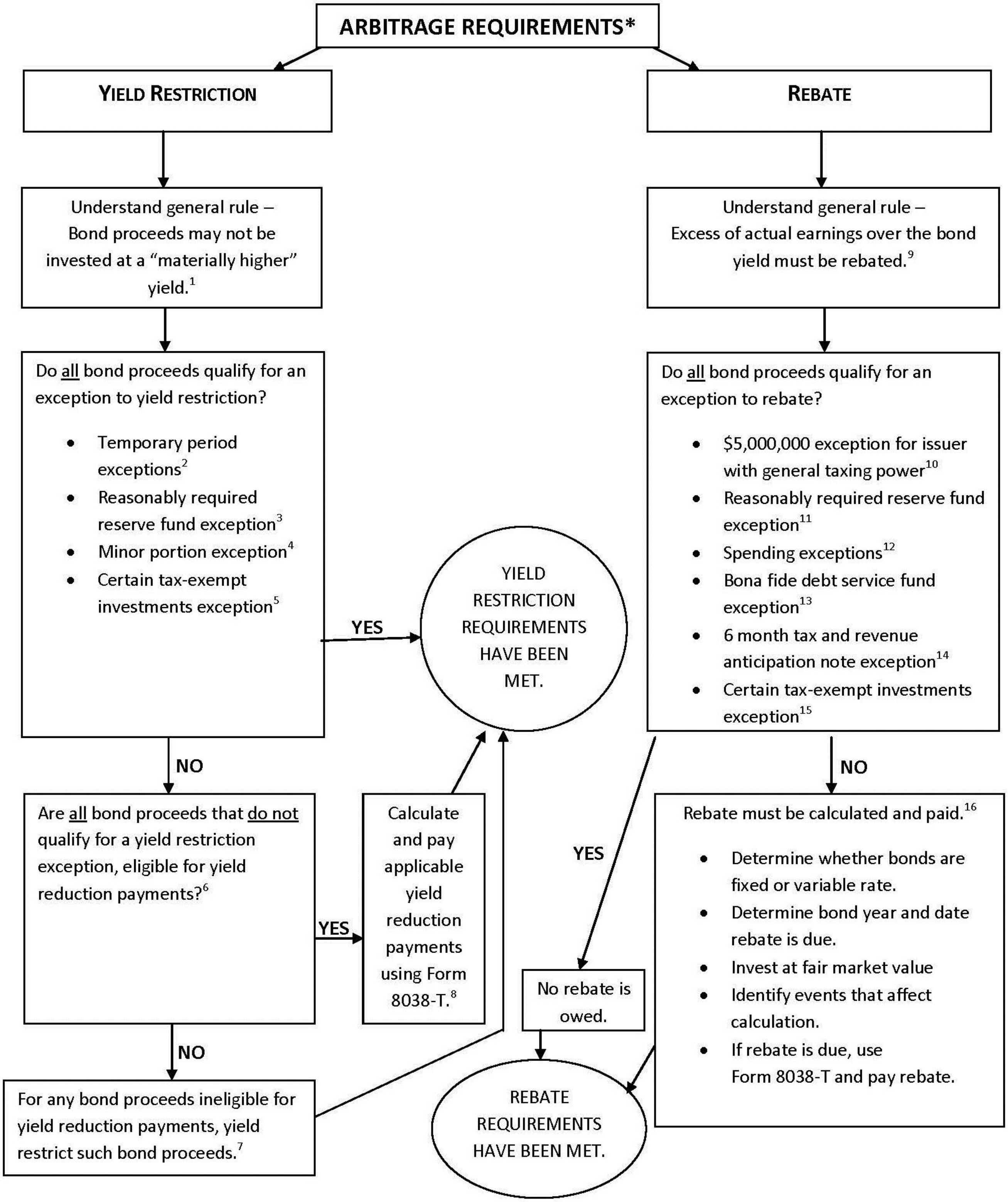
[1] The Arbitrage Requirements also apply to bonds issued by state and local governmental issuers that are eligible for tax-advantaged treatment such as Build America Bonds and certain tax credit bonds.
[2] IRC §148(a), provides that the term "arbitrage bond" means "any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly -- (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments." §148(a) further provides that a bond will be an arbitrage bond if an issuer intentionally uses any portion of bond proceeds to invest in or replace funds invested in higher yielding investments. "Higher yielding investments" are defined in §148(b)(1) as any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.

III. Roadmap to Arbitrage Requirements Chart

The following chart outlines a process for determining whether the yield restriction and rebate requirements applicable to tax-exempt governmental and qualified Section 501(c)(3) bonds are met by highlighting key questions that should be addressed in the process. Please see the sections of this Publication that are referenced in the chart for a more in-depth discussion of the yield restriction and rebate requirements.

Roadmap to Arbitrage Requirements

(See endnotes referenced below on next page)



*Failure to comply with the arbitrage requirements of the Internal Revenue Code of 1986 causes tax-exempt bonds to become "arbitrage bonds," the interest on which is not exempt from federal income taxes.

Endnotes from Roadmap to Arbitrage Requirements Chart

[1] See Section IV. A. Yield Restriction – General Rule.

[2] See Section IV. B. 1. Exceptions to Yield Restriction – Temporary Periods.

[3] See Section IV. B. 2. Exceptions to Yield Restriction - Reasonably Required Reserve Fund.

[4] See Section IV. B. 3. Exceptions to Yield Restriction - Minor Portion Exception.

[5] See Section IV. B. 4. Exceptions to Yield Restriction – Exception for Certain Tax-Exempt Investments.

[6] See Section IV. C. How is Yield Restriction Satisfied If There is No Exception and Section IV. D. What is "Materially Higher" than the Bond Yield.

[7] See Section IV. C. How is Yield Restriction Satisfied If There is No Exception and Section IV. D. What is "Materially Higher" than the Bond Yield.

[8] See Section IV. C. How is Yield Restriction Satisfied If There is No Exception and Section IV. D. What is "Materially Higher" than the Bond Yield.

[9] See Section V. Rebate, Subsection A. - General Rule and Subsection B. - Definition of Rebate.

[10] See Section V. C. 1. Exceptions to Rebate - Small Issuer Exception.

[11] See Section V. C. 2. Exceptions to Rebate - Reasonably Required Reserve Fund Exception.

[12] See Section V. C. 3. Exceptions to Rebate - Spending Exceptions to Rebate.

[13] See Section V. C. 4. Exceptions to Rebate - Bona Fide Debt Service Fund Exception.

[14] See Section V. C. 5. Exceptions to Rebate - TRAN Exception.

[15] See Section V. C. 6. Exceptions to Rebate - Exception for Certain Tax-Exempt Investments.

[16] See Section V. Rebate, Subsection D. Amount of Rebate Due, Subsection E. Computation Date, Subsection F. Payments and Receipts and Payments on Nonpurpose Investments, Subsection G. Determination of Future Value and Subsection H. Paying Rebate.

IV. Yield Restriction

A. General Rule

Tax-exempt bond proceeds may not be invested at a "materially higher" yield than the yield on the bonds. Under Section 148(a) of the Code, bonds are arbitrage bonds if the issuer expects to invest or actually invests all or a portion of the bond proceeds at a yield that is "materially higher" than the bond yield.[3] Bond proceeds that may not be invested at a "materially higher" yield than the bond yield must be "yield restricted".

There are exceptions to yield restriction for all or portions of bond proceeds during "temporary periods",[4] proceeds held in a "reasonably required reserve or replacement fund",[5] proceeds representing a "minor portion"[6] and proceeds invested in certain tax-exempt investments all of which are discussed below. Bond proceeds that do not qualify for an exception or after expiration of an applicable "temporary period", must be yield restricted.

Despite exceptions to yield restriction, some bond proceeds may still be subject to rebate. If this is the case, any arbitrage that the issuer or conduit borrower earns must be rebated to the federal government. As an example, a reasonably required reserve or replacement fund is subject to rebate even though it need not be yield restricted.

B. Exceptions to Yield Restriction

1. Temporary Periods

The "temporary period" exceptions to yield restriction apply for specified periods of time and depend on the purpose for which the bonds are issued and the type of fund in which the proceeds are held.

a. 3-Year Temporary Period for Capital Projects

The 3-year temporary period is available for bond proceeds expected to be used for acquisition or construction of capital projects which are commonly deposited in a construction or project fund.

Generally, the proceeds in the construction/project fund are the proceeds that the issuer or conduit borrower expects to spend on acquisition or construction of capital projects. As a technical matter, these are the "net sale proceeds",[7]

[3] Id.
[4] IRC §148(c).
[5] IRC §148(d).
[6] IRC §148(e).
[7] Net sale proceeds" of a bond issue are the proceeds received or constructively received by the issuer from the sale of the

(which include capitalized interest raised with the bond issue) and the "investment proceeds"[8] resulting from the investment of the money deposited in the fund. Often costs of issuance included in the sizing of the issue are also deposited in the construction/project fund.

These "net sale proceeds" and the resulting "investment proceeds" are eligible for an exception from yield restriction for a 3-year temporary period (from the date of issuance of the bonds)[9] so long as the issuer reasonably expects:

(i) to incur a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds on the capital project within 6 months of the date of issuance of the bonds;[10]

(ii) to allocate at least 85% of the net sale proceeds of the issue to expenditures on the capital project within 3 years of the date of issuance of the bonds;[11] and

(iii) that the completion of the project and allocation of net proceeds to the expenditure proceeds with due diligence.[12]

The issuer must certify these expectations which are usually included in the tax certificate executed in connection with the issuance of the bonds.

b. Other Temporary Periods

(1) *Extension to 5-Year Temporary Period*. The 3-year temporary period may be extended to five years if the issuer and a licensed architect or engineer certifies that a period longer than three years is necessary to complete the capital project.[13]

(2) *13-month temporary period for bona fide debt service funds*. Amounts in a bona fide debt service fund qualify for a 13-month temporary period.[14]

bonds (includes amounts used to pay underwriter's discount or compensation and accrued interest other than pre-issuance accrued interest) reduced by proceeds deposited in a "reasonably required reserve and replacement fund" and proceeds invested for a "minor portion". Treas. Reg. §1.148-1(b).

[8] The regulations define "investment proceeds" as any amounts actually or constructively received from investing proceeds of an issue. Treas. Reg. §1.148-1(b).

[9] Treas. Reg. §1.148-2(e)(2).

[10] Treas. Reg. §1.148-2(e)(2)(i)(B).

[11] Treas. Reg. §1.148-2(e)(2)(i)(A).

[12] Treas. Reg. §1.148-2(e)(2)(i)(C).

[13] Treas. Reg. §1.148-2(e)(2)(ii).

[14] Treas. Reg. §1.148-2(e)(5)(ii).

A bona fide debt service fund is one that is used primarily to achieve a proper matching of revenues and debt service during each year by depositing revenues in the fund until they are needed to pay debt service. The fund must be depleted at least once each bond year, except for a residual amount that does not exceed one/twelfth of the debt service on the bonds for the prior bond year or the earnings on the fund for the prior bond year.[15]

(3) *13-month temporary period for restricted working capital expenditures*. Proceeds of a bond issue that are expected to be used for restricted working capital expenditures[16] within 13 months of the date of issuance may be invested without regard to yield restriction during those 13 months.[17] This category consists of general working capital and does not include working capital associated with bond issuance such as issuance costs and accrued or capitalized interest.

Note: The 13-month temporary period is extended to the maturity date of tax and revenue anticipation notes (TRANS) if:[18]

a) The issuer expects to use tax revenues for a single fiscal year to redeem or retire an issue; AND

b) The TRANS will mature by the earlier of 2 years after the issue date or 60 days after the last date the tax payments are due.

(4) *30-day temporary period for replacement proceeds*. Replacement proceeds qualify for a 30-day temporary period from the date the proceeds are first treated as replacement proceeds.[19]

(5) *1-year temporary period for investment proceeds*. Investment proceeds qualify for a 1-year temporary period from date of receipt.[20]

(6) *30-day temporary period for other amounts*. Gross proceeds not qualifying for any other special temporary period exception under §148(c) of the Code or Treas. Reg. §1.148-2(e), qualify for a 30-day temporary period exception from date of receipt.[21]

[15] Treas. Reg. §1.148-1(b). Generally, "bond year" means each 1-year period that ends on the day selected by the issuer.
[16] "Restricted working capital expenditures" means working capital expenditures that are subject to the proceeds- spent-last rule of Treas. Reg. §1.148-6(d)(3)(i) and are ineligible for any exception to that rule. Treas. Reg. §1.148-1(b).
[17] Treas. Reg. §1.148-2(e)(3)(i).
[18] Treas. Reg. §1.148-2(e)(3)(ii).
[19] Treas. Reg. §1.148-2(e)(5). "Replacement proceeds" are amounts, other than bond proceeds, that have a sufficient nexus to the bonds or the purpose of the bonds to conclude that the amounts would have been used for the purpose for which bond proceeds are being used. Examples include sinking funds, pledged funds and funds subject to "negative pledges". See Treas. Reg. §1.148-1(c).
[20] Treas. Reg. §1.148-2(e)(6). For the definition of "investment proceeds" see footnote 8, *supra*.
[21] Treas. Reg. §1.148-2(e)(7) .

(7) *Refundings*. The temporary period for proceeds (other than transferred proceeds) of an advance refunding issue is generally 30 days.[22] The temporary period for proceeds (other than transferred proceeds) of a current refunding issue is generally 90-days.[23]

a) *Transferred Proceeds*. In general, transferred proceeds are any proceeds of a refunded prior bond issue that become proceeds of a refunding bond issue.[24] Transferred proceeds of a current refunding generally have a temporary period that begins on the date of transfer of the proceeds and ends when it would have otherwise ended if they had remained proceeds of the refunded bonds.[25] Any temporary periods that exist for transferred proceeds of an advanced refunding (e.gs. the 3/5 year temporary period for construction funds and the 13-month temporary period for restricted working capital) end on the date the advance refunding bonds are issued.[26]

2. Reasonably Required Reserve Fund

Amounts held in a reasonably required reserve or replacement fund may be invested without regard to the yield restriction rules for the entire term of the bond issue.[27] A reserve fund is a reasonably required reserve or replacement fund only if the amount of bond proceeds in the fund does not exceed the lesser of:

(i) 10% of the principal amount of the issue;

(ii) Maximum annual debt service on the bonds; OR

(iii) 125% of the average annual debt service on the bonds.[28]

3. Minor Portion Exception

Bond proceeds in an amount which is the lesser of $100,000 or 5% of the sale proceeds[29] of the issue are not subject to yield restriction.[30]

[22] Treas. Reg. §1.148-9(d)(2)(i). This 30-day temporary period ends 30 days after the date the advance refunding bonds are issued.
[23] Treas. Reg. §1.148-9(d)(2)(ii)(A). See also Treas. Reg. §1.148-2(d)(2)(ii)(B) which provides that (1) the temporary period for proceeds (other than transferred proceeds) of a current refunding issue that has an original term of 270 days or less may not exceed 30 days and (2) the total temporary periods for proceeds (other than transferred proceeds) of all current refunding issues with an original term of 270 days or less that are part of the same series of refunding is 90 days.
[24] “”Transferred proceeds” are generally, unallocated or unspent proceeds of a refunded issue that “transfer” to a refunding issue ratably when refunding proceeds discharge a portion of the refunded bond. See Treas. Reg. §1.148-9(b).
[25] Treas. Reg. §1.148-9(d)(2)(iii)(A).
[26] Treas. Reg. §1.148-9(d)(2)(iii)(B).
[27] Treas. Reg. §1.148-2(f)(2)(i).
[28] Treas. Reg. §1.148-2(f)(2)(ii). For a refunding issue, a reserve is reasonably required for purposes of this exception only if the aggregate amount invested in higher yielding investments for both the refunding issue and the refunded issue does not exceed these limits by reference only to the refunding issue (whether or not the proceeds of the refunded issue have become transferred proceeds). Treas. Reg. §1.148-9(e).

4. Exception for Certain Tax-exempt Investments

If bond proceeds are invested in tax-exempt governmental bonds and tax-exempt qualified Section 501(c)(3) bonds, earnings on those investments are not subject to yield restriction.[31]

C. How Is Yield Restriction Satisfied If There is No Exception

If there is no exception or an applicable temporary period has expired, the yield on investments of bond proceeds in securities, obligations, annuity contracts and "investment type property" may not be "materially higher" than the yield on the bonds. To meet the yield restriction requirements, the issuer needs to determine what is "materially higher" for the type of proceeds and the investment and either:

1. Invest proceeds in securities that do not exceed the "materially higher" yield; OR
2. Invest proceeds above the permitted yield and make yield reduction payments. Yield reduction payments may only be made for certain types of bond proceeds including proceeds that qualify for the 3/5-year temporary period, the 13-month temporary period for restricted working capital or the 1-year temporary period for investment proceeds.[32] Yield reduction payments may also be made under certain conditions for investments of reserve funds, transferred proceeds of refunding issues and investments of replacement proceeds of refunded issues.

D. What is "Materially Higher" than the Bond Yield

1. **In General.** Investments made with bond proceeds are either "purpose" investments or "nonpurpose" investments. "Purpose" investments are those acquired to carry out the governmental purpose of the bond issue. For example, the loan of proceeds to a conduit borrower is a "purpose" investment.[33] "Nonpurpose" investments are all other investments, such as investment of proceeds in a construction fund, debt service fund or a refunding escrow.[34] As a general rule, for both purpose and nonpurpose investments, "materially higher" means one-eighth of

[29] Generally, sale proceeds means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriter's discount or compensation and accrued interest other than pre-issuance accrued interest. Treas. Reg. §1.148-1(b).
[30] Treas. Reg. §1.148-2(g).
[31] Treas. Reg. §1.148-2(d)(2)(v). Generally, investments in AMT bonds made with non-AMT bond proceeds are subject to yield restriction but investment in AMT bonds made with AMT bond proceeds are not. Similarly, investments in non-AMT bonds made with non-AMT bond proceeds are not subject to yield restriction.
[32] Treas. Reg. §1.148-5(c)(3).
[33] Treas. Reg. §1.148-1(b).
[34] Treas. Reg. §1.148-1(b).

1%.[35] Also as a general rule, if bond counsel is providing an opinion that bonds bear tax-exempt interest, bond counsel has determined that any purpose investment does not produce a "materially higher" yield and the issuer or borrower only needs to be concerned about the yield on nonpurpose investments.

2. **Exceptions to General Rule.** Exceptions to the one-eighth of 1% general rule for nonpurpose investments are listed below:

Type of Investment	Definition of materially higher
Advance Refunding Escrow	1/1000 of 1%[36]
Replacement Proceeds	1/1000 of 1%[37]
Tax-exempt obligations that are non-AMT bonds	no yield limitation[38]

E. Waiver of Temporary Period Permitted

1. **Waiver Permitted.** An issuer may waive any temporary period or the reasonably required reserve and replacement fund exception to yield restriction on or before the date bonds are issued. An issuer may waive the "minor portion" exception at any time.[39]

2. **Effect of Waiver.** If an exception to yield restriction is waived, the issuer can use the yield on investments during the temporary period in calculating rebate. This can be helpful in calculating rebate if bonds are issued during a period when returns on available investments are low and can reduce overall yield if investment returns increase at a later date over the term of an issue.

V. Rebate

A. General Rule. Section 148(f) of the Code generally provides that arbitrage must be paid to the federal government as rebate unless a specific exception to the rebate requirement applies. Otherwise, the bonds become "arbitrage bonds."

B. Definition of Rebate. Rebate is a payment made by an issuer to the federal government in connection with an issue of tax-exempt bonds. The payment represents the amount of arbitrage earnings on bond proceeds and certain other related funds, except for

[35] Treas. Reg. §1.148-2(d)(2)(i). For purpose investments that are categorized as "program investments", the percentage is 1.5%. Treas. Reg. §1.148-2(d)(2)(iii).
[36] Treas. Reg. §1.148-2(d)(2)(ii).
[37] Treas. Reg. §1.148-2(d)(2)(ii).
[38] Treas. Reg. §1.148-2(d)(2)(v). *See also* footnote 31 *supra.*
[39] Treas. Reg. 1.148-9(g).

earnings that are not required to be rebated under limited exceptions provided under the Code.

C. Exceptions to Rebate. An exception from rebate applies only to rebate and "yield restriction" rules must still be satisfied. The exceptions to rebate discussed below are the "Small Issuer Exception", the "Reasonably Required Reserve Fund Exception", the "Spending Exceptions", the "Bona Fide Debt Service Fund Exception", the "Restricted Working Capital Exception for Tax and Revenue Anticipation Notes (the "TRAN Exception")", and an exception if bond proceeds are invested in certain tax-exempt investments. All of these exceptions are available for governmental bonds. The Spending Exceptions, the Bona Fide Debt Service Fund Exception and the exception for investment in tax-exempt obligations are also available for qualified Section 501(c)(3) bonds.

The exceptions generally apply only to a specific type of fund. For example, the Spending Exceptions apply generally to the Project or Construction Fund so that even if the Project Fund meets a Spending Exception, it is necessary to determine whether earnings on a debt service fund are also eligible for a rebate exception. The Spending Exceptions depend on "allocating" or spending certain proceeds within specified time periods.

For determining whether these exceptions apply, it is necessary (i) to identify which proceeds must be spent, (ii) to identify when proceeds are considered spent and (iii) to monitor the type and timing of expenditures to ensure application of these exceptions.

1. Small Issuer Exception

a) General rule. Under the Small Issuer Exception, all proceeds of governmental bonds issued during a calendar year by a governmental unit that does not expect to issue more than $5 million of tax-exempt governmental bonds in that calendar year are excepted from the rebate requirements.[40]

b) Qualifications for Exception. In order to qualify for the Small Issuer Exception:

(1) The issuer must be a governmental unit with general taxing powers;[41]

(2) No part of the issue can be a private activity bond (i.e., the bond issue must consist entirely of governmental bonds);

[40] §148(f)(4)(D). All proceeds are excepted including proceeds in a reasonably required reserve and replacement fund, if any. See Section V.C. 2. *infra.*

[41] An issuer does not have general taxing power if the issuer's ability to tax is contingent on approval by another governmental unit, IRC §148(f)(4)(D)(iv) and Treas. Reg. §1.148-8(b).

(3) 95% or more of net proceeds are to be used for local governmental activities of the issuer or of governmental units located within the issuer's boundaries; AND

(4) The issuer must either:

  (a) reasonably expect, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during calendar year will not exceed $5 million; OR

  (b) actually issue tax-exempt bonds (other than private activity bonds) during the calendar year with an aggregate face amount no more than $5 million.

    i. A current refunding is not taken into account in determining the amount of bonds issued in a calendar year in (a) and (b) above, to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.[42]

(5) Size limit. The following issues count toward the $5 million size limitation:

  (a) The issue to which the Small Issuer Exception applies;

  (b) Previous issues of governmental bonds in the same calendar year;

  (c) Issues of governmental bonds reasonably expected to be issued or actually issued in the same calendar year; AND

  (d) Issues must be "aggregated" namely:

    (a) Any bonds issued by an entity that is directly or indirectly controlled by the issuer (a "Subordinate entity") unless the issuer properly allocates a portion of the $5 million to the Subordinate entity.[43]

    (b) Bonds issued by all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

    (c) Bonds issued by an entity formed to avoid the $5 million size limitation together with bonds issued by all entities that would benefit from the avoidance.[44]

[42] §148(f)(4)(D)(iii).
[43] Treas. Reg. §1.148-8(c)(2)(ii) If an issuer irrevocably allocates a portion of the $5 Million to a subordinate entity or on behalf of issuer and the allocation bears a reasonable relationship to the benefits received by the allocating issuer from the subordinate entity, bonds issued by the subordinate entity will be treated as issued only by the subordinate entity and will not be aggregated with other issuers by the allocating issuer.
[44] Treas. Reg. §1.148-8(c)(2)(iii). Examples of situations in which an entity is formed to avoid the $5 million limit include

c) Refundings. Advance and current refundings are not eligible for the Small Issuer Exception unless:[45]

(1) The face amount of the refunding issue is not greater than $5 million;

(2) The refunded bonds met the Small Issuer Exception;

(3) The average maturity date of the bonds to be refunded by the issue is not later than the average maturity date of the refunded bonds;[46] AND

(4) The final maturity date of the refunding bonds is not later than 30 years after the date the original bonds were issued.

d) Increased Limit for School Construction Bonds. The $5 million limit is increased by an additional $10 million for bonds issued to finance construction of public school facilities.[47] "Construction" includes reconstruction and rehabilitation.

e) The Small Issuer Exception and TRANS. Tax and revenue anticipation notes (TRANS) are eligible for the Small Issuer Exception but are also eligible for the TRAN Exception discussed below. In testing whether the Small Issuer Exception applies, TRANS must be counted toward the $5 million limit for other bonds expected to be issued during the year even if the TRANS are eligible for the TRAN Exception.

f) The Small Issuer Exception and "Bank Qualified Bonds." The Small Issuer Exception should not be confused with the provisions of Section 265 of the Code which permit financial institutions to purchase "bank qualified bonds" issued by a "qualified small issuer" without losing a deduction for a portion of the financial institutions' interest expense.

situations in which the issuer issues bonds which, but for the $5 million limit would have been issued by another entity and situations in which the issuer does not receive a substantial benefit from the project financed by the bonds.

[45] IRC §148(f)(4)(D)(v).

[46] This requirement does not apply if the average maturity of the issue of which the original bond was a part (and of the issue of which the bonds to be refunded are a part) is 3 years or less. IRC §148(f)(4)(D)(v). Average maturity shall be determined in accordance with IRC §147(b)(2)(A).

[47] IRC §148(f)(4)(D)(vii).

g) The Small Issuer Exception and Reserve Funds. If an issue qualifies for the $5 million Small Issuer Exception, a reasonably required reserve and replacement fund, if any, is excepted from the rebate requirements.

2. Reasonably Required Reserve Fund Exception

As a starting point, issuers should assume that earnings on a reasonably required reserve fund and replacement fund (a "reserve fund") are subject to rebate because there is no generally applicable exception to rebate for reserve funds. However, there are limited exceptions to rebate for reserve funds that are available in connection with other specific exceptions.

If an issue qualifies for the $5 million Small Issuer Exception, a reasonably required reserve or replacement fund, if any is excepted from the rebate, as discussed in Section V. C. 1. (g).

In connection with the 2-year/24-month spending exception (discussed in Section V. C. 3 (e)), earnings on a reserve fund must be included in the "available construction proceeds" and are included in the amount that must be spent during the 2-year/24-month period. After the 2-year/24-month period, the reserve fund becomes subject to rebate. Alternatively, the issuer may elect to exclude earnings on the reserve fund in the spendable amount and thereby subject the reserve fund to the rebate requirement from the issuance date of the bonds.

For the 6-month spending exception (discussed in Section V. C. 3. (c)) or for an issue that meets the 18-month spending exception (discussed in Section V. C. 3. (d)), earnings on the reserve fund during the required spending periods do not have to be spent, but remain subject to rebate from the date of issuance.

3. Spending Exceptions to Rebate

a) Generally. There are three spending exceptions available for governmental and qualified 501(c)(3) bonds: the "6-month spending exception", the "18-month spending exception" and the "2-year/24-month construction spending exception". Each of these exceptions is available for proceeds in a project or construction fund of a new money issue. The 6-month exception is also available for proceeds in a current refunding escrow.

For each of the three Spending Exceptions, two conditions must be met: first, certain proceeds must be spent within the relevant 6, 18 or 2-year/24 month time period and second, all other bond proceeds must meet the rebate requirement either through an exception applicable to those proceeds or rebate must be paid based on the earnings on those proceeds in order for the applicable spending exception to be satisfied.

b) Accounting Rules. Proper application of the allocation and accounting rules discussed in Section VI is critical in satisfying the spending exceptions.

c) 6-month spending exception.

(1) General rule. The 6-month spending exception is met if:

(a) The "Proceeds That Must Be Spent" for the 6-month spending exception are spent or allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date; AND

(b) The rebate requirement is met for all other proceeds of the issue (excluding earnings on a bona fide debt service fund).

(2) The "Proceeds That Must Be Spent" for this exception" are the "gross proceeds" of the issue[48] (i.e., all proceeds including sale proceeds, investment proceeds and replacement proceeds)[49] minus."

(a) Amounts in a bona fide debt service fund;

Note: Amounts in a bona fide debt service fund are exempt from the rebate requirement as described in Section V. C. 4 below.

(b) Amounts in a reasonably required reserve or replacement fund;

Note: There is no exception for amounts in a reasonably required reserve or replacement fund under the 6-month spending exception and the rebate requirement must be met for the reserve fund in order to qualify for the 6-month spending exception.

(c) Gross proceeds that arise after the 6-month period and that were not reasonably anticipated on the date of issuance.

Note: The rebate requirement must be met for unanticipated gross proceeds arising after the 6-month period.

[48] "Gross proceeds" are all proceeds of the issue including sale proceeds, investment proceeds, transferred proceeds and replacement proceeds. See Treas. Reg. §1.148-1. Definitions and Elections for the foregoing definitions.
[49] "Transferred proceeds" must also be spent within the 6-month period but they are not mentioned here because the discussion relates to new money issues. The 6-month exception as applied to current refunding is discussed in Section V. C. 3. (c)(3).

(3) Application of the 6-month spending exception to a current refunding. Proceeds of the refunding issue applied to refund the refunded bonds and to pay costs of issuance are the "Proceeds That Must Be Spent" for a current refunding. As is the case with a construction issue, all other proceeds (including transferred proceeds[50] if any) must meet the rebate requirement either through an exception or payment of rebate.

(4) Time extensions in certain limited situations. For governmental bonds (except TRANs) and qualified 501(c)(3) bonds, the 6-month time period is extended to one year for an amount of the gross proceeds that does not exceed 5% of the proceeds of the issue.[51] This extension is important in cases where costs of issuance or investment earnings have not been spent within the 6-month period.

d) <u>18-month spending exception</u>.

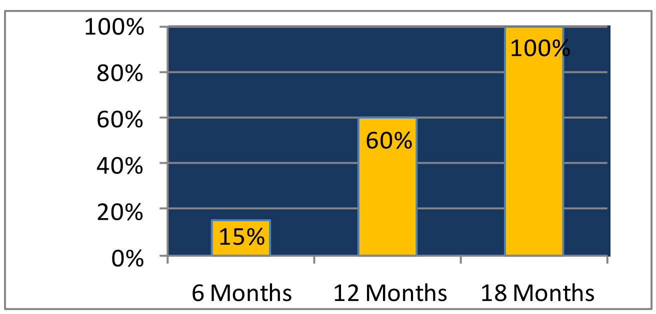
(1) General rule. The 18-month spending exception is met if:

(a) The "Proceeds That Must Be Spent" for the 18-month spending exception" are allocated to expenditures for the governmental purposes of the issue in accordance with the following schedule measured from the date of issue as set forth below and as also illustrated in the graph below:

(i) At least 15% within 6 months;

(ii) At least 60% within 12 months; and

(iii) 100% within 18 months; AND



(b) The rebate requirement is met for all other proceeds within the 18-month spending period (excluding earnings on a bona fide debt service fund); AND

[50] See Treas. Reg. §1.148-1 Definitions and Elections for the definition of "transferred proceeds". See also footnote 24.
[51] IRC §148(f)(4)(B)(ii).

(c) All the "Proceeds That Must Be Spent" for the-18-month spending exception" qualify for the 3-year temporary period with respect to bonds for capital projects which is described above in Section IV.B.1(a) above.

The "Proceeds That Must Be Spent" for the 18-month spending exception has the same definition as for the 6-month spending exception except that for the first two spending periods (i.e., 6-months and 12-months), the amount of investment proceeds included in computing the "Proceeds that Must Be Spent" is based on the issuer's reasonable expectations as of the issue date. For the third and final spending period, actual earnings are used to compute investment proceeds.

Note: As is the case for the 6-month spending exception, there is no exception for amounts in a reasonably required reserve or replacement under the 18-month spending exception and the rebate requirement must be met for the reserve fund in order to qualify for the 18-month spending exception.

(2) Time extensions for reasonable retainage. The 18-month period is extended to 30 months (i.e., one additional year) for reasonable retainage. "Reasonable retainage" means an amount not to exceed 5% of net sale proceeds that is retained for reasonable business purposes relating to the property financed (e.g., retention to ensure compliance with a construction contract).[52]

(3) *De minimus* exception. There is an exception for failure to meet the spending tests for the third and final spending periods if:

(a) The unspent proceeds do not exceed the lesser of:

(i) 3% of the issue price; OR

(ii) $250,000; AND

(b) The issuer exercises due diligence to complete the project.

(4) Application to multipurpose rules. The 18-month exception may be combined with the 6-month exception but may not be used if any part of the issue meets the 2-year/24-month construction spending exception.[53]

[52] Treas. Reg. §1.148-7(d)(2).
[53] Treas. Reg. §1.148-7(d)(4).

e) 2-year/24-month construction spending exception.

(1) The 2-year/24-month construction spending exception is available only if the issue is a "construction issue", i.e., if:

(a) All of the bonds which are part of the issue are:

(i) Governmental bonds;

(ii) Qualified 501(c)(3) bonds; or

(iii) Private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization; AND

(b) The issuer reasonably expects that at least 75% of the "available construction proceeds" of the construction issue will be used for construction expenditures with respect to property which is to be owned by a governmental unit or a 501(c)(3) organization.[54]

(i) "available construction proceeds" generally means issue price,[55] plus earnings on the issue price, earnings on any reasonably required reserve fund not funded by the issue and earnings on the foregoing (including earnings on any tax-exempt bond), minus amounts in a reasonably required reserve or replacement fund funded by the bond issue and amounts of proceeds used to finance costs of issuance.[56]

(ii) Earnings on a reasonably required reserve fund are generally included in "available construction proceeds" until the earlier of the close of the 2-year/24-month period or the date construction is substantially completed.[57] *After that point in time, earnings on the reasonably required reserve fund are subject to rebate.*

(iii) Construction includes reconstruction and rehabilitation[58] but does not include the cost of acquiring an interest in existing real property or acquisition of equipment. However, an issue can qualify as a "construction issue" if no more that 25% of proceeds will be used to finance equipment.

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[54] The issuer may elect, no later than the issue date to use actual facts rather than expectations in meeting this requirement provided it has not made a 1 ½ percent penalty election. Treas. Reg. §1.148-7(f)(2).

[55] The "issue price" determines the yield, for tax purposes, on the bonds. After bond closing, issuers and conduit borrowers usually look to Part II of Forms 8038-G and Form 8038, respectively, which states the issue price for the bonds as determined by the issuer in consultation with bond counsel when the bonds were issued.

[56] IRC §148(f)(4)(C)(vi).

[57] The issuer may elect to exclude earnings on the reserve from "available construction proceeds" but the earnings on the reserve fund will be subject to rebate from the date the bonds are issued. Treas. Reg. §1.148-7(i)(2).

[58] IRC §148(f)(4)(C)(iv).

(2) If the issue is a "construction issue," the 2-year construction spending exception is met if the "available construction proceeds" are spent in accordance with the schedule measured from the issue date as set forth below and as also illustrated in the graph below:

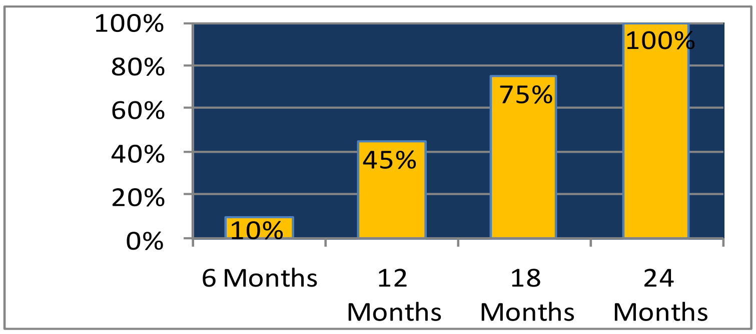
(a) At least 10% within 6 months;

(b) At least 45% within 12 months;

(c) At least 75% within 18 months; and

(d) 100% within 2 years.

In determining earnings during the first 3 time periods, earnings are estimated but, as with the 18-month exception, actual earnings are used for the final time period.



(3) Time extension for reasonable retainage. The 2-year time period is extended to 3 years for reasonable retainage. "Reasonable retainage" means an amount not to exceed 5% of the available construction proceeds as of the end of the final spending period that is retained for reasonable business purposes relating to the property financed (e.g., retention to ensure compliance with a construction contract).[59]

(4) *De minimus* exception. There is an exception for failure to meet the requirements of the final spending period if:[60]

(a) The unspent proceeds do not exceed the lesser of:

(i) 3% of the issue price; or

(ii) $250,000; AND

(5) The issuer exercises due diligence to complete the project.

[59] Treas. Reg. §1.148-7(h).
[60] Treas. Reg. §1.148-7(b)(4).

(6) Application of 2-Year Construction Spending Exception to Multipurpose Issues. If any part of a bond issue is to be used for construction expenditures, the issuer may elect, on or before the issue date, to treat the nonrefunding portion of the issue as two and only two separate issues in applying the 2-year construction spending exception if one of the two resulting non-refunding issues is a "construction issue" and the issuer reasonably expects, as of the issue date, that this "construction issue" will finance all of the construction expenditures to be financed.[61]

(7) Penalty in Lieu of Rebate. An issuer of a construction issue may elect on or before the issue date to pay a "penalty in lieu of rebate" under the 2-year construction spending exception.[62] The penalty is applied at the end of each 6-month period after the date of issuance and equals 1.5% of the amount of available construction proceeds which are underexpended, at the end of each 6-month spending period.

The penalty in lieu of rebate may be terminated by making an election not later than 90 days after the expiration of the original temporary period or substantial completion of all or a portion of the financed construction.[63] To terminate the 1.5% penalty, the issuer must pay 3% of the unexpended available construction proceeds as of the end of initial temporary period, multiplied by the number of years in the initial temporary period and meet certain other requirements. If the 3% penalty is not elected, the 1.5% penalty must be paid throughout the term of the bond issue.

4. Bona Fide Debt Service Fund Exception

Earnings on a bona fide debt service fund are not taken into account for rebate if the gross earnings for a bond year are less than $100,000.[64] This $100,000 limit is deemed met if an issue has an average annual debt service not greater than $2,500,000.[65]

Earnings on a bona fide debt service fund for a governmental bond issue are not taken into account for rebate if the governmental bond issue has an average maturity of at least 5 years and only fixed interest rates while it is outstanding.[66]

[61] Treas. Reg. §1.148-7(j).
[62] IRC §148(f)(4)(C)(vii).
[63] IRC §148 (f)(4)(C)(viii).
[64] IRC §148(f)(4)(A).
[65] Treas. Reg. §1.148-3(k).
[66] IRC §148(f)(4)(A).

5. TRAN Exception

The TRAN Exception is a statutory safe-harbor pursuant to which a tax and revenue anticipation issue can meet the 6-month spending exception. Under the safe-harbor, if, within 6 months of issuance of a TRAN, the "cumulative cash flow deficit" exceeds 90% of the proceeds of the issue, all net proceeds of the issue plus investment earnings will be treated as spent and thus, satisfy the 6-month exception.[67]

The "cumulative cash flow deficit" is the excess of actual expenses paid during the 6 month period that would ordinarily be paid from or financed by anticipated tax or other revenues over the aggregate "available amount" (other than proceeds of the TRAN issue) during the period.[68]

The "available amount" includes cash, investments, and other amounts held in accounts by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type financed without a legislative, judicial or contractual requirement that those amounts be reimbursed.[69] For purposes of this safe-harbor, a "reasonable working capital reserve" is treated as part of the available amount.[70] A working capital reserve is treated as reasonable if it does not exceed 5% of the actual working capital expenditure of the issuer in the fiscal year before the year in which the determination of available amount is made.

6. Exception for Certain Tax-Exempt Investments

If bond proceeds are invested in tax-exempt governmental bonds and tax-exempt qualified Section 501(c)(3) bonds, earnings on those investments are excluded from earnings for purposes of rebate.[71]

D. Amount of Rebate Due. The rebate amount due to the federal government is based on the difference between the amount actually earned on nonpurpose investments[72] made with gross proceeds over the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the bond issue.[73] The "rebate amount" is defined, as of any date, as the excess of the future value of all "receipts" on

[67] IRC §148(f)(4)(B)(iii)
[68] IRC §148(f)(4)(B)(iii).
[69] §1.148-6(d)(3)(iii)(A).
[70] §1.148-6(d)(3)(iii)(D).
[71] See footnote 31 for a more detailed discussion.
[72] See Section IV D. for a discussion of nonpurpose investments.
[73] Treas. Reg. §1.148-3(a).

nonpurpose investments over the future value of all payments on nonpurpose investments.[74]

The general steps to calculate rebate liability are (1) calculate the yield on the bonds; (2) calculate the actual earnings on all nonpurpose investments purchased with the gross proceeds of the bonds subject to rebate; (3) calculate the allowable earnings on these nonpurpose investments assuming the investments were earning a rate equal to the bond yield; and (4) future value the difference from the actual payment or receipts date to the computation date at a rate equal to the yield on the bond issue.[75]

In order to apply these general steps it is necessary to identify whether an issue is a "fixed yield" or "variable rate" issue, the "computation date", the "computation period", the "yield on the issue", the "yield on the investments," the "value of nonpurpose investments", "receipts" and "payments" on nonpurpose investments, and the "future value" of payments and receipts earned by an issuer. For each issue, identifying these items can be complex and require an in-depth interpretation of Treasury Regulations. The discussion that follows is intended to address basic concepts and to point out areas where an issuer may need to take additional steps in order to apply the Arbitrage Requirements correctly.

E. Computation Date. Rebate is calculated for each computation date for an issue and issuers are subject to different rules in selecting a computation date depending on whether an issue is a "fixed" or "variable" yield issue.

A "fixed yield issue" is an issue that consists solely of bonds that have a fixed yield based on the assumptions and rules provided in Treasury Regulation §1.148-4(b).[76] For a fixed yield issue, an issuer may treat any date as a computation date.[77] Since the first rebate installment must be made for a computation date that is not later than 5 years after the issue date and for each computation date not later than 5 years after the previous date, generally, issuers use the last day of the 5th bond year (i.e., a 1-year period except for the first and last bond year which may be shorter)[78] and of each 5th year thereafter as the calculation date. In addition, the final computation date is the date that an issue is discharged.[79]

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[74] Treas. Reg. §1.148-3(b).
[75] Treas. Reg. §1.148-3(c).
[76] Treas. Reg. §1.148-1(b); Treas. Reg. §1.148-4(b) specifies the method of calculating yield on a fixed yield issue including rules relating to mandatory, contingent or optional redemption and yield recomputed upon transfer of certain rights associated with a bond.
[77] Treas. Reg. §1.148-3(e)(1).
[78] Treas. Reg. §1.148-1(b). See footnote 15, *supra* for the definition of bond year.
[79] Treas. Reg. §1.148-3(e)(2). If an issue is retired within 3 years, the final computation date need not occur before the end of 8 months after issuance or the period in which the issuer reasonably expects that any of the "spending exceptions" will apply.

A "variable yield issue" is any issue that is not a fixed yield issue.[80] For a variable yield issue, an issuer may treat as a computation date, the last day of any bond year ending before the first required payment date, which is 5 years after the issue date. The issuer can change computation dates at any time before the first required payment date but after that, computation dates must be consistently either the end of each bond year or the end of each 5th bond year.[81] The final computation date for a variable yield issue is the same as the date that an issue is discharged.[82]

Because the categorization of an issue as fixed or variable can be difficult, it is advisable that an issuer discuss this with bond counsel or other professional at the time the bonds are issued. This is especially advisable if an issuer enters into a hedge which may, under certain circumstances, permit variable rate bonds to be treated as fixed rate bonds for purposes of calculating rebate.[83]

F. Payments and Receipts and Payments on Nonpurpose Investments. For purposes of calculating rebate, payments are: (1) amounts actually or constructively paid to acquire a nonpurpose investment, (2) the value on the date that a nonpurpose investment previously acquired is allocated to an issue or becomes subject to rebate, (3) the value of an investment on the first day of a subsequent computation period if it was allocated at the end of the prior period, (4) a $1,000[84] computation credit on the last day of a bond year during which amounts are allocated to the issue that are subject to rebate and on the final maturity date, and (5) yield reduction payments.[85]

Receipts are (1) amounts actually and constructively received from a nonpurpose investment, (2) the value of a nonpurpose investment on the date it ceases to be allocated to an issue before its disposition or redemption or the date it ceases to be subject to rebate.[86]

Special rules under Treasury Regulation Section 1.148-6(e) limit certain of the required determinations of payments and receipts for commingled funds.[87] Special rules also apply in connection with respect to receipts and payments on hedges, investment in guaranteed investment vehicles and termination or deemed termination thereof.[88]

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[80] Treas. Reg. §1.148-1(b).
[81] Treas. Reg. §1.148-3(e)(1)(i) and (ii). After the 5th anniversary, the issuer may not change either the initial or subsequent computation dates.
[82] Treas. Reg. §1.148-3(e)(2).
[83] Treas. Reg. §1.148-4(h)(4).
[84] This credit has been adjusted for inflation since 2008. For bond years ending in 2013, the credit is $1,590. Rev. Proc. 2012-41.
[85] Treas. Reg. §1.148-3(d)(1).
[86] Treas. Reg. §1.148-3(d)(2) Examples include investments that become allocable to transferred proceeds of another issue or that cease to be allocable pursuant to the universal cap under Treas. Reg. §1.148-6 or an investment allocated to a fund initially subject to rebate that subsequently qualified as bona fide debt service fund.
[87] Treas. Reg. §1.148-3(d)(3).
[88] Treas. Reg. §1.148-4(h) and 1.148-5(d)(6).

G. Determination of Future Value. As discussed above in Section D, the "rebate amount" is defined, as of any date, as the excess of the future value of all "receipts" on nonpurpose investments over the future value of all "payments" on nonpurpose investments.[89] Future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield on the issue.

H. Paying Rebate. An issuer must pay rebate in installments for computation dates that occur at least once every 5 years. Rebate payments are due within 60 days after each computation date. The final rebate payment for an issue is due within 60 days after the issue is discharged.[90] If rebate is due, the issuer must complete Form 8038-T which is available at www.irs.gov/pub/irs-pdf/f8038t.pdf and send Form 8038-T along with the rebate payment to the IRS to the address set forth in the Form 8038-T instructions which is available at www.irs.gov/pub/irs-pdf/i8038t.pdf.

I. Penalties for Rebate Failures. If an issuer fails to pay the correct amount of rebate on time, unless the IRS determines the failure was due to willful neglect, the issuer can pay a penalty to avoid loss of tax-exemption. The penalty for governmental and qualified Section 501(c)(3) bonds is 50% of the underpayment plus interest.[91] The penalty is automatically waived if the rebate plus interest is paid within 180 days after the failure is discovered unless the failure is due to willful neglect or the issue is under audit.[92]

J. Refund of Overpayments. An issuer may be able to claim a refund of an overpayment of rebate using Form 8038-R.[93] Any claim must be made no later than 2 years after the final computation date. Instructions for filing a claim are provided in the Instructions to Form 8038-R.

VI. Accounting for Expenditures and Allocations

A. Generally. Accounting for expenditures is important in applying the Arbitrage Requirements such as in determining whether a spending exception to rebate applies and in calculating rebate if there is no applicable exception. Under the regulations, as a technical matter, an issuer does not "spend" proceeds but "allocates" proceeds to expenditures.[94]

[89] Treas. Reg. §1.148-3(b).
[90] Treas. Reg. §1.148-3(g).
[91] Treas. Reg. §1.148-3(h)(1).
[92] Treas. Reg. §1.148-3(h)(3). It is not willful neglect if the failure is due to selection of a short first bond year and the rebate is paid within 60 days of selection of that bond year.
[93] Treas. Reg. §1.148-3(i).
[94] Treas. Reg. §1.148-6(d).

B. Cash Outlay. Any allocation of bond proceeds must involve a current outlay of cash, which is defined as an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation is made.[95]

C. Time Limit on Final Allocations. In addition, there is a time limit under the regulations for making a final allocation. The allocation must be made no later than 18 months after the later of the date when the expenditure is paid or the project is placed in service and in any event no later than the date the first rebate payment would be due (i.e., the earlier of (i) 60 days after the fifth anniversary of the date the bonds were issued or (ii) 60 days after the date the issue is retired.)[96]

D. Allocation Methods. Under the Regulations, an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.[97] The specific tracing method is applied if the issuer lacks sufficient evidence that another method has been selected. The Regulations provide rules for accounting for capital expenditures, working capital, grants, reimbursements and commingled funds.

E. Four Accounting Methods for Capital Expenditures. The Regulations identify four accounting methods as reasonable for allocating funds from different sources to capital expenditures: (1) specific tracing; (2) gross proceeds spent first; (3) first-in, first out; and (4) ratable allocation.[98]

1. Specific tracing allows an issuer to track actual payments keeping in mind the rule about cash outlays described above. Thus, an issuer can record payments to test application of the 6-month, 18-month and 2-year spending exceptions.
2. The Gross Proceeds Spent First Method can be used in cases where an issuer has funds in addition to bond proceeds. The issuer can first allocate expenditures to bond proceeds then to other funding sources. This may be used to meeting a spending exception.
3. The First- In, First-Out Method allows an issuer with more than one outstanding issue to treat proceeds of the first issue as spent before proceeds of the second issue.
4. The Ratable Allocation Method allows proceeds of more than one bond issue to be treated as spent ratably from each issue.

[95] Treas. Reg. §1.148-6(d)(1)(ii).
[96] Treas. Reg. §1.148-6(d)(1)(iii).
[97] Treas. Reg. §1.148-6(a)(1).
[98] Treas. Reg. §1.148-6(d)(1)(i).

F. Working Capital. The general rule for working capital expenditures is that bond proceeds are spent on a "Proceeds Spent Last" method[99] with the result that bond proceeds are spent only after working capital expenditures exceed other "available amounts", which, in general, are any other amounts available to be used by the issuer for the working capital being financed by the bonds without legislative or judicial action or without a binding requirement, legal or contractual that they be reimbursed.[100] Except in the case of an issue that satisfies the statutory safe-harbor for the 6-month exception, a reasonable working capital reserve of no more than 5% of the actual working capital expenses of the issuer in the prior fiscal year is not "available."[101]

There are exceptions to the "Proceeds Spent Last" method for: (1) issuance costs and any qualified administrative costs of the issue; (2) fees for a "qualified guarantee" or a "qualified hedge"; (3) capitalized interest; (4) rebate and yield reduction payments and payments of the 1.5% penalty for failure to meet the 2-year exception; (5) costs that are "directly related" to financed capital expenditures in an amount not greater than 5% of sale proceeds of the issue in addition to items described in (1) through (4); (6) principal or interest paid from unexpected excess sale or investment proceeds; (7) principal or interest paid from earnings on a debt service reserve or replacement fund deposited in a bona fide debt service fund.[102] There are also exceptions for payment of extraordinary items, such as casualty losses or extraordinary legal judgments in excess of insurance coverage and principal and interest on a prior issue.[103]

G. Grants. Generally, bond proceeds are allocated to a grant on the date the grant is made if the grant is to a party that is not related to the grantor or is not an agent of the grantor. If the grant is repaid, the repayment is treated as unspent unless spent within 60 days.[104]

H. Reimbursements of Working Capital. Proceeds to reimburse working capital expenditures incurred before the bonds are issued are treated as spent on the date of the reimbursement if the reimbursement is for one of the exceptions to the "Proceeds Spent Last" rule described above or if there are no available amounts on the date the expenditure was made and on the date of the reimbursement.[105]

[99] Treas. Reg. §1.148-6(d)(3)(i).
[100] Treas. Reg. §1.148-6(d)(3)(iii)(A)
[101] Treas. Reg. §1.148-6(d)(3)(iii)(B).
[102] Treas. Reg. §1.148-6(d)(3)(ii)(A).
[103] Treas. Reg. §1.148-6(d)(3)(ii)(B) and (C).
[104] Treas. Reg. §1.148-6(d)(4).
[105] Treas. Reg. §1.148-6(d)(5).

I. Commingled Funds. In order to be a reasonable method, an accounting method for proceeds in a commingled fund must meet the following conditions:

1. At least at the close of each fiscal period, all payments and receipts on the fund must be allocated among the different "investors" in the fund on a consistently applied, "reasonable ratable allocation" method. "Reasonable ratable allocation" methods include methods that allocate items in proportion to either (a) the average daily balance of the amounts in the commingled fund from different investors during the fiscal period or (b) the average of the beginning and ending balances of the amounts in the fund from different investors for a fiscal period that does not exceed one month.
2. An "investor" means each different source of funds invested (e.g., tax revenues and bond proceeds from the same governmental entity are different investors).[106]
3. The same ratable allocation method must be used to allocate payments and receipts and expenditures.
4. The fiscal year is the calendar year unless the fund adopts another. A fiscal period is any consistent period that does not exceed three months.
5. If an issuer and a related party own more than 25% of a commingled fund, the fund must treat all investments as if sold at fair market value at the end of the fiscal year or the last day of the fiscal period ("mark-to-market") and net gains or losses must be allocated among all investments.
6. However, the mark-to-market rule does not apply if the remaining weighted average maturity of all investments held during a fiscal year does not exceed 18 months and the investments held by the fund consist exclusively of obligations. A fund that operates exclusively as a reserve fund, sinking fund or replacement fund for two or more issues of the same issuer is not subject to the mark-to- market rule.

J. Reallocation. Reallocations of bond proceeds are permitted so long as they are within the time period for making final allocations. If an issuer is monitoring expenditures to determine whether a spending exception applies and finds that there is a shortfall in necessary expenditures for the specific time-period, the issuer may be able to reallocate the proceeds to other capital expenditures that were made with sources other than bond proceeds. In order to do so, it is important for the issuer to determine the allocation method and apply it consistently. If expenditures were made with non-bond proceeds on another project within the applicable time frame, the issuer may allocate bond proceeds to those expenditures using the "proceeds spent first" method.

[106] Treas. Reg. §1.148-6(e)(2)(iii).

K. Reimbursement of Pre-Bond Issuance Expenses. If an issuer wants to be reimbursed from bond proceeds for expenditures paid before the bonds are issued, the issuer (or, in the case of qualified section 501(c)(3) bonds, the conduit borrower), must adopt or express "official intent" that satisfies the requirements of Treas. Reg. §1.150-2(e)[107] and be reimbursed no later than 18 months after the later of (i) the date the original expenditure is paid or (ii) the date the project is placed in service and in any event within 3 years from the date of the original expenditure, in order for the bond proceeds allocated to the reimbursement to be treated as spent, when made.[108]

For issues that satisfy the $5,000,000 Small Issuer rebate exception, the reimbursement must be made within 3 years of the later of the date the expenditure is paid or the project is placed in service and the maximum 3 year limitation on the reimbursement is disregarded.[109] This rule is only available if the original expenditure is a capital expenditure, a cost of issuance, certain extraordinary working capital items and grants.[110] Preliminary expenditures such as architectural, engineering, surveying and soil testing,[111] and no more than a *de minimus amount* of bond proceeds (i.e., not greater than $100,000 or 5% of bond proceeds, whichever is less)[112] are treated as spent when reimbursed without the need for a reimbursement resolution.

[107] Treas. Reg. §1.150-2(d).
[108] Treas. Reg. §1.150-2(d)(2)(i).
[109] Treas. Reg. §1.150-2(d)(2)(ii). For issues that are eligible for the 5-year temporary period, the maximum reimbursement period is extended from 3 to 5 years. Treas. Reg. §1.150-2(d)(2)(iii).
[110] Treas. Reg. §1.150-2(d)(3).
[111] Treas. Reg. §1.150-2(f)(2).
[112] Treas. Reg. §1.150-2(f)(1).

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Appendix B

[Proposed IRS Publication]

Establishing Written Post-Issuance Compliance Procedures for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

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Establishing Written Post-Issuance Compliance Procedures for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

I. Introduction

The Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division, offers specialized information and services to the municipal finance community. Municipal bonds provide tax-exempt financing for the furtherance of governmental and qualified purposes including constructing hospitals, recreational and cultural facilities, schools, water infrastructure, road improvements, as well as facilities and equipment used in providing police, fire and rescue services.

This IRS Publication, Establishing Written Post-Issuance Compliance Procedures for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers, provides information to assist smaller and infrequent issuers of tax-exempt governmental bonds and smaller conduit borrowers of qualified Section 501(c)(3) bonds in developing written post-issuance compliance procedures including procedures relating to compliance with the yield restriction and rebate requirements of Section 148 of the Internal Revenue Code of 1986, as amended (the "Code) and applicable Treasury Regulations. As used in this Publication, "Smaller Issuers" refers to issuers of tax-exempt governmental bond issues and conduit borrowers[1] of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount.

The information provided is intended primarily as a basic guide and does not necessarily address all questions or issues that may arise in developing written post-issuance compliance procedures.

This Publication does not address the federal tax requirements that must be met in order for bonds to bear tax-exempt interest. IRS Publication 4079, Tax-Exempt Governmental Bonds and IRS Publication 4077, Tax-Exempt Bonds for 501(c)(3) Charitable Organizations provide a general overview of federal tax rules that apply post-issuance to governmental bonds and qualified section 501(c)(3) bonds respectively. IRS Publication ___ , A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers is a guide to assist Smaller Issuers in complying with the yield restriction and rebate requirements of Section 148 of the Code. All ap-

[1] In practice, many conduit issuers require in their bond documents that the conduit borrowers assume responsibility for complying with the Arbitrage Requirements for the related tax-exempt conduit bonds. However, the IRS's stated position is that compliance with the Arbitrage Requirements and other tax requirements for tax-exempt conduit bonds is the responsibility of the conduit issuer. *See* Publication 5005, Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds (Rev. 4-2012).

plicable federal tax law requirements must be met to ensure that interest earned by bondholders is not taxable under section 103 of the Code.

TEB also provides detailed information on specific provisions of the tax law through IRS publications (available online) and through outreach efforts as noted on the TEB website at www.irs.gov/Tax-Exempt-Bonds.

Readers of this Publication should consult their own counsel for legal advice on whether the Arbitrage Requirements are met with respect to a particular issue of bonds.

II. Why Adopt Written Post- Issuance Compliance Procedures

A. General. Post-issuance compliance procedures assist issuers in satisfying the federal tax law requirements that apply to tax-exempt bonds for the life of the bonds. Based on the experience of representatives of TEB, failures in compliance can frequently be attributed to lack of written procedures, particularly with respect to the yield restriction and rebate requirements of Section 148 of the Code. Although federal tax law does not require adoption of written procedures, the IRS encourages issuers to do so.

Form 8038 information returns which must be filed in connection with the issuance of tax-exempt bonds now ask the issuer to disclose whether the issuer has established written procedures to monitor the requirements of the Code.

Some of the Forms 8038[2] ask specific questions such as: (i) whether the issuer has elected to pay a penalty in lieu of rebate,[3] and (ii) (a) whether the issuer will be reimbursed from bond proceeds for prior expenditures, (b) the amount of the reimbursement, and (c) the date the issuer adopted the required official intent[4]. The instructions for each Form 8038 that asks about the establishment of written procedures simply direct the issuer to "[C]heck the box if the issuer has established written procedures to monitor compliance with the arbitrage, yield restriction and rebate requirements of Section 148 without further guidance". Because of the complexity of the arbitrage requirements, an issuer may want to include more detail about arbitrage compliance in its general post-issuance compliance policy.

B. Voluntary Closing Agreement Program. An issuer with written post-issuance procedures that meet specific requirements set forth in the Internal Revenue Manual can avail itself of more lenient Voluntary Closing Agreement Program rules set forth in Internal Revenue Manual (IRM) Section 7.2.3.4.4.

1. IRM Section 7.2.3.4.4

Revised administrative procedures under Section 7.2.3 of the IRM for the voluntary closing agreement program for tax-exempt bonds, tax credit bonds and direct

[2] Form 8038-G (Information Return for Tax-Exempt Governmental Obligations) (Rev. September 2011)(Form 8038-G"), Form 8038 (Information Return for Tax-Exempt Private Activity Bonds) (Rev. April 2011) (Form 8038"), Form 8038 -B (Information Return for Build America Bonds and Recovery Zone Economic Development Bonds) (January 2012) (Form 8038-B") and Form 8038-TC (Information Return for Tax Credit Bonds and Specified Tax Credit Bonds) (June 2010) (Form 8038-TC")each ask whether the issuer has established written procedures to monitor the requirements of Section 148 of the Code. Form 8308-GC (Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales) (Rev. January 2012) (Form 8038-GC"), which applies to issues of tax-exempt governmental obligations with issue prices of less than $100,000, does not ask whether the issuer has adopted such written procedures. Copies of these forms are available under www.irs.gov/Forms-&-Pubs by searching current forms for 8038s.

[3] Form 8038-G; Form 8038 and Form 8038-B, supra, footnote 1.

[4] Form 8038-G; Form 8038; Form 8038-TC, supra, footnote 1.

pay bonds (collectively, "Tax-Advantaged Bonds") known as TEB VCAP (VCAP) were released on August 5, 2011. VCAP is an alternative dispute resolution program allowing an issuer[5] of Tax-Advantaged Bonds to voluntarily identify a federal tax law violation or violations with respect to a bond issue and negotiate with the IRS for an appropriate resolution. Generally, an issuer[6] receives more favorable treatment through VCAP than if the same violation was discovered through an IRS examination of the bond issue. VCAP is administered by the Compliance & Program Management staff within the IRS' Office of Tax Exempt Bonds.

The revised VCAP procedures added a new Section 7.2.3.4.4 to the IRM providing for a reduced settlement amount[7] when an issuer [8] submits a timely VCAP request following the identification of a violation pursuant to due diligence monitoring processes established in the issuer's[9] written post-issuance compliance procedures. Under IRM 7.2.3.4.4 if the issuer adopted written procedures before the date of the violation, the time period for applying under the VCAP program is based on 6 months from the earlier of the date the issuer actually discovered the violation or should have discovered the violation.[10]

Paragraph (2)(A) of Section 7.2.3.4.4 describes what "written procedures" qualify for VCAP purposes. It provides that such procedures must, ***at a minimum:***

- specify the official(s) with responsibility for monitoring compliance;
- a description of the training provided to such responsible official(s) with regard to monitoring compliance;
- the frequency of compliance checks (must be at least annually);
- the nature of the compliance activities required to be undertaken;
- the procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur;

[5] Internal Revenue Manual Section 7.2.3.2.1, paragraph (2), calls for the issuer to submit a VCAP request. A conduit borrower that identifies a violation may request the issuer to make the VCAP request or join with the issuer in making the request.
[6] Id.
[7] As a general rule, under the VCAP program, in order to resolve a problem, the issuer must pay the greater of 1,000 or 100% of the tax exposure of bond holders for the period that the violation is uncorrected if the VCAP request is made within 6 months of the date of the violation. If the request is made later than 6 months but within a year, the payment is based on 110% of taxpayer exposure.
[8] Id.
[9] Section 7.2.3.4.4. of the Internal Revenue Manual refers to the issuer's written procedures. It is not clear whether a conduit borrower's written procedures can be relied on to benefit from this Section.
[10] The modification to the time period also applies if the issuer implemented the written procedures after the violation if the issuer identifies the violation timely after implementing the procedures and applies for VCAP within 90 days after the discovery.

- procedures for the retention of all records material to substantiate compliance with the applicable federal tax requirements; and
- an awareness of the availability of TEB VCAP and other remedial actions to resolve violations.

Section 7.2.3.4.4.specifically provides that "Generally, a reference to reliance on the bond documents, without more, will ***not*** qualify as written procedures that satisfy this paragraph."[11] (emphasis added)

C. Yield Restriction and Rebate Compliance Issues an Issuer Should Consider When Drafting Its Written Post-Issuance Compliance Procedures

IRS Publication ___, A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers is a guide to arbitrage compliance for Smaller Issuers and includes a chart that highlights key questions that should be addressed in the process of monitoring arbitrage compliance. If an issuer wants to include more specific arbitrage compliance procedures in its post-issuance procedures, TEB recommends referring to Publication ___ in general and in particular, the Chart at page ___ of the Publication.

D. Example of Minimum Written Post-Issuance Compliance Procedures for Purposes of IRM Section 7.2.3.4.4.

Exhibit I provides an example of written procedures which address the required minimum elements to be included for purposes of IRM Section 7.2.3.4.4.[12] Issuers should revise Exhibit I to suit their specific situations and practices after reviewing the example of written procedures and the issues identified in Publication___ and the included Chart on page ___ for arbitrage matters as suggested in Part B. There is no one-size-fits-all approach to written post-issuance compliance procedures. Given the varying practices and types of bond issues of issuers, it is imperative that each issuer takes the time to make sure that the written post-issuance compliance procedures it drafts and adopts will work for it and most importantly, that it can comply with them.

[11] Information on IRS.gov provides "Issuers should adopt written procedures, applicable to tax-advantaged bonds, which go beyond reliance on tax certificates included in bond documents provided at closing. Sole reliance on the closing bond documents may result in procedures insufficiently detailed or not incorporated into an issuer's operations." (Excerpt from IRS webpage as last updated and reviewed on August 11, 2011 and located at *http://irs.gov/taxexemptbond/article/0,,id=243503,00.html*.

[12] It should be noted that the procedures outlined in Exhibit I refer only to tax-exempt bonds. However, other tax-advantaged bonds (such as Build America Bonds) are also subject to post-issuance compliance and issuers should include procedures for other tax-advantaged bonds and tax-credit bonds, if applicable.

Exhibit I

Example of Written Post-Issuance Compliance Procedures For Purposes of IRM Section 7.2.3.4.4

Post-Issuance Tax Compliance Procedures

[NAME OF ISSUER] (the "Issuer") is adopting these Post-Issuance Tax Compliance Procedures (the "Procedures") to: (1) maximize the Issuer's compliance with the federal tax law requirements applicable to its outstanding tax-exempt bonds, (the "Bonds"); and (2) identify and resolve any noncompliance matters, on a timely basis, to preserve the tax-exempt status of the Bonds.

The approval of these Procedures by the Issuer will be treated by the Issuer as the establishment of written procedures to: (1) ensure that any Bonds that no longer qualify for tax-exempt status are identified and remediated in accordance with the requirements of the Internal Revenue Code of 1986, as amended (the "Code") and applicable regulations, including the remediation provisions of Treas. Reg. Sec. 1.141-12 or other remedial actions authorized by the Commissioner of the Internal Revenue Service under Treas. Reg. Sec. 1.141-12(h); and (2) monitor compliance with the requirements of Section 148 of the Code (which include arbitrage, yield restriction and rebate requirements) and related regulations.

1. **Monitoring of Post-Issuance Compliance**
   The [______________________] (the "Compliance Officer") will be responsible for monitoring post-issuance compliance for the Bonds pursuant to these Procedures. The Compliance Officer may designate employees within his office to carry out his duties under these Procedures on his behalf in the same manner and with the same effect as any similar designation for any other purpose permitted by law.

2. **Compliance with Covenants in Bond Documents**
   The Compliance Officer will ensure compliance with all covenants made by the Issuer in the documents related to the Bonds (the "Bond Documents") which must be complied with to maintain the preferential tax status of the Bonds, including, but not limited to use of the Bond-financed facilities, timely completion of arbitrage rebate calculations, required filings and restrictions on investment of Bond proceeds.

3. Federal Tax Law Compliance

a. Proper Use of and Allocation of Bond Proceeds

The Compliance Officer will ensure that Bond proceeds are allocated to expenditures in a manner that is consistent with the purpose for which each Bond issue was undertaken, as set forth in the Bond Documents. The Compliance Officer will also ensure that allocations of Bond proceeds to expenditures are timely made in accordance with the applicable tax regulations. (e.g., as of the date of adoption of these Procedures, for each Bond issue, allocations of Bond proceeds to expenditures must be made within 18 months after the later of the date the expenditure was made or the date the project was placed in service, but not later than the earlier of five years after the Bonds were issued or 60 days after the Bond issue is retired.)

b. Investment of Bond Proceeds

The Compliance Officer will ensure that Bond proceeds are invested in investments that are permissible under the Bond Documents, and any applicable state laws and federal tax laws (e.g., federal tax law requires that investments purchased with Bond proceeds must be purchased and sold at fair market value).

c. Arbitrage Calculations

The Compliance Officer will ensure the timely completion of arbitrage yield restriction and rebate calculations and filings for each issue of Bonds.

d. Yield Reduction/Rebate Payments

The Compliance Officer will ensure the timely payment, if applicable, of yield reduction payments and/or rebate, for each issue of Bonds.

e. Use of Bond-financed Facilities

The Compliance Officer will review any agreement or other arrangement for the sale, lease, or use of any portion of any Bond-financed facilities, including, but not limited to, service, vendor and management contracts, research agreements, licenses to use Bond-financed property or naming rights agreements for compliance with federal tax laws and the Bond Documents. The Compliance Officer will consult bond counsel for further guidance if he deems it necessary.

f. Post-Issuance Transactions

The Compliance Officer will, as directed by the Bond Documents or as otherwise deemed appropriate by the Officer, consult with bond counsel before making any changes or amendments to Bond Documents for a Bond issue, including, but not limited to entering or modifying investment agreements; making any change in security for the Bonds, engaging in post-issuance credit enhancement transactions (e.g., change in letter of credit) or hedging transactions (e.g., interest rate swap, cap); terminating or appointing a successor trustee; changes in mode, releasing any liens; or reissuing a Bond issue.

g. Remedial Action

If at any time during the life of a Bond issue, the Compliance Officer discovers that a violation of federal tax law requirements applicable to that issue may have occurred, the Compliance Officer may consult with bond counsel to determine whether any such violation actually has occurred. If the Compliance Officer determines that a violation has in fact occurred, the Compliance Officer will inform the [GOVERNING BOARD] of the same and the [GOVERNING BOARD] [COMPLIANCE OFFICER] will take prompt action to accomplish an available remedial action under applicable regulations or to enter into a closing agreement with the IRS under the IRS's Voluntary Closing Agreement Program or other future published guidance.

4. Recordkeeping

a. Responsibility for Records Maintenance

   i. The Compliance Officer will be responsible for maintaining records related to the Bonds.

   ii. [The Compliance Officer will maintain a central list of records related to each issue of Bonds. The list shall identify:

      1. The name and date of the document related to the issue,
      2. The person or office responsible for the document, and
      3. The physical or electronic location of the document.]

b. Bond Records to be Maintained

   i. The following documents will be maintained at the Compliance Officer's office (the "Bond Records") in electronic and/or hard-copy format for the term of each issue of Bonds (including refunding Bonds, if any), plus at least three years after the April 15 of the year the last Bond of each issue is retired:

      1. The bond transcript for each Bond issue (which includes among other Bond Documents, the trust indenture, loan, lease, or other financing agreement, the relevant IRS Form 8038 (including Forms 8038-G or 8038, as applicable) with proof of filing, the bond counsel opinion and the tax agreement including all attachments, exhibits and any verification report);
      2. Records of debt service payments for each issue of Bonds;
      3. Documentation evidencing the expenditure of Bond proceeds, such as construction or contractor invoices and receipts for

equipment and furnishings, bond trustee requisitions and project completion certificates, as well as records of any special allocations made for tax purposes including post-issuance changes in allocations;

4. Documentation evidencing the lease or use of Bond-financed property by public and private sources, including, but not limited to, service, vendor, and management contracts, research agreements, licenses to use Bond-financed property, or naming rights agreements;
5. Documentation pertaining to investment of Bond proceeds, including the yield calculations for each class of investments, actual investment income received from the investment of proceeds, investment agreements, payments made pursuant to investment agreements and rebate calculations and copies of any 8038-T or 8038-R filed with respect to the Bonds;
6. Documentation pertaining to remedial action and other change-of-use records;
7. Amendments and other changes to the Bond Documents (including interest rate conversions and defeasances);
8. Letters of credit and other guarantees for Bond issues; and
9. Interest rate swaps and other derivatives that are related to Bond issues.

5. Bond Counsel Review

a. The Compliance Officer may engage bond counsel to assist in implementing these Procedures, including, but not limited to, assistance in the following areas:

i. Rebate calculations and compliance;
ii. Records retention;
iii. Periodic review of the Bond Records for compliance with federal tax laws regarding private business use;
iv. Determination of whether a violation of federal tax law requirements applicable to that Bond issue may have occurred and the Issuer's options to address the violation so the preferential tax status of the Bond issue is maintained;
v. Termination or modification of any interest rate swaps or other derivatives;
vi. Review of investment agreements;
vii. Modifications to Bond Documents; and
viii. Other federal tax law compliance, including any annual reporting requirements that may be imposed by the IRS.

6. Review

The Compliance Officer is responsible for an annual review of each outstanding Bond issue pursuant to these Procedures. The initial review of each outstanding Bond issue must occur within [____] months of the adoption of these Procedures and subsequent reviews must be completed [_____________] of each year. Subsequent reviews will focus on events that happened in the immediately preceding year (e.g., new investment agreements, whether a spending exception threshold was met, whether there was a change in use of a portion of the Bond-financed facility). The Compliance Officer is required to present the annual review to the [GOVERNING BOARD] of the Issuer. The Compliance Officer may delegate all or any portion of the reviews to other employees, but such employees must report their findings to the Compliance Officer. The Compliance Officer will recommend changes to these Procedures to the [GOVERNING BOARD] of the Issuer as appropriate to ensure compliance with any covenants in the Bond Documents and other federal tax law requirements which must be complied with to maintain the preferential tax status of the Bonds.

7. Training Requirements

[Within [__] months of his appointment or designation, and [on an annual basis][every ___ years] thereafter,] the Compliance Officer and his designees will undergo training regarding basic federal tax concepts relating to the Bonds and records required to be maintained under these Procedures. Such training may include, but is not limited to attending post-issuance compliance sessions presented by the Government Finance Officers Association(GFOA), National Association of Bond Lawyers (NABL) or other similar trade organizations and public finance law firms and arbitrage compliance specialists.

8. Deadline Reminder System

For any Bond issues issued after the date of adoption of these Procedures, a deadline reminder sheet will be completed within two weeks of the date such Bonds are issued. The deadline reminder sheet will list responsibilities and dates to make post-issuance compliance easier. For example, it will include rebate dates (commencement of rebate computations, completion of rebate computations and rebate payment dates), spending milestones for Bond proceeds in project funds and expiration dates for interest rate swaps or other derivatives, letters of credit and investment agreements.

Appendix C

[Proposed IRS Publication]

Engaging an Arbitrage Compliance Professional for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

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Engaging an Arbitrage Compliance Professional for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers

Introduction

The Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division, offers specialized information and services to the municipal finance community. Municipal bonds provide tax-exempt financing for the furtherance of governmental and qualified purposes including the construction of hospitals, recreational and cultural facilities, schools, water infrastructure, road improvements, as well as facilities and equipment used in providing police, fire and rescue services.

This IRS Publication, Engaging an Arbitrage Compliance Professional for Tax-Exempt Governmental and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers, is a guide to assist "Smaller Issuers" of tax-exempt governmental bonds and qualified section 501 (c) (3) bonds with the decision making process involved in engaging and selecting a professional to provide arbitrage compliance services to satisfy the yield restriction and rebate requirements of Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and applicable regulations (the "Arbitrage Requirements"). As used in this Publication, "Smaller Issuers" refers to issuers of tax-exempt governmental bond issues and conduit borrowers[1] of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount. For each of the years 2006 through 2010, the number of issues of tax-exempt governmental bonds with par values under $10 million comprised approximately 85% of the total number of all issues of tax-exempt governmental bonds in each of those calendar years.

This Publication is one of a series intended to assist Smaller Issuers in complying with the Arbitrage Requirements.

The information provided in this Publication relates solely to the decision making process involved in engaging and selecting a professional to provide arbitrage compliance services. It does not provide any information regarding the Arbitrage Requirements or any other provisions of federal tax law applicable to tax-exempt bonds.

IRS Publication 4079, Tax-Exempt Governmental Bonds and IRS Publication 4077 Tax-Exempt Bonds for 501(c)(3) Charitable Organizations provide a general overview of federal tax rules that apply post-issuance to governmental bonds and qualified Section 501(c)(3)

[1] In practice, many conduit issuers require in their bond documents that the conduit borrowers assume responsibility for complying with the Arbitrage Requirements for the related tax-exempt conduit bonds. However, the IRS's stated position is that compliance with the Arbitrage Requirements and other tax requirements for tax-exempt conduit bonds is the responsibility of the conduit issuer. *See* Publication 5005, Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds (Rev. 4-2012).

bonds respectively and IRS Publication ______, A Roadmap to the Arbitrage Requirements for Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers addresses topics of arbitrage compliance of particular interest to Smaller Issuers. All applicable federal tax law requirements must be met to ensure that interest earned by bondholders is exempt from taxation under section 103 of the Code. TEB also provides detailed information on specific provisions of the tax law through IRS publications (available online) and through outreach efforts as noted on the TEB website at
www.irs.gov/Tax-Exempt-Bonds

Readers of this Publication should consult their own counsel for legal advice on whether the Arbitrage Requirements are met with respect to a particular issue of bonds.

Background

Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and related regulations restrict the amount of "arbitrage" which an issuer or conduit borrower can earn and retain from investing proceeds of a tax-exempt bond issue (the "Arbitrage Requirements").[2] As applied to tax-exempt bonds, "arbitrage" generally refers to profit earned from taxable investments purchased with proceeds of bonds bearing interest at tax-exempt rates. There are two main categories of Arbitrage Requirements – yield restriction and rebate. If ***either*** the yield restriction requirements ***or*** the rebate requirements are not satisfied, tax-exempt bonds become "arbitrage bonds"[3] and lose their tax-exempt status. The Arbitrage Requirements are among the most complicated of the federal tax provisions that apply to tax-exempt bonds and challenge professionals and issuers alike in their application. Representatives of the Office of Tax Exempt Bonds (TEB), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities Division have identified a number of aspects of the Arbitrage Requirements that are frequently misinterpreted or misapplied by "Smaller Issuers" of tax-exempt governmental and qualified Section 501(c)(3) bonds. As used in this Publication, "Smaller Issuers" refers to issuers of tax-exempt governmental bond issues and conduit borrowers of qualified Section 501(c)(3) bond issues each under $10,000,000 in principal amount ("Smaller Issuers").

Smaller issuers sometimes misinterpret or misapply yield restriction and rebate requirements and their interaction. Given the frequency with which these errors occur, and potential staffing and other difficulties of Smaller Issuers, it may be advisable for Smaller Issuers to engage a professional to assist with arbitrage compliance for certain bond issues.

In the current economic environment of constrained budgets, it is tempting to keep many processes and functions in-house instead of incurring fees for an independent expert. However, saving fees for an arbitrage compliance specialist may result in higher costs in the long run. As describe above, both yield restriction and rebate apply to tax-exempt bond issues. Rebate, if any, on a tax-exempt bond issues is due generally at five year intervals over the life of the bond issue.[4] If an issue does not meet exceptions to rebate or yield restriction, an issuer must determine whether any rebate or yield reduction payment is due in sufficient time to permit the issuer to meet payment deadlines. Failure to satisfy these deadlines can result in loss of tax-exemption on the bonds unless the failure was not due to willful neglect and the issuer is permitted to pay a penalty.[5] One of the frequent errors that TEB encounters is failure

[2] The Arbitrage Requirements also apply to bonds issued by state and local governmental issuers that are eligible for tax-advantaged treatment such as Build America Bonds and certain tax credit bonds.
[3] IRC Section 148.
[4] Rebate, if any, must be paid no later than 60 days after the end of the fifth bond year after date of issuance and no later than 60 days after the end of each fifth bond year thereafter. Treas. Reg. §1.148-3(g).
[5] The penalty for governmental and qualified Section 501(c)(3) bonds is 50% of the underpayments. The penalty is automatically waived if rebate plus interest is paid within 180 days after the failure is discovered unless the failure is due to

to pay rebate because the issuer is unaware that rebate applies to the issuer's bonds. Frequently occurring errors of Smaller Issuers include errors that Smaller Issuers make in applying the rebate rules including errors in applying rebate exceptions and in making required calculations. Smaller Issuers sometimes pay rebate but fail to yield restrict bond proceeds when required. In addition, Smaller Issuers sometimes fail to satisfy the Arbitrage Requirements because they are unaware that they apply to their bonds.

If a Smaller Issuer's errors regarding rebate are discovered during an audit, the costs incurred to engage bond counsel, tax counsel and/or an arbitrage compliance professional to represent the Smaller Issuer, may outweigh the costs that a Smaller Issuer would have incurred if a professional had been retained in the normal course of business.

Hiring a rebate compliance professional may be the most efficient and cost-effective way for a Smaller Issuer to meet its arbitrage compliance obligations. Comparing costs and other factors before deciding how to manage arbitrage compliance can benefit an issuer in the long run.

Assessing How to Manage Arbitrage Compliance

Depending on a Smaller Issuer's specific circumstances, a Smaller Issuer may decide that in-house staff will monitor all arbitrage compliance, that in-house staff will monitor certain bond issues and one or more professionals will be engaged to monitor specific issues, or that all issues will be monitored by an outside professional. Variations can include the use of commercially available software by in-house staff. The following are some of the factors to be consider in the decision making process:

Size and experience of staff, frequency of borrowing and type of bonds to be monitored.

Composition of staff available to undertake arbitrage compliance and the knowledge and experience of staff are significant factors in deciding whether an issuer is able to fulfill its compliance obligations adequately. If an issuer has limited staff, it may not be feasible for an issuer to monitor compliance in-house.

If staff is available, the type of bond issue and the frequency with which the issuer borrows are factors to consider when determining whether staff has sufficient knowledge and experience. If the issuer borrows infrequently, staff may lack familiarity with the Arbitrage Requirements. If the issue is a fixed rate, new money issue, staff may have sufficient experience with temporary periods, selecting rebate computation dates and identifying rebate exceptions to be able to understand the yield restriction and rebate requirements. If the issue is an ad-

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willful neglect or the issue is under audit. Treas. Reg. §1.148-3(h)(3).

vance refunding with transferred proceeds, staff may not have sufficient experience to handle compliance without expert help. Similarly, staff may need assistance with other types of issues such as multipurpose issues, or variable rate bonds.

In considering staff level of expertise, familiarity with temporary periods and rebate exceptions is important both before and after bonds are issued so the issuer can ensure applicable conditions can be met for rebate exceptions such as the small issuer exception to paying rebate for issuers with general taxing power if the aggregate amount of all tax-exempt bonds issued in a calendar year does not exceed $5 million. Ability to navigate the complex definitions and procedures under the Code such as the categories of proceeds, determination of yield, and the method of calculating rebate is also important. Does responsible staff know when research is necessary and how to do the research?

If in-house staff lacks training or experience to be responsible for yield restriction and rebate compliance, factors to consider are: the costs in time and money to train staff, the number and types of issues the issuer must monitor, the complexity of the issues to be monitored and the time necessary for staff to monitor compliance. Other factors to consider include: the burdens that will be shifted to other staff, fees that will be charged by an arbitrage compliance professional and the risk of forgoing professional advice in terms of likelihood of IRS audits or the complexity of rebate issues.

Similar factors apply even if an issuer's staff is experienced. In such a case, issuer costs will include ongoing training to keep staff up to date. In addition, the complexity of one or more of the issuer's bonds may have more importance. If staff needs no further training, but is stretched due to layoffs, retirements or for other reasons, the fees for a professional may be worth incurring because use of the professional leaves staff free to engage in more productive activities.

Availability of Software

Software applications are readily available. Many of the questions previously discussed related to in-house preparation are also applicable when considering utilizing a software option.

Many of the applications available today only address/compute the rebate calculation. If an issuer needs help with the application of rebate exceptions, yield restriction requirements or other related matters, retaining a professional may be more suitable than using a software application.

Every bond issue is unique and not all specialized software applications are appropriate for all types of bond issues. An issuer should consider whether or not a specific application will meet its needs and how it will ensure that the software version utilized reflects the most current Code provisions. Depending on the answer to these questions, selection of an arbitrage compliance professional may provide more comfort in the accuracy of the rebate computation.

Selection of Outside Arbitrage Compliance Professionals

If an issuer has decided to engage an arbitrage compliance professional, whether for one issue or all of its issues, at the outset, an issuer should consider is whether the issuer wants a tax opinion supporting the rebate analysis. An opinion demonstrates that the firm stands behind its report and explicitly states that the methodologies used in preparation of the report are correct, the assumptions are reasonable, and the calculations comply with federal tax law. Some issuers seek this additional comfort in the event an issue is audited. Should an organization determine it requires an opinion, requests for proposal (RFP) would be directed to a professional provider that is able to provide a legal opinion.

If an organization determines a tax opinion is not necessary, then RFPs should be sent to several types of providers. If an organization's accountant/auditor has a division performing these services, fee reductions might be possible based on a bundle of services approach. If an organization's bond trustee has a division performing these services, report preparation time might be reduced as transaction data often can be directly transferred from the trustee into the rebate preparer's software.

Regardless of the type of firms identified for RFPs, Exhibit I includes suggested questions to ask potential candidates in order for an issuer to find a qualified provider to meet its needs.

Whether an issuer monitors compliance in-house, through a professional provider or in some combination, considering the factors outlined in this Publication should prove helpful to an issuer in understanding and managing arbitrage compliance.

Exhibit I

Questions Regarding the Organization to Include in RFP for External Arbitrage Compliance Professional

1. *Contact Information.*

    a. The name and contact information of one person with whom the selection committee or its designees should communicate regarding any questions about the submission.

2. *Firm Information.*

    a. Proposals should include a short history of the firm, its size, financial stability, experience and description of its practice areas.

    b. Provide the addresses of:

        i. Home office

        ii. Proposed office(s) that would provide services.

    c. Describe the firm's legal expertise.

        i. Does the firm provide a legal opinion from a law firm that the calculations are in conformance with the Federal tax laws and regulations?

        ii. If your firm is not a law firm, how would you assure that the rebate and yield restriction calculations are consistent with the Federal tax law and regulations?

3. *Expertise/Staffing*

    a. Description of resources and expertise in the arbitrage compliance services. Including experience in:

        i. Fixed and Variable-rate issues;

        ii. Interim Financing Structures;

        iii. Refundings;

        iv. Commingled Funds;

        v. Investment Agreements;

        vi. Hedge Transactions;

        vii. Transferred Proceeds; and,

viii. Any Others.

b. Identify the lead relationship person and provide a biography of their expertise.

c. Describe your process and required timeframes in order to provide rebate reports by required due date(s).

d. Identify the resources/personnel or materials needed to be provided and how requests for information will be coordinated.

4. *Describe the Computational Software Utilized in Preparing Rebate Reports*

a. Is the program proprietary, purchased or other?

b. What is the process/timeline for modifying?

c. How do you ensure it is compliant with current tax law?

5. *Describe the Rebate Report Preparation Process including Final Review*

a. Does your firm's arbitrage compliance report provide detailed investment activities (i.e., purchase, maturities, gain/loss and interest) for each fund and account subject to the arbitrage rules and regulations?

b. In light of the fact that fund structure and investment strategies vary across the board for various clients, how does your firm insure that the rebate and yield restriction calculations are tailored and customized to meet the rebate requirements?

c. Describe how your firm would assist the client if any of the arbitrage calculations by your firm were the subject of an audit/inquiry by the IRS?

6. *Fee Proposal*

a. Provide your recommendation for the fee structure.

7. *References*

Please include the names, titles, phone number and e-mail address for three current clients for whom your firm provides services similar to what you propose to provide in this RFP.