Advisory Committee on Tax Exempt and Government Entities (ACT)

Report of Recommendations

Public Meeting
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June 11, 2008

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Public Meeting
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Washington, D.C. 20224

June 11, 2008

Meeting Begins at 11:00 a.m.

AGENDA

Welcome and Opening Remarks

- Douglas Shulman, Commissioner, Internal Revenue Service
- Steven T. Miller, Commissioner, Tax Exempt and Government Entities
- Steven J. Pyrek, Designated Federal Official of the ACT
- Maxwell D. Solet, Chair of the ACT

Improving the Employee Plans Compliance System: A Roadmap for Greater Compliance

The Appropriate Role of the Internal Revenue Service With Respect to Tax-Exempt Organization Good Governance Issues

The Streamlined Closing Agreement for Tax-Exempt Bonds: A Cure for Common Violations

Protecting Plan Benefits: Improving Governmental Defined Contribution Plan Compliance

Tax Treatment of Cellular Telephones and Internet-Provider Allowances

Governmental Relationship and Communication Between the Internal Revenue Service and Indian Tribal Governments

Closeout

ADVISORY COMMITTEE
ON TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

2007-2008

Member Biographies

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Ms. Diehl is the president of PenServ Inc., a nationally recognized pension consulting firm providing services to more than 800 financial organizations on sponsoring retirement plans. A major part of her activities and products involves educating individuals and practitioners on the whole range of retirement plans — including IRAs, Qualified Plans, 403(b) and 457 plans, and Nonqualified Deferred Compensation Plans. Ms. Diehl has a Bachelor of Arts in mathematics from Arcadia University in Pennsylvania.

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Ms. Gross is an executive compensation and employee benefits lawyer and partner with Reed Smith LLP, one of the 15 largest global law firms. In this capacity, she represents local, national and multinational corporations with operations in the United States, Puerto Rico, Canada, Germany, United Kingdom and other countries. Her work encompasses the full range of executive compensation and employee benefits matters with respect to retirement, savings, welfare and nonqualified deferred compensation plans and related employment matters — including design, administration, compliance, dispute resolution, government audits, and corporate and employment transactions. Ms. Gross has a Juris Doctor from Duquesne University School of Law.

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Mr. Schwartz is a shareholder in the St. Louis law firm of Greensfelder, Hemker & Gale, P.C. His practice encompasses all aspects of employee benefits and executive compensation law, with a special emphasis on employee benefits issues for tax-exempt organizations. Mr. Schwartz is a Charter Fellow of the American College of Employee Benefits Counsel. He received his Juris Doctor from the University of Missouri-Kansas City.

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Mr. Sirkin is senior partner and Co-Chair of the Employee Benefits and Executive Compensation Group in his firm, Proskauer Rose LLP. He has practiced in the employee benefits area since 1972 and has been heavily involved with all aspects of employee benefits, including extensive experience in qualified plans, 403(b) plans and nonqualified plans. Mr. Sirkin is a graduate of Columbia Law School.

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Mr. Spickard is the owner, chief executive officer and chief actuary of Summit Retirement Plans Services, a leading third-party administrator in northern Ohio. He has more than 17 years experience designing and administering all types of retirement plans, with in-depth experience in the areas of salaried, hourly and union defined benefit plans. Mr. Spickard holds a Bachelor of Science in Applied Mathematics from the University of Akron.

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Ms. Wagner is a principal of The Wagner Law Group, an ERISA/employee benefits boutique law firm. Ms. Wagner specializes in the full range of employee benefits matters with respect to retirement plans, welfare plans and executive compensation. With respect to such plans, she specializes in design, administration, compliance, dispute resolution, government audits, and corporate and employment transactions. Ms. Wagner received her Juris Doctor from Harvard Law School.

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Ms. Brier is the general counsel of The Children's Hospital of Philadelphia. She is a past chair of the American Bar Association Health Law Section and of the Exempt Organizations Committee of the American Bar Association Taxation Section. In her over 25 years of practice in the field of exempt organizations, she has specialized in the area of health care, compensation and benefits, charitable giving and nonprofit governance. Ms. Brier has an A.B. from Cornell University and a Juris Doctor from Stanford University.

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Mr. Delany is the Executive Director of Lawyers Alliance for New York, Inc., an organization that provides non-litigation legal assistance to nonprofits and community development organizations in New York City. His organization provides services dedicated to improving the accountability and efficiency of small tax-exempt organizations, and includes counseling on their ongoing compliance with federal and state regulatory obligations. He has also served as Assistant Attorney General in Charge of the Charities Bureau in the New York Attorney General's office.

Fred T. Goldberg, Jr., Washington, D.C.

Mr. Goldberg is a partner at Skadden, Arps, Slate, Meagher & Flom LLP, with a broad gauged tax practice that includes not only exempt organizations but also employee plans and tax exempt bonds. Mr. Goldberg served as Commissioner of Internal Revenue (1989 – 1991) and Assistant Secretary (Tax Policy) (1992). He holds a Juris Doctor from Yale University.

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Ms. Rauschenberg is Director of Deloitte Tax LLP's Chicago healthcare and not-for-profit tax practices. Her clients include academic medical centers, colleges and universities, teaching hospitals, cultural organizations, trade associations, public and private foundations, and other tax-exempt organizations. Ms. Rauschenberg holds a Masters of Accounting Science from the University of Illinois.

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Ms. Thompson is the executive director of the Charles and Helen Schwab Foundation, where she works closely with the Board of Directors to identify and select nonprofit organizations that demonstrate an entrepreneurial and results

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Mr. Hoffman is the tax manager for The Ohio State University, where he is responsible for issues concerning taxation in state and local governments and tax-exempt entities. His background includes 15 years with the IRS and with OSU's tax-exempt bond activity. Hoffman, an enrolled agent and a certified financial planner, has a Master of Science in Taxation from Capital University in Ohio.

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Mr. Merrill is the manager of the accounting division for the State Employees' Retirement System of Illinois, a large statewide Public Employees' Retirement System. He is a certified public accountant and previously worked for a national public accounting firm where he specialized in governmental audits. He has served as President of the National Conference of State Social Security Administrators (NCSSSA), as well as in other roles within that organization. He is also active in the Government Finance Officers Association.

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Mr. Regan has held leadership, regulatory, client service and risk management roles for a number of governmental organizations and private sector firms that serve tax-exempt entities. He is currently Vice President, Fidelity Investments, where he is responsible for developing governance and policy across the company's retirement plan business lines. Prior to joining Fidelity, Mr. Regan was Executive Director, New York State Deferred Compensation Board, where he ran the State's then 159,000-member, $7.7 billion deferred compensation plan and developed regulations that govern 250 local government plans. Previously, he was Assistant General Manager and Budget Director, Massachusetts Bay Transportation Authority and Assistant Vice President, Mellon Trust. Mr. Regan received a Bachelors Degree in Business Administration and an MBA from Suffolk University.

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

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Mr. Puzz is a member of the Yurok Tribe of Northern California and an attorney in the Native American Law section of Best & Flanagan. Mr. Puzz focuses his practice on representing tribal governments in the areas of gaming, economic development, constitution, ordinance and regulation drafting, and employment. Prior to rejoining the firm, he was executive director of the Yurok Tribe, in Klamath, Calif. As executive director, he oversaw all operations of the tribal government, which employs approximately 250 employees and operates on a yearly budget of $12 million. He was also tasked with managing all Tribal Council initiatives internally, representing the Tribe on these issues with outside entities, and managing four outside law firm relationships regarding these projects. Mr. Puzz has a Juris Doctor from the University of Minnesota Law School.

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Ms. Streitz is a partner in the law firm of Dorsey & Whitney LLP, with wide experience in a wide variety of tax issues affecting Indian tribal governments and other tribal entities. She has represented tribes in all regions of the country. She also heads up her firm's national Indian tax practice. Ms. Streitz has a Juris Doctor from the New York University School of Law.

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Ms. DiMarco is the managing partner of the Philadelphia office of BondResources Partners LP. Her background includes a wide range of experience in consulting to investment bankers, law firms, issuers and governmental agencies. She has more than 30 years of experience in municipal bonds and structured finance. Ms. DiMarco is a certified public accountant and has a Bachelor of Science in business administration from Drexel University.

John G. Pasicznyk, Albany, N.Y.

Mr. Pasicznyk is the chief financial officer and treasurer of the Dormitory Authority of the State of New York, one of the largest issuers of tax-exempt debt and one of the largest public construction companies in the nation. In this position, Mr. Pasicznyk is responsible for all treasury, accounting, computer and information services functions related to administering a $36 billion debt portfolio, including investments and arbitrage rebate compliance. Mr. Pasicznyk holds a Masters of Business Administration from the Duke University Fuqua School of Business.

Maxwell D. Solet, Boston

Mr. Solet is a member of the law firm of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., where he has principal tax responsibility in connection with the firm's role as bond counsel, underwriter's counsel and purchaser's counsel on state or local bond issues. These include bonds of large general obligation issuers, specialized revenue bond issuers, housing finance agencies, student loan agencies, and conduit issuers of bonds to finance healthcare and education facilities and solid waste disposal facilities. He is a former chair of the Tax Section of the Boston Bar Association and is a member of the steering committee of the annual Bond Attorneys Workshop. Mr. Solet received a Bachelor's degree from Harvard College and a Juris Doctor from Harvard Law School.

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

This report is presented in connection with the seventh annual public meeting of the IRS Advisory Committee on Tax Exempt and Government Entities (the "ACT"). The Tax Exempt and Government Entities ("TE/GE") division of the Internal Revenue Service is comprised of branches which are responsible for administration of federal tax law as it relates to (i) Exempt Organizations, (ii) Employee Plans, (iii) Federal, State and Local Governments, (iv) Indian Tribal Governments, and (v) Tax-Exempt Bonds. These areas involve entities which are not private taxpayers operating for profit. The Exempt Organization and Employee Plans branches involve entities which perform functions in our society thought to be worthy of exemption from tax. The Federal, State and Local Governments branch and the Tax Exempt Bond branch involve governmental entities with their own sovereign status within our federal system. The Indian Tribal Governments branch involves governmental entities with independent sovereignty recognized by statute and treaty. These factors impose a special responsibility on the Internal Revenue Service in dealing with these constituencies. Since the ACT members are drawn from such constituencies and the professionals who serve them, the ACT is particularly well suited to assist the IRS in creating a respectful, fair and efficient working relationship with each.

The ACT's principal activity traditionally has been a series of year-long projects with specific topics, resulting in the preparation and production of reports at this public meeting. This year's projects include: in the Exempt Organization area, consideration of the role of the IRS in issues of governance; in the Employee Plans area, a series of recommendations as to the Employee Plans Compliance Resolution System ("EPCRS"); in a project bridging the Employee Plans and Federal, State and Local Governments areas, proposals for improving public sector defined contribution plans; in

the Federal, State and Local Governments area, a report on tax treatment of cellular telephones and Internet-provider allowances; in the Indian Tribal Governments area, a survey and recommendations as to government-to-government relationships, and in the Tax-Exempt Bond area, a proposal for a streamlined closing agreement process to efficiently resolve certain common, recurring violations.

In addition to these projects, the ACT has urged TE/GE to utilize this committee and its subgroups for ongoing consultation in the hope of improving both the administration of the tax law and the relationship of the IRS to their constituencies. The ACT believes that significant progress has been made in filling this additional role.

The following members of the ACT are completing their terms this year:

Betsy Buchalter Adler, Silk, Adler and Colvin, San Francisco, CA
Sean Delany, Lawyers Alliance for New York, Inc., New York, NY
Nicholas C. Merrill, Jr., State Employees Retirement System of Illinois, Springfield, IL
Julian Regan, Fidelity Employer Services Company, Marlborough, MA
Daniel J. Schwartz, Greensfelder, Hemker & Gale, P.C., St. Louis, MO
Michael S. Sirkin, Proskauer Rose LLP, New York, NY
Maxwell D. Solet, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., Boston, MA
Sandra Starnes, Port Gamble S'Klallam Tribe, Kingston, WA.

The ACT thanks them for their service and commitment and for their friendship.

The ACT wishes to thank Commissioner of Internal Revenue Douglas Shulman for meeting with us soon after his appointment and for being with us at today's public meeting to receive our reports. The ACT also wishes to thank TE/GE Commissioner Steven Miller for allowing us to play an important role in assisting his division and for his own direct involvement with our activities. We also thank the deputy commissioners,

directors, and branch heads with whom we have had the pleasure of working. Finally, we thank Steven Pyrek, the ACT's "Designated Federal Official," who, with diligence and good humor, has worked to facilitate our meetings and activities.

As ACT members, we have found our experience to be personally and professionally gratifying. We hope our work has been helpful to the Internal Revenue Service and to the constituencies we both serve.

Maxwell D. Solet
Chair

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

IMPROVING THE EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM: A ROADMAP FOR GREATER COMPLIANCE

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June 11, 2008

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Exhibit A – All Master, Non-Master and Prototype Closings

Exhibit B – Summary of ACT Survey Responses

Exhibit C – EPCRS – Notice of Intent to File VCP Application

Exhibit D – Voluntary Correction Program (VCP Application)

I. EXECUTIVE SUMMARY

A. Overview of Report

The Employee Plans Compliance Resolution System ("EPCRS") is an important program in encouraging employers that sponsor retirement plans ("Plan Sponsors") to voluntarily comply with the complex set of rules governing retirement programs. Comprised of three subparts – the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP") and the Audit Closing Agreement Program ("Audit CAP") – EPCRS covers nearly all facets of plan correction. While there are no statistics available regarding the extent to which Plan Sponsors utilize SCP, statistics respecting VCP and the Internal Revenue Service's ("Service") audit activity are readily available and demonstrate the broad impact of these programs. For example, the Service issued nearly 3,000 voluntary compliance agreements and engaged in over 11,500 retirement plan audits and enforcement contacts in the fiscal year ending in 2007.[1]

Like every program, as good and useful as it is, EPCRS can be improved. The purpose of this report is to make recommendations to improve EPCRS. The reasons the ACT undertook this project are (i) a recognition that Congress has directed the Service, pursuant to section 1101 of the Pension Protection Act of 2006 ("PPA")[2], to continue to update and improve EPCRS and (ii) a determination through the members' informal discussions with other practitioners and their own experience that certain system improvements are desirable.

B. Principles

In developing its recommendations, the ACT was guided by the following principles:

- EPCRS is a valuable, generally well-received compliance tool which should remain intact.
- The ACT's due diligence process should solicit the views of the Service and the practitioner community.
- The recommendations should be directed at enhancing fairness and ease of use as well as address a number of technical issues.
- The recommendations should reflect the specific areas of concern cited in section 1101 of the PPA.

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[1] Internal Revenue Service Data Book, 2007 Publication 55B, Washington, D.C. issued March 2008 (table 22); internal statistics compiled by the Service, *see* Exhibit A.

[2] Pub. L. No. 109-200, 190th Cong., 2nd Sess (2006).

- The recommendations should be practical and be able to be implemented within the budget and manpower constraints of the Service.

C. Recommendations

The ACT's recommendations can be classified into four categories as follows:

1. Recommendations to Improve the Self-Correction Program

- Extend the duration of the self-correction period for significant Operational Failures from the last day of the second (2nd) plan year following the plan year for which the Plan Failure occurred to the last day of the third (3rd) plan year following the plan year for which the Plan Failure occurred.

- Expand the self-correction amendment options, using a narrow set of criteria, to include the retroactive correction by amendment of unequivocal drafting errors.

2. Recommendations to Improve the Voluntary Correction Program

- Adopt a new program to allow Plan Sponsors to submit a notice informing the Service that a VCP submission is forthcoming with respect to identified Plan Failures; in the event of an audit in the interim, the Plan Sponsor will be treated as though a VCP submission was actually filed.

- Adopt a standardized application form for VCP which will assist the Service in the initial screening process to classify submissions as routine or complex and to, in general, expedite the submission and review process.

- Reform the VCP fee structure to make it fairer and encourage more participation and use of it.

- Amend the VCP rules to permit a Plan Sponsor to file a QSLOB correction in the event the Plan Sponsor fails to timely file the proper notice.

- Amend the VCP procedures to clearly permit the use of the DOL Online Calculator in calculating earnings adjustments.

- Amend the VCP procedures to permit, as a specific correctable Plan Failure, limited exclusive benefit violations such as the inadvertent receipt and retention by a Plan Sponsor of demutualization proceeds.

- Amend the VCP procedures to permit a Plan Sponsor who is not otherwise entitled to use the DOL's delinquent filer program to correct IRS Form 5500 filing failures.

3. Recommendations to Improve the Audit CAP Program

- Make information available to the public regarding the administration of Audit CAP that would facilitate a better understanding of the resolution process.

- Permit a Plan Sponsor to request an internal high-level reconsideration of proposed Audit CAP sanctions and thereby improve consistency and the sense of fairness.

4. Recommendations to Improve EPCRS Generally

- Improve education and outreach by (i) contacting Plan Sponsors in writing at the time the IRS Form 5500 is submitted to remind them of compliance issues and (ii) reaching non-traditional stakeholders, such as registered investment advisors, through an innovative initiative designed to enlist their assistance in the compliance effort for small employers.

- Develop a Revenue Procedure to assist payors in reporting corrective distributions.

- Expand EPCRS to include section 457(b) programs.

- Expand EPCRS to permit correction of section 403(b) Plan Document Failures.

II. INTRODUCTION

"EPCRS is a popular program, and it has greatly helped many plan participants retain tax-favored retirement benefits. We hope Plan Sponsors will take advantage of the features of EPCRS. But even if they don't, the IRS strongly encourages Plan Sponsors to regularly monitor and evaluate their retirement plans to ensure compliance with the law."

Carol Gold
Director, Employee Plans (1999-2006)
May 5, 2006[3]

A. Reason for the Report

This project arises from a perceived need to improve what Commissioner Steven T. Miller has referred to as a "signature program" of the Employee Plans Division ("EP") of the Tax-Exempt and Government Entities Branch of the Service ("TE/GE").[4] While agreeing that EPCRS has become a successful mainstay of the compliance mechanism for qualified plans, tax-sheltered annuities ("403(b) plans"), Simplified Employee Pension Plans ("SEPs") and SIMPLE IRAs, the Advisory Committee to TE/GE (the "ACT") believes that significant improvements to the system would further the purpose of EPCRS and make it a more useful and beneficial program. This belief emanates from two sources. First, as described more fully below, the enactment of section 1101 of the PPA represents a Congressional directive to improve EPCRS. Second, the collective experience of the ACT members demonstrates that, while extremely valuable, EPCRS should be refined to make it even fairer, easier to use, and more responsive to a number of technical concerns.

[3] IR – 2006-75, May 5, 2006.

[4] Remarks of Steven T. Miller, Commissioner, Tax-Exempt and Government Entities, before the Great Lakes Benefit Conference, Chicago – May 3, 2007. Reprinted at Tax Core No. 86, Friday, May 4, 2007.

B. EPCRS

1. The Three Sub-Parts of EPCRS

Designed to allow plan administrators to voluntarily correct Plan Failures[5] when discovered, EPCRS is composed of the following three programs:

- Self-Correction Program

  Under SCP, administrators that have established compliance practices and procedures may generally correct insignificant Operational Failures under a qualified plan, a 403(b) plan, a SEP, or a SIMPLE IRA at any time without paying any fee or sanction, provided that, if a SEP or SIMPLE IRA is involved, the SEP or SIMPLE IRA is established and maintained on a Service-approved document. In addition, in the case of a qualified plan that is the subject of a favorable Service determination letter, or in the case of a 403(b) plan, administrators may generally correct significant Plan Failures without payment of any fee or sanction by the end of the second plan year following the plan year in which the Plan Failure occurred.[6]

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[5] As used in EPCRS and this report, a Plan or Qualification Failure is any failure that adversely affects the tax qualified status of a plan. Plan Failures may be divided into four classifications: (i) Plan Document Failures, (ii) Operational Failures, (iii) Demographic Failures, and (iv) Employer Eligibility Failures. Plan Document Failures include plan provisions (or the absence of plan provisions) that, on their face, violate the requirements of section 401(a) or section 403(a) of the Code. For example, the failure of a plan to be amended to reflect a new qualification requirement within the plan's applicable remedial amendment period under section 401(b) is considered a Plan Document Failure. Additionally, a "non-amender" (an employer that has not adopted amendments required by legislation or IRS guidance by the required date) would also be considered to have experienced a Plan Document Failure. An Operational Failure is a type of a Plan Failure that arises solely from the failure to administer the plan in accordance with plan provisions. For example, allowing an "in-service" distribution to a plan Participant, in contravention of the plans' provisions is considered to be an Operational Failure. A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively pursuant to section 401(b) or another statutory provision to reflect the plan's operations. However, if within the applicable remedial amendment period under section 401(b), a plan has been properly retroactively amended for statutory or regulatory changes, but during that retroactive period, the amended provisions were not followed, then the plan is considered to have an Operational Failure. A Demographic Failure is the type of failure which results from violations of section 401(a)(4), section 401(a)(26) or section 410(b), which are not Operational Failures or Employer Eligibility Failures. For example, a plan's failure to meet the minimum coverage requirements of section 410(b) is a Demographic Failure. Generally, the correction of a Demographic Failure requires a corrective amendment to the plan document expanding eligibility or benefits for plan Participants. The final type of failure is an Employer Eligibility Failure. These failures result when a Plan Sponsor is not eligible to adopt the type of plan that it has adopted. For example, certain types of employers are ineligible to adopt 401(k) plans.

[6] Rev. Proc. 2006-27, § 9.02.

- Voluntary Correction Program

  Under VCP, administrators may, at any time before being notified by the Service of an audit, pay a fee and receive the Service's approval for a correction of Operational, Plan Document, Demographic and Employer Eligibility Failures. VCP is available to a qualified plan, a 403(b) plan, SEP or SIMPLE IRA. In addition, under VCP, there are special procedures for anonymous and group submissions.[7]

- Audit Closing Agreement Program

  Under Audit CAP, administrators may make corrections while the plan is under audit and pay a sanction based on the nature, extent and severity of the Plan Failure being corrected. If the Service and the Plan Sponsor cannot reach an agreement regarding the correction, the Plan Failure, or the amount of the sanction, the plan will be disqualified, or, in the case of a 403(b) plan, SEP, or SIMPLE IRA, its tax favored status will be revoked.[8]

2. General Principles of EPCRS

EPCRS is based on the following general principles:

- Sponsors should be encouraged to establish practices and procedures that ensure the plans are operated according to Code requirements.

- Sponsors should satisfy the applicable plan document requirements of the Code.

- Sponsors should make voluntary and timely correction of any Plan Failures, whether involving discrimination in favor of highly compensated employees, plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer. Timely and efficient correction protects affected participants, beneficiaries and alternate payees ("Participant") providing them with their expected retirement benefits, including favorable tax treatment.

- Fees for voluntary corrections that have been approved by the Service should promote voluntary compliance and reduce uncertainty with regard to employers' and Participants' potential tax liability.

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[7] *Id.*

[8] Rev. Proc. 2006-27, § 13.04.

- Incentives to make corrections promptly should be ensured by providing fees and sanctions graduated in a series of steps.
- Sanctions for Plan Failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation.
- EPCRS administration 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.[9]

In addition, a uniform set of correction principles governs all three of the EPCRS programs. Generally, a Qualification Failure is not considered to be corrected unless full correction is made with respect to all Participants for all relevant tax years, regardless of whether the tax year is closed, considering the terms of the plan at the time of the Plan Failure.[10] The correction method should restore the plan to the position in which it would have been had the Plan Failure not occurred. Current and former Participants should be restored to the benefits and rights they would have had if the Plan Failure had not occurred.[11]

Corrections are to be reasonable and appropriate. Depending on the nature of the Plan Failure, more than one reasonable and appropriate correction may exist. Any standardized correction method permitted is deemed to be reasonable and appropriate. Whether any other particular correction method is reasonable and appropriate is determined according to the facts and circumstances and the following principles:

- The method should resemble one already provided for in the Code, regulations, or other guidance.
- The method for Qualification Failures relating to nondiscrimination should provide benefits for non-highly compensated employees.
- The method should keep plan assets in the plan, except to the extent the Code, regulations or other publications already provide for distribution.
- The method should not violate another qualified plan requirement.[12]

Generally, where more than one correction method is available to correct an Operational Failure for a plan year, the correction method should be applied

[9] Rev. Proc. 2006-27, § 1.02.
[10] Rev. Proc. 2006-27, § 6.02.
[11] Rev. Proc. 2006-27, § 6.02(1).
[12] Rev. Proc. 2006-27, § 6.02(2).

consistently in correcting Operational Failures of the same type for that plan year. Similarly, earnings adjustment methods generally should be applied consistently with respect to corrective contributions or allocations for a particular type of Operational Failure for a plan year.[13]

[13] Rev. Proc. 2006-27, § 6.02(3).

III. BACKGROUND

A. History of EPCRS

1. The Development of Voluntary Correction Mechanisms[14]

Prior to 1991, the options available to Plan Sponsors for the correction of Qualification Failures were extremely limited. Sponsors discovering such Plan Failures were forced either to accept the risk of audit, disclose the Plan Failure to, and negotiate the correction with the Service, or simply treat the plan as disqualified. There was no assurance that a Plan Failure could be properly corrected, and if so, at what cost to Plan Sponsors and Participants.

EP operated under the Draconian rule that a plan would lose its qualified status if any form or Operational Failure existed that violated section 401(a) of the Code. Often, the Service would threaten to disqualify such a plan unless the employer paid an amount designed to approximate the tax the Service could collect if the plan were disqualified. The Service lacked a formal administrative correction mechanism of general applicability that could match the severity of an infraction with the appropriateness of the corresponding sanction.

a. Self-Correction

The Service first acknowledged that certain operational violations did not merit outright disqualification when it implemented the Administrative Procedure Regarding Self-Correction ("APRS"), announced March 26, 1991.[15] APRS was limited to tax-qualified plans under section 401(a), and could be applied only at the discretion of the applicable Service Key District Office. APRS allowed self-correction of plan defects, meaning the employer could correct on its own without submitting any filing to the Service; there was no possibility of obtaining any written confirmation that the correction was adequate.

To be eligible for correction under APRS, an Operational Failure had to satisfy several narrowly drawn criteria, one of which was that if the Plan Failure occurred in more than one year or if multiple unrelated Plan Failures occurred in a single year, relief was not available. Among other problems, the "one year" requirement in particular limited the usefulness of APRS, since most Plan Failures tend to occur in more than one year. Everyone recognized that some modifications were necessary if APRS was to function effectively.

On December 23, 1996, the Service replaced APRS with the Administrative Procedure Regarding Self-Correction or "APRSC."[16] APRSC broadened the array of operational

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[14] For a more complete discussion of this topic *see* Wagner and Bianchi, 375 T.M. A-2, *EPCRS – Plan Correction and Disqualification.*

[15] Memorandum from the Assistant Commissioner (Employee Plans and Exempt Organizations) to the Assistant Regional Commissioners (Examination) and the Brooklyn, Chicago and Cincinnati District Directors (the "APRS Memo").

[16] APRSC was announced in an IRS News Release on that date.

defects that could be self-corrected and it also extended relief to 403(b) plans. APRSC was not available to correct violations that could be corrected only by plan amendment, nor was it available for exclusive benefit violations relating to the misuse or diversion of plan assets.

Relief under APRSC was predicated on the correction of all relevant violations for all plan years in which they occurred and, to the extent possible, the correction needed to put the Participants and the plan in the position in which they would have been had the Plan Failure not occurred. Moreover, the rights and benefits of all Participants and beneficiaries were required to be fully restored.

APRSC was available for the correction of both "significant" and "insignificant" Operational Failures. In the case of a Plan Failure which was determined to be significant applying the criteria specified in APRSC, Plan Sponsors had until the last day of the year following the plan year (subsequently extended to two years) in which the defect occurred to make full correction, and the Plan Failure had to be corrected prior to an audit of the plan for the plan year in which the violation took place. Insignificant violations, on the other hand, could be corrected at any time without penalty even if discovered on audit.

b. Approved Corrections

In Rev. Proc. 92-89,[17] the Service established a temporary, experimental program designed to encourage Plan Sponsors' voluntary compliance with the qualification requirements. Unlike APRSC, which was a self-correction program as described above, the Voluntary Compliance Resolution Program ("VCR") allowed Plan Sponsors to voluntarily disclose Operational Failures and their correction to the Service and obtain a "compliance statement" from the Service assuring that it would not disqualify the plan with respect to the operational violations identified. One of the distinguishing features of VCR was that monetary sanctions were fixed in advance in the form of a "compliance fee" based on the amount of plan assets and the number of plan Participants. For 403(b) plans, the number of employees were used instead of the number of Participants.

Rev. Proc. 93-36[18] extended VCR until December 31, 1994, and also identified and provided standardized, pre-approved correction methods for certain common Qualification Failures. The Service collectively referred to these standardized correction methods as the Standardized Voluntary Correction Procedure or "SVP." The Service established a reduced compliance fee to encourage the use of the SVP correction methods.

[17] 1992-2 C.B. 498.
[18] 1993-2 C.B. 474.

Rev. Proc. 92-89 and Rev. Proc. 93-36 were superseded by Rev. Proc. 94-62[19] which extended the VCR program indefinitely, modified the VCR eligibility standards and expanded the types of Plan Failures that could be corrected under SVP. Further changes to VCR were made in Rev. Proc. 96-29[20] relating to eligibility standards and the circumstances under which a plan is determined to be under examination.
Most Operational Failures (except egregious Plan Failures or exclusive benefit violations) could be corrected under VCR so long as the plan had a current determination letter. The voluntary compliance fee ranged from $500 to $10,000, depending on the size of the plan and the number of plan Participants (or the number of employees where a 403(b) plan was involved). Under VCR, Plan Sponsors were required to identify and describe the Operational Failures and the proposed correction mechanism. The Service could request modifications or changes to the correction mechanism, and it could also require the amendment or adoption of administrative practices and procedures. Plan Sponsors had 90 days in which to implement corrections following the issuance of the VCR compliance statement.

2. The Development of Audit Correction Mechanisms

On December 21, 1990,[21] the Service announced the Employee Plans Closing Agreements Pilot Program ("CAP"). CAP was originally designed to give Service Field Agents the ability to negotiate a closing agreement with a Plan Sponsor under audit as an alternative to plan disqualification. This allowed the Service to meet its regulatory objectives without injuring plan Participants. Under CAP, the Service could agree not to revoke a plan's qualified status if the identified Qualification Failures were completely corrected and a sanction amount paid. The taxpayer had no right to participate in CAP; rather, the Service could agree in its sole discretion to enter into a closing agreement under CAP. CAP was generally available as a possible alternative to revocation of a plan's tax qualified status in cases involving (i) failure to timely amend a plan for TEFRA, DEFRA, and REA, (ii) improper application of an integration formula, (iii) partial termination or (iv) operational top-heavy violations.

Rev. Proc. 94-16,[22] effective January 12, 1994, gave retirement Plan Sponsors the right to voluntarily request consideration of plan defects under CAP. This portion of the CAP program was separately referred to as "Walk-in CAP," and the original CAP program was alternatively referred to as "Field CAP" or "Audit CAP." Rev. Proc. 94-16 explained the compliance options and sanction limitations applicable to Plan Sponsors which voluntarily requested consideration under CAP because of disqualifying defects that were not eligible for the VCR Program.

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[19] 1994-2 C.B. 778.
[20] 1996-1 C.B. 693.
[21] CAP was initially announced in a memorandum from the Director, Employee Plans Technical and Actuarial Division, and the Director, Employee Plans/Exempt Organizations Operations Division, to the Assistant Regional Commissioners. By memorandum dated October 9, 1991, to and from the same parties, CAP was established as a permanent program. Procedures applicable to closing agreements originating in field offices are set out in section 8(13)10 of the Internal Revenue Manual and in Rev. Proc. 68-16, 1968-1 C.B. 770.
[22] 1994-1 C.B. 576.

Under CAP, the party to the closing agreement was required to pay a non-deductible sanction amount to the government to maintain the plan's qualified status. The starting point for determining the sanction amount was the maximum tax liability that would result from the disqualification of the plan, including loss of the employer's tax deductions, tax on trust earnings, inclusion of contributions in employees' income, and penalties and interest for all open years.[23] A reduction in this so-called "maximum payment amount" could be negotiated based on the facts and circumstances of a particular case. In general, the Service would take into account such considerations as the inadvertence of the error, significance of the defect, and any other relevant equitable factors.

In imposing a sanction amount, the Service could take into account the employer's financial situation, and it could impose a lower sanction amount than it would otherwise if the employer could demonstrate financial hardship. In a bankruptcy situation, the Service would take into account the percentage recovered by general creditors.[24] Moreover, the Service could take into account the hazards of litigation, and it could impose a lower sanction where there was some question as to whether the Service would prevail if the matter were litigated.[25]

3. The Development of a Separate Correction Mechanism for 403(b) Plans

Rev. Proc. 95-24[26] established a separate temporary (through October 31, 1996), experimental program designed to encourage voluntary compliance by section 403(b) plans. The Tax Sheltered Annuity Voluntary Compliance Program or "TVC" program, as it was called, permitted employers who offered 403(b) plans to voluntarily identify and correct plan defects. Employers who took advantage of TVC received written assurances that the Service would not pursue available tax remedies. Rev. Proc. 96-50 extended the TVC program through December 31, 1998.[27]

The original TVC guidance suffered from some serious drawbacks, limiting the program's appeal. The potential sanction amounts were significant, and the program was not available to fix a number of commonly encountered defects. The Service later expanded TVC, made it permanent, and addressed many of its shortcomings in Rev. Proc. 99-13.[28]

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[23] *See* section on "General Guidelines for Closing Agreements" in memorandum dated Dec. 21, 1990 concerning the CAP Program.
[24] Statement of Martin I. Slate, 19 BNA Pension Rept. 1027 (6/22/92).
[25] "Litigation Strategies in Retroactive Disqualification Cases," Pension Plan Guide (CCH) ¶26,281 (Sept. 6, 1991) at 27,037-41 and n. 17.
[26] 1995-1 C.B. 694.
[27] 1996-2 C.B. 370.
[28] 1999-5 I.R.B. 52 (2/1/99).

4. Consolidation into EPCRS

In Rev. Proc. 98-22, generally effective September 1, 1998, the Service revised and consolidated all of its previously established correction programs for tax qualified retirement plans, including section 403(b) plans, under the name of the "Employee Plans Compliance Resolution System" or "EPCRS." The original EPCRS included three voluntary correction programs: (APRSC, VCR and Walk-in CAP), and an audit correction program (Audit CAP). The stated purpose of EPCRS was to provide a comprehensive system of correction programs that enable Plan Sponsors to correct Qualification Failures and thereby continue to furnish their employees with retirement benefits on a tax-favored basis.[29]

Relief under EPCRS was accomplished through self-correction, voluntary correction with Service approval or correction on audit, depending on the nature of the Qualification Failure and the manner of its discovery.[30] EPCRS clarified that there may be more than one appropriate method of correcting Qualification Failures, and it permitted, in appropriate circumstances, the use of reasonable adjustments in making corrections. EPCRS also permitted Plan Sponsors to rely on its availability, unlike CAP and APRSC, which were originally available only at the discretion of the Service.[31]

The next step in EPCRS' evolution was Rev. Proc. 99-31, issued on August 6, 1999,[32] which supplemented Rev. Proc. 98-22 and announced correction principles and examples for particular disqualifying defects in qualified plans. The Service made clear that the model correction methods it contained were not the exclusive means of correcting such Qualification Failures.

The first comprehensive update of EPCRS appeared in Rev. Proc. 2000-16,[33] which, in addition to providing a unified procedure and a single document as the source for the EPCRS, also clarified and revised EPCRS in certain particulars, and allowed multiple corrections, under multiple correction programs under EPCRS, to be consolidated into one submission.

Effective May 1, 2001, Rev. Proc. 2001-17 further expanded the types of plan Qualification Failures that could be corrected under the system as well as the universe of plans to which EPCRS was available. VCR, SVP, Walk-in CAP, and TVC were restructured into a single voluntary correction program, which was referred to as the "Voluntary Compliance Program with Service Approval" or "VCP."[34] VCR was referred to as "VCO"[35] (Voluntary Correction of Operational Failures); SVP as VCS[36] (Voluntary

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[29] Rev. Proc. 98-22, § 1.01.
[30] Rev. Proc. 98-22, § 1.03.
[31] Rev. Proc. 98-22, § 2.01 (bullet 4).
[32] 1999-34 I.R.B. 280.
[33] 2000-16 I.R.B. 780.
[34] Rev. Proc. 2001-17, Part V.
[35] *Id.*, § 10.10.
[36] *Id.*, § 10.11.

Correction of Standardized Operational Failures); TVC as VCT[37] (Voluntary Correction of Tax Sheltered Annuity Failures); and APRSC as "SCP" (Self-Correction Program).[38] The term "Walk-In CAP" was eliminated. In addition, a new program, VCGroup,[39] was added under which master and prototype Plan Sponsors, insurers administering 403(b) plans, and third-party administrators could receive compliance statements that affect more than one Plan Sponsor. Another new program was added that permitted anonymous submissions referred to as the "John Doe Program"[40] under VCP.

Rev. Proc. 2002-47[41] permitted sponsors of eligible 457(b) plans to submit requests in connection with but "outside of" EPCRS;[42] it increased the de minimis distribution amount from $20 to $50, and provided a new de minimis exception under which Plan Sponsors need not seek refunds of overpayments of $100 or less; and made clear that EPCRS was available to correct problems with terminated plans.

Rev. Proc. 2003-44[43] represented a major procedural overhaul of EPCRS, making it a truly integrated system rather than an amalgamation of several independently developed programs. Among other changes, 2003-44 consolidated all voluntary correction procedures requesting Service approval into a single program, the "Voluntary Correction Program" or "VCP," and provided a fixed fee schedule for all VCP submissions.

The latest iteration of EPCRS is set out in Rev. Proc. 2006-27.[44] Among other new features, 2006-27 provides:

- that the Service will waive the section 4974 excise tax for failure to satisfy minimum distribution requirements, and that the Service will not pursue other excise taxes under sections 4972 and 4979 in appropriate circumstances;
- that VCP and Audit CAP now apply to terminating orphan plans, and that the Service may not require full correction and may waive the VCP fee for such plans;
- a special fee schedule for plans in the determination letter process found to be nonamenders for tax law changes;

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[37] *Id.*, § 10.13.
[38] *Id.*, Part IV.
[39] *Id.*, § 10.14.
[40] *Id.*, § 10.12.
[41] IRB 2002-29.
[42] *See*, NPRM Preamble, Compensation Deferred Under Eligible Deferred Compensation Plan, 67 Fed. Reg. 30826, 30830-1 (2002) (inviting public comment on the ways in which EPCRS might be expanded to cover eligible deferred compensation arrangements).
[43] 2003-35 I.R.B. 1051.
[44] 2006-22 I.R.B. 945.

- a special reduced fee where the sole Plan Failure is the failure to timely adopt certain plan amendments;
- a special reduced compliance fee for SEPs and SIMPLE IRAs; and
- alternative fixed correction methods for certain plan loan failures, and for failure to obtain spousal consent.

The Service has continually attempted to improve EPCRS, and the current program is a reflection of that effort. Practitioners and Plan Sponsors alike now have a mechanism upon which they may rely to correct Plan Failures in an even-handed and equitable manner.

B. Section 1101 of the Pension Protection Act

Section 1101 of the PPA addressed two aspects of EPCRS: the Service's authority to implement the program, and future improvements.

1. Authority

Since the inception of EPCRS's predecessor in 1991, the Service has debated the authority of its Employee Plans branch to resolve issues relating to Plan Failures in plan design and operation and to compromise income and excise tax as related to such Plan Failures.[45] Section 1101(a) of the PPA ended this debate by providing that:

> the Secretary of the Treasury shall have full authority to establish and implement the Employee Plans Compliance Resolution System (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise or other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the Plan Failure.

This provision serves as formal, legislative approval of EPCRS, clarifying the Service's authority not only to establish the program, but also to resolve income and excise tax issues and to ensure that taxes, penalties and sanctions are relevant to the Plan Failure.

2. Continued Improvements

Although the Senate Finance Committee praised the Service for establishing EPCRS, it noted in a report concerning an early version of section 1101 of the PPA that continued improvements of EPCRS are necessary.[46] More specifically, section 1101(b) of the

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[45] T. David Cowart, *EPCRS: A Review*, SN027 A.L.I.-A.B.A. 1079 (2007).

[46] *See* PENSION PROTECTION ACT OF 2006: LAW, EXPLANATION AND ANALYSIS 383 (CCH Tax and Accounting Publishing ed. 2006) (citing S. Rep. No. 109-174).

PPA requires the Service to continue updating and improving EPCRS by giving special attention to the following:

- Increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS;
- Taking into account special concerns and circumstances facing small employers with respect to compliance and correction of Compliance Failures;
- Extending the duration of the self-correction period under the Self-Correction Program for significant Compliance Failures;
- Expanding the availability to correct insignificant Compliance Failures under the Self-Correction Program during audit; and
- Assuring that any tax, penalty or sanction that is imposed by reason of a Compliance Failure is not excessive and bears a reasonable relationship to the nature, extent and severity of the Plan Failure.

Congress mandated that the Service pay more attention to the needs of small employers and to improve and expand the relief available under EPCRS.

The ACT understands that some officials in the Service and Treasury Department believe that the specific areas of concern referred to in section 1101(b) are suggestive in nature rather than a directive for required changes. The ACT understands that the basis for this opinion is the express prefatory language of the section which provides that

> "The Secretary of Treasury shall continue to update and improve the Employee Plans Compliance Resolution System (or any successor program), <u>giving special attention to</u> …" (emphasis added).

Apparently, some believe that the use in section 1101(b) of the language "giving special attention to" rather than the use of more specific, direct language requiring improvements in the five specified categories, supports their interpretation.

While it would be presumptuous of the ACT to offer a legal opinion on the issue, we believe that there are strong arguments to support a position that section 1101(b) requires improvements in the specific identified areas. More importantly, we would hope that the Service respond to the specific areas of concern referred to in section 1101(b)(1)-(5) rather than rely on legal interpretation. This would respond to the Congressional intent.

IV. DUE DILIGENCE PROCESS

While the members of the ACT each brought with them extensive experience in dealing with the EPCRS, there was still a belief that more knowledge of the program was necessary. To that end, the ACT devoted its working sessions of August 13-14, 2007, October 22-23, 2007, January 14-15, 2008 and April 7-8, 2008 to gathering additional background information. As more fully described below, the ACT primarily focused its attention on two sources (i) interviews with officials in EP, and (ii) collecting information from the practitioner community. The ACT extends its appreciation to all of the individuals who participated.

A. The IRS and the Treasury Department

At the outset, the ACT wishes to expressly thank Steven T. Miller, Commissioner, TE/GE, and his entire team for providing exceptional cooperation during the preparation of this report. The conversations with Service officials were open, candid and productive. All of the conversations were held in a spirit of cooperative problem solving.

Both Joseph Grant (former Director, Employee Plans) and Michael Julianelle (current Director, Employee Plans) were extremely generous with their time as well as the time of their team. The conversations with Directors Grant and Julianelle were particularly helpful in providing valuable insight into the policy background of EPCRS and the practicality of the ACT's recommendations.

The administrative enforcement of EPCRS is divided between the Manager, EP Voluntary Compliance, who essentially maintains jurisdiction over VCP, and the Director, Examinations, who essentially maintains jurisdiction over Audit CAP. The two offices generally work closely together to ensure a harmonized application of the rules. The ACT spent significant time at its August, October, January and April meetings with Monika Templeman, Director, EP Examinations, regarding the Audit CAP aspect of EPCRS. Discussions were held about the relationship between Audit CAP and self-correction, potential improvements to Audit CAP, and policy issues in general.

Additionally, the ACT had open discussions with Joyce Kahn, Manager, EP Voluntary Compliance, extensively at its August, January and April meetings regarding the operation of the VCP and self-correction program. Detailed discussions were had regarding policy issues and specific technical methods by which EPCRS could be improved.

The ACT also spoke with a number of other Service officials including Andrew Zuckerman, EP Director, Rulings and Agreements; Martin Pippins, EP Manager, Technical Guidance and Quality Assurance; Mark O'Donnell, Director, Customer Education and Outreach; Maxine Terry, EP Tax Law Specialist; Bill Hulteng, EP Tax Law Specialist; Marjorie Taylor, EP Tax Law Specialist; and Rhonda Migdail, EP Supervisory Tax Law Specialist, all of whom provided valuable insight into EPCRS.

At its April meeting, the ACT met with William Bortz, Associate Benefits Tax Counsel, United States Department of Treasury. Mr. Bortz provided background into the policy considerations behind the Service's future efforts to update and improve EPCRS.

A few basic themes emerged regarding EPCRS from the interviews with government personnel, including the following:

- EPCRS is a valuable program which addresses the needs of Plan Sponsors to deal with Plan Failures. The program is considered a success by both the Service and the practitioner community and should continue to be improved and updated.

- Voluntary compliance, through self-correction and the VCP, should be encouraged. Accordingly, it is important to sufficiently penalize offenses discovered during audit so as to reward voluntary compliance and penalize non-compliance.

- Self-correction is perceived to be an important tool to enable Plan Sponsors to comply. However, there are no current statistics regarding the use of the self-correction program and, therefore, the extent to which the program is used and its effectiveness is somewhat speculative.

B. The Practitioner Community

The ACT determined that the most effective means of surveying the practitioner community regarding improvements to EPCRS would be to survey practitioners through a posted survey on the BenefitsLink website.[47] BenefitsLink is a website that caters to the employee benefits community. It is a widely recognized source of benefits information and also offers a forum for discussion and analysis of various retirement plan related issues. The site is generally frequented by professionals who provide legal counsel or administrative and testing services to sponsoring organizations as well as employers maintaining qualified retirement plans. In order to survey this group, the ACT posted an invitation to comment on EPCRS:[48] The link was posted between October 4, 2007 and October 18, 2007 and produced 25 responses. A detailed summary of those responses is attached as Exhibit B.

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[47] The ACT extends its gratitude to Dave Baker of BenefitsLink who assisted with the publication of the survey and the report of its results.

[48] The letter provides as follows: "The IRS Advisory Committee on Tax Exempt and Government Entities is undertaking to formulate recommendations on how to improve the Employee Plans Compliance Resolution System, which recommendations will address, but not be limited to, the directive to the Secretary of the Treasury under the Pension Protection Act of 2006, section 1101, requiring EPCRS be modified as follows: (1) increasing the awareness and knowledge of small employers concerning the availability and use of the program; (2) taking into account special concerns and circumstances that all employers face with respect to compliance and correction of compliance failures; (3) extending the duration of the self-correction period under the Self-Correction Program for significant compliance failures; (4) expanding the availability to correct insignificant compliance failures under the Self-Correction Program during audit; and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure. If you have any suggestions, kindly forward them by December 31, 2007 to Marcia Wagner."

Additionally, at its October meeting, the ACT interviewed Seth H. Tievsky, the Chair of the Service's EPCRS liaison group. The EPCRS liaison group is an unofficial group that provides the Service with a line of communication with the practitioner community on an ongoing basis. The liaison group shared with the ACT its proposals to update and improve EPCRS. Three of those proposals, the proposal to expand the reporting aspects of corrections under EPCRS, the proposal to expand EPCRS to include 457(b) Operational and Plan Document Failures, and the proposal to expand EPCRS to include 403(b) Plan Document Failures are included in this report.

A few basic themes emerged regarding EPCRS from the information gathered from the practitioner community, including the following:

- Self-correction is an important component of EPCRS and should be expanded.

- Clarity regarding the application of a corrective earnings formula would be helpful.

- Some form of "scrivener's error" relief would be an important part of reform.

- Greater efforts on the part of the Service to promote awareness and communication to small employers would be helpful.

V. RECOMMENDATIONS

A. Recommendations to Improve the Self-Correction Program

1. Extension of Self-Correction Period for Significant Operational Failures to the Last Day of the Third (3rd) Plan Year in Which the Failure Occurred

Provided that certain conditions are met, plans which are found to have insignificant and/or significant Operational Failures may voluntarily correct the Plan Failures under the SCP. Insignificant Operational Failures discovered during a Service audit may also be corrected pursuant to the SCP. Self corrections require no disclosure to the Service and no payment of fees or sanctions.

Because the Service has not provided a clear definition of "insignificant" or "significant," the determination tends to be subjective. Several factors to be considered in determining whether an Operational Failure is insignificant or significant include: (1) whether other Plan Failures occurred during the same period; (2) the percentage of plan assets and contributions involved in the Plan Failure; (3) the number of years the Plan Failure occurred; (4) the number of Participants affected by the Plan Failure relative to the total number of Participants in the plan; (5) the percentage of plan Participants potentially affected as a result of the Plan Failure; (6) whether correction was made within a reasonable time after discovery of the Plan Failure; and (7) the reason for the Plan Failure.[49] No single factor is determinative.[50]

Insignificant Operational Failures may be corrected at any time after they are discovered. However, voluntary self-correction for significant Operational Failures is available only for a limited period of time. Generally, a significant Operational Failure must be corrected by the end of the second plan year following the plan year in which the Operational Failure occurred.[51] Special rules apply to determine the period for correcting a failed average deferral percentage ("ADP") or average contribution percentage ("ACP") test and for correcting Plan Failures related to assets transferred due to a corporate merger, acquisition or similar business transaction.

The initial discovery of an Operational Failure often occurs many years after the Plan Failure began. This is especially true for smaller employers who do not maintain professional benefits personnel and employers who utilize a lowest cost approach when selecting a third party administrator. Employers who charge administration fees back to the plan may feel compelled to find the least expensive way to maintain their qualified plan to avoid criticism. These considerations, as well as the complex and changing nature of Service regulations, and turnover among the persons responsible for qualified

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[49] Rev. Proc. 2006-27, § 8.02.
[50] *Id.*
[51] Rev. Proc. 2006-27, § 9.02.

plan oversight, combine to create and perpetuate plan errors, sometimes for many years.

Some practitioners believe that certain Plan Sponsors, especially smaller employers, are not properly correcting significant Operational Failures because the Plan Failure is discovered more than two years after it began.[52] Under EPCRS guidelines, such a Plan Failure requires the use of the VCP, which: 1) carries the perception (although false) of increased audit risk because the filing requires a detailed explanation of noncompliance; 2) requires payment of professional fees to prepare and submit the filing, sometimes exceeding the correction amount; 3) requires use of internal time and resources to collect data, find terminated Participants, and provide the professionals with adequate information to produce the VCP filing; and 4) may bring further delays in correction due to long processing times. Thus, the existing rules may actually encourage an employer to either partially or completely correct the Plan Failure without making the required VCP filing or correct the Plan Failure prospectively without correcting for past years in order to reduce exposure without increasing the employer's perceived probability of audit.

Congress clearly suggested (if not directed) the Service to extend the duration of the self-correction period for significant Operational Failures. The PPA requires the Secretary of the Treasury to "continue to update and improve EPCRS" and specifically directs the Service to pay "special attention … to extending the duration of the self-correction period under the Self-Correction Program for significant Compliance Failures."[53] Of the many facets of EPCRS, Congress chose to single out the ***duration*** of the self-correction period.

The ACT believes that, if a Plan Sponsor is willing to undertake the risk and cost of self-correction, it should be given a greater opportunity to do so than that currently afforded under the EPCRS. Many benefits to the Service, Plan Sponsors, and plan Participants will follow an extension of the duration. An extension will allow and encourage Plan Sponsors to comply with the requirements of the Internal Revenue Code. It will also decrease the volume of VCP filings, reducing the backlog of an overloaded and understaffed Service.

While the ACT understands the concern of some within the Department of Treasury and Service that such an extension will simply mean the Plan Sponsor has another year to make the correction it could have made earlier, it is not the experience of the individual ACT members that Plan Sponsors with known Plan Failures delay correction until the last possible date. Many errors are not discovered until the second year and any delay would push the Plan Sponsor beyond the current deadline. Delays often increase the total cost of correction because of accruing interest on corrective contributions, increased fees paid to consultants and counsel, and communication difficulties that can

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[52] These comments were made by practitioners responding to the ACT's BenefitsLink survey, *see* notes 47 and 48.
[53] PPA, §1101(b)(3).

arise when the corrective measure involves a participant who has terminated from the Plan Sponsor and has moved to a new address.

In order to encourage Plan Sponsors to make a diligent search for and properly correct significant Plan Failures, the ACT recommends extending the duration of the self-correction period for significant Operational Failures to the end of the third (3rd) plan year following the plan year in which the Operational Failure occurred. To discourage delay, the Service may want to consider adding to the duration extension a requirement that self-correction must be substantially completed within one year of the time that the Plan Failure is discovered.[54] This added requirement will ensure that timely corrections are made, particularly in those cases where affected Participants are aware of the Plan Failure and are concerned about timely correction(s) being made.

2. Expansion of SCP Amendment Options

Permitting Plan Sponsors to adopt retroactive corrective plan amendments without prior Service approval is not a new concept. In Rev. Proc. 2005-16[55] (Employee Plan Qualification Requirements – M&P and Regional Prototype Program), the Service recognized that Plan Sponsors may retroactively amend prototypes to correct typographical and cross-referencing errors.[56] Moreover, EPCRS currently allows a Plan Sponsor to use SCP to correct Operational Failures by plan amendment for certain designated Operational Failures and according to specified methods.[57] The listed Plan Failures are:

- Considering compensation in excess of the Code section 401(a)(17) limits;
- Making hardship distributions to employees under a plan that does not provide for hardship distributions;
- Permitting plan loans to employees under a plan that does not provide for plan loans; and
- Including in a plan an otherwise ineligible employee who has not completed the plan's minimum age and service requirements, or who has completed the plan's minimum age and service

[54] In order to further ensure good faith efforts to self-correct significant Operational Failures by Plan Sponsors, the ACT considered supporting the American Society of Pension Professionals and Actuaries ("ASPPA") in its recommendation that Plan Sponsors be required to notify the Service when a self-correction of a significant Operational Failure is made. A new form could be created for this purpose, or the Form 5500, which already asks certain questions about operational and fiduciary compliance, could be modified to include additional questions pertaining to utilization of the SCP during the plan year. While the ACT respects the concept behind the recommendations and it may be consistent with Commissioner Miller's recent statement that the Service needs to know more about the process of SCP (*see* note 4), the Act is concerned about the chilling effect that such a requirement could have, as well as the lack of clarity as to what the Service would do with these findings. Hence, it does not recommend such a filing requirement.

[55] 2005-10 I.R.B. 674, 2/18/2005.

[56] *Id.* at § 19.03.

[57] Rev. Proc. 2006-27, § 4.05(2).

requirements but entered the plan on a date earlier than the applicable entry date.[58]

Although these self-correction provisions are helpful, they are not extensive enough. The ACT proposes that SCP be liberalized by expanding the availability of corrective amendments to additional Operational Failures. This is desirable considering the degree of complexity of both plan provisions and the rules applicable to qualified plans. Since even ministerial errors can be fatal, the likelihood of employers making errors which jeopardize plan qualification is significant; permitting simplified correction of these errors will greatly assist the ongoing maintenance of qualified plans.

Thus, the ACT recommends that the SCP section of EPCRS be amended to permit the correction of unequivocal drafting errors based on the following narrow guidelines:

1) The amendment may not reduce a participant's benefits;

2) The amendment must not discriminate in favor of highly compensated employees;

3) Extrinsic evidence must exist to support the argument that the document provision is a mistake;

4) The operation of the plan must be consistent with the intended result;

5) The amendment must relate to a discretionary provision rather than a qualification provision; and

6) The change cannot create another problem with the plan. In other words, an amendment to correct one problem cannot result in another Operational Failure.

The following example illustrates a situation in which the availability of a retroactive corrective amendment would be useful under SCP:

> A Plan Sponsor maintains a 401(k) plan and also has a collective bargaining agreement covering certain union employees. The collective bargaining agreement permits union employees to participate in the Plan Sponsor's 401(k) plan, with immediate eligibility and an employer matching contribution of 100% of deferrals up to 3% of compensation. An Adoption Agreement signed in 2003 provides that union employees are immediately eligible, in accordance with the collective bargaining agreement. A restated Adoption Agreement signed in 2006 excludes union employees. The Plan Sponsor discovers this error in 2008. At all times, union employees have been permitted to participate in operation and have been given the matching contributions required under the

[58] Rev. Proc. 2006-27, App. B, § 2.07.

collective bargaining agreement. Under the ACT's proposed changes for corrective amendments, the Plan Sponsor is permitted to adopt an amendment in 2008 with a retroactive effective date, providing that union employees are eligible to participate in the plan during the period from 2006 forward. [59]

Because VCP correction remains available to SCP candidates, an employer desiring assurance regarding a proposed corrective amendment could pursue VCP rather than the SCP alternative. Nonetheless, we recommend that the SCP amendment alternative be made available for a broader range of Operational Failures.

B. Recommendations to Improve the Voluntary Correction Program

The ACT's recommendations regarding VCP fall into two basic areas: administrative improvements and a broadened range of substantive matters covered by the VCP.

1. Suggested Administrative Improvements

a. Pre-Submission Notice Protection

Many Plan Sponsors are concerned that they will receive notice of an examination by the Service while they are completing the complex and time-consuming VCP submission process. This often leads to "sloppy" or incomplete submissions, as well as extensive discussions with the Service if such a notice is received in the interim. Accordingly, the ACT is recommending a Pre-Submission Notice that would have the same impact as an actual VCP filing for a limited period of time in order to give the Plan Sponsor the time to file a complete VCP without the concern of an interim audit.

A VCP filing is lengthy and requires obtaining and compiling a significant amount of information as to the extent of Operational Failures, their economic impact, and the potential correction methods. The VCP process often requires searching of old, often unavailable or difficult to locate, records, seeking information from no-longer-utilized vendors and third-party administrators, and prior Plan Sponsors, and performing calculations covering a lengthy period of time for a significant number of participants or former participants. As a result of the foregoing, it often takes several months to gather the information and prepare the submission or to make the correction once the Plan Failure is initially identified.

A Pre-Submission Notice will encourage Plan Sponsors to act diligently and relieve them of audit concerns by assuring that no audit will commence with regard to the submitted issues while they are trying to correct their mistakes and voluntarily bring their plans into compliance. This will also assist the Service in limiting the administrative burden of "sloppy" and incomplete submissions and the long discussions that occur if an

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[59] This example is based on an example in ASPPA's proposal to the IRS regarding amending EPCRS to permit the correction of drafting errors.

audit notice is received. The ACT recognizes that, under current procedures, even if an audit begins during the VCP process, in the audit and any closing agreement, the Service will take into consideration any admitted failures and the steps taken to rectify them.[60] However, this is an informal administrative practice and requires application of judgment by the field examiner as to the degree of disclosure and correction that exists and how to treat it. A formal, written procedure is needed.

The ACT recognizes that Plan Sponsors should not be permitted to avoid audit penalties by simply filing a notice and then not taking the necessary steps to complete the VCP correction process in a timely manner. Because limits on the utilization of any such notice procedure are needed, the ACT suggests the following program: a Plan Sponsor will file with the Service a simple one-page notice identifying the plan, the Plan Failure, and the time period involved (the "Notice of Intent to File VCP Application"). Two copies of the Notice would be filed, one for the VCP unit and one for EPCU. A sample Notice of Intent to File VCP Application is attached as Exhibit C. The Plan Failures will have to be described in detail and the description will be treated narrowly. The Plan Sponsor will then be required to file the VCP filing within 180 days of the date of filing the Notice.

Modifications to the Notice would be permitted to add additional discovered Plan Failures or additional plan years affected by filing an amended Notice. The amended Notice would not extend the 180-day audit protection period and would not create a new protection period or VCP filing deadline for the newly discovered Plan Failures. There could only be one Notice in effect for a plan at any time.

If the VCP submission is not completed and filed by the VCP filing deadline, the protection of the Notice will be lost. Such protection could only be afforded upon filing the full VCP submission or authorization by the Service for good cause (which the ACT contemplates would be granted only in highly limited circumstances, such as natural disaster, terrorism or similar events outside of the Plan Sponsor's control). In addition, the Service would be entitled to audit plans as a result of the Notice if the VCP filing is not timely made. To avoid shortening the time period during which the Service would have to audit a Plan before the end of the statute of limitations period, the Plan Sponsor would be required to attach to the Notice an agreement for a six-month extension of the statute of limitations with regard to any Plan Year impacted by the contemplated VCP filing.

b. Standardized and Simplified VCP Application Form

Section 11 of Rev. Proc. 2006-27 sets forth the procedures for obtaining a compliance statement from the Service under the VCP. The procedures generally require a letter from the Plan Sponsor (or the Plan Sponsor's representative) that contains a description of the Plan Failures, a description of the proposed correction method, procedural items such as a penalty of perjury statement and checklist, together with supporting

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[60] *See*, Rev. Proc. 2006-27, § 14.02(3).

information and documents. Although the instructions for filing a VCP submission are clear, they are scattered throughout the Rev. Proc.

Section 11.02 of Rev. Proc. 2006-27 includes a list of items that must be addressed in the cover letter requesting the compliance statement. Section 11.03 of Rev. Proc. 2006-27 lists the documents that must be submitted and the order for submitting the documents and identifies the Service address where the VCP submission should be filed. Appendix C of Rev. Proc. 2006-27 contains the required VCP Checklist that aids the Plan Sponsor in ensuring that all required documents and information have been included in the submission. Appendix D of Rev. Proc. 2006-27 contains a Sample Format for VCP Submission by a Qualified Plan and includes instructions for assembling the submission. Appendix D of Rev. Proc. 2006-27 provides another sample submission where the sole Plan Failure is a nonamender Plan Failure for a qualified plan. Appendix E of Rev. Proc. 2006-27 contains a form of Acknowledgement Letter that the Service will send to the Plan Sponsor (or representative) to acknowledge receipt of the VCP Application. Plan amendment failures for EGTRRA good faith compliance, 401(a)(9) final and temporary regulations and interim amendments are eligible for a streamlined procedure described in Appendix F of Rev. Proc. 2006-27, which contains a sample submission form for this purpose.

The ACT recommends that the Service adopt a standard form of application to make the VCP application process simpler for Plan Sponsors, eligible organizations, and for the Service screeners. The ACT understands that the Service is in favor of streamlining the application process for VCP applications. While getting a new form approved by the Office of Management and Budget and other departments of the Service takes a significant amount of time and resources, it is possible for the Service to include as part of an updated Rev. Proc. a sample application form. The sample VCP formats included in Appendix D and Appendix F of Rev. Proc. 2006-27, are not conducive to “check the box” completion which promotes uniformity and consistency. Notwithstanding the challenges of getting a new form approved, the ACT proposes a single application form that can be used for all Plan Failures and corrections. To even further simplify the application process and expedite the review process, this standard VCP Application Form could be supplemented by a schedule to be used in those situations where a single standard Plan Failure and standard correction method is utilized.

It is proposed that the VCP Application Form contain an initial question as to whether the VCP application is “Eligible for Expedited Processing for Standard Failure and Correction.” The ACT recommends that the answer to this question be used to sort VCP applications as they are received into two distinctive categories (i) routine VCP applications and (ii) all other VCP applications. Criteria, such as whether the VCP proposed correction falls within a clearly identified published method of correction, could be established to identify routine VCP applications. By sorting the VCP applications as they come in, the Service could better allocate its limited resources and more promptly process all applications.

A proposed sample VCP Application Form is attached as Exhibit D to this Report. Until approved, the Act recommends that this Form be published by the Service in a Notice

or other pronouncement as a Sample that can be used and meets the requirements of Rev. Proc. 2006-27.

c. VCP Fee Structure Changes

Under Rev. Proc. 2006-27 a Plan Sponsor that makes a voluntary compliance submission generally must include a fee based on the following schedule:

Total Number of Plan Participants[61]	Fee
20 or fewer	$ 750
21 to 50	$ 1,000
51 to 100	$ 2,500
101 to 500	$ 5,000
501 to 1,000	$ 8,000
1,001 to 5,000	$15,000
5,001 to 10,000	$20,000
Over 10,000	$25,000

This fee schedule is based on the number of Participants in the plan rather than the nature, extent or severity of the Plan Failure. In contrast, section 1101(b)(5) of the PPA states that the Service should be "…(5) assuring that any tax, penalty, or sanction that is imposed by reason of a Compliance Failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the Failure."

The ACT believes that the current compliance fees, in many cases, are excessive and do not bear a reasonable relationship to the severity of the Plan Failures covered by the program. Specific cases identified by ACT members demonstrate that significant compliance fees may discourage rather than encourage correction of the Plan Failures. This is often because the correction itself will require a significant dollar cost. At other times, it is because the Plan Sponsor's human resources representatives that discover the Plan Failure and prepare the VCP filing will not want to approach the Chief Financial Officer or finance department for a significant check.

Currently, fees are based on the size of the plan to reflect the Service's view that a progressive schedule is more equitable. Additionally, the Service believes that such a schedule is appropriately tied to the Maximum Payment Amount that might be incurred on Plan Failure. However, the ACT believes that the EPCRS program has progressed to the point where encouraging correction should be the primary goal. Accordingly, the ACT recommends that the VCP fee should not be dependent on the size of the employer or total number of plan Participants; instead, the fee should be based on the number of *affected* Participants or on a fixed schedule dependent upon the specific Plan Failure.

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[61] *See* Rev. Proc. 2006-27 § 12.07, for a description of how to calculate the number of Participants. Generally, reference is made to the number of Participants reported on line 7 of the IRS Form 5500.

The ACT recommends that the fee structure outlined in section 12.02 of Rev. Proc. 2006-27 be modified under one of the following approaches to reflect the intent of PPA section 1101(b)(5):

(1) Modify the fee structure to be based on the number of affected Participants rather than the total number Participants. This modification could be implemented by using the existing fee structure but referencing affected Participants instead of Participants as follows:

Number of Affected Plan Participants	Fee
20 or fewer	$ 750
21 to 50	$ 1,000
51 to 100	$ 2,500
101 to 500	$ 5,000
501 to 1,000	$ 8,000
1,001 to 5,000	$15,000
5,001 to 10,000	$20,000
Over 10,000	$25,000

(2) Modify the existing fee structure to reflect a more reasonable fee by combining some of the existing brackets and applying the fee schedule to affected Participants, thereby making it more reasonable for large and small employers as follows:

Number of Affected Plan Participants	Fee
250 or fewer	$ 1,000
251 to 1,000	$ 2,500
1,001 to 5,000	$ 5,000
Over 5,000	$10,000

(3) Replace the existing fee schedule with an Alternate Fee Schedule based partially on the number of affected Participants and partially on the total number of Participants. Determination of the fee would be a three-step process: [62]

1. Determine the portion of the fee based upon the total number of plan Participants:

Total Number of Plan Participants	Fee
20 or fewer	$ 375
21 to 50	$ 500
51 to 100	$ 1,250
101 to 500	$ 2,500
501 to 1,000	$ 4,000

[62] The following proposed fee structure is calculated by reducing each dollar amount on the existing fee schedule by 50%. These reduced dollar amounts are used in the corresponding lines of each of the following charts.

1,001 to 5,000	$ 7,500
5,001 to 10,000	$10,000
Over 10,000	$12,000

2. Determine the portion of the fee based upon the number of affected plan Participants.

Total Number of Affected Participants	**Fee**
20 or fewer	$ 375
21 to 50	$ 500
51 to 100	$ 1,250
101 to 500	$ 2,500
501 to 1,000	$ 4,000
1,001 to 5,000	$ 7,500
5,001 to 10,000	$10,000
Over 10,000	$12,000

3. Add the two numbers together.

For example, suppose that the Plan has a total of 7,000 Participants, of whom 15 are affected by a particular Plan Failure. The applicable VCP fee of $10,375.00 would be calculated as follows:

1. $10,000 (the portion of fee determined based on total number of Participants)

2. + $ 375 (the portion of fee determined based on number of affected Participants)

3. $10,375 (total fee)

(4) Expand the "Special Fee" Category. In addition to its general fee schedule, EPCRS provides a number of "special fee" categories, including a specific fee schedule for non-amenders, special fee assessments for SEPs and SIMPLE IRA plans, or the special fee applicable to the required minimum distribution correction program, which permits Plan Sponsors who have fewer than 50 Plan Failures to correct for a fee of $500, regardless of the number of plan Participants.

In light of section 1101(b)(5) of the PPA, the ACT recommends expanding the special fee categories to include other types of Plan Failures. For example, where a Plan Sponsor has fewer than 50 affected Participants, a fixed special fee of $500 could be added for correction of the following failures, which are listed on the Service's website (www.irs.gov) as the "Top Ten Failures Found in Voluntary Correction Program."

1. Failure to follow the definition of compensation for determining contributions;

2. Impermissible in-service withdrawals;

3. Failure to satisfy Code section 415;

4. Failure to amend plans for compliance with Code section 132(f)(4); and

5. Failure to satisfy plan loan requirements.

The ACT believes that adding a fixed fee for correction of the above failures would promote compliance where Plan Failures are insignificant. For example, suppose that a Plan Sponsor with over 10,000 Participants discovers that there are 5 Participant loan Plan Failures. At the present time, any Participant loan Plan Failures must be corrected through VCP; there is no correction principle available under SCP. Currently, this Plan Sponsor will be required to pay a compliance fee of $25,000, even though the cost of correction will be only a few hundred dollars. Plan Sponsors, especially large employers, will make the corrections, but may not be willing to file under VCP for a handful of loan Plan Failures when the fee is disproportionately high.

2. Suggested Substantive Changes to VCP

a. Addition of QSLOB Corrections To VCP

Under the Internal Revenue Code, one of the requirements for an employer to be treated as operating a qualified separate line of business ("QSLOB") for purposes of meeting various coverage and nondiscrimination requirements is that a notice must be timely filed with the Service not later than 10 months after the end of the applicable plan year.[63] The notice is required to be updated annually if a QSLOB changes or the Plan Sponsor no longer maintains a QSLOB. The notice requirements are specified in regulations under Code section 414(r).[64]

Currently, IRS Form 5310-A is the form used to comply with the above-described notice requirements. A 5310-A is utilized for the initial notice, modifications to the initial notice, and revoking the notice of treatment as a QSLOB. If the notice is not timely filed, the Plan Sponsor will not be treated as operating a QSLOB for purposes of meeting the applicable coverage and nondiscrimination requirements and the plan will be disqualified for a Demographic Failure, since a QSLOB is generally used when the general Code section 410(b) coverage tests cannot be met.

A Plan Sponsor can request an extension of the time to file the QSLOB election, if the Plan Sponsor makes the request before the Plan Failure is discovered on audit and provides "evidence . . . to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government". In order for the Plan Sponsor to be deemed to have acted reasonably and in good faith, it would have to show that the failure to make the election (*i.e.*, file the 5310-A) occurred because of intervening events beyond its control,

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[63] Code § 414(r)(2)(B) (2007).
[64] Treas. Reg. §§ 1.414(r)-1(b)(2)(iv)(C), -4(c) (2007).

that it was unaware of the filing requirement (after reasonable due diligence), that it reasonably relied on written advice of the Service, or that it relied upon a tax professional, competent and aware of all of the relevant facts, who either failed to file the notice for the Plan Sponsor or failed to advise the Plan Sponsor of the filing requirement. An extension would not be granted in certain situations, such as where an income tax return would be changed, the Plan Sponsor knew of the requirement, but affirmatively chose not to file, or is using the QSLOB to meet the requirements in 20/20 hindsight. Prejudice to the Government would occur and the extension would not be granted if it would result in a lower tax liability or in some situations where the statute of limitations has closed. The procedure for obtaining the extension is to file for a private letter ruling and pay the applicable filing fee. See Treasury Regulation Section 301.9100-3 and Rev. Proc. 2008-1.[65]

Under Rev. Proc. 2008-4,[66] Employee Plans Technical will consider a request for an extension of time to make the QSLOB filing even if submitted after the deadline has passed or an audit has commenced and will notify the Director of Employee Plans of the request. The request is still considered to be a private letter ruling request that must meet the ruling request requirements and the compliance fee will still be required.

Applying for a private letter ruling is an onerous and costly task which requires substantial legal counsel involvement and potential filing fees.[67] It appears that from 1996 through 2007 there were less than a dozen ruling requests regarding QSLOB filings and there are likely many more plans that currently use the QSLOB approach or once did and have never filed the initial notice or an amended notice on Form 5310-A. Since this type of a violation would fall within the Demographic Failures described in VCP, the QSLOB notice failure should be correctable within the VCP under a simplified method with a fixed fee.

Clearly, a distinction should be made between a violation of the notice requirement and a substantive failure to qualify as a QSLOB. The ACT's proposed change to VCP to allow for delinquent QSLOB notices to be filed, as discussed below, would not relieve the Plan Sponsor of its obligation to meet all other substantive requirements for being able to establish a QSLOB. Rather, the change would be for the sole purpose of providing relief for failure to timely file the required notice.

With the recent liberalization of VCP to cover such issues as Employer Eligibility Failures, transferred asset issues, orphan plans, etc., the QSLOB filing is a similarly unique issue which should be correctable through the VCP. Doing so would be consistent with the intent of correcting qualification errors involving Demographic Failures which would result if a QSLOB notice is not filed or is not filed on a timely basis.

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[65] 2008-1 I.R.B. 10.
[66] 2008-1 I.R.B. 121, January 7, 2008.
[67] Beginning on February 1, 2008 the Service filing fee for a PLR is $11,500.

One proposed way to establish the appropriate fee is to create a chart similar to that adopted for nonamenders discovered during the determination letter application process not related to a VCP submission.[68] QSLOB notice violations should become subject to a fixed dollar sanction rather than loss of QSLOB status.

Presumably, if an employer has a QSLOB issue not related to an untimely notice filing, but rather related to a substantive deficiency to comply with other applicable requirements, such Plan Failure can be corrected through the VCP process. However, since Rev. Proc. 2006-27 is silent on the subject of QSLOBs generally, the ACT recommends that QSLOB violations be specifically addressed so that it is clear to Plan Sponsors that these types of issues, whether notice-related or substantive, can be resolved through VCP.

b. Use of the DOL Online Calculator as an Acceptable Earnings Methodology

In many VCP filings for qualified plans, correction of Operational Failures involves calculating lost earnings in order to make Participants whole. In some cases, the Operational Failure is strictly one which affects qualification, for example, the exclusion of eligible employees from the ability to make elective deferrals. However, in other cases, the Plan Failure may constitute both a Qualification Failure under the Internal Revenue Code and a Plan Failure under ERISA; for example, the late transmittal of elective deferrals in plans where the required date of deposit of elective deferrals is a stated plan provision.

Under the DOL's Voluntary Fiduciary Correction Program ("VFCP"), the online calculator is the preferred methodology to be utilized when filing a plan with VFCP. For plans which have only qualification issues, it would be convenient to utilize the online calculator under VCP. For plans with both Qualification Failures under the Code and ERISA failures enforced by the DOL, use of the online calculator would solve a number of problems faced by Plan Sponsors.

In such cases, Sponsors are often put in a position where the correction amount required under VCP is a different correction amount from that calculated and submitted under the VFCP. Not only does this inconsistency make no logical sense; it also creates a real-world dilemma for plan administrators: *different correction amounts* have been calculated for the *same plan Participants* for the *same operational problem,* causing uncertainty as to the amount to be deposited in the Participants' accounts to achieve full correction.

Also, since there is some overlap in enforcement of certain plan provisions, practitioners are challenged in preparing IRS Form 5330 filings, wondering whether to report the amount actually contributed to the plan for correction as required by the DOL or the amount calculated under VCP.

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[68] Rev. Proc. 2006-27, § 14.04.

Further, practitioners are often required to recalculate correction amounts in order to satisfy VCP reviewers regarding corrections that have already been made and reported as satisfactory to the DOL, perhaps as a result of an earlier audit. Often, IRS Form 5330 has been filed and excise taxes paid on different amounts from those later required by a VCP reviewer.

EPCRS provides, in relevant part, as follows:

> …This section 3 provides earnings adjustment methods…that <u>may</u> be used by an employer to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods <u>may</u> be used to determine the earnings adjustments for corrective contributions or allocations made under the correction methods in section 2 and under the correction methods in Appendix A. <u>If</u> an earnings adjustment method in this section 3 is used to adjust a corrective contribution or allocation, that adjustment is treated as satisfying the earnings adjustment requirement of section 6.02(4)(a) of this revenue procedure. <u>Other earnings adjustment methods, different from those illustrated in this section 3, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings</u>.[69]

(emphasis added)

Although it is clear even from the Rev. Proc.'s own terms that the methodologies suggested in Appendix B are not required, but rather are suggested, it is not uncommon for VCP reviewers to insist that these methodologies are the sole permitted correction method.

This lack of coordination between the Service and DOL is problematic, especially in light of the fact that the DOL apparently anticipated some coordination with the Service when it utilized relevant Code sections in its development of the online calculator methodology. Generally, under the VFCP, lost earnings are calculated as follows:

- The applicable Service underpayment rate under Code section 6621(a)(2) for each quarter from the loss date to the recovery date is determined.
- The applicable factors from Rev. Proc. 95-17 for such quarterly rates from the loss date to the recovery date are obtained.

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[69] Rev. Proc. 2006-27, App. B, § 3.01.

- The calculation is made as follows:
  - o First Quarter – principal amount is multiplied by the first applicable factor;
  - o Second Quarter – principal amount plus the earnings determined for the first quarter are multiplied by the applicable factor; and
  - o Subsequent Quarters – the principal amount plus the earnings as of the end of the quarter immediately preceding the one being calculated are multiplied by the applicable factor until the recovery date is reached.
- If the lost earnings are paid to the plan after the recovery date, the earnings are calculated from the recovery date to the payment date by the same method as discussed above, except that earnings begin on the recovery date and end on the payment date. The amount of interest is calculated on the lost earnings instead of on the principal.

Note, if the lost earnings plus interest on lost earnings exceed $100,000, the amount must be redetermined using interest as set forth under Code section 6621(c)(1) instead of 6621(a)(2).

The ACT understands that, in part, the Service is concerned that the DOL calculation will not fairly reflect plan earnings, especially in years when returns are above average. The ACT suggests that the Service and DOL coordinate in order to determine if any modifications can be made to the calculator to assuage the Service's concerns that, consistent with its philosophy, Participants should be made whole. However, the ACT believes that, at a minimum, any qualification errors brought to VCP which also constitute ERISA violations enforceable by the DOL should be allowed and encouraged to utilize the DOL online calculator as an efficient means of correction for the same error.

Further, even for those operational errors which do not constitute DOL enforceable violations, the DOL online calculator is an efficient instrument for calculation of lost earnings and falls under the language of "…other earnings adjustment methods, different from those illustrated in this section 3…" per the actual language of the Rev. Proc.[70] VCP reviewers should accept the use of the online calculator and EPCRS should confirm the DOL online calculator as an acceptable correction method.

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[70] Rev. Proc. 2006-27, App. B, § 3.01.

c. Correction of Exclusive Benefit Rule Violations

There have been increasing instances of: (i) employers learning years after the fact that proceeds or returned money were not identified as qualified plan assets at the time of receipt (e.g., demutualization of an insurance company), (ii) employers receiving and retaining money or proceeds after a plan termination, (iii) employers receiving proceeds due to a plan, years after the Participants to whom the money should have been allocated have severed from service (e.g., litigation settlements, a limited partnership interest that had been assigned a minimal value but liquidates with a significant value, the receipt of dividends on assets of a plan long terminated, etc.). By the time the error is discovered, the assets may have been held by the Plan Sponsor for an extended period of time.

These cases are not available for correction under VCP because they are most likely a diversion of plan assets, categorized as an exclusive benefit violation. These cases are also not currently available for correction under the DOL VFCP as a listed correctable transaction.

The ACT is reluctant to propose that this error be added as Plan Failure correctable under the VCP, because specifically excluded from VCP, unless otherwise specifically included, are matters for which a tax consequence other than disqualification applies.[71] Prohibited transactions are specifically excluded. In addition, diversion of plan assets (exclusive benefit violation) is specifically excluded from SCP, VCP and Audit CAP.[72]

The ACT believes that the Service should consider adding, as correctable under VCP, the inadvertent retention of assets such as in the demutualization cases. The Act also recommends that if the inadvertent retention of plan assets, such as a demutualization error, is corrected under the DOL VFCP, the Service and the DOL should coordinate their efforts in a manner similar to PTCE 2002-51 and the Amendment to PTCE 2002-51 regarding late deposit of Participant elective deferral contributions, *i.e.*, voluntary correction accomplished and approved by both the Service and DOL through proper voluntary filings, notices, reporting, and/or payment of excise taxes.

d. Expansion of VCP to Non-ERISA Form 5500 Filers

If a plan administrator complies with the Delinquent Filer Voluntary Correction program sponsored by the DOL (the "DFVCP"), the administrator is relieved of Service penalties for the delinquent IRS Form 5500 filings.[73] However, if a plan is not subject to ERISA's Title I reporting requirements (*i.e.*, IRS Form 5500-EZ filers and IRS Form 5500 filers for plans without employees), the DFVCP is not available[74] and the plan cannot obtain relief from Service penalties for delinquent filings. Filers of IRS Form 5500-EZ are typically

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[71] Rev. Proc. 2006-27 § 6.09.
[72] Rev. Proc. 2006-27 § 4.12.
[73] I.R.S. Notice 2002-23.
[74] DFVC Program, § B3.

smaller, less sophisticated employers who may need a program for voluntary correction of delinquent IRS Forms 5500.

The ACT recommends that the VCP be broadened to include relief from Code penalties for delinquent IRS Form 5500-EZ filers and for delinquent IRS Form 5500 filers for plans without employees. Penalty relief and sanction payment in accordance with a stated chart could be added as a separate section of the VCP. Broadening VCP in this way is consistent with recent expansions of the program to similar small employer or unique employer situations, *e.g.,* corrections allowed regarding SIMPLE IRAs, SEPs and orphan plans.

C. Recommendations to Improve Audit CAP

1. Audit CAP as it Currently Exists

Plan Sponsors of plans which are found on audit to have "insignificant" Operational Failures may "self–correct" the Plan Failure.[75] Such action may be taken without the imposition of a sanction.

Plan Sponsors of plans under audit that are found to have one or more Qualification Failures (e.g., Plan Document or Operational Failure) that are other than "insignificant" may choose to enter the Audit CAP Program. Under Audit CAP, in lieu of disqualification, the Plan Sponsor corrects the Plan Failure as required by the specialist (a front line agent), pays a monetary sanction that is a negotiated percentage of the Maximum Payment Amount,[76] satisfies certain additional requirements that may be required by the Service and enters into a closing agreement.[77] For qualified plans, the Maximum Payment Amount is a monetary amount that is approximately equal to the tax the Service could collect upon plan disqualification.

The sanction must not be excessive and must bear a reasonable relationship to the nature, extent and severity of the Plan Failures.[78] In determining the sanction amount,

[75] Rev. Proc. 2006–27, § 8.01. No precise definition of "insignificant" is given in the Rev. Proc. Rather, a list of seven factors to be considered is provided. Since there is no public disclosure of the specifics of Audit CAP cases, it is unclear how often self-correction during audit is permitted.

[76] The Maximum Payment Amount is the sum for the open taxable years of the (a) tax on the trust (Form 1041) (and any interest and penalties applicable to the trust return); (b) additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties applicable to the Plan Sponsor's return); (c) additional income tax resulting from income inclusion for Participants in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other qualified trusts (as defined in section 402(c)(8)(A)) or eligible retirement plans (as defined in section 402(c)(8)(B)) (and any interest and penalties applicable to the Participants' returns); and (d) any other tax that results from a Qualification Failure that would apply but for the correction under Audit CAP. For 403(b) Plans, the Maximum Payment Amount is the monetary amount that is approximately equal to the tax the Service could collect as a result of the 403(b) Failure, and is the sum for the open taxable years of the (a) additional income tax resulting from income inclusion for employees or other Participants (Form 1040), including the tax on distributions that have been rolled over to other qualified trusts (as defined in section 402(c)(8)(A)) or eligible retirement plans (as defined in section 402(c)(8)(B)) (and any interest and penalties applicable to the Participants' returns); and (b) any other tax that results from a 403(b) Failure that would apply but for the correction under Audit CAP.

[77] With respect to non–amender violations discovered by the IRS during a determination letter application, a sanction is imposed according to a pre–established chart. Rev. Proc. 2006–27, § 14.04.

[78] Rev. Proc. 2006-27, § 14.01.

the agent is required to consider a number of subjective factors.[79] The Internal Revenue Manual ("Manual") contains the sole source of published guidance regarding how specialists are to administer Audit CAP.[80] As a general matter of procedure, the specialist is required to fully develop the facts and legal aspects of the case.[81] If a Plan Failure is discovered, the specialist is required to consult with his or her Group Manager prior to advising the Plan Sponsor that disqualification of the plan is being proposed. The Plan Sponsor is then offered the opportunity to enter into negotiations for a closing agreement under Audit CAP, including a proposal of the sanction amount to be paid.[82]

With respect to the determination of the sanction amount, the Manual repeats the standard set forth in Rev. Proc. 2006-27 that a sanction not be excessive and bear a reasonable relationship to the nature, extent and severity of the Plan Failure. The Manual reminds the specialist to take into account the extent to which correction occurred before audit;[83] however, the Manual is silent as to how a specialist is to determine (i) a dollar amount for an initial demand, (ii) a dollar amount for a final settlement offer, and (iii) how the sanction should relate to a specific set of circumstances. Rather, the Manual requires that the specialist discuss any case (including sanction amounts) where the specialist is considering entering into a closing agreement with the Audit CAP Coordinator before completing negotiations with the Plan Sponsor.[84] The Audit CAP Coordinator is responsible for maintaining consistency in Audit CAP closing agreement cases, providing correction guidance to specialists and ensuring simultaneous processing of the closing agreement package and the remittance to the collection remittance processing function.[85] The ACT understands that there are, at the time of this report, five CAP coordinators covering each of the five EP Examination Areas. The Central Coordination Committee (an informal committee to, in part, enforce consistency) is available as a resource for the Audit CAP Coordinator.

In cases involving 500 or more Participants, or involving a potential maximum payment figure of $1 million or more, the Audit CAP Coordinator is encouraged, though seemingly not required, to consult with the Manager, Voluntary Compliance,

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[79] The steps taken by the Plan's Sponsor to ensure that the plan had no failures include identifying failures that may have occurred; the extent to which correction had progressed before the examination was initiated, including full corrections; the number and type of employees affected by the failure; the number of non-highly-compensated employees who would be adversely affected if the plan were not treated as qualified or as satisfying the requirements of section 403(b), section 408(k) or section 408(p); whether the failure is the failure to satisfy the requirements of section 401(a)(4), section 401(a)(26) or section 410(b), either directly or through section 403(b)(12); the period over which the failures occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under section 401(b) for a Plan Document failure); the reason for the failures (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors). Factors relating only to qualified plans also include: whether the plan is the subject of a Favorable Letter; whether the plan has both Operational and other failures; the extent to which the plan has accepted Transferred Assets, and the extent to which the failures relate to Transferred Assets and occurred before the transfer; whether the failures were discovered during the determination letter process. Additional factors relating only to 403(b) plans include whether the plan has a combination of Operational, Demographic or Employer Eligibility Failures; the extent to which the failures relate to Excess Amounts; and whether the failure is solely an Employer Eligibility Failure.

[80] Manual § 7.2.2 *et seq.*

[81] *Id.* at § 7.2.2.6.2.

[82] *Id.* at § 7.2.2.6.1.

[83] *Id.* at § 7.2.2.6.4. Interestingly, the other factors set forth in Rev. Proc. 2006-27 §14.02 are not repeated.

[84] *Id.* at § 7.2.2.6.1.

[85] *Id.* at § 7.2.2.6.6.

T:EP:RA:DC, located in Washington, D.C., prior to finalizing the closing agreement. The Manager, Voluntary Compliance may also be consulted during the negotiation phase of a closing agreement in other cases.[86]

After negotiations, if the Plan Sponsor refuses to agree to a sanction amount, the plan involved will be disqualified and all sanctions and procedures resulting from disqualification (such as issuance of a 30-day letter) will apply.

The ACT learned from its discussions with senior EP leadership that there are a number of policy considerations overlaying the published guidelines, as follows:

- Sanctions Must Be Consistent

  Consistency and uniform treatment with respect to taxpayer-to-taxpayer treatment, comparable-case-to-comparable-case treatment, and area-office-to-area-office treatment was expressed as a strong policy goal.

- Plan Disqualification Not a Favored Outcome

  In other than abusive cases, EP leadership expressed a desire to work with Plan Sponsors to achieve settlement under Audit CAP. Disqualification of plans with its attendant negative consequences to plan Participants is to be avoided. On the other hand, Plan Sponsors involved in abusive transactions are treated with little tolerance.[87]

- The Larger the Plan Sponsor, the Higher the Sanction

  EP leadership expressed the desire that sanctions achieve the intended result of discouraging non–compliant behavior. To that end, the view was expressed that sanctions should become progressively higher with the size of the plan to reflect the fact that larger employers will routinely have greater MPAs. The ACT views this policy as lacking clear support – particularly in light of section 1101 of the PPA, which expressly requires that the sanction not be excessive and bear a reasonable relationship to the nature, extent and severity of the offense. Section 1101 does not require the sanction to bear a reasonable relationship to the size of the Plan Sponsor or its bottom line.

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[86] *Id.* at § 7.2.2.6.1.

[87] Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, before the Great Lakes Benefit Conference, Chicago, May 3, 2007 reprinted TaxCore, Friday, May 4, 2007.

- <u>Sanctions Must be Designed to Encourage Plan Sponsors to Utilize Voluntary Compliance</u>

  A sanction imposed under Audit CAP must be higher than what would be imposed under voluntary compliance; otherwise, Plan Sponsors would have no incentive to voluntarily comply. This line of reasoning assumes that Plan Sponsors always have full knowledge of Plan Failures and thus choose between proper correction of every Plan Failure or leaving the Plan Failure uncorrected in the hopes that their plan will not be audited or the Plan Failure will not be discovered upon audit. In reality, Plan Failures discovered upon audit are often unknown to the Plan Sponsor until the time of the audit. The issue of how much higher a sanction should be remains elusive.

Since a detailed analysis of the actual administration of Audit CAP is not available, and, to our knowledge, the Government Accounting Office has not conducted a review of the program, the ACT was unable to determine how close the actual operation of the program is to its policy objectives.

2. Reasons For Improvement of Audit CAP

The ACT did not find empirical data indicating wide-spread practitioner dissatisfaction with Audit CAP. Indeed, one might argue that the large number of cases that are resolved within TE/GE indicates just the contrary – widespread satisfaction with the system.[88] Additionally, the ACT has no information which suggests the Service is not earnestly and diligently administering the system in a fair and equitable manner. Nevertheless, there is some evidence that some skepticism exists in the practitioner community.[89] More importantly, section 1101(b)(5) of the PPA requires that the Secretary of the Treasury:

> …continue to update and improve the Employee Plan Compliance Resolution System (or any successor program), giving special attention to…assuring that any…penalty or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure.[90]

In light of the public skepticism, mild though it may be, and, in particular, the Congressional directive, as strong as it is, the ACT believes the current Audit CAP procedures require improvement. Three aspects of Audit CAP, considered together, create an impression that it is less than balanced. First, Audit CAP is subjective. Specialists are directed to impose a sanction on the Plan Sponsor that will not be

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[88] *See* Exhibit A.
[89] BNA Daily Tax Report, Mar. 5, 2007 "IRS Officials Reject Attorney's Assertions Employee Plans Compliance Less Flexible."
[90] PPA § 1101(b)(5).

excessive and will bear a reasonable relationship to the nature, extent and severity of the Plan Failure, based on a set of vague factors susceptible to wide interpretation.[91] Given the fact that the sanction is a "negotiated percentage of the Maximum Payment Amount," the starting point for the negotiation has the potential for being high and the range of appropriate sanction amounts has the potential for being enormous. For large and small plans alike, the Maximum Payment Amount can reach into the millions of dollars. Although specialists generally do not begin the negotiation process at the Maximum Payment Amount, nevertheless, the specialists can exercise a great deal of discretion in formulating an initial demand and a final settlement offer.[92] Moreover, in all but the largest cases, decisions are made by relatively low grade-level Service employees. Some practitioners who cannot reach agreement with the specialist may informally contact TE/GE leadership in an attempt to resolve the case. The ACT views this step as problematic both for the practitioner and the Service's senior leadership since it could give rise to a claim of uneven treatment. Ultimately, most Plan Sponsors accept the Service's final settlement offer.

Second, Audit CAP is closed. Specifically, there is no public information as to the disposition of cases. While the specialists, the Group Manager and the CAP Coordinator have access to data revealing the range of sanction amounts imposed in comparable cases, the Plan Sponsor has no such access. Thus, the Plan Sponsor is at a disadvantage in crafting a reasonable proposal and determining whether the Service's demands are appropriate.

Third, a Plan Sponsor who cannot arrive at a settlement under Audit CAP has no meaningful right of appeal. In the event a Plan Sponsor is unable to reach an agreement with the Service, the Service issues a letter disqualifying the plan. The letter includes a reminder that the Plan Sponsor has 30 days to file an administrative appeal with the Service Appeals Office, an independent division under the authority of the Office of Chief Counsel. At Appeals, substantive issues are reviewed, but decisions to settle are generally based on an assessment of the hazards of litigation.[93] If the case cannot be resolved at Appeals, the Sponsor has the right to appeal to the Tax Court.

Unfortunately, this appeal procedure is of little use to most Plan Sponsors. Because of plan disqualification's Draconian consequences to Plan Sponsors and Participants alike, and the fact that a disqualifying event usually has occurred, most Plan Sponsors are unwilling to risk an appeal and subsequent litigation even if the Plan Sponsor believes the Service's position is unwarranted. Thus, Plan Sponsors who have negotiated to the best of their ability with the specialist often feel that they are forced to accept inequitably high sanction amounts.

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[91] Manual § 7.2.2.6.4.

[92] The ACT considered recommending a more objective system as a replacement to the existing one modeled after the federal criminal sentencing guidelines, but rejected this approach as too restrictive. This view seemed to be shared by the EP leadership because of the inherently complicated set of facts routinely presented in plan Failure cases.

[93] Oshinsky, "Employee Plans: Guidelines for the Resolution of Qualification Violations," 20 Tax Management Compensation Planning Journal 167, 175–176 (8/7/92); *see also* Wagner and Bianchi 375 T.M., EPCRS – Plan Correction and Disqualification at A–9.

3. Recommendations

a. Public Disclosure of Audit CAP Information

The ACT believes that the administration of Audit CAP would be enhanced with the public release of information regarding the imposition of sanctions. Currently, Plan Sponsors are left with speculation, rumor and limited *ad hoc* experience to serve as the basis for negotiation. The ACT understands it may be unrealistic for the Service to release detailed information regarding prior cases, such as redacted closing agreements, as this would likely violate the Service's privacy policies. Therefore, the ACT recommends the release of general information such as statistics regarding cases where the insignificant[94] exception to Audit CAP has been used, the size of sanctions as a percentage of Maximum Payment Amounts, and the dollar amount of sanctions in relation to the size and type of plan audited. Because of resource limitations, the ACT understands that even this information may be difficult to compile and release. As an alternative, the development and dissemination of stylized examples describing Plan Failures and typical sanction amounts would be helpful.

b. Creation of a More Formalized Internal Review

The ACT also believes that a more formalized internal review of Audit CAP cases that cannot be settled at the specialist level would be beneficial. Therefore, the ACT recommends that if a Plan Sponsor disagrees with an agent's final settlement offer, the Plan Sponsor be entitled to request a reconsideration of the case. If the request meets a basic threshold for substance, the case could be reviewed by a two-person committee consisting of a senior individual appointed by the Director, EP who is not in the audit chain-of-command (e.g., Manager, EP Voluntary Compliance) and the Area Manager under whose jurisdiction the audit case is processed. The review process could be limited to whether the recommended sanctions are reasonable.

Moreover, the ACT does not recommend that fees be charged for a request for reconsideration but, as part of the process, the Plan Sponsor may be encouraged to submit a brief statement explaining why the Plan Sponsor believes that the decision of the specialist is incorrect. Additionally, the Service may wish to limit Plan Sponsor representation before the committee as Service resources may be unavailable to create a formalized review panel. In the event the committee cannot resolve an issue, the Directors of EP Examinations and EP Rulings and Agreements could become involved. Any such review procedure should be formally incorporated into EPCRS to provide adequate notice to Plan Sponsors.

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[94] Rev. Proc. 2006-27, § 8.01.

D. Recommendations to Improve EPCRS Generally

1. Improve Education and Outreach

Pursuant to section 1101(b)(1) of the PPA, Congress instructed the Service to increase its education and outreach to potential users of the EPCRS, specifically to increase the “awareness and knowledge of small employers concerning the availability and uses of the program”. In order to do so, the Service will have to demystify the process. There are two ways in which the Service might do so.

First the ACT recognizes and is cognizant of the fact that the Service is under budgetary constraints. However, the ACT is aware that effective for the 2009 plan year, Forms 5500 will be submitted electronically to the DOL, which may mitigate the cost of the ACT’s following suggestion: the Service should consider writing (pursuant to U.S. Mail or e-mail) to Plan Sponsors on or about the time the Plan Sponsors submit their Forms 5500. All identifying information will be on the Form and, in that way, the gate-keepers who sometimes do not always provide the most appropriate or timely information to Plan Sponsors, will be by-passed. The correspondence from the Service should be, optimally, short, informative and non-threatening. Perhaps “a top 10 questions” for the Plan Sponsor to engage in self-audit would be appropriate: for example, are the elective deferrals made timely? Are all eligible employees given the option to be in the plan? Are all members of the controlled group accounted for, etc.?

Second, there are stakeholders in the industry that the Service does not usually proactively engage, such as: brokers, broker-dealers and registered investment advisors. Consideration should be given to having a meeting at the Service National Office, with no more than a dozen representatives of such constituencies, in order to determine what would be the best forum to contact these stakeholders, *en masse*, and how this might best be accomplished, e.g., trade conferences, booths, seminars, etc.

2. Reporting Guidance Regarding Corrective Distributions

As some confusion and a lack of proper reporting guidance currently exists with respect to the manner in which excess contributions and corrective distributions are reported, the ACT recommends that the Service issue a Rev. Proc. that clarifies such reporting requirements. More specifically, the Rev. Proc. should provide and explain the requirements for reporting corrective distributions on Form 1099-R. For example, in the case of an individual who receives a corrective distribution of a Code section 402(g) excess contribution where the violation is attributable to an employer error, there should be no requirement to file an amended Form 1099-R for the year in which the excess deferral occurred, and the Service should have the authority under EPCRS to waive the double-taxation of such amounts. As part of the Rev. Proc., the Service should clarify that the 10% tax on early distributions from qualified retirement plans under Code section 72(t) is inapplicable to these types of distributions.

Such a Rev. Proc. would provide payors with greater certainty with respect to the Service’s reporting requirements for corrective distributions from employer plans.

Moreover, by providing more understandable corrective procedures, the Service will likely receive more accurate reporting of corrective distributions and an increased rate of compliance.

Finally, where applicable, the Rev. Proc. should provide guidance with respect to corrective reporting related to SEPs and SIMPLE IRAs that would also affect Form 5498.

3. Expansion of EPCRS to Include 457(b) Programs

The correction programs under EPCRS are generally available to sponsors of retirement plans that are intended to satisfy the requirements of Code sections 401(a), 403(a), 403(b), 408(k), or 408(p) – i.e., tax-qualified plans, 403(b) plans, SEPs, and SIMPLE IRAs.[95] Eligible non-qualified deferred compensation plans under Code section 457(b) ("457(b) plans") are not on the list. Section 457(b) limits sponsorship of 457(b) plans to (i) states, and their political subdivisions, agencies, instrumentalities and political subdivisions and (ii) other tax-exempt entities. Except in the case of a church or government plan where 457(b) plans are often offered to a broad range of employees, participation in 457(b) plans is generally limited to "top-hat" employees (i.e., management and other highly paid employees). While there are important technical differences between the regulation of tax-qualified plans, 403(b) plans, SEPs, and SIMPLE IRAs, on the one hand, and 457(b) plans, on the other, these differences are rarely apparent to Plan Sponsors. Both sets of plans provide important tax-benefits that are designed to encourage retirement savings, and both present daunting compliance challenges.

EPCRS permits correction of four broad categories of errors: Plan Document Failures, Demographic Failures, Operational Failures, and Employer Eligibility Failures.[96] The ACT proposes that EPCRS be expanded to permit correction of Plan Document Failures, Operational Failures, and Employer Eligibility Failures under Code section 457(b). Because 457(b) plans are not subject to non-discrimination rules, a 457(b) plan would never experience a Demographic Failure.

Plan Sponsors of 457(b) plans are no less committed to complying with the law than are Plan Sponsors of qualified plans, 403(b) plans, and SEP and SIMPLE IRAs, and they are every bit as challenged by the technical complexity of the applicable rules. Essentially, EPCRS encourages the diligent operation of plans and the voluntary identification and correction of form and operational errors. Because these concerns apply with equal force to Plan Sponsors of 457(b) plans, the ACT recommends that EPCRS be expanded to include 457(b) plans.

[95] Rev. Proc. 2006-27, § 1.01.
[96] *See* note 5.

4. Expansion of EPCRS to Permit Correction of 403(b) Plan Document Failures

Final regulations under Code section 403(b) for the first time impose a written plan requirement on 403(b) plans effective January 1, 2009.[97] EPCRS already allows for the correction of Operational Failures arising under 403(b) plans. EPCRS in its current form also refers to, and allows for, correction of Plan Document Failures. The current Plan Document Failure corrections are all limited to tax-qualified plans, however, since there was previously no plan documentation requirement that applied to 403(b) plans.

The ACT recommends that EPCRS be amended to permit that Plan Document Failures arising under the Code section 403(b) written plan document requirement are eligible for two types of corrections: first, a Plan Sponsor that fails to comply should be able to adopt a plan document, and second, a Plan Sponsor should be able to correct a deficiency in a plan document.

[97] *See* Treas. Reg. §§ 1.403(b)-3(b)(3), -11(a) (2007).

VI. CONCLUSION

EPCRS is an important and much-needed program, and the Service is to be commended for addressing the needs of Plan Sponsors, who often require remedial assistance in dealing with very complex rules. The ACT acknowledges that some recommendations contained in this report may be difficult for the Service to implement because of, among other reasons, its lack of resources. In light of the directive to the Service in section 1101 of the PPA to update and improve EPCRS, the ACT hopes that Congress will allocate sufficient funds to permit it to fulfill its obligations.

EXHIBIT A

All Master and Prototype Closings (Form 5500, 5500-EZ and Form 5330)

Closing Code	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
01 - Regulatory/Revenue Protection	3	1	1	3	2	0	0	3
02 - No Change	2,509	2,457	2,013	1,809	2,412	2,321	2,139	1,695
03 - Agreed Tax Change	24	13	3	4	1	1	13	29
04 - Change to Related Return	65	50	29	31	54	57	33	66
05 - Delinquent Related Return Secured	195	142	66	67	77	83	95	102
06 - Delinquent Return Secured	264	196	75	84	198	186	148	227
07 - Unagreed - Protest to Appeal	17	18	9	13	0	1	0	1
08 - Written Advisory - Form 5666 Required	3	5	2	8	390	538	682	757
09 - Revocation	4	5	6	2	3	0	0	0
10 - Unagreed - Without Protest	13	9	8	7	0	0	0	0
11 - Unagreed - Petition to Tax Court	0	0	0	1	0	0	3	0
12 - Amendment Secured	17	18	7	13	7	25	16	18
13 - Referrals to Examination Division	17	16	16	19	38	54	59	95
14 - Administration	309	344	295	275	416	462	380	423
15 - Closing Agreement	70	63	66	59	78	117	159	232
Total	**3,510**	**3,337**	**2,596**	**2,395**	**3,676**	**3,845**	**3,727**	**3,648**
Change Rate (using 02 as only no change code)	**28.52%**	**26.37%**	**22.46%**	**24.47%**	**34.39%**	**39.64%**	**42.61%**	**46.46%**

EXHIBIT A (continued)

All Non Master and Prototype Closings (Form 5500, 5500-EZ and Form 5330)

Closing Code	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
01 - Regulatory/Revenue Protection	20	9	4	4	2	1	1	6
02 - No Change	4,896	5,103	4,049	2,260	2,469	2,352	1,894	1,572
03 - Agreed Tax Change	34	43	9	13	8	8	26	63
04 - Change to Related Return	243	164	73	77	98	83	52	94
05 - Delinquent Related Return Secured	432	316	202	138	108	102	117	142
06 - Delinquent Return Secured	567	419	150	144	198	137	210	617
07 - Unagreed - Protest to Appeal	80	83	29	17	11	11	0	7
08 - Written Advisory - Form 5666 Required	15	13	17	13	317	402	526	550
09 - Revocation	24	19	17	6	9	4	6	4
10 - Unagreed - Without Protest	42	30	29	4	0	2	0	18
11 - Unagreed - Petition to Tax Court	7	9	3	9	0	6	0	20
12 - Amendment Secured	61	49	26	11	19	30	22	40
13 - Referrals to Examination Division	44	65	60	31	43	49	66	118
14 - Administration	457	499	432	400	336	333	290	320
15 - Closing Agreement	257	159	148	101	94	191	228	565
Total	**7,179**	**6,980**	**5,248**	**3,228**	**3,712**	**3,711**	**3,438**	**4,136**
Change Rate (using 02 as only no change code)	**31.80%**	**26.89%**	**22.85%**	**29.99%**	**33.49%**	**36.62%**	**44.91%**	**38.01%**

EXHIBIT B

PRACTITIONER COMMENTS AND RECOMMENDATIONS ON EPCRS PROGRAM

Self-Correction	Contribution Errors	Scriveners' Errors and Document Related Issues	Size of the Plan	Promote Awareness and Communication	General
Allow retroactive corrective amendments (i.e. for hardship distributions, loan provisions, last day service requirements) to rectify erroneous overpayment; apply similar time frame as other voluntary amendments, possibly limited to non-HCEs	Add more safe harbors, more leniency for small offenses - i.e. if an error affects only HCEs, no correction is needed; if an error affects less than 5% of the Participants, any reasonable correction is permitted; if an error results in less than $100 in additional contributions, no action required	Scrivener's errors may lead to document errors and misunderstandings that extend over long periods; correction is expensive but restatement of the plan is a disfavored approach; consider a more liberal approach to these errors	Current VCP compliance fee schedule based on number of Participants in the plan provides disincentive for larger plans; consider a fee schedule dependent on number of Participants affected	Increase awareness of compliance issues and the self-correction process, particularly for small plans; provide resources from the private sector to assist small employers with compliance issues	Require that an applicant for the correction program submit a written agreement that proves the applicant has retained a practitioner recognized under Circular 230 to properly advise the plan administrator regarding the class of the error in question; the agreement should require the IRS be advised if the practitioner resigns within 3 years
Under Rev Proc 2006-27, self-correction under certain circumstances can be accomplished via amendment but must be submitted to the IRS during the next cycle under SCP; seems to contradict the idea of self-correction	Expand use of highest rate of return to correct earnings; currently only applicable for corrections involving multiple funds if most of affected employees are non-HCEs	Allow self correction of plan document due to scrivener's errors and mapping errors, particularly when Participant accounts are not affected and the sponsor can document intent	Broader application of flat fees; fees based on plan size discourage large plans with minor errors from using the program	Increase employee benefits guidance; small employers rely too heavily on 401(k) providers; persuade providers to encourage compliance	Expand useful correction procedures available for loan failures currently available only through VCP and SCP; minor Operational Failures related to loans are common and large VCP fees seem disproportionate

Self-Correction	Contribution Errors	Scriveners' Errors and Document Related Issues	Size of the Plan	Promote Awareness and Communication	General
Allow more flexibility to amend the plan to meet compliance standards, particularly for sponsors who make relatively small contributions and cannot afford large penalties	Apply DOL's VFC correction method for any correction of earnings within 2 years; current application of rate of return of highest fund is unrealistic	Less severe penalties for document errors i.e. failure to adopt interim amendments; in particular failure to add 132(f)(4) to 415 def. of compensation	Allow employer plans that cover only the owner (and spouse), which are not subject to ERISA, to participate in DOL DFVC program	Make availability of correction programs more widely known	Expand the $50 exception that currently applies to corrective distributions to apply to corrective contributions and allocations; possibly reduce to $10 for very small corrections
Reasonable efforts to self correct should result in lower sanctions; provide formal written guidelines regarding the sanction amounts relative to the error	Allow employers to use reasonable estimates to correct earnings without having to show the cost would significantly exceed the probable difference	Employers participating in the EPCRS program should be represented by counsel; third-party administrators may correct Operational Failures by preparing amendments with inaccurate dates without the employers knowledge	Correction program for small plans adopted through a third party which are subsequently discontinued	Clarify violations that qualify for submission to the EPCRS	Allow EPCRS correction filings to include multiple delinquent filings
More flexibility for self corrections and other VCP corrections based on facts and circumstances to encourage compliance	Allow employers to correct contributions with additional "safe harbor" interest calculated with plan's qualified default investment option	Allow the use of plan amendments to correct any Operational Failures under SCP, except when the use of an amendment would violate a statutory prohibition such as 411(d)(6)		Better training for agents who review filings and audit 5500's	Modify correction methods to align administrative costs with benefits delivered
Respondent supports self-correction by retroactive amendment for exclusion of eligible employees and hardships	Expand use of lowest rate if a reduction to account balances is needed; currently only applicable if most employees involved are non-HCEs	Address when a scrivener's error can be corrected and what documents are necessary to establish the drafter's original intent		Direct benefit advisory communications to HR, not to preoccupied owners	Enforcement should focus on egregious violations; perfection is not attainable

Self-Correction	Contribution Errors	Scriveners' Errors and Document Related Issues	Size of the Plan	Promote Awareness and Communication	General
Expand the ability to self-correct; IRS is not capable of processing formal applications in a timely manner	Publish indexes that can be used for earnings corrections; for example, allow the crediting of interest at the applicable federal rate			Provide more practical examples for correction methods	Expand the list of IRS approved correction methods, make them easier to apply
Extend the time period under SCP to 5 years to self-correct significant Compliance Failures	Add a minimum correction amount for 402(g) excesses corrected by 4/15 of the following year; if corrected after 4/15 apply $50 minimum				Coordinate and apply uniform corrections
Allow self-correction of "insignificant failures" during audit, more guidance re: "insignificant"	Adopt the method used to compute the Gap Period Income in the final Roth rules to rectify earnings				Guidelines for 412(i) plans may be too stringent
Expand use of correction by plan amendment to other operational errors	Correct lost earnings due to late payment of elective contributions with DOL calculator				
Extend self-correction period for significant Operational Failures by one plan year	Allow distribution of employer dollars to correct 415 excesses				
Extend the duration of the self-correction period for significant Plan Failures					
Extend the time period under SCP to 5 years to self-correct significant					

Self-Correction	Contribution Errors	Scriveners' Errors and Document Related Issues	Size of the Plan	Promote Awareness and Communication	General
Compliance Failures					
Any expansion of self correction period					
Expand self correction period					

EXHIBIT C

EPCRS
Notice of Intent to File VCP Application

Who May Complete: Each Plan Sponsor who intends to voluntarily correct a Plan Document or Operational Failure and who is not Under Examination (within the meaning of IRS Notice 2007-46) may file this Notice of Voluntary Correction to inform the IRS of a Voluntary Compliance Application to be submitted within 180 days. Two copies of the Notice are to be filed with: Internal Revenue Service, EPCU, Washington, DC. It should be accompanied by an extension of the statute of limitations for six (6) months for all years involved.

Retention of This Form: A copy of this form is to be retained and attached to the VCP filing.

Effect of this Notice Filing: This Notice puts the IRS on Notice that the Plan Sponsor will be filing a VCP Application within 180 days of the date this Notice is filed. During such 180-day period, the Failure(s) identified in the Notice will be exempt from audit. If a VCP Application or Notice of Self-Correction is not filed within the 180-day period, this Notice shall expire and no additional notices (other than the VCP) may be filed with regard to the identified defects. The Service may for good cause extend such 180-day period. The Service may also refer the Plan for audit if the VCP submission is not made within the 180-day period. If additional defects or years involved are later determined, an amended Notice can be filed, but it will not extend the six months period. Only one Notice may be outstanding at any time with regard to a Plan.

<table>
<tr><td>1. Name of Plan</td><td>2. Employer Identification Number of Plan (or if none, Sponsor)</td><td>3. Plan Number</td></tr>
<tr><td>4. Name and Address of Plan Administrator</td><td>5. Name and Address of Plan Sponsor</td><td>6.
□ Initial
□ Amendment</td></tr>
<tr><td colspan="3">7. Name, address and telephone number of contact person/authorized representative if information needed:</td></tr>
<tr><td colspan="3">8 List defects identified (additional sheet may be attached) with specificity, including years involved:</td></tr>
</table>

I certify that the above information is true and correct to the best of my knowledge.

Plan Sponsor or Plan Administrator

By: ______________________________________ ____________________
Date Signed

Name of Plan Sponsor or Plan Administrator (Please Print)_____________________________

Signature of Person Signing______________________________________

Title of Person Signing____

EXHIBIT D

Submission Type: ____________________________________
(insert from list of Submission Type Codes listed in instructions)

Eligible for Expedited Processing for Standard Failure and Correction – ❑ **Yes** ❑ **No**

VOLUNTARY CORRECTION PROGRAM (VCP) APPLICATION

Internal Revenue Service Revenue Procedure 2006-27 (Rev. Proc. 2006-27)[98] *establishes the Voluntary Correction Program (the "VCP"), which permits Plan Sponsors to correct a failure or failures to meet the requirements of the Internal Revenue Code for applicable plan years. The following constitutes a submission under the VCP and a request for a compliance statement. All section references are to the Submission Requirements in section 11.02 of the VCP unless otherwise indicated.*

❑ If John Doe Submission Check this Box and Skip to Question 5.

<table>
<tr><td>1. Name and Address of Plan Sponsor</td><td>2. Employer Identification Number</td></tr>
<tr><td>3. Name of Plan</td><td>4. Plan Number</td></tr>
<tr><td colspan="2">5. Name, address and telephone number of contact person/authorized representative if more information needed:</td></tr>
<tr><td>6. Type of Plan:
❑ Qualified Plan (401(a)) ________
<u>(Insert Plan Code from list in instructions)</u>
❑ 403(b)
❑ SEP or SARSEP (408(k))
❑ SIMPLE IRA (408(p))</td><td>7. Check if the submission is one of the following:
❑ Group Submission
❑ Anonymous Submission
❑ Nonamender Submission
❑ Multiemployer or Multiple Employer Plan Submission
❑ Orphan Plan Submission
❑ Terminated Plan Submission</td></tr>
<tr><td>8. Identification of Qualification Failure(s)
(Check <u>all</u> that apply and insert applicable Failure Code from list in instructions)
❑ Operational Failure ________________________
❑ Plan Document Failure ______________
❑ Demographic Failure _____________________
❑ Employer Eligibility Failure _________________</td><td>9. Description of Qualification Failure(s):</td></tr>
</table>

[98]The Voluntary Correction Procedures are set forth in Internal Revenue Service Revenue Procedure 2006-27, 2006-22 I.R.B. 945.

10.

Plan Years in Which Failure Occurred (including Closed Years)	Number of Participants Affected by Failure in Plan Year

11. Compliance fee: $_____

Number of Participants Used for Fee Determination (leave blank if N/A)_________________________

Number of Affected Participants Used for Fee Determination (leave blank if N/A)_____________

Flat Fee ❑ Yes ❑ No

12. Description of Administrative Procedures in Effect at the Time of the Failure(s)

13. Explanation of How and Why the Failure(s) Occurred:

14. Expected Cost of Correction and Calculations/Assumptions Used to Determine the Amounts Needed and Description of the Method for Correcting the Failures that the Plan Sponsor has implemented or Proposes to Implement.

❑ Plan Amendment

❑ Method from Appendix A______________________________(insert Sec. No. App. A of Rev. Proc. 2006-27)

❑ Other Method Explain ____

15. Description of the Methodology Used to Calculate Earnings or Actuarial Assumptions on Any Corrective Contributions or Distributions (including Computation Periods and the Basis for Determining Earnings or Actuarial Adjustments)

❑ DOL Calculator

❑ Method from Appendix B _____________________________(insert Sec. No. App. B of Rev. Proc. 2006-27)

❑ Other – Explain ____

16. Specific Calculations – Attach calculations and check one of the applicable boxes below:

❑ Each Affected Employee or ❑ A Representative Sample of Affected Employees

17. Method Used to Locate and Notify Former Employees and Beneficiaries or put N/A if there are no former employees or beneficiaries affected by the failure or will receive a correction.

18. Description of Measures Implemented or to be Implemented to ensure that the same Failures will Not Reoccur.

19. Description of a Failure Relating to Transferred Assets (put N/A if not applicable):

20. Group Submission Information (put N/A if not applicable):

21. Additional Requests for Relief and Explanations. Check all that apply and provide further information as required.

- ❑ Participant Loans – Income Tax Reporting Option or Relief from Income Tax Reporting Option
- ❑ Relief from Excise Taxes pursuant to Internal Revenue Code sections 4972 (nondeductible contributions), 4974 (late minimum distributions) or 4979 (failed ADP/ACP test).
- ❑ Orphan Plan VCP Application Fee Waiver
- ❑ Other: ____________________________

Explanation: ____

____

____

____

22. Attached Documentation (Check each document which accompanies this submission):

- ❑ VCP Checklist.
- ❑ Acknowledgment Letter.
- ❑ Form 5500 or substitute information.

❑ Check box if the Plan was not required to file a Form 5000 and attach the information that would be included on the first three pages of the Form 5500.

- ❑ Check here for John Doe Submissions to indicate that a redacted employee census is attached.
- ❑ Plan Document
- ❑ Determination Letter Application
- ❑ Internal Revenue Service Form 2848 Power of Attorney and Declaration of Representative
- ❑ Notice of Intent to File VCP Application – attach Initial Notice and all Amended Notices if applicable
- ❑ Other: __________________________________

23. Under penalties of perjury, the Plan Sponsor declares that (check all that apply):

- ❑ To the best of the Plan Sponsor's knowledge, the Plan is not currently under examination of either an Employee Plan Form 5500 series return or other Employee Plan examination.
- ❑ To the best of the Plan Sponsor's knowledge, the Plan Sponsor is not under an Exempt Organizations examination).
- ❑ To the best of the Plan Sponsor's knowledge, neither the Employer nor any of its representatives have received verbal or written notification from the TE/GE Division of an impending examination or of any impending referral for such examination.
- ❑ To the best of the Plan Sponsor's knowledge, the Plan is not currently under investigation by the Criminal Investigation Division of the Internal Revenue Service.
- ❑ Abusive Tax Avoidance Transaction: Neither the Plan nor the Plan Sponsor has been party to an abusive tax avoidance transaction.
- ❑ Determination Letter Filing: The Plan Sponsor applied for and has currently pending an application for a favorable determination letter with the internal Revenue Service filed on (Insert date) ____.
- ❑ 403(b) Plan Submissions: The Plan Sponsor has contacted all other entities involved with the Plan and has been assured of cooperation in implementing the applicable correction to the extent necessary.
- ❑ The correction method fully complies with the method set forth in Appendix A or B of section 6.07 of Rev. Proc. 2006-27. I understand that EPCRS is not binding on the US Department of Labor or plan participants.
- ❑ Penalty of Perjury Statement: I have examined this submission, including supporting documents and, to the best of my knowledge and belief, the facts and information present in support of this submission are true, correct and complete.

24. Signature, Name and Title of Plan Sponsor Officer (or Form 2848/Form 8821 Representatively)

____
(Signature)

____
(Title)

____
(Print Name)

____
(Date Signed)

VCP CHECKLIST

TAXPAYER'S NAME ______________________________
TAXPAYER'S I.D. NO. ______________________________
PLAN NAME & NO. ______________________________
ATTORNEY/P.O.A. ______________________________

The following items relate to all submissions (for each item insert Yes, No or N/A)
If you insert "N/A" for any item enter explanation under the item.

_______ 1. Does the submission consist solely of a failure to amend a plan timely for (a) good faith plan amendments for EGTRRA, (b) plan amendments for the final and temporary regulations under § 401(a)((9) or (c) interim amendments? If yes, please proceed to Appendix F. (See section 11.01 and sections 4.06 and 10.08)

_______ 2. Have you included an explanation of how and why the failure(s) arose, including a description of the administrative procedures for the plan in effect at the time the failure(s) occurred? (See sections 11.02(3) and (4))

_______ 3. Have you included a detailed description of the method for correcting the failure(s) identified in your submission? This description must include, for example, the number of employees affected and the expected cost of correction (both of which may be approximated if the exact number cannot be determined at the time of the request), the years involved, and calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction. In lieu of providing correction calculations with respect to each employee affected by a failure, you may submit calculations with respect to a representative sample of affected employees. However, the representative sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. Note that each step of the correction method must be described in narrative form. (See section 11.02(5))

_______ 4. Have you described the earnings or interest methodology (indicating computation period and basis for determining earnings or interest rates) that will be used to calculate earnings or interest on any corrective contributions or distributions? (As a general rule, the interest rate (or rates) earned by the plan during the applicable period(s) should be used in determining the earnings for corrective contributions or distributions.) (See section 11.02(6))

_______ 5. Have you submitted specific calculations for either affected employees or a representative sample of affected employees? (See section 11.02(7))

_______ 6. Have you described the method that will be used to locate and notify former employees or, if there are no former employees affected by the failure(s) or the correction(s), provided an affirmative statement to that effect? (See section 11.02(8))

_______ 7. Have you provided a description of the administrative measures that have been or will be implemented to ensure that the same failure(s) do not recur? (See section 11.02(9))

_______ 8. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the plan is not currently under an Employee Plans examination? (See section 11.02(10))

_______ 9. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the Plan Sponsor is not under an Exempt Organizations examination? (See section 11.02(10))

_______ 10. Have you included a statement that neither the plan nor the Plan Sponsor has been a party to an abusive tax avoidance transaction? Alternatively, have you provided a statement identifying the abusive tax avoidance transaction(s) to which the plan or the Plan Sponsor has been a party? (See section 11.02(11))

_______ 11. If the submission includes a failure related to Transferred Assets, have you included a description of the related employer transaction, including the date of the employer transaction and the date the assets were transferred to the plan? (See section 11.02(11))

_______ 12. Have you included a copy of the portions of the plan document (and adoption agreement, if applicable) relevant to the failure(s) and method(s) of correction? (See section 11.03(2))

_______ 13. Have you included the original signature of the sponsor or the sponsor's authorized representative? (See section 11.06)

_______ 14. Have you included a Power of Attorney (Form 2848) or Tax Information Authorization Form (Form 8821)? Note: Authorization to represent a Plan Sponsor before the Service using Form 2848 is limited to attorneys, certified public accountants, enrolled agents, and enrolled actuaries. (See section 11.07)

_______ 15. Have you included a Penalty of Perjury Statement signed (original signature only) and dated by the Plan Sponsor? (See section 11.08)

_______ 16. Have you designated your submission for a Qualified Plan, 403(b) Plan, SEP or SIMPLE IRA Plan, or Orphan Plan? In addition, the submission should indicate if the submission is a Group Submission, an Anonymous Submission or nonamender submission, a mutliemployer or multiple employer plan submission. (See section 11.10)

_______ 17. Have you submitted the Appendix E acknowledgement letter? (See section 11.11)

_______ 18. If you are requesting a waiver of the excise tax under § 4974 of the Code, have you included the request, and, if applicable, an explanation supporting the request for any affected owner-employee or 10 percent owner? (See section 6.09(3))

_______ 19. If you are requesting relief of the excise tax under §§ 4972 or 4979, have you included the request and a detailed description of the failure? (See sections 6.09(3) & (4))

_______ 20. If you are requesting that participant loans being corrected under this revenue procedure not be treated as distributions pursuant to § 72(p), have you included the request and a detailed description of the failure? Alternatively, if you are requesting that participant loans being corrected under this revenue procedure be recognized as distributions in the year of correction, instead of the year that the deemed distribution occurred under § 72(p), have you include the request and a detailed description of the failure? (See sections 6.02(6) and 6.07)

_______ 21. Have you submitted an application for a determination letter and Form 8717 together with a check for the compliance fee made payable to the U.S. Treasury? (See sections 10.06 and 11.03(3))

_______ 22. If the plan is currently being considered in an unrelated determination letter application, have you included a statement to that effect? (See section 11.02(12))

_______ 23. Have you included a copy of the first three pages of the Form 5500 (which includes employee census information) and the applicable Financial Information Schedule of the most recently filed Form 5500 series return? Note: If a Form 5500 is not applicable, insert N/A and furnish the name of the plan, and the census information required of Form 5500 series filers. (See section 11.03(1))

_______ 24. Have you included a check for the VCP compliance fee, and, if applicable, a separate check for the determination letter fee each made payable to the U.S. Treasury? (See sections 10.06 and 12.01))

_______ 25. If your submission is for a terminating Orphan Plan, have you included a request for a waiver of the VCP fee? (See section 12.02(4))

_______ 26. If you submitted a Notice of Intent to File VCP Application, have you included a copy of the Initial Notice and all Amended Notices? (See section [insert Rev. Proc. Section when Rev. Proc. Revised])

_______ 27. Have you assembled your submission as described in section 11.14?

______________________________ Signature	______________________ Date
______________________________ Title or Authority	
______________________________ Typed or Printed Name of Person Signing Checklist	

VOLUNTARY CORRECTION PROGRAM (VCP)
ACKNOWLEDGEMENT LETTER

1. Name and address:	2. Plan Name:
3. Control # (to be completed by IRS):	4. Received Date (to be completed by IRS):

The Internal Revenue Service, Employee Plans Voluntary Compliance, has received your VCP Submission for the above-captioned plan. Your request has been assigned the control number listed above. This number should be referred to in any communications to us concerning your submission.

You will be contacted when the case is assigned to an agent. If you are not contacted within 120 days from the date of this letter and need to inquire about the status of your case, please call (202) 283-9888 (not a toll-free number). Please leave a message with the name of the Plan, the Control Number, your name and a phone number where you can be reached.

Thank you for your cooperation.

Instructions for VCP Submission

Item by Item Instructions

If John Doe submission, check box and skip to Question 5

1. Name and Address of Plan Sponsor as shown on IRS Form 5500.
2. Insert 9 digit Taxpayer Identification Number shown on IRS Form 5500.
3. Name of Plan from Plan document
4. Three digit Plan Number assigned under Department of Labor regulations and shown on IRS Form 5500.
5. Name of authorized representative. If not an employee of the Plan Sponsor, attached IRS Form 2848 Power of Attorney.
6. Type of Plan – for Qualified Plans Only use the following 2-digit Code

Defined Benefit	QP 1
401(k)	QP 2
Money Purchase	QP 3
Profit Sharing	QP 4
Stock Bonus	QP 5
ESOP	QP 6
Cash Balance	QP 7
Other	QP 8

7. See Rev. Proc. 2007-27 for Special Submissions.

An Orphan Plan is one where the Plan Sponsor no longer exists, cannot be located, is unable to maintain the Plan or has abandoned the Plan pursuant to DOL regulations, as determined by an Eligible Party. See section 5.06 of Rev. Proc. 2006-27 for more information.

8. Qualification Failure – Use the following 2-digit Code

Plan Document Failure	Code
Disqualifying Provision	P1
Missing Provision	P2

Operational Failure	Code
Qualified Plan Minimum Top-Heavy Benefit – 416	OF1
Qualified Plan ADP Test - 401(k)(3)	OF2
Qualified Plan ACP Test - 401(m)(2)	OF3
Qualified Plan Multiple Use Test prior to January 1, 2002 - 401(m)(9)	OF4
Qualified Plan Excess Deferrals - 402(g)	OF5
Qualified Plan Exclusion of Eligible Employee from contributions or accruals – not 401(k)/(m)	OF6
Qualified Plan Exclusion of Eligible Employee from contributions or accruals – 401(k)/(m)	OF7
Qualified Plan Minimum Distribution - 401(a)(9)	OF8
Qualified Plan Participant or Spouse Consent – 401(a)(11), 411(a)(11), 417	OF9
Qualified Plan Excess 415 – Defined Contribution Plan	OF10
Qualified Plan Loan	OF11
Qualified Plan Excess Distribution	OF12
SARSEP deferral percentage Failure (408)(k)(6)(A)(iii)	OF13
SEP or SIMPLE under contribution Failure	**OF14**
SEP or SIMPLE Excess Failure	OF15
403(b) Plan - 403(b)(12)(A)(ii) relating to universal availability of salary reduction contributions	OF16
403(b) Plan - 401(m) test per 403(b)(12)(A)(i)	OF17
403(b) Plan - 401(a)(17) relating to compensation limit per 403(b)(12)(A)(i)	OF18
403(b) Plan – 403(b)(7) or (11) relating to distribution restrictions	OF19
403(b) Plan – 403(b)(10) relating to incidental death benefits	OF20
403(b) Plan – 403(b)(10) relating to minimum required distributions	OF21

403(b) Plan – 403(b)(10) relating to notice of direct rollover option	OF22
403(b) Plan – 403(b)(1)(E) and 401(a)(31) relating to annuity contract or custodial failure to give notice of direct rollover elections	OF23
403(b) Plan – 403(b)(1)(E) relating to limit on elective deferrals	OF24
403(b) Plan – 403(b)(1)(E) and 401(a)(30) relating to limit on elective deferrals	OF25
403(b) Plan – 403(b)(1)(E) and 401(a)(30) relating to annuity contract or custodial agreement failure to provide the limit on elective deferrals	OF26
403(b) Plan – Excess Amount Failure	OF27
403(b) Failure – Other	OF28

Demographic Failure	Code
Minimum Participation (401(a)(26))	D1
Coverage (410(b)) not involving Separate Lines of Business including failure to timely file IRS Form 5310-A to notify that QSLOB no longer applied	D2
Coverage (410(b)) involving Qualified Separate Lines of Business including failure to timely file IRS Form 5310-A QSLOB Notice	D2S
Nondiscrimination (401(a)(4))	D3

Employer Eligibility Failure for 403(b) Plan	Codes
Adoption by a Plan Sponsor that is not a tax-exempt organization under 501(c) (3) or a public education organization under 170(b)(1)(A)(ii)	EEF1
Failure to satisfy the nontransferability requirement of 401(g)	EEF2
Failure to initially establish or maintain a custodial accounts as required by 403(b)(7)	EEF3
Failure to purchase (initially or subsequently) either an annuity contract from an insurance company (not grandfathered under Rev. Rul. 82-102) or custodial account from a regulated investment company utilizing a bank or an approved non-bank trustee/custodian.	EEF4

9. Describe Qualification Failure. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
10. Insert Plan Years in Which the Failure Occurred and the number of participants affected by the failure each Plan Year. The number of participants affected includes active and former participants as well as beneficiaries and alternate payees.
11. Insert the Compliance Fee and the number of participants or number of affected participants used to determine the Fee and check No under Fixed Fee. If the fee is a fixed fee, check Yes and leave the participant information blank. The number of participants is the number from the most recent 5500 series filed with the Plan for active plans. Special rules apply to terminated plans See section 5.07 of Rev. Proc. 2006-27.
12. Describe Procedures. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
13. Describe How and Why the Failures Occurred. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
14. See Rev. Proc. 2006-27
15. See Rev. Proc. 2006-27
16. See Rev. Proc. 2006-27
17. Describe the Method Used to Locate and Notify Former Employees or Beneficiaries if applicable. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
18. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
19. If need more space, attach separate sheet but include Name of Plan Sponsor and EIN/PN on each page and Item No. that is being supplemented.
20. See Rev. Proc. 2006-27
21. See Rev. Proc. 2006-27
22. See Rev. Proc. 2006-27

23. Under Examination means (a) a Plan under an Employee Plans examination (Form 5500 series or other), (b) a Plan Sponsor under an Exempt Organizations examination (Form 990 series or other); or (c) a Plan under investigation by the Criminal Investigation Division of the IRS. Also included is a Plan that has received verbal or written notification from Employee Plans or Plan Sponsor has received a verbal or written notification form Exempt Organizations of an impending examination, of an impending referral for an examination, or is in Appeals or litigation for issues raised in an examination. A Plan that is aggregated for nondiscrimination testing (401(a)(4), 401(a)(26), 410(b), or 403(b)(12) with a Plan under examination is considered to be Under Examination for this filing. A Plan that is aggregated for qualification requirements (401(a)(30), 415, 416 but not the average benefits test of 410(b)(2)) with a Plan under examination is considered to be Under Examination for this filing. A Plan is considered to be Under Examination if the Plan Sponsor has filed any Form 5300 series form and the Employee Plans Agent notifies the Plan Sponsor or representative of possible Qualification Failures even if not formally notified of an examination (including partial termination concerns on a Plan termination). See section 5.03 of Rev. Proc. 2006-27 for more details.
24. See Rev. Proc. 2006-27

Assembling Instructions for the VCP Submission

As instructed in Internal Revenue Service Revenue Procedure 2006-27 in Appendix C, the Service will be able to process a Voluntary Correction Program ("VCP") submission more quickly if the submission package contains all of the items required by the Appendix C check list and the submission is assembled in the following order:

1. If applicable, Form 8717 Compliance Fee for Employee Plan Determination Letter Request and the check for the determination letter compliance fee made payable to the U.S. Treasury.
2. Determination letter application (i.e., Form 5300 series form), if applicable.
3. VCP Application Form signed by the Plan Sponsor or Plan Sponsor's authorized representative, with a check for the VCP fee made payable to the U.S. Treasury attached to the front of the submission letter.
4. Notice of Intent to File VCP Application and all Amended Notices if applicable.
5. Power of Attorney (IRS Form 2848) or Tax Information Authorization (Form 8821), if applicable.
6. Form 5500, (first three pages and the applicable Financial Information Schedule) or equivalent information.
7. Copy of opinion or determination letter (if applicable).
8. Relevant Plan document language or Plan document (if applicable).
9. Plan Amendment if applicable.
10. Any other items that may be relevant to the submission.

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES

Bonnie S. Brier, Project Leader

Ana Thompson, Project Leader

Betsy Buchalter Adler

Sean Delany

Fred Goldberg

Mary Rauschenberg

June 11, 2008

In its diversity and strength the voluntary sector is uniquely American—not in the fact of its existence, because it exists elsewhere, but in its extraordinary richness and variety. It encompasses a remarkable array of American institutions. . . . . Perhaps the most striking feature of the sector is its relative freedom from constraints and its resulting pluralism. Within the bounds of the law, all kinds of people can pursue any idea or program they wish… Our pluralism allows individuals and groups to pursue goals that they themselves formulate, and out of that pluralism has come virtually all of our creativity. Every institution in the independent sector is not innovative, but the sector provides a hospitable environment for innovation. Ideas for doing things in a different, and possibly better, way spring up constantly. If they do not fill a need, they quickly fall by the wayside. What remains are the few ideas and innovations that have long-term value… Government bureaucracies are simply not constructed to permit the emergence of countless new ideas, and even less suited to the winnowing out of bad ideas… The sector is the natural home of nonmajoritarian impulses, movements, and values. It comfortably harbors innovators, maverick movements, groups which feel that they must fight for their place in the sun, and critics of both liberal and conservative persuasion. Institutions of the nonprofit sector are in a position to serve as the guardians of intellectual and artistic freedom… My observations about the positive aspects of the sector are not intended to gloss over the flaws that are evident in institutions and organizations. Some nonprofit institutions are far gone in decay. Some are so badly managed as to make a mockery of every good intention they might have had. There is fraud, mediocrity, and silliness. In short, the human and institutional failures that afflict government and business are also present in the voluntary sector. Beyond that, it is the essence of pluralism…that no particular observer will approve of everything that goes on. If you can't find a nonprofit institution that you can honestly disrespect, then something has gone wrong with our pluralism. But these considerations are trivial compared to the attributes that make the independent sector a source of deep and positive meaning in our national life. If it were to disappear from our national life, we would be less distinctly American. The sector enhances our creativity, enlivens our communities, nurtures individual responsibility, stirs life at the grassroots, and reminds us that we were born free. Its vitality is rooted in good soil—civic pride, compassion, a philanthropic tradition, a strong problem-solving impulse, a sense of individual responsibility and, despite what critics may say, an irrepressible commitment to the great shared task of improving our life together.

John W. Gardner[1]

[1] John W. Gardner, The Independent Sector, Forward to America's Voluntary Spirit; A Book of Readings, O'Connell, Brian, ed., The Foundation Center, 1983, at ix, xiii-xv.

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I. EXECUTIVE SUMMARY

In recent years, the subject of "good governance" and its potential to prevent wrongdoing, ensure compliance with the law, and enhance the overall effectiveness of the nonprofit sector has been a topic of enormous interest. It has had the attention of the media, Congress, the public, and the nonprofit community. The Internal Revenue Service ("IRS") has significantly increased its own role with respect to promoting improved governance and has announced it plans to become even more active in the area. Under the circumstances, we thought this was an opportune time to consider what the appropriate role of the IRS is with respect to good governance practices by tax-exempt entities.

The IRS's view that "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance" seems self-evident. At the same time, efforts to promote good governance are fraught with complexity. There are over 1.2 million organizations described in section 501(c)(3) today. Effective governance practices among these organizations will vary depending on numerous factors, including size, sophistication, location, available resources, and activities. Moreover, while we may all agree that governance matters, it is not at all clear that requiring specific governance practices results in greater compliance with the tax laws. In fact, superior board governance may have much more to do with the values, active engagement, and accountability of those in charge than with the adoption of procedures and policies.

We acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. But, the IRS is a powerful force that can drive behavior merely by asking about specific governance practices. Charities can feel pressured to adopt the specified practices, even where it is inadvisable in their situation, because they believe the IRS or others will consider them poorly governed if they fail to do so. This then can effectively usurp the judgment of governing boards in determining what governance practices make sense in their specific context, place undue burdens on organizations, divert their attention to proxies for governance instead of actual governance, and adversely impact the unique, diverse, vibrant, and flexible charitable sector in this country. Accordingly, we believe the IRS should approach this area with caution. We provide a framework and 12 recommendations that are intended to assist the IRS as it seeks to balance the desirability of promoting good governance against the potential deleterious consequences to the sector.

Background. After first setting forth the scope of our report, we examine what is meant by good governance, and the extent to which there is empirical evidence to support specific governance practices. We conclude that while there is a growing list of "good governance" indicators that are organized roughly around the composition, structure, responsibilities, and operations of nonprofit boards and their committees, there is little or no empirical evidence to date that supports the efficacy of any specific governance practices by nonprofit organizations, much less compliance with the requirements for maintaining tax exemption. We do not mean to suggest that the adoption of specific

practices and policies are not useful for organizations in providing a structure that assists them in their decision-making and operational processes. Rather, we believe that respect for the diverse and evolving nature of the nonprofit sector requires that we continue to value flexibility in our expectations of the specific governance practices that may be essential to the health of the sector. Thus, we support the autonomy of an organization's governing body and its exercise of its business judgment as to what best reflects the needs of its organization.

Regulation and Self-Regulation of Nonprofit Governance Outside of the IRS. One of the issues that arises is whether there is a need for the IRS to be more involved in nonprofit governance beyond the specific statutory requirements in the tax laws. Nonprofit organizations can be regulated by many—and sometimes conflicting—authorities. Because nonprofit organizations are established under state law, states historically have had the principal responsibility and greatest authority to regulate in the area. Organizations with offices in more than one state or that solicit contributions in multiple jurisdictions may be subject to the laws of a number of states. There also are industry-specific accreditation agencies, standards relating to participation in particular membership groups, and innumerable voluntary standards and publications from leading organizations regarding nonprofit governance. Because large, sophisticated, and complex organizations are subject to regulation and/or are accredited and, in any event, have numerous governance resources available to them, it is less clear what the IRS adds to the governance discussion in their case. Conversely, while smaller and more rural organizations have less governance resources available to them, there is a greater need to tread lightly because of the burdens flowing from encouraging unnecessarily extensive governance reforms, the fact that the costs of adopting certain practices simply may not be worth the benefits, and the reality that the costs of governance will consume charitable assets that could otherwise be devoted to the organizations' programs. Finally, while disclosure and transparency, facilitated by the public availability of Forms 990 and 1023, undeniably play an influential role in encouraging appropriate nonprofit governance, they have limitations.

Role of IRS/Treasury in Governance Involving Tax-Exempt Organizations. The IRS has sought, to varying extents, to promote good governance practices in each of its five points of contact with tax-exempt organizations: in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach. Our report reviews each in turn to identify how governance is involved and to highlight some concerns.

Governance Issues on Standards for Exemption. While Congress has not required the adoption of specific governance practices as a condition for exemption under section 501(c)(3), there are a limited number of situations where the IRS has mandated specific governance practices as a condition for exemption in precedential (sometimes non-precedential) rulings and other documents. Most of these arise in the health care arena, although the IRS requires a conflict of interest policy in certain low-income housing joint ventures. We appreciate that in the quickly-changing field of health care it can, in some instances, be difficult to distinguish a health care organization that qualifies for exemption from one that is merely the for-profit practice of medicine or a health-related

business. In various contexts, as the IRS has labored to draw that line, it has created a *per se* requirement for exemption that requires the organization be governed by an independent body. The IRS's position, however, has not always been sustained by the courts and we are concerned about *per se* requirements.

Governance Issues Involving Determinations. Both stages of the determination process—the completion and submission of Form 1023; and the administrative process where the IRS determines whether exemption is merited—address governance matters. We were not able to find guidance as to how the IRS takes governance issues into account in the determination process, except in limited instances in the health care and low-income housing joint venture areas. We certainly appreciate that governance can bear on the operational test, among other issues. Our personal experience and research for this report suggest, however, that the IRS may require specific governance practices on an ad hoc and inconsistent basis. For example, determination specialists may require organizations seeking exemption to have independent boards or at least some independent board members. Similarly, despite the fact that the Form 1023 specifically states that a conflict of interest policy is recommended but not required, our experience and interviews suggest that determination specialists often require adoption of such a policy, and occasionally require adoption of the sample form of policy included with the Form 1023 instructions. We appreciate we have only anecdotal evidence regarding governance issues in the determination process. It is, however, our impression that the "when" and "what" are unclear and not uniformly applied. We are concerned about the IRS having this level of discretion in cajoling or requiring specific governance process, particularly in the determination phase, where there usually is no track record evidencing operational failures.

Governance Issues Involving Form 990 Disclosure. The addition of a number of governance-related questions to the recently redesigned Form 990 serves as further demonstration of the IRS's growing involvement in the area. The IRS's approach to the redesigned Form 990 for 2008 has been a model of inclusiveness and collaboration. We believe in large part the governance questions on the redesigned Form 990 for 2008 are appropriate and formulated in a relatively neutral manner, recognizing that true neutrality is an unattainable goal. The inclusion of the questions, however, inherently (and intentionally) suggests that the IRS supports adoption of specific governance policies and practices. The danger then is that organizations will take the path of least resistance and adopt the policies and practices whether or not they are appropriate for them, or effective in their context.

Governance Issues in the Examination or Other Compliance Initiative Context. As with determinations, the IRS considers an organization's governance in the context of an audit or other compliance initiative. However, the audit context differs significantly from determinations in that the organization has a track record and the IRS is, or should be, considering the organization's actual operations in ascertaining whether the organization qualifies for exemption. Thus, where there are violations of the standards for exemption, the IRS rightfully has a greater interest and duty and correspondingly increased latitude to address misbehavior. However, we were not able to find

significant guidance as to how the IRS takes governance issues into account in the examination process; and we find the absence of guidelines in this area to be troubling.

Governance Issues in Education and Outreach. In recent years, the IRS has been active in addressing governance issues as part of its education and outreach efforts. Although these initiatives do not have the force of law, the structure of these pronouncements can and does signal IRS's expectations regarding charitable organization governance. We believe the IRS has an important role to play in this area. We note, however, that efforts to promote good governance are fraught with complexity. While we may all agree that governance matters, there is little or no empirical support for the proposition that requiring specific governance practices results in greater compliance with the tax laws pertinent to exempt organizations. We are very mindful of the fact that even the most modest level of prescription from a regulatory body such as the IRS regarding what constitutes "good governance" can undermine the fundamental and wholly legitimate authority of the organization's governing board and can suggest a one-size-fits-all approach that can place undue burdens on an organization, divert the organization's attention from meaningful governance to polices and procedures, and do damage to the uniquely diverse and vibrant charitable sector in this country. Given the diversity of the sector and the varying, and often unpredictable, challenges facing an organization, the organization's governing board generally is in the best position to determine what the most appropriate practices are for its organization.

Why Treasury/IRS Should Proceed With Caution in Promoting Nonprofit Governance. The IRS should remain mindful of the following set of cautionary concerns:

- Beware the law of unintended consequences.
- The power to inquire is the power to punish.
- Governance is an unfunded mandate.
- One size does not fit all.
- Conventional wisdom is not empirical evidence.
- Good governance cannot be captured in a "punch list."
- Policies are not practices.
- Bad policies can lead to bad practices.
- The bully pulpit is a form of regulation.
- Exempt organizations are governed by boards, not by the IRS.

These concerns should be considered by the IRS in any instance in which the IRS inquiries or opines about matters of nonprofit governance. However, the inherent risks and the need for caution are not of equal sensitivity in all circumstances. Therefore, we offer a framework and recommendations that take these concerns into account in our consideration of the appropriate role of the IRS with respect to nonprofit governance.

Recommendations. We again acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. But because of the concerns expressed above and the dearth of empirical evidence supporting the effectiveness of specific nonprofit governance measures, we believe the IRS should approach the governance area with caution. We recommend that in each instance the IRS is considering involvement in a specific governance issue it should consider the importance of the specific governance practice to compliance with the laws under its jurisdiction and then balance that against potential countervailing considerations (*e.g.*, will it elicit or promote a meaningful response related to tax compliance and what harm might flow) in determining whether to proceed. We believe the context in which the IRS is operating—in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach—is relevant to this balancing. We conclude our report with 12 recommendations we hope the IRS will find useful as a framework in helping it navigate appropriately between its mandate to ensure compliance with the tax laws and the broader and more aspirational goal of promoting good governance in the sector. We recognize that in a number of instances the IRS already follows or substantially follows these recommendations, but we include all 12 to ensure a complete framework.

(1) The IRS Should Continue to Work Collaboratively With The Tax-Exempt Community In Connection With Its Governance Initiatives.

(2) Specific Governance Practices Should Be Mandated Only In Rare And Limited Circumstances.

(3) The Closer The Nexus To Tax Compliance, The More Appropriate The Governance Inquiry Or Recommendation.

(4) The IRS Should Explain The Specific Relationship Between Tax Compliance And Each Governance Practice About Which It Is Inquiring Or Which It Is Addressing.

(5) Compliance Questions Or Commentary Are More Appropriate Than Governance Questions Or Commentary.

(6) Governance Inquiries Should Be Made And Comments Addressed In As Neutral A Manner As Possible Under the Circumstances.

(7) Questions That Ask About Practices And Approaches Are Typically Better Than Questions That Ask About Policies.

(8) The IRS Should Expressly Acknowledge When Governance Practices About Which It Is Inquiring Or Which It Is Addressing Are Not Required.

(9) The IRS Should Expressly Acknowledge That Governance Practices About Which It Is Inquiring Or Which It Is Addressing May Be More Appropriate For Some Types Of Organizations Than For Others And Respect The Role Of The Governing Body In Making Those Decisions.

(10) Taking Into Account The Absence Of Certain Governance Practices In Determining Whether To Audit Or Take Other Compliance Actions May Be Appropriate in Certain Instances.

(11) Consistency and Fair Treatment are Critical.

(12) Education, Implemented Thoughtfully, Is More Appropriate Than Pressuring Change.

II. STATEMENT OF THE PROBLEM AND THE PROJECT OBJECTIVES

A. Problem

Recently, the IRS has become increasingly involved in seeking to promote "good governance" practices across the tax-exempt sector based on its belief that a well-governed organization is more likely to be compliant and that good governance also allows for self-identification and resolution of problems. We acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. However, the efficacy of specific governance practices is unproven; and the IRS merely asking about specific governance practices is a powerful force that can drive behavior. Charities can feel pressured to adopt the specified practices even where it is inadvisable in their situation because they believe the IRS or others will consider them poorly governed if they fail to do so. This then can effectively usurp the judgment of their governing boards in determining what governance practices make sense in their individual contexts, place undue burdens on organizations, divert their attention to proxies for governance instead of actual governance, and adversely impact the unique, diverse, vibrant, and flexible charitable sector in this country. Accordingly, we believe that caution is critical when seeking to promote specific governance practices.

B. Objective

The objective of this report is to provide a framework that will assist the IRS as it seeks to balance the desirability of promoting good governance against the potential deleterious consequences to the sector.

III. PROCESS

ACT members obtained information and perspectives about governance issues and practices through interviews with IRS and Treasury staff, charities' experts in state attorneys general offices, academics, and practitioners in the field (including exempt organization and other attorneys, accountants that work with nonprofit organizations, those involved with the promotion of voluntary standards in the nonprofit sector, and other experts and stakeholders). The interviews explored the history of the IRS's involvement in governance issues with respect to exempt organizations, any empirical evidence regarding the efficacy of specific governance practices, and the interviewees' perspectives on what is meant by good governance and the appropriate role of the IRS in this area.

ACT members also benefited from the perspectives of many more professionals and practitioners through their participation in two mini-conferences convened at the suggestion of the ACT:

- *Internal Revenue Service Role in Corporate Governance of Nonprofits*, convened by the National Center on Philanthropy and the Law at New York University Law School, in New York City, on October 4, 2007.
- *Improving Governance in Nonprofits: Do We Know How? Do For-Profits Provide Lessons?, co-c*onvened by the Urban Institute Center on Nonprofits and Philanthropy and the Harvard University Hauser Center for Nonprofit Organizations, in Washington, D.C., on January 16, 2008.

The ACT also reviewed general and specialized publications (including articles, books, and special reports relating to governance in the for-profit and nonprofit sectors); materials, publications, forms, rulings, and advice issued by the IRS and Department of Treasury; publications and speeches by senior IRS officials; congressional testimony and reports; case law; and other materials. Appendix 1 provides a list of the persons interviewed for this report, greater detail about the October 2007 and January 2008 mini-conferences, and a detailed bibliography of certain written materials consulted in the preparation of this report.

IV. INTRODUCTION

In recent years, the subject of "good governance" and its potential to prevent wrongdoing, ensure compliance with the law, and enhance the overall effectiveness of an organization has been a topic of enormous interest. This current period of heightened attention began with the corporate scandals in the for-profit world, including Enron Global Crossing, WorldCom, Adelphia, and Tyco International, and the attendant passage of Sarbanes-Oxley.[1] But nonprofit organizations have not been immune from the focus on "best practices."

Nonprofit governance is a topic of interest in the media and to the public. In recent years, the growth of media outlets (including 24-hour cable television news and the proliferation of Internet news sites and blogs[2]), combined with the greater availability of information on the financial transactions of nonprofit organizations,[3] has added increased scrutiny from the media to the oversight that governmental agencies are charged with exercising.[4] The *Boston Globe*, the *New York Times,* and the *Washington Post* are among the major newspapers that have covered questionable transactions involving nonprofit organizations such as the American Red Cross, the

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[1] American Competitiveness and Corporate Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (hereinafter *Sarbanes-Oxley* or *SOX*).

[2] There also are an increasing number of blogs dedicated to the nonprofit sector. *See*, *e.g.*, http://www.wheremostneeded.org, http://nonprofiteer.typepad.com, http://charitygovernance.blogs.com, http://donttellthedonor.blogspot.com.

[3] IRC section 6104(d). *See*, *e.g.*, www.guidestar.org, where Forms 990 and 990-PF are publicly available for viewing and downloading.

[4] *See*, *e.g.*, Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 Exempt Org. Tax Rev. 25 (2003)

United Way, Oral Roberts University, the Smithsonian Institution, American University, the J. Paul Getty Trust, and the Nature Conservancy.[5]

At the same time, congressional attention to the nonprofit sector has increased, with hearings[6] in the Senate Finance Committee and in the House Committee on Ways and Means, and its Subcommittee on Oversight, and the release of various discussion drafts addressing possible remedies for perceived problems in the sector.[7] Senator Grassley, first as Chair of the Senate Finance Committee and then as Ranking Minority Member, and his colleague Senator Baucus, the current Chair of the Senate Finance Committee and former Ranking Minority Member, have emphasized the importance of governance and transparency in the tax-exempt sector.[8]

A common thread in the media coverage, in testimony before (and written comments submitted to) congressional committees,[9] and in remarks by legislators of both parties[10] has been a sense that those responsible for the charities in question have not lived up to their duties. They contend that better governance could have prevented, or at least limited, the harm caused by abusive transactions involving charities and their insiders. In fact, it is virtually tautological today that a significant failure by an organization is a failure of governance.

The nonprofit sector has responded to this increased scrutiny with a number of self-regulatory initiatives. Independent Sector, in response to a request from Senators Grassley and Baucus in the summer of 2004, convened the Panel on the Nonprofit Sector to consider proposals for improving the effectiveness and accountability of nonprofit organizations, with particular attention to self-governance. The Panel issued reports in June 2005 and April 2006 with recommendations for legislative and regulatory

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[5] *See*, *e.g.*, Gretel C. Kovach, *Oral Roberts and President Part Ways*, N.Y. Times, Nov. 28, 2007, at A22; Stephanie Strom, *Red Cross Head Quits; Board Woes, Not Storm, Are Cited*, N.Y. Times, Dec. 14, 2005 at A32; Felicity Barringer, *United Way Finds Pattern of Abuse by Former Chief*, N.Y. Times, April 4, 1992 at Section 1 Page 1; *American University Investigated by IRS*, Tax Notes Today, 2007 TNT 39-8, Doc 2007-4907 (Feb. 27, 2007).

[6] *See*, *e.g.*, Senate Finance Committee hearings: *Taking the Pulse of Charitable Care and Community Benefits at Nonprofit Hospitals* (Sept. 13, 2006); *Charities on the Frontline: How the Nonprofit Sector Meets the Needs of America's Communities* (Sept. 13, 2005); *The Tax Code and Land Conservation: Report on Investigations and Proposals for* Reform (June 8, 2005); *Charities and Charitable Giving: Proposals for Reform* (April 5, 2005); and *Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities* (June 22, 2004); House Committee on Ways and Means hearings: *To Examine Whether Charitable Organizations Serve the Needs of Diverse Communities (*Subcommittee on Oversight *Sept. 25, 2007); On Tax-Exempt Charitable Organizations* (Subcommittee on Oversight July 24, 2007); *To Review the Response by Charities to Hurricane Katrina* (Subcommittee on Oversight Dec. 13, 2005); O*n the Tax-Exempt Sector* (May 26, 2005); *On an Overview of the Tax-Exempt Sector* (April 20, 2005)

[7] *See*, *e.g.*, *Tax-Exempt Hospitals: Discussion Draft* (July 18, 2007), http://www.senate.gov/~finance/press/Gpress/2007/prg071907a.pdf, recommending imposing an array of governance practices on tax-exempt hospitals; *Staff Discussion Draft*, (June 21, 2004), http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf, recommending sweeping governance proposals for all exempt organizations, including limiting board size to 15 members, only one of whom could be compensated by the organization, and requiring at least one-fifth of board members of public charities to be independent.

[8] *See* joint letter of Senators Baucus and Grassley to the Treasury Secretary (May 29, 2007), http://www.senate.gov/~finance/press/Gpress/2007/prg052907a.pdf.

[9] For example, Ira M. Millstein submitted comments to the Senate Finance Committee regarding the governance of The Nature Conservancy and describing the changes that the organization had implemented, following congressional and media attention to alleged failures of oversight by TNC's Board (June 8, 2005), http://finance.senate.gov/hearings/testimony/2005test/imtest060805.pdf.

[10] *See*, *e.g.*, Stephanie Strom, *Senator Urges Red Cross to Overhaul Its Board*, N.Y. Times, Feb. 28, 2006, at A12.

action as well as sector-generated educational and enforcement efforts.[11] In October 2007, in an effort to "advance the state of governance and self-regulation," the Panel issued *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (hereinafter, "Panel *Principles*").[12] The Council on Foundations released stewardship principles developed by its private foundation members; its community foundation members released standards for community foundations.[13] Organizations aimed at increasing the effectiveness of nonprofit organizations, such as BoardSource, similarly have increased their efforts at improving governance practices,[14] and the American Bar Association has issued various publications designed to educate nonprofit organizations about nonprofit governance.[15] The American Law Institute's project, begun in 2000, to develop *Principles of the Law of Nonprofit Organizations*, includes a strong educational component.[16]

State legislators, too, have responded to perceived abuses in the nonprofit sector with legislation designed to require greater oversight from the governing bodies of charities. In California, for example, the Nonprofit Integrity Act of 2004[17] imposed detailed governance obligations on charities (whether organized as corporations or trusts) with any operations or assets in California, regardless of the state of incorporation or formation. These obligations include an annual compensation review of certain officers and the appointment of an audit committee (with specific limits on who may and may not serve on it) for charities with assets above a threshold amount. While other states considered comprehensive reforms,[18] the threat of sweeping SOX-type legislation has

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[11] Supplement: Strengthening the Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector (Panel on the Nonprofit Sector, Independent Sector ed., 2006); Report to Congress and the Nonprofit Sector on Governance, Transparency and Accountability (Panel on the Nonprofit Sector, Independent Sector ed., 2005); Strengthening the Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector (Panel on the Nonprofit Sector, Independent Sector ed., 2005), www.nonprofitpanel.org.

[12] Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (Panel on the Nonprofit Sector, Independent Sector ed., 2007), at http://www.nonprofitpanel.org/report/principles/Principles_Guide.pdf.

[13] *Stewardship Principles and Practices for Independent Foundations* (Nov.7, 2005), http://www.cof.org/files/Documents/Stewardship%20Principles%20%20Best%20Practices%20Initiative/Independent/Independent_Principles_-_FINAL.pdf, and *National Standards for U.S. Community Foundations*, at http://www.cof.org/files/Documents/Community_Foundations/National_Standards/NationalStandards.pdf.

[14] *See*, *e.g.*, www.boardsource.org. Locally-based organizations that work to improve nonprofit management, such as www.compasspoint.org in Northern California, also increased their efforts.

[15] *See*, *e.g.*, ABA Coordinating Committee on Nonprofit Governance, Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (2005).

[16] American Law Institute, *Principles of the Law of Nonprofit Organizations*, Tentative Draft No. 1 (2007) (hereinafter "*ALI Draft Nonprofit Principles*").

[17] Cal. Gov. Code Sections 12585-86, 12599; see generally California Registry of Charitable Trusts *Nonprofit Integrity Act of 2004*, http://ag.ca.gov.charities/publications/php.

[18] *See*, *e.g.*, the extensive nonprofit mini-SOX New York statute (S.B. 4836-B, 226th Leg. Reg. Sess. (N.Y. 2004)) proposed by then Attorney General Elliott Spitzer; Act to Promote the Financial Integrity of Public Charities, Summary of Draft 1, (http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/Mass_AG.Act_to_promote_fin_integ_pub_charities.pdf), suggested by then Attorney General Tom Reilly. *See* also Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 Chi.-Kent L. Rev. 559 (2005).

not materialized. A number of states have, however, issued educational materials for nonprofit organizations[19] or supported such endeavors by groups within their states.[20]

In this environment, the Internal Revenue Service ("IRS") similarly has been active in promoting "best practices" for tax-exempt organizations. The IRS added a governance section to its redesigned Form 990 for tax years beginning in 2008; it included a paper entitled "Governance and Related Topics – 501(c)(3) Organizations" in its Life Cycle on-line educational tool;[21] and the Commissioner for Tax Exempt and Government Entities ("TE/GE") and the Director of Exempt Organizations have spoken nationally about the importance of tax-exempt organizations adopting good governance practices.[22] In a very recent speech, the Commissioner for TE/GE advised as follows:[23]

Over the past year, we have said repeatedly that we care because a well-governed organization is more likely to be compliant, while poor governance can easily lead to trouble. Good governance also allows for self-identification and resolution of problems. Some disagree with us on this. My view is clear. Despite the absence of explicit federal statutory provisions setting forth clear governance standards, what I am calling jurisdictional gaps, we are not interlopers trying to regulate an area that is beyond our sphere. Rather, the effects of good or bad nonprofit governance cut across virtually everything we see and do in our work. It impacts whether the organization is operated to further exempt purposes and public, rather than private, interests. It dictates whether the organization's executives are compensated fairly or excessively. It influences whether the organization makes informed and fair decisions regarding its investments or its fundraising practices, or allows others to take unfair advantage. The question is no longer whether the IRS has a role to play in this area, but rather, what that role will be.

Under the circumstances, we thought this was an opportune time to consider the appropriate role of the IRS with respect to good governance practices by tax-exempt entities.

We begin by acknowledging the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its

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[19] *See*, *e.g.*, Guidebook for New Hampshire Charitable Nonprofit Organizations (New Hampshire Attorney General, Charitable Trust Unit ed., 2005), available with other resources, www.doj.nh.gov/charitable; Iowa Principles and Practices for Charitable Nonprofit Excellence (Iowa Governor's Nonprofit Task Force ed. 2006), http://www.sos.state.ia.us/pdfs/Nonprofits/IAPP4CNE.pdf; Attorney General Andrew M. Cuomo, Internal Controls and Financial Accountability for Not-for-Profit Boards (2007), at http://www.oag.state.ny.us/charities/internal_controls.pdf; Attorney General Andrew M. Cuomo, Right from the Start (2007), http://www.oag.state.ny.us/charities/not_for_profit_booklet.pdf.

[20] *See*, *e.g.*, Colorado Nonprofit Association, Principles and Practices for Nonprofit Excellence in Colorado (2007), http://www.coloradononprofits.org/PandP/PandP.pdf ; Maine Association of Nonprofits, Guiding Principles and Practices for Nonprofit Excellence in Maine (2008), http://www.nonprofitmaine.org/documents/PandP_2008.pdf.

[21] *See* http://www.irs.gov/charities/article/0,,id=178221,00.html and http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

[22] *See*, *e.g.*, Remarks of Steven T. Miller, Commissioner, TE/GE, IRS, Georgetown Tax Conference (April 26, 2007), The Exempt Organization Tax Review, Vol. 56, No. 3, 256 (June 2007), and *The IRS Role in an Evolving Charitable Sector,* Philanthropy Roundtable (Nov. 10, 2007), http://www.irs.gov/pub/irs-tege/philanthoropy_roundtable11.pdf. *See* also the letter of June 28, 2007 from IRS Acting Commissioner Kevin M. Brown to Senator Grassley as to the importance of "an independent, empowered and engaged board of directors. . . ." http://www.senate.gov/~finance/press/Gpress/2007/prg072307a.pdf.

[23] *See* Remarks of Steven T. Miller, Commissioner, TE/GE, IRS, Georgetown Tax Conference, (April 23, 2008), http://www.irs.gov/pub/irs-tege/gulc_governance_speech_042308.pdf.

jurisdiction. Charitable governance issues arise from section 501(c)(3)'s operational test and inurement proscription;[24] section 4958's imposition of excise taxes on excess benefit transactions between public charities[25] and those in a position to exercise substantial influence over them (particularly the procedures set forth in the regulations to section 4958 regarding how to obtain the rebuttable presumption of reasonableness);[26] the limits on transactions involving private foundations and their insiders, including directors, trustees, their family members, and other related parties;[27] and the statutorily mandated public disclosure of the Forms 1023 and 990.[28] Governance is an issue in each of the IRS's five points of contact with the tax-exempt sector: in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach.

The IRS's view that "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance"[29] seems self-evident. At the same time, efforts to promote good governance are fraught with complexity. There are over 1.2 million organizations described in section 501(c)(3) today.[30] Effective governance practices among these organizations will vary depending on numerous factors, including size, sophistication, location, available resources, and activities.[31] Moreover, while we may all agree that governance matters, it is not at all clear that requiring specific governance practices results in greater compliance with the tax laws. In fact, superior board governance may have much more to do with the values, active engagement, and accountability of those in charge than with the adoption of procedures and policies. Yet, the IRS merely asking about specific governance practices is a powerful force that can drive behavior. Charities can feel pressured to adopt the specified practices even where it is inadvisable in their situation because they believe the IRS or others will consider them poorly governed if they fail to do so. This can effectively usurp the judgment of the governing board in determining what governance practices make sense in its specific context, place undue burdens on organizations, divert their attention to proxies for governance instead of actual governance, and adversely impact the unique, diverse,

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[24] All references to "section" are to the IRC unless otherwise indicated. Inurement also is proscribed by IRC sections 501(c)(4), 501(c)(5), 501(c)(6), 501(c)(7), 501(c)(9), and 501(c)(10), *inter alia.*

[25] IRC section 4958 also regulates excess benefit transactions involving IRC section 501(c)(4) organizations.

[26] Treas. Reg. § 53.4958-6.

[27] *See* IRC sections 4946 (defining disqualified persons to private foundations), 4941 (self-dealing), and 4945 (taxable expenditures).

[28] *See* discussion *infra* at notes 104-06 and accompanying text.

[29] Preface to *Governance and Related Topics – 501(c)(3) Organizations*, *supra* note 22.

[30] *See* Remarks of Steven T. Miller, Commissioner, TE/GE, IRS, Georgetown Tax Conference (April 24, 2008), http://www.irs.gov/pub/irs-tege/represent_manage_speech_042408.pdf.

[31] *See* Panel *Principles*, *supra* note 13, at 5: "[G]iven the wide, necessary diversity of organizations, missions, and forms of activity that make up the nonprofit community, it would be unwise, and in many cases impossible, to create a set of universal standards to be applied uniformly to every member. Instead, the Panel commends the following set of principles to every charitable organization as guideposts for adopting specific practices that best fit its particular size and charitable purpose"

vibrant and flexible charitable sector in this country. Accordingly, we believe that the IRS should approach this area with caution.

Our goal then is to attempt to provide a framework that will assist the IRS as it seeks to balance the desirability of promoting good governance against the potential deleterious consequences to the sector.

This report is comprised of the following additional sections:

- Section V defines the scope of the nonprofit sector addressed in the report, looks at the meaning of "good governance," and considers the extent to which there is empirical evidence that can be helpful in considering appropriate governance;
- Section VI looks at regulation of the nonprofit sector outside the IRS—the states, accreditation systems, voluntary standards, and oversight by watchdog groups, the media, the public and others;
- Section VII reviews the IRS's evolving role in governance issues involving tax-exempt entities at the IRS's five points of contact with the tax-exempt sector: in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach;
- Section VIII explains the bases for our call for caution; and
- Section IX sets forth specific recommendations and a framework we hope will assist the IRS as it continues to promote good governance.

V. BACKGROUND

A. Scope of Report

Although concerns about governance cut across every part of the nonprofit sector, we focus in this report on organizations recognized as exempt under section 501(c)(3) of the Internal Revenue Code. These organizations represent both the largest number of tax-exempt entities and those in which the public has the greatest stake; and most of the attention and discussion about governance has centered on this segment of the sector.[32]

We also focus on public charities rather than private foundations. Because private foundations tend not to rely on, and therefore not to be accountable to, governmental units or the general public for their source of funds or for their operations, Congress chose to restrict their conduct prophylactically through the imposition of excise taxes.[33]

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[32] *See*, *e.g.*, Panel *Principles, supra* note 13.

[33] IRC sections 4941 (self-dealing), 4942 (failure to distribute income), 4943 (excess business holdings), 4944 (jeopardizing investments), and 4945 (taxable expenditures). For example, Section 4941 creates a *per se* prohibition on certain "self dealing" transactions between private foundations and insiders, by imposing excise taxes even if such transactions are "fair" and at arm's length (or even more favorable to the private foundations). In passing the Tax Reform Act of 1969, which subjected private foundations to these harsher rules, the House Report explains: "[Y]our committee has concluded that even arm's-length standards

Thus, certain significant decisions, such as those involving purchases and leases between an organization and its insiders, that the law generally leaves to the discretion of the governing board of a public charity are not permitted in the case of private foundations. While we do not mean to suggest that governance is unimportant in the context of private foundations, we have chosen not to discuss them here because of the different regulatory framework applicable to them.

Finally, we often refer in this report to "boards" and "board members," although our analysis and recommendations apply with equal force to other types of governing bodies, including those directing charitable trusts.

B. What Does "Good Governance" Mean?

Notwithstanding the substantial attention devoted to nonprofit governance in recent years, analysis of the appropriate role for the IRS is hampered by the lack of a common understanding of what characterizes "good governance." The foundation for nonprofit governance is based on the relative behavioral standard found in the "duty of care," in which board members are held to norms appropriate for similarly situated individuals, and in the standard of conduct contained in the "duty of loyalty," pursuant to which board members are expected to act in the best interests of the charity.[34]

This conceptual underpinning, however, captures neither the mindset that characterizes superior board governance nor the specific practices that so often serve as proxies for that condition. We may agree that a vigilant and involved board that is continually educated about its responsibilities, understands the organization and its obligations, receives in advance and reviews information necessary for decision-making, attends and participates in meetings attentively, determines the strategic direction of the organization, approves and oversees significant activities performed by management, adopts or causes management to adopt policies and procedures relating to areas of significant vulnerability for the organization, and seeks appropriate counsel and other expertise when warranted is likely to result in an organization that is governed well. But this description does not begin to capture the lengthening catalog of procedures and polices that are, at least according to conventional wisdom, today considered indicators of good governance. We predicate this report on the conviction that no list of specific governance practices, however comprehensive, can ever capture the attitude of

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often permit use of a private foundation to improperly benefit those who control the foundation. . . . In order to minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between the sanctions and improper acts, and to make it more practical to properly enforce the law, your committee has determined to generally prohibit self-dealing transactions. . . ."

[34] *See*, *e.g*., *ALI Draft Nonprofit Principles* § 300 (Fiduciary Duties), § 310 (Duty of Loyalty), § 315 (Duty of Care); New York Not-for-Profit Corporation Law § 715 ("Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."); California Corporations Code § 5231(a) ("director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."). Some states also separately recognize a "duty of obedience," combining a general duty of legal compliance with an obligation to adhere to the corporation's charitable mission. *See*, *e.g.*, Manhattan Eye Ear and Throat Hospital v. Spitzer, 186 misc. 2d 126; 715 N.Y.S. 2d 575 (Sup. Ct. NY Co. 1999).

responsibility and accountability by nonprofit boards that good governance entails in a world of innumerable and unpredictable challenges.

Some of the indicators that have become proxies for good governance concern the composition and structure of nonprofit boards and their committees, while others focus on board and committee responsibilities and operations.[35] The factors, varying with source, can include: board size (focusing both on boards that are too small to provide proper oversight[36] and too large for meaningful participation); qualifications of directors, including their independence and whether they collectively bring the requisite talents and resources; written expectations for directors, including board and committee attendance requirements; agenda setting; executive board and committee sessions; board and committee orientation and continuing education programs; board committee oversight of finance, audit, investment management, legal compliance, compensation and governance, and whether committees operate pursuant to written charters that delineate roles and responsibilities;[37] long-range strategic planning, with attention to mission statements, community or constituent needs assessments, and performance metrics; periodic performance assessment of the organization, board, and individual directors; evaluation of CEO and determination of CEO compensation; approval of other executive compensation; succession planning relating to the board and its leadership, as well as the CEO and key senior managers; selection and oversight of outside auditors, auditor independence, and lead auditor rotation; supervision of internal audit processes; oversight of financial controls; setting parameters for acceptable investment allocations and practices; development and implementation of various policies, including conflict of interest policies, whistleblower policies, document retention and destruction policies, fundraising and gift acceptance policies, and codes of ethics; and practices designed to promote transparency, including making publicly and readily available (such as by posting on the organization's website) an annual report, information about activities, finances, structure and principals (officers, directors and senior managers), and disclosure of committee charters, policies, and documents reflecting governance practices.

Most of these proxies for a well-governed organization are not even indirectly rooted in state statutory obligations, let alone in the Internal Revenue Code, but rather derive at best imprecisely from the duties of care and loyalty. While this collection of indicators, to a greater or lesser degree, may all appear to be reasonably related to the prudent and purposeful conduct of the affairs of nonprofit boards, as discussed immediately

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[35] No list intending to encompass every practice signifying superior governance can be complete, inasmuch as standards for good governance evolve with the nonprofit sector. *See*, *e.g.*, the 33 standards set forth in the Panel's *Principles*, *supra* note 13. Although responsibility for governance is typically discussed as a board function, many of the behaviors associated with superior governance are, in fact, management functions; ultimate responsibility for ensuring implementation of those behaviors, however, rests with the board. *See*, *e.g.*, *ALI Draft Nonprofit Principles, supra* note 17, § 320 (Board Responsibilities, Functions and Composition).

[36] Some state laws provide for a minimum number of directors, (*see, e.g.,* New York Not-for-Profit Corporation Law § 702), while others set no minimum (s*ee, e.g.,* Delaware General Corporation Law § 141(b)). State laws may impose other requirements for eligibility for board service, such as a minimum number of directors who are independent of family ties. *See, e.g.,* New Hampshire Voluntary Corporations and Associations § 292:6-a ("In the interests of encouraging diversity of discussion, connection with the public, and public confidence, the board of directors of a charitable nonprofit corporation shall have at least 5 voting members, who are not of the same immediate family or related by blood or marriage.").

[37] *See, e.g., ALI Draft Nonprofit Principles, supra* note 17, § 325 (Committees and Delegation).

below, the empirical evidence to date does not confirm the efficacy of specific nonprofit governance practices, much less compliance with the requirements for maintaining tax exemption. Under the circumstances, we must remain mindful that many of these indicators of good governance are articles of faith and resist clinging to them with talismanic certainty. While we do not mean to suggest that the adoption of specific practices and policies are not useful for many organizations in providing a structure that assists them in their decision-making and operational processes, humility necessitates that we respect the diverse and evolving nature of the nonprofit sector and continue to value flexibility in our expectations of the specific governance practices that may be essential to the health of the sector. Thus, we support the autonomy of an organization's governing body and its exercise of its business judgment as to what best reflects the needs of its organization.

C. What Empirical Evidence Exists About Governance?

There is little or no empirical evidence with respect to nonprofit governance.[38] In 2007, the Urban Institute released what it described as "the first national representative study of nonprofit governance."[39] That study, based on "self-reports" from the over 5,000 nonprofits that responded to a survey, looked principally at six Sarbanes-Oxley inspired indicators—external audits, independent audit committees, rotating audit firms/partners, conflict of interest policies, whistleblower policies, and document retention policies—and then at factors (such as board size, board composition, organization size, field, and funding source) to determine which factors were associated with those indicators. It also looked at specific self-reported practices, including the frequency and consequences of financial transactions between organizations and their board members, board compensation, levels of board activity in different roles, and the correlation between various factors and that activity, and board composition. The study's design, however, allows for only nominal analysis as to whether the six SOX-type practices are effective.

There are, however, a number of studies involving for-profit corporate practices. The question then is what can the nonprofit sector learn from for-profit corporate governance? Corporate governance "best practices" in the nonprofit sector have borrowed heavily from the for-profit world. The history of regulation and the pressure for greater self-regulation in both sectors have ebbed and flowed, emerging most strongly in the face of public indignation over abuses and crises, real or perceived, and the belief—or at least hope—that imposing additional "safeguards" can forestall similar

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[38] When asked which governance practices have been empirically established to be effective during an interview for this report, Marion R. Fremont Smith, Senior Research Fellow and Adjunct Lecturer at the Hauser Center for Nonprofit Organizations at Harvard University, observed: "We have anecdotes of what fails, but no evidence of what works." *Interview with Marion Fremont Smith*, September 27, 2007. *See* also Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 Fordham L. Rev. 521, particularly note 81 (2007).

[39] Francie Ostrower, Nonprofit Governance in the United States (The Urban Institute 2007) (hereinafter 2007 Urban Institute Study"), at 21. There are organizations that survey nonprofit organizations from time to time about their governance practices. *See*, *e.g.*, *The 2007 Grant Thornton LLP National Board Governance Survey for Not-for-Profit Organizations*.

occurrences in the future.[40] As noted previously, the current period of intense scrutiny with respect to governance relates back to Enron and other corporate scandals and Congress' subsequent enactment of SOX. In fact, much of the discussion of "best practices" in the nonprofit sector since that time has focused on the extent to which SOX-type reforms (sometimes broadened to include related changes to the exchange rules) should be adopted—or required—of nonprofit corporations.[41]

Professor Robert Clark of Harvard University, in a 2005 paper,[42] reviewed the empirical studies then to date involving publicly-traded corporations and their adoption of SOX-type governance measures, such as independent directors, section 404 internal controls, an independent audit committee, and restricting non-audit services provided by the auditing firm, and concluded that "the search for strong empirical evidence supporting a belief that key items in the recent wave of corporate governance changes will have a major positive impact is generally disappointing."[43] He also examined the specific "good governance practices" advocated by the rating agencies, such as a supermajority of independent directors, a relatively small board size, a separate (*i.e.*, independent, non-CEO) board chairman, a specified number and length of meetings, regular executive sessions (at which company officers are not present), regular evaluations of the CEO, regular self-evaluations of the board, minimum stock ownership requirements for directors, and limits on director tenure (term limits and/or retirement ages). Citing a plethora of studies examining these and similar "good practices," Professor Clark concluded: "For most of these practices, the empirical evidence bearing on their correlation with shareholder value is limited or mixed or both, and does not prove decisively that they cause increases in value."[44]

In some sense, this is not surprising. For example, on paper, Enron had in place a rigorous conflict of interest policy and other controls. The problems at Enron related to implementation, including the board not demanding or ensuring it understood the pertinent information, the board waiving conflicts that should not have been waived, and the board not responding appropriately once problems began to emerge.**[45]** Anecdotal

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[40] *See* Appendix 2 for a discussion of for-profit corporate governance. The enactment of groundbreaking federal securities laws often was prompted by profound failure or crisis.

[41] *See*, *e.g.*, Paul D. Brode & Richard L. Prebil, *The Impact of Sarbanes-Oxley on Private & Nonprofit Companies* (National Directors Institute 2005); Carl Oxholm III, *Sarbanes-Oxley in Higher Education: Bringing Corporate America's "Best Practices" to Academia*, 31 J.C. & U.L. 351 (2005); Moody's Investor Services, *Governance of Not-for-Profit Healthcare* Organization (2005); Fitch Ratings, *Sarbanes-Oxley and Not-For-Profit Hospitals: Increased Transparency and Improved* Accountability (2005); Standard & Poor's, *Under Legislative Scrutiny, The U.S. Nonprofit Sector Embraces Corporate-Style Oversight* (2005) and "Research: U.S. Not-for-Profit Health Care Sector Explores the Benefits of Sarbanes-Oxley Compliance *(2005). See* also ABA Coordinating Committee on Nonprofit Governance, *supra* note 16.

[42] Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 Ga. St. U.L. Rev. 251 (2005). See also Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2005).

[43] Clark, *supra* note 43, at 308. The one exception involved disclosure, which he found to be positively correlated with reducing the volatility of stocks. *Id.* at 304-05.

[44] *Id.* at 303.

[45] *See* William Powers, Jr., Chairman of the Special Investigation Committee, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (Feb. 1, 2002), at 148:

evidence such as this may indicate that good governance in the end is a question of the values, active engagement, and accountability of those in charge, rather than the adoption of specific practices or policies.

Even if empirical evidence suggested that certain “best practices” were “best” for business corporations, it is not at all clear that this would translate to nonprofit corporations.[46] One dramatic difference between business corporations and nonprofits is that the former has almost a singular purpose—the overarching purpose of business corporations is to promote the welfare of shareholders, specifically to maximize shareholder value. The objective of corporate governance initiatives in this sector then is to protect investors and promote fair and efficient markets that both encourage investors to provide capital and protect investors who do so. For example, such initiatives endeavor to protect shareholders from attempts by management to benefit itself to the detriment of shareholders, to prevent insiders from trading on non-public information, and to require timely public release of accurate financial information that investors should have in determining whether to buy, sell, or hold securities. But even with that more limited and approachable standard, the empirical data either fails to support or is inconclusive or controversial with respect to the efficacy of many “good governance practices” in the for-profit setting. The purposes of nonprofit organizations are more diverse and complicated and, concomitantly, the roles of their boards are broader and more nuanced than in the for-profit sector. This diversity and complexity in the nonprofit sector may suggest that specific good governance practices are even less likely to be effective in the nonprofit context.

VI. REGULATION AND SELF-REGULATION OF NONPROFIT GOVERNANCE OUTSIDE OF THE IRS

A. *Introduction*

One of the issues that arises is whether there is a need for the IRS to be more involved in nonprofit governance beyond the specific statutory requirements in the tax laws. Nonprofit organizations can be regulated by many—and sometimes conflicting—authorities. Because nonprofit organizations are established under state law, states historically have had the principal responsibility and greatest authority to regulate in the area. Organizations with offices in more than one state or that solicit contributions in multiple jurisdictions may be subject to the laws of a number of states. There also are industry-specific accreditation agencies, standards relating to participation in particular

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> Oversight of the related-party transactions by Enron’s Board of Directors and Management failed for many reasons. As a threshold matter, in our opinion the very concept of related-party transactions of this magnitude with the CFO was flawed. The Board put many controls in place, but the controls were not adequate, and they were not adequately implemented. Some senior members of Management did not exercise sufficient oversight, and did not respond adequately when issues arose that required a vigorous response. The Board assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the reviews only in a cursory way. The Board of Directors was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it. Enron’s outside auditors supposedly examined Enron’s internal controls, but did not identify or bring to the Audit Committee’s attention the inadequacies in their implementation.

[46] *See* Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. Davis L. Rev. 205 (2004).

membership groups, and innumerable voluntary standards and publications from leading organizations regarding nonprofit governance. Because large, sophisticated and complex organizations are subject to regulation and/or are accredited and, in any event, have numerous governance resources available to them, it is less clear what the IRS adds to the governance discussion in their cases. Conversely, while smaller and more rural organizations have less governance resources available to them, there is a greater need to tread lightly because of the burdens flowing from encouraging unnecessarily extensive governance reforms, the fact that the costs of adopting practices that may be advisable for larger nonprofits simply may not be worth the benefits, and the reality that the costs of governance will consume charitable assets that could otherwise be devoted to the organizations' programs. Finally, while disclosure and transparency, facilitated by the public availability of Forms 990 and 1023, undeniably play an influential role in encouraging appropriate nonprofit governance, they have limitations. This section briefly reviews these regulation and self-regulation measures involving nonprofit governance outside of the IRS.

B. *States*

Whether formed as nonprofit corporations or charitable trusts, charities are creatures of state law. The laws under which they are formed and the laws controlling their structure and finances are state laws, and their internal affairs remain subject to state laws even when they operate entirely in other geographical jurisdictions.[47] While not all states distinguish the formation and operation of nonprofit and business corporations by separate statutory schemes,[48] every state accords to the attorney general the authority to correct abuses by charitable fiduciaries and to bring them to account in the courts.[49] As a mechanism to protect charitable assets, and flowing from the formative authority found in state law, states nonprofit laws speak with increasing specificity to governance practices.[50]

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[47] Under long-standing, although sometimes criticized, conflict-of-laws principles for business corporations, the "internal affairs doctrine" holds that the law of the state of incorporation applies to regulate the intra-corporate matters of a foreign corporation authorized to transact business in the forum state. However, a few states are particularly concerned about the "pseudo-foreign corporation"—the entity whose only tie to the state of incorporation is incorporation itself. California and New York, in particular, have adopted statutes applying much of their domestic corporate law to foreign corporations operating in-state that meet a threshold test. For a discussion of the internal affairs doctrine in the context of nonprofit corporations, see, *e.g.*, American Center for Education, Inc. v. Cavnar, 145 Cal. Rptr. 736, 742 (Cal. App. 1978); National Association for the Advancement of Colored People v. Golding, 679 A.2d 554, 559 (Md. 1996).

[48] *See*, *e.g.*, Delaware General Corporations Law § 101.

[49] The authority of the state attorneys general typically is very broad. *See*, *e.g.*, In re Milton Hershey Sch. Trust, 807 A.2d 324, 328 (Pa. Commw. Ct. 2002); In re the Charles M. Bair Family Trust, 208 MT 144 (April 29, 2008). While standing to enforce fiduciary duties has long been limited to the state attorney general and insiders with sufficient stake in the nonprofit's governance, such as directors, officers, and members of the corporation, *see*, *e.g.*, Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 699 A.2d 995, 998 (Conn. 1997), the doctrine of limited standing has occasionally been relaxed to permit others to enforce these obligations, particularly in response to perceived inaction by the state attorney general, *see, e.g.*, Smithers v. St. Luke's-Roosevelt Hospital Center, 281 A.D. 2d 127 (App. Div. 1st Dep. 2001). *See* generally, Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable Donor Standing*, 41 GA. L. REV. 1183 (2007).

[50] California has the most detailed state laws requiring particular governance practices, specifying among other things the composition of the audit committee for those corporate-form charities required by state law to have audited financial statements (Cal. Gov. Code Section 12586(e)(2)); the procedure by which the governing body of a charity, regardless of form, must review the compensation of certain corporate officers (Cal. Gov. Code Section 12586(g)); and the maximum percentage of a nonprofit public benefit corporation's board that may consist of persons who are compensated by the charity or family members of those whom the charity compensates (Cal. Corp. Code Section 5227).

The conceptual advantages of state supervision of nonprofit governance are manifest. The duties of care and loyalty imposed upon nonprofit board members and other fiduciaries that are the foundation of good governance are evolving matters of state law. These duties are rarely expressed as "bright lines" that forbid certain actions and mandate others, but rather are relative standards that invite comparison to others in similar positions in comparable subsectors and geographical areas. What passes for adequate board conduct in one part of the country may be an anathema to the public in another, given the diversity of nonprofit activity and the variety of governance practices around the country. Local regulation respects those differences and allows innovation even as it accords discretion to the overseers in the offices of the attorneys general to define the boundaries of acceptable conduct through individual enforcement action. Where action is appropriate, states generally are closer to the activity and more able to be responsive. State regulation and supervision also promotes experimentation among states, allowing for individual states to experiment and for other states to then see what works. More importantly, the equitable powers invested in state courts and the power of the state attorneys general, unknown in the federal tax code but historic and long-standing in the states, generally permit solutions to malfeasance and nonfeasance, such as the removal of miscreant board members, that are tailored to the violations of law and minimize depletion of the very assets that the enforcement actions are designed to protect.[51]

The incursion of the IRS into matters of nonprofit governance beyond enforcement of the tax laws represents a departure from that long-standing division of authority, notwithstanding its gradual erosion over the past 40 years. The IRS has only limited formal enforcement tools—revocation of exemption, and in certain cases the ability to assess excise taxes. Moreover, any effort to impose a uniform set of federal standards risks obstructing the evolution that is so critical to the sector. At the same time, however, we recognize the persistently limited resources devoted to charities' regulation by the states has encouraged an expanded role for the IRS in promoting stronger nonprofit governance. Although charitable fundraising is subject to regulation in 39 states, few but the most active states devote significant staffing to charities' oversight, including oversight of nonprofit governance, a pattern that has remained unchanged in more than thirty years.[52] At the same time, the enforcement staffs in even the most active states are increasingly disproportionate to the number of charities operating and soliciting in their jurisdictions as the nonprofit sector has grown dramatically in recent decades.[53] We also recognize the geographically expansive nature of nonprofit activity, without regard to state borders, that makes federal involvement more attractive. The

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[51] For example, New York Not-for-Profit Corporation Law § 706(d) provides "an action procuring a judgment removing a director may be brought by the attorney general or by ten per cent of the members, whether or not entitled to vote." *See also,* Adelphi University v. Board of Regents of the State of New York, 229 A.D. 2d 36 (App. Div. 3rd Dept. 1997)(board of regents of state education department properly delegated authority under education law to private parties to bring proceeding to remove trustees for permitting excessive compensation to CEO and unlawful self-dealing by trustees).

[52] David Biemesderfer & Andras Kosaras, The Value of Relationships Between State Charity Regulators and Philanthropy (2006), at. 4.

[53] New York, for example, has the largest charities enforcement staff in the country, with more than 20 attorneys. However, the New York Attorney General's website states that New York has almost 50,000 charitable organizations registered to operate and/or solicit funds within its borders. http://bartlett.oag.state.ny.us/Char_Forms/search_charities.jsp.

Internet has facilitated this interstate and international expansion, not only in the solicitation of funds, but also in the operation of programs. The fact that an organization that is active in a state with developed expectations about nonprofit governance practices need only adhere to the potentially more relaxed rules of its state of incorporation—even if it has no physical presence in the latter jurisdiction—becomes increasingly hard to accept from interstate nonprofit operators.[54]

It is perhaps unsurprising then that in our discussions with state charities regulators we found them generally receptive to the expanding role of the IRS in matters of nonprofit governance, at least with respect to additional Form 990 governance disclosures, an expanded educational role for the IRS, and, most importantly, the IRS sharing data with the states.[55] States requiring reporting by charities often accept the federal Form 990 for their purposes,[56] and the new form's expanded inquiries into governance provides additional tools for state charities regulators to identify organizations that are lacking some of the governance indicators that are believed associated with the protection of charitable assets.[57] In the absence of adequate enforcement resources at the state level, the IRS can play an important educational role that promotes self-correction. In sum, our interviews indicate that the recent expansion of federal interest in nonprofit governance is viewed by the states as a complement and supplement to state efforts, rather than as a threat to their authority.[58]

However, state regulators' receptivity to an expanded federal role in matters of nonprofit governance is not without qualification. Concerns include the federalization of governance issues and impinging on the enforcement discretion of the states. One state regulator from a state active in charity regulation speaking to the "duplicative" state

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[54] For example, Delaware, a popular state of incorporation for organizations even with no programmatic presence in that state, permits corporations to be formed with only a single director. Delaware General Corporation Law § 141(b). But s*ee* American Center for Education, Inc. v. Cavnar, 80 Cal. App. 3d 476, 478 (Cal. 1978)("[W]e believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law, merely because the founders chose to incorporate elsewhere.").

[55] We also note that the IRS plays a collaborative role with the states in connection with sharing certain information about charities. Prior to Congress adopting the Pension Protection Act of 2006, P.L. 109-280, federal tax law imposed strict limits on the information the IRS could disclose to state law enforcement officials about concerns involving section 501(c)(3) organizations. Under new IRC section 6103(p)(4), the state official charged with regulating charities may request in writing (on Form 8821), and the IRS must then disclose, a notice of proposed revocation of exempt status, or proposed refusal to recognize exemption; a notice of propose deficiency of tax under section 507 or the private foundation provisions in chapter 42; the names, addresses and taxpayer identification numbers of organizations that have applied for exemption; and return information pertinent to any of the above. Similar disclosures are now permitted for any 501(c) organization but only for the purpose of, and to the extent necessary in, the administration of state laws regarding charitable assets. *See* IRC sections 6103, 6104, 7213, 7213A and 7413.

[56] According to the National Association of State Charities Officials, *s*tate regulators have been accepting the Form 990 as a state filing instrument, at least in part, since 1981. *See* National Association of State Charity Officials Comments on proposed Changes to Form 990, September 14, 2007, http://www.nasconet.org/NASCO_Comments_IRS_Form_990.pdf.

[57] One representative from a state attorney general's office, interviewed along with others from the National Association of State Charities Officials, described the new governance questions as "great" because not all states have the capacity to monitor nonprofits and, if the IRS does not ask governance questions of these organizations, no one will." (Telephone interview with state charities regulators, National Association of State Charity Officials, November 5, 2007).

[58] James Tierney, the former Attorney General of Maine, dismissed the prospect of confusion caused by differences in state and federal approaches to nonprofit governance as something that the various states must confront every day, observing "We're not France." . (Telephone interview with James Tierney, David E. Ormstedt, Tam Ormiston, and Cindy Lott, National State Attorneys General Project, Columbia University Law School, October 29, 2007).

and federal powers stated that "it is for us [the states] to decide."[59] That regulator also remarked: "People on the ground know who is doing what within their jurisdiction, something that is not readily available to a national organization."[60] Former and current state regulators interviewed for this report expressed hesitation about unintended consequences that may occur when governance matters are raised through questions on federal forms such as the Form 990 or Form 1023, particularly when the subjects of those inquiries are not tied to explicit authority in the Internal Revenue Code but, rather, are intended to "drive behavior" toward generally accepted indicators of good governance. To the extent that the more active states with more developed nonprofit laws already have a comprehensive framework in place articulating governance expectations, these regulators note a risk that the necessarily more diluted federal articulation, one that has been crafted for national consumption, will stop short of those more vigorous state norms.[61]

We believe that the primacy of state law in matters of nonprofit governance (other than with respect to the tax code) remains unassailable, and that, on the merits, the states are better positioned than the IRS to regulate nonprofit governance in a manner that is both sensitive to the diversity of and experimentation in the sector and meaningful in the legal remedies that are available to correct governance failures. After decades of inadequate state funding for charities enforcement, and with the interstate reach of an increasing number of charities, however, an expanded IRS role in this area is unsurprising. Moreover, as states have become more cognizant of their responsibility to supervise the administration of charitable assets—and without a pervasive solution to the endemic lack of resources for that effort in many states—we generally found an acceptance of an increased role for the IRS has emerged among state regulators. Thus, while we believe the IRS needs to tread carefully to ensure that it does not usurp the primacy of the states, and that it respects diversity and experimentation, we do not believe that the historically dominant role of the states is a bar to greater IRS involvement in governance.

C. *Models Outside Of Federal and State Regulations*

In addition to the regulations of federal and state entities, there is a continuum of self-regulatory models within the nonprofit sector ranging from systems of accreditation that carry the force of law and sanctions for violation to standards that can be adopted by nonprofit organizations on a voluntary basis, without external verification. In between these two extremes are standards that members of an association or network of similar organizations may be required to adopt in order to benefit from membership in the

[59] A representative from a state attorney general's office in a discussion with ACT members, October 4, 2007.

[60] *Id.*

[61] Offering a phrase that arose in other contexts, one former regulator interviewed for this report observed that, in matters of governance: "One size does not fit all." While that observation was also made by others interviewed for this report in reference to the need to distinguish among diverse organizations, here it connoted the pluralistic value of a federalist approach to the regulation of governance.

umbrella organization promulgating such standards.[62] The following section touches briefly on these different models.

1. Accreditation Systems

Over time, accreditation systems have evolved that focus on specific types of organizations. In the usual case, accreditation is a form of self-regulation typically intended both to ensure high standards and improve quality in specific segments and to minimize external control by engendering public confidence in the accreditation process. The assumption is that some prescriptive standards are merited because there are sufficient commonalities across the class of organizations involved. Many accreditation schemes are quite comprehensive and call for compliance with extensive governance and other requirements, comprehensive applications, self-assessments, and site visits.

While accreditation in education and health care is probably the most well known, there are numerous accreditation organizations, including for museums,[63] zoos and aquariums,[64] camps,[65] land trusts,[66] early childhood programs,[67] parks,[68] research organizations,[69] and other groups.[70]

There are many accrediting organizations in the education field, depending on the discipline, the type of institution, the academic level, and other factors. For example, in the area of postsecondary education, the U.S. Secretary of Education recognizes various accrediting agencies and state approval agencies as reliable authorities to accredit postsecondary institutions and programs and then lists on a publicly available database those postsecondary institutions and programs accredited by an approved agency.[71] It is the norm for such agencies to focus on governance requirements. An illustration is the Middle States Commission on Higher Education, which accredits degree-granting colleges and universities in Delaware, the District of Columbia, Maryland, New Jersey, New York, Pennsylvania, Puerto Rico, the U.S. Virgin Islands,

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[62] Panel *Principles*, *supra* note 13, at 4 (paraphrased from the Preamble).

[63] *See*, *e.g.*, the accreditation program of the American Association of Museums, http://www.aam-us.org/museumresources/accred/index.cfm.

[64] *See*, *e.g.*, the accreditation program of the Association of Zoos & Aquariums, http://www.aza.org/Accreditation.

[65] *See*, *e.g.*, the accreditation program of the American Camp Association, http://www.acacamps.org/accreditation.

[66] *See*, *e.g.*, the accreditation program of the Land Trust Alliance, http://www.landtrustaccreditation.org.

[67] *See* http://www.nccic.org/poptopics/nationalaccred.html for a listing of national accreditation organizations for early childhood programs.

[68] *See*. *e.g.*, the accreditation program of the National Recreation and Park Association, http://www.nrpa.org/content/default.aspx?documentId=1038.

[69] *See*, *e.g.*, the accreditation programs of the Association for Assessment and Accreditation of Laboratory Animal Care, http://www.aaalac.org/about/index.cfm, and The Association for Accreditation of Human Research Participant Protection Programs, http://www.ncddr.org/products/researchexchange/v07n01/7_aahrpp.html.

[70] For example, the Evangelical Council for Financial Accountability, http://www.ecfa.org/Content.aspx?PageName=WhatIsECFA, accredits "leading Christian nonprofit organizations that faithfully demonstrate compliance with established standards for financial accountability, fund-raising and board governance."

[71] U.S. Department of Education Database of Accredited Postsecondary Institutions and Programs, http://ope.ed.gov/accreditation.

and several locations internationally. Colleges and universities are subject to a rigorous accreditation review every ten years, and to a lesser review approximately five years into the cycle. In addition to the eligibility requirements, many of which bear on governance, half of the 14 standards for accreditation[72] involve governance-type requirements. Over five pages on "Leadership and Governance" provide a fairly detailed description of the role of the governing body of a college or university, recognizing that differences may be appropriate. Among the many matters discussed as context or fundamental are the importance of: a diverse governing body (view points, interests, experiences, and characteristics such as age, race, ethnicity, and gender); periodic self-assessment by the governing body of itself, of institutional leadership, and of governance; orientation of new members and continuing updates for current members; selection, evaluation, and determining of compensation for the CEO, and, in some cases, other major members of executive management; leadership transition planning; a governing body not chaired by the CEO; and a conflict of interest policy for the governing body that addresses matters such as remuneration, contractual relationships, employment, family, financial, or other interests that could pose conflicts of interest and that assures that those interests are disclosed and do not interfere with the impartiality of governing board members or outweigh the greater duty to secure and ensure the academic and fiscal integrity of the institution. The final page and-a-half provides optional analysis and evidence, and focuses principally on policies, handbooks, plans, and other writings. The involvement of faculty and, to a lesser extent, of students is a theme throughout the accreditation standards.[73]

There also are a number of accrediting agencies in the health care area, depending on the type of organization, services offered, and other factors.[74] The most prominent is The Joint Commission[75] (formerly, the Joint Commission on the Accreditation of Healthcare Organizations), which subjects most hospitals and certain other health care organizations to a demanding accreditation review at least every three years. Its comprehensive manual,[76] over 500 pages in length, requires hospitals to comply with numerous specific requirements, including in connection with their governance. A key theme throughout is the inclusion of the medical staff and medical staff leadership in decision making.

While accreditation systems vary, each has the advantage of being tailored to the specific type of organization subject to review, and is therefore better able to create requirements that are suitable in its context. In contradistinction, the IRS oversees an

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[72] *Characteristics of Excellence in Higher Education* (2006), http://www.msche.org/publications/CHX06060320124919.pdf. Governance-type standards are included in the following requirements: mission and goals; planning, resource allocation, and institutional renewal; institutional resources; leadership and governance; administration; integrity; and institutional assessment.

[73] *Id.*

[74] *See*, *e.g.*, the accreditation programs of: The American Osteopathic Association, https://www.doonline.org/index.cfm?PageID=edu_main&au=D&SubPageID=acc_main, The National Committee for Quality Assurance, http://www.ncqa.org/tabid/58/Default.aspx, the Accreditation Commission for Healthcare, http://www.achc.org, and URAC, http://www.urac.org

[75] The Joint Commission, http://www.jointcommission.org.

[76] *Comprehensive Accreditation Manual for Hospitals: The Official Handbook (*updated September 2007).

enormously broad range of tax-exempt organizations and therefore its governance materials are much more prone to suffer from a "one size fits all" approach. Even within accreditation schemes, however, it is noteworthy that there typically is broad deference to the role and judgment of a governing board, rather than specific prescriptions.

2. Voluntary Standards and Participation in Membership Groups

There are today innumerable groups that purport to rate charities, have created voluntary standards for charitable organizations, and/or that have released suggested "best practices." As the Panel on the Nonprofit Sector noted in its *Principles for Good Governance and Ethical Practice*, there are many existing systems, dating back to at least 1918 when a group of nonprofits established the National Charities Information Bureau ("NCIB") to educate the public about the ethical practices and stewardship of nonprofit organizations seeking donations.[77] The NCIB and the Philanthropic Advisory Service of the Council of Better Business Bureaus' Foundation merged in 2001, with the Standards for Charity Accountability of the Better Business Bureau ("BBB") superseding the NCIB's prior standards.[78]

The BBB has created a voluntary system of charity accreditation based on its Standards for Charity Accountability, which are among the most prescriptive of nonprofit standards, including with respect to governance.[79] For example, in the governance area, the board must provide adequate oversight of the charity's operations and staff, including regularly scheduled appraisals of the CEO's performance, evidence of disbursement controls such as board approval of the budget, fundraising practices, establishment of a conflict of interest policy, and establishment of accounting procedures sufficient to safeguard charity finances; the governing board must be comprised of at least five voting members, a maximum of ten percent of whom (or one member in the case of a small board) is permitted to be directly or indirectly compensated (and compensated members cannot serve as chair or treasurer); the board must meet a minimum of three evenly spaced meetings per year, at least two of which meetings must be with face-to-face participation; no transaction is permitted in which any board or staff member has a material conflicting interest with the charity; and the board must have a policy requiring that the organization assess, at least every two years, the organization's performance, effectiveness, and future actions required to meet its mission, and a written report of the assessment must be submitted to the board for its approval.

National charities can voluntarily participate in the BBB Wise Giving Alliance's Online Charity Evaluation and Reporting System, pursuant to which the charity provides information and the BBB generates an Alliance report available on give.org that summarizes basic facts about a charity's governance, programs, finances, fundraising, and operations and shows whether or not the subject charity meets the comprehensive

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[77] Panel *Principles*, supra note 13, at 3-4.

[78] The Standards for Charity Accountability, http://www.give.org/standards/newcbbbstds.asp.

[79] The key here, of course, is that adoption of such standards is voluntary. They would not be appropriate for many organizations, and certainly should not be imposed.

Standards for Charity Accountability.[80] A charity meeting all of the standards is considered a BBB Accredited Charity.[81] In addition, a charity that meets the Standards for Charity Accountability has the option of applying for the Better Business Bureau's Charity Seal Program, pursuant to which it can be designated a BBB Accredited Charity Seal Holder and can display a seal that indicates it meets the standards. The goals of the seal program are "to offer a highly visible accountability tool that will help inform donors, assist charities in establishing their commitment to ethical practices, and encourage greater confidence in giving."[82] In addition to these programs, the BBB prepares evaluative reports about charities upon request from the public and also receives complaints about charities, which may be included in reports.[83] Finally, while the BBB focuses on national charities, many local BBBs engage in similar activities with respect to charities in their regions.

Other groups take different approaches. Some organizations, such as Charity Navigator[84] and the American Institute of Philanthropy,[85] as well as publications, such as Forbes Magazine and Worth Magazine, rate charities, typically based on financial criteria set forth in their Forms 990. A new website, GreatNonprofits,[86] provides a forum for the public to rate and review nonprofits.

GuideStar performs a number of functions today. It makes Forms 990 and other information about charities readily available to the public for free. For a fee, it also searches and packages data, based on public filings already required by law and private information provided voluntarily by charities and philanthropic organizations, that support industry best practices for governmental bodies, businesses, grantmakers, and others. It provides educational information and sector news, and encourages charities to provide additional information that is then available to the public.

There are national membership organizations such as Independent Sector, the Council on Foundations, and the Philanthropy Roundtable that are dedicated to assisting charitable organizations comply with legal and ethical mandates and achieve their objectives. There also are state programs that offer standards and, in some cases, certification programs.[87] Earlier in this report we cited a number of organizations that have released voluntary standards and/or recommended "best practices" for charitable

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[80] The Better Business Bureau's Wise Giving Alliance's Online Charity Evaluation and Reporting System, http://us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=f822f4e6-dd71-4721-ba5f-46e5056a79f5.

[81] *See* discussion of a Better Business Bureau Accredited Charity, http://charityreports.bbb.org/public/accreditation.aspx.

[82] *See* discussion of Better Business Bureau Accredited Charity Seal Holder Program, http://charityreports.bbb.org/public/accreditation.aspx . A license agreement and sliding scale fee are involved in the seal program.

[83] *See* the Better Business Bureau discussion about evaluative reports and complaints, http://us.bbb.org/WWWRoot/SitePage.aspx?site=113&id=b18e1411-c420-47aa-a086-0a711d9af7e7.

[84] Charity Navigator, http://www.charitynavigator.org.

[85] American Institute of Philanthropy, http://www.charitywatch.org/toprated.html.

[86] GreatNonprofits, http://www.greatnonprofits.org.

[87] *See*, *e.g.*, Maryland's Standards for Excellence program, a project of the Maryland Association of Nonprofit Organizations, http://www.standardsforexcellence.org, which provides voluntary standards and a certification program for nonprofit organizations in Maryland. The program has been replicated in nine states. *Id.*

organizations.[88] There also are innumerable situations where a tax-exempt organization's affiliation with or membership in another organization requires or encourages the former organization to adopt specific governance and other measures. This can include, for example, organizations affiliated with a college or university, organizations affiliated with a religious order, and local branches of a national organization such as youth groups or health organizations focused on a specific disease, among others.

While this is a cursory review of the voluntary standards available to the thoughtful nonprofit, several points are worthy of note. First, many organizations have released publications on nonprofit governance. Second, these organizations often bring tremendous expertise to their analyses.[89] Third, while there are common themes, even these governance "experts" can disagree.[90] These differences suggest the advisability

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[88] *See supra* notes 12-17.

[89] For example, in developing its set of 33 Principles, the Panel on the Nonprofit Sector convened 34 leaders from charities, foundations, academia and oversight agencies to form a special Advisory Committee on Self-Regulation, commissioned two studies of self-regulation regimens already in use, and examined principles and standards drawn from more than 50 such systems, including selections from the nonprofit and for-profit sectors. In addition, the first draft was circulated for public comment and further modified as a result. *See* Panel *Principles*, *supra* note 13, at 4. The BBB's Standards for Charity Accountability were developed with "professional and technical assistance from representatives of small and large charitable organizations, the accounting profession, grant making foundations, corporate contributions officers, regulatory agencies, research organizations and the BBBs. The BBB Wise Giving Alliance also commissioned significant independent research on donor expectations to ensure that the views of the general public were reflected in the standards." *See supra* note 81.

[90] *See*, *e.g.*, Adam Meyerson, *We're Not Signing It: Our Concerns About Independent Sector's "Principles for Good Governance and Ethical Practice*," Philanthropy Magazine (Dec. 17, 2007), http://www.philanthropyroundtable.org/article.asp?article=1510&paper=1&cat=1, in which the president of the Philanthropy Roundtable explained why the organization would not be signing on to the Panel's *Principles*. It "applauds Independent Sector and the Panel. . .for their tireless and well-organized work to improve nonprofit governance, board financial oversight, fundraising practices, and compliance with the law" and found "most of the 33 principles" to be "quite sensible and offer a helpful guide for self-assessment" but then set forth its three reasons for not recommending the document as a whole:

> First, a number of the Independent Sector principles take an arbitrary and one-size-fits-all approach to setting standards for a very diverse sector.
>
> Second, the Independent Sector principles imply improperly that foundations act unethically or practice misgovernance unless their boards include members from diverse backgrounds.
>
> Third, while it is entirely appropriate for Independent Sector to put together standards of conduct for its own members and for anyone else who wishes to adhere to them, it would be a mistake for the philanthropic community as a whole to endorse the entire document. Despite Independent Sector's assurance that its principles represent "standards of practice that organizations are encouraged, but not required to meet," a number of the more problematic principles could be written into law [including by Senators Baucus and Grassley] or regulation [including by the IRS] if it is perceived that there is a wide consensus behind them in the nonprofit community.

The president's note provides as examples of principles that "unnecessarily restrict the ability of donors and trustees to use their best judgment in carrying out their charitable objectives" Principle 10, which suggests a minimum board size of five in most situations, and Principle 20, which includes a strong presumption against compensating governing body members. With respect to governing body size he argues: "Does anyone really think the Gates or Dell Foundation would be more effective or better governed if they had six or seven board members instead of two or three? And if not, why is this one-size-fits-all rule in there?" In connection with compensation, he points to the "long and venerable tradition" of both volunteer board service, which is more common, and compensated board service, and opines that "philanthropic excellence" and "philanthropic mediocrity" are present in both, and that one tradition should not be favored over the other. He provides specific circumstances where a foundation might legitimately consider paying board members situations.

The president also contends that the Panel's Principle 11, which speaks to boards including members with diverse backgrounds, including but not limited to ethnic, racial and gender, experience, and organizational and financial skills, misunderstands diversity. He asserts: "The goal should not be to diversify each board--that's a recipe for sector-wide homogeneity. The goal should be a sufficiently vibrant sector with lots of different foundations representing lots of different interests, philosophies, and philanthropic strategies." With respect to philosophical outlooks and life experiences, he notes that a grantmaking organization may, in fact, avoid paralysis and "run best where there are common values and a shared sense of mission" and "strong mutual trust among board members, so they can speak more freely with each other. . . ." In connection with varying backgrounds and skills, he argues that

of deferring to an organization's governing body and to the danger of too much prescription, particularly given the dearth of empirical data in the nonprofit sector.[91]

D. *Disclosure and Transparency*

"Sunlight is said to be the best of disinfectants; electric light the most efficient of policemen."

Justice Louis D. Brandeis 1914[92]

Complementing the role played by accreditation systems for certain types of organizations and voluntary standards and ratings for charities is the role that disclosure and transparency can play. In addition to the legally-mandated public availability of Forms 990 and 1023, significant amounts of information—whether public, released by the organization itself, or otherwise available—are readily accessible through the Internet. This allows the general public (and its attendant representatives such as the media and various watchdog groups) to peer into an organization's operations, programs, and finances. This public access has been enhanced significantly in recent years with the advent of e-filing and organizations such as Guidestar.

Conventional wisdom suggests that this greater disclosure will facilitate enforcement by those agencies so charged and enable the public (itself and as represented by the media and watchdog groups) to enhance this enforcement capacity. Additionally, it is reasoned that a nonprofit organization focused on public disclosure will seek to improve its behavior in order to appeal to potential funders and other constituencies, will be deterred from taking certain actions that cast the organization in a poor light, and may feel compelled to meet purported standards of excellence.

While we are not denigrating the role that disclosure and transparency play in strengthening the sector, and we respect the value placed on it by Justice Brandeis, the Filer Commission, Congress, the IRS, and others, it is important not to overstate its significance in enhancing enforcement or to underestimate the costs involved. As Professor Dana Brakman Reiser concluded in an article on the disclosure focus of recent legislative proposals,[93] disclosure *per se* is no panacea. The cost in time and money for otherwise compliant organizations to adhere to new requirements must be considered, as well as the extent to which they detract from an organization's focus on

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while a board needs to draw on such perspectives, that does not necessitate a board seat. Finally, he looks to the need for race, gender, and ethnicity diversity as "factually unmerited," having "the unintended consequence of encouraging philanthropists to focus their charitable resources only on the communities where they are personally most familiar" and "contrary to principles of philanthropic freedom."

For a more thorough assessment of the pros and cons of board compensation, *see* William A. Schambra, *Compensating Foundation Directors?*, Hudson Institute (March 18, 2008), http://www.hudson.org/index.cfm?fuseaction=publication_details&id=5497.

[91] While we appreciate that there are organizations that jeopardize their tax exemptions and act inappropriately, we believe nonprofits overwhelmingly want to do the right thing and appreciate the reputational risks, potential loss of resources, and impact on their ability to achieve their goals if they act otherwise.

[92] Louis D. Brandeis, Other People's Money 62 (Richard M. Abrams ed.1967), as cited in Reiser, *supra* note 19, at 605.

[93] Reiser, *supra* note 19.

its mission. The serious funding and staff shortages faced by regulators limit the value of "better data" to increase enforcement. In addition, the analogy to the for-profit role of shareholders who can vote with their feet or bring lawsuits is limited in the nonprofit sector where individual donors do not possess similar clout or have similar metrics for assessing an organization. While funders have greater leverage with an organization where they control meaningful grant or other support, there are not agreed-upon criteria that readily lend themselves to metrics (such as share price) as is the case with public companies. In any event, there is little or no empirical evidence to date to show if "sufficient and comprehensible" information were made available to the public that donors would "use it comparatively and donate more time and money to more accountable nonprofits."[94] And "among individual donors, evidence has not yet suggested that donor choice will be a robust enforcement tool."[95]

Thus efforts to increase "disclosure" as a means of engendering better compliance or improving governance must keep these shortcomings in mind. In this vein, when the Joint Committee on Taxation in 2000 recommended greater disclosure of information relating to tax-exempt organizations, it balanced the competing policy objectives and looked at a number of factors, including:[96]

- the public interest served by the disclosure of the information and the countervailing reasons for nondisclosure;
- whether the information is relevant to determining compliance with the law;
- whether disclosure of the information will increase or reduce voluntary compliance;
- whether and how disclosure of the information will modify the behavior of tax-exempt organizations and those associated with such organizations, including donors;
- privacy concerns of the organization and others;
- the costs involved in complying with disclosure requirements and whether the costs are reasonable given the benefit to be derived from disclosure of the information;
- whether the information should be disclosed by the IRS or the organization;
- whether the Federal tax laws should be used to collect the information;
- whether the information will be understandable to those with an interest in the information; and
- the extent to which the information is subject to misuse.

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[94] *Id.* at 603.

[95] *Id.* at 603, note 176.

[96] Joint Comm. on Tax'n, Study of Present Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998 (2000), *Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations, (JCS-1-00),* at 82 (hereinafter *2000 JCT Study*). *See* also *id.* at 5, 62-70, 80-84.

Thus, while disclosure and transparency play a valid role in promoting compliance with the tax laws and in encouraging appropriate nonprofit governance, they also can impact behavior in a manner that can be harmful to the sector, and inappropriately suggest to the public and watchdog groups that the absence of specific governance policies or practices is in effect misgovernance. Accordingly, the IRS should carefully consider the public disclosures it requires.

VII. ROLE OF IRS/TREASURY IN GOVERNANCE INVOLVING TAX-EXEMPT ORGANIZATIONS

A. Introduction

We have seen an evolution over the years in the IRS's approach to governance. Historically, the IRS may have considered specific governance practices, without typically denominating them as such, as it grappled with determining whether certain types of organizations merited exemption. The law of charity has always adapted to reflect the changing needs of society, and that flexibility has challenged the IRS to determine whether non-traditional types of organizations will meet the operational test (by engaging in sufficient charitable activity, not serving private persons more than incidentally, and not violating the proscription against private inurement) in contexts that could not have been imagined a decade or two earlier, much less when the predecessor to section 501(c)(3) was enacted in 1913.[97] Only in more recent years has the IRS focused on the adoption of "good" governance practices as an objective in itself, based on the IRS's view that "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance."[98] To this end, the IRS has engaged to varying extents in seeking to promote good governance practices in each of its five points of contacts with exempt organizations: in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach.

B. Governance Issues on Standards for Exemption

Congress. We are not aware of Congress requiring the adoption of specific governance practices as a condition for exemption.[99] Congress has, however, spoken about governance in two respects: in the context of potential excess benefit transactions under section 4958 and the rebuttable presumption of reasonableness established thereunder; and in connection with the public availability of Forms 1023 and 990.

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[97] Ch. 16, § II(G)(a), 38 Stat. 172 (1913). *See Statement of Bruce Hopkins*, House Committee on Ways and Means, April 20, 2005, for the history of section 501(c)(3), http://waysandmeans.house.gov/hearings.asp?formmode=view&id=2603. *See* Appendix 3 for a discussion of the IRS's application of governance issues in the health care context.

[98] *See supra* note 31.

[99] The independence of governing body members may be relevant for other purposes, such as in connection with aspects of qualification under IRC section 509(a)(3).

Section 4958[100] imposes an intermediate sanction, short of revocation, where a disqualified person enters into a transaction or receives compensation from an organization described in sections 501(c)(3) or (c)(4) that results in the insider receiving more than fair market value. In order to encourage the governing board of an organization to more vigilantly oversee such transactions, Congress mandated a rebuttable presumption of reasonableness, set forth in Treasury Regulation section 53.4958-6, pursuant to which an organization may create a rebuttable presumption that a transaction is not an excess benefit transaction if it follows the following three-step procedure:[101]

- The transaction is "approved in advance by an authorized body of the applicable tax exempt organization. . .composed entirely of individuals who do not have a conflict of interest."
- The "authorized body obtained and relied upon appropriate data as to comparability prior to making its determination."
- The "authorized body adequately documented the basis for its determination concurrently with making that determination."

Under Treasury Regulation section 53.4958-6(b), if a transaction satisfies this three-step process, the IRS may rebut the presumption that arises to find an excess benefit transaction only if it produces "contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body."[102] The rebuttable presumption is a unique provision because Congress specifically found that organizations are more likely to make better decisions about the fairness of insider compensation and the fairness of certain transactions between the organization and insiders if they follow the three specified governance procedures.

Congress also has determined that Forms 1023 and 990 should be publicly available. In stark contrast to the strict confidentiality rules governing other tax return information,[103] certain tax return information of charities has been available for public inspection since 1950.[104] The purpose of requiring tax-exempt organizations to file information returns and to make those information returns publicly available is to promote tax compliance through transparency and accountability, and to enable the

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[100] 141 Cong. Rec. E1765 (Sept. 12, 1995). An excess benefit transaction is a non-fair market value transaction in which a disqualified person pays less than fair market value to the exempt organization or charges the exempt organization more than fair market value; or an unreasonable compensation transaction in which a disqualified person receives compensation in excess of fair market value. In addition, once regulations are issued, a proscribed revenue sharing transaction also will constitute an excess benefit transaction.

[101] Treas. Reg. § 53.4958-6(a).

[102] Treas. Reg. § 53.4958-6(b). H.R. Rep. No. 104-506, at 57 (1996) ("If these three criteria are satisfied, penalty excise taxes could be imposed . . . only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (*e.g.*, the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position.)").

[103] The unauthorized disclosure of tax return information by IRS is a felony under Section 6103. These same sanctions apply to other governmental authorities and contractors who are authorized to receive tax return information from the IRS.

[104] *See* Appendix 4 for a history of public disclosure. *See* also discussion, *supra,* notes 93-97 and 104-06 and accompanying text.

public to contribute to oversight of the nonprofit sector.[105] Under current law, section 6104 provides for public inspection and dissemination of information from tax-exempt organizations, including Form 1023 (Application for Tax-Exempt Status), Form 990 (Annual Information Return), and, in the case of section 501(c)(3) organizations, Form 990-T (Annual Business Income Tax Return). At the outset, the public availability of information from tax-exempt organizations was limited and cumbersome, and the information provided in returns filed by charities was relatively incomplete. Appendix 4 is a summary of the history of the rules governing disclosure requirements applicable to tax-exempt organizations and shows the enormous evolution over the last half century in terms of the information available for public disclosure, the expanded rationales for disclosure, and the ease with which returns can be accessed. The Internet, of course, has played a dramatic role in making the information immediately accessible.

The increased availability of certain tax return information by charities has enhanced the ability of third-party stakeholders (e.g., donors and potential donors, beneficiaries and potential beneficiaries, state attorneys general, the public, watchdog groups, Congress, and the media) to play a more active oversight role. This, in turn, has facilitated IRS enforcement, at least to the extent that wrongdoing has been brought to the attention of the IRS. Nevertheless, as discussed above, transparency has its limitations.

IRS. While Congress has not required the adoption of specific governance practices as a condition for exemption under section 501(c)(3), there are a limited number of situations where the IRS has mandated specific governance practices as a condition for exemption in precedential (sometimes non-precedential) rulings and other documents. Most of these arise in the health care arena,[106] although the IRS requires a conflict of interest policy in certain low-income housing joint ventures.[107] We appreciate that in the quickly-changing field of health care it can, in some instances, be difficult to distinguish a health care organization that qualifies for exemption from one that is merely the for-profit practice of medicine or a health-related business. In various contexts, as the IRS has labored to draw that line, it has created a *per se* requirement for exemption that requires the organization be governed by an independent body. The IRS's position, however, has not always been sustained by the courts[108] and we are concerned about *per se* requirements.

C. Governance Issues Involving Determinations

The determination process may be viewed as involving two stages: the completion and submission of the Form 1023; and the administrative process where, based in

[105] *See* generally 2000 JCT Study, *supra* note 97.

[106] *See* Appendix 3 for a discussion of the IRS's application of governance issues in the health care context.

[107] In the case of an organization that proposes to further its purposes by participating, as a general partner, in a section 42 low income housing tax credit limited partnership, the IRS requires that the organization adopt a conflict of interest policy like the sample set forth in Appendix A to the Form 1023 instructions or another form to protect the organization's interest. *See* Memorandum for Manager, EO Determinations, from Director, EO Rulings and Agreements (July 30, 2007), at 2, http://www.irs.gov/pub/irs-tege/lihtcp_choimemo_073007.pdf.

[108] *See supra* note 107.

substantial part on the information contained in the Form 1023, the IRS determines whether exemption is merited. Both stages involve governance matters. We begin by looking at the Form 1023 governance questions and we then consider the impact of governance in the determination process.

1. Form 1023 Governance Questions

The focus on governance issues as set forth in the Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,* has evolved over the years. While the Form 1023 prior to the current version asked questions regarding organization structure and governance, it principally focused on the charitable activities of the organization.[109]

In contrast, the 2004 (the most current) version places an increased emphasis on an organization's governance by focusing on board and management relationships (independence) as well as compensation and other potential opportunities for inurement. For example, the form seeks information about:

- Whether any of the officers, directors or trustees are related to each other through family or business relationships, whether any organization officer director or trustee is related to or does business with the organization, and whether they are related to any of the organization's most highly compensated employees or independent contractors (Part V).
- Practices related to establishing compensation[110] for the organization's officers, directors, trustees, highest compensated employees, and independent contractors, including whether:
    - the individuals that approve compensation arrangements follow a conflict of interest policy;
    - the individuals approve compensation arrangements in advance of paying compensation;
    - the individuals document in writing the date and terms of approved compensation arrangements; and

[109] Questions on the prior version of Form 1023 included: Who will be on the governing body? Are they a member of the governing body by reason of being a public official? Are any members of the governing body "disqualified persons" with respect to the organization or do any of the members have a business or family relationship with "disqualified persons"? Is the organization controlled by or financially accountable to another organization? Is the organization a membership organization? – if so, the form went on to ask the nature of the members and how they were solicited, with no questions as to how the members govern the organization.

[110] Part V also seeks information about compensation and other financial arrangements with officers, directors, trustees, employees, and independent contractors; and Part I, Line 8 asks "was a person who is not one of your officers, directors, trustees, employees, or an authorized representative paid or promised payment to help plan, manage, or advise you about the structure or activities of your organization, or about your financial or tax matters?" (If yes, must provide name, address, amounts paid, and description of that person's role.).

  – the organization records in writing the decision made by each individual who decided or voted on compensation arrangements (Part V).

- Whether the organization has adopted a conflict of interest policy consistent with the sample policy in Appendix A to the instructions; and, if not, what procedures will be used to assure that persons who have a conflict will not have influence over their compensation setting and/or business deals with themselves (Part V).

There also are specific governance questions relating to churches[111] and hospitals.[112]

2. Governance Issues in the Administration of Determinations

We were not able to find guidance as to how the IRS takes governance issues into account in the determination process except in limited instances in the health care and low-income housing joint venture areas.[113] We certainly appreciate that governance can bear on the operational test, among other issues. Our personal experience and research for this report suggests, however, that specific governance practices may be required on an *ad hoc* and inconsistent basis. This can include determination specialists requiring independent boards or at least some independent board members. Similarly, despite the fact that the Form 1023 specifically states that a conflict of interest policy is recommended but not required,[114] reports suggest that determination specialists often require adoption of such a policy, occasionally the form of policy included with the Form 1023.

There typically is no public record where taxpayers agree to make the changes required, strongly urged, or recommended by the IRS in the determination process and receive an exemption; or where an application is withdrawn. The public release of IRS denials of exemption[115] has, however, shed a little light on how the IRS focuses on specific governance practices in the determination process. For example, in one denial of exemption involving an organization that sought to supply ski boats to tax-exempt

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[111] Schedule A inquires about a church's religious hierarchy or ecclesiastical government, as well as whether its religious leader is also an officer, director or trustee.

[112] In the case of a hospital, Schedule C asks: whether its board of directors is comprised of a majority of individuals who are representative of the community; with a description of the board members' credentials and how each is a community representative; whether it will participate in joint ventures; and, if so, whether the partners are section 501(c)(3) organizations, the activities of the joint venture, how the hospital exercises control over the joint venture's activities and how it furthers the hospital's exempt purpose; whether it will manage activities or facilities through its own employees or volunteers; and whether it has adopted a conflict of interest policy consistent with the sample health care organization conflict of interest policy attached to the Instructions to the Form 1023; and, if not, a description of how it will avoid any conflicts of interest in its business dealings.

[113] *See supra* notes 107-108 and accompanying text.

[114] The Form 1023 itself (Part V, question 5a, page 4) states: "a conflict of interest policy is recommended though it is not required to obtain exemption." The instructions to Form 1023 (Part V, question 5a, page 9) goes further and also explains how such a policy may facilitate tax compliance (although it appears to confuse inurement and private benefit and could have been written clearer): "Adoption of a conflict of interest policy is not required to obtain tax-exempt status. However, by adopting the sample policy or a similar policy, you will be choosing to put in place procedures that will help you avoid the possibility that those in positions of authority over you may receive inappropriate benefit" Form 1023 (rev. June 2006).

[115] Following a Freedom of Information suit brought by Tax Analysts, denial of exemption determinations and revocations are being made available in redacted form under IRC section 6110. *See* discussion *infra* at note 243 and accompanying text.

youth camps, the IRS determined that the activity was a commercial one, but it also found that because the five-person board of directors included three members of one family and compensation arrangements did not follow a conflict of interest policy, this could result in inurement.[116]

A recent case, Exploratory Research, Inc. v. Commissioner,[117] also is enlightening. The IRS had advised the organization that it was unable to make a final determination and therefore was closing the case because the organization had failed to provide sufficient information in connection with follow-up requests from the IRS. The court agreed that the organization had not described its proposed activities in sufficient detail and therefore found that the organization had failed to exhaust its administrative remedies. Of interest is the extent to which the IRS sought governance changes:

Additionally, Mr. St. Julien [the IRS determination specialist] expressed his concern that petitioner might act in the private interest of Mr. Anderson [the founder and sole director, who proposed to be compensated at the rate of $400 per week if and when the organization obtained funding]. He also renewed his request that petitioner add members to its board of directors, asked whether petitioner had adopted a conflict of interest policy, and inquired as to what policies and procedures were in place to ensure that the board of directors was not receiving benefits from petitioner's activities. Finally, he asked petitioner to detail what internal controls on decision-making were in place to prevent petitioner from operating for the private benefit of Mr. Anderson.[118]

The organization refused to add additional directors, but listed several controls in place to prevent Mr. Anderson from using the organization for his own purposes, including the organization's governing documents and IRS oversight. The letter from the Director of Exempt Organizations informing the organization that the IRS was closing the case because it was unable to make a final determination also stated that her office had contacted petitioner's attorney and explained to her that the organization's responses were insufficient and that the organization "does not meet the operational test and

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[116] PLR 200733027 (May 21, 2007). *See* also TAM 200737044 (June 18, 2007) and PLR 200736037 (June 15, 2007)(both noting that father and son were sole officers and directors and son provided most funding and almost 90% of the bank's sperm to organization that provided sperm without charge); PLR 200736031 (Dec. 7, 2006)(noting that married couple were sole officers and directors, there was no conflict of interest policy and couple did not recuse themselves when causing organization to contract for management services with for-profit company of which husband was sole shareholder); PLR 200535029 (June 9, 2005)(" Finally, despite the expansion of your governing board from three (3) to five (5) members, and the enactment of a conflict of interest policy, we still have some concern that your actual operations will be controlled and directed by B and his daughter C. We acknowledge that there is no evidence of any inurement to the benefit of these individuals, but then there has been no financial activity on your part to date.); PLR 200514021 (Jan. 13, 2005)("There seems to be great likelihood of inurement to these individuals in that they all serve on the Board of Directors, and have a vote on compensation arrangements, leasing arrangements, and other financial matters that would affect the organization's financial interests as well as their own. This situation gives rise to an inherent conflict of interests that would potentially, adversely impact the financial well being of the organization. Thus, you have failed to show that B, C, D and E, through their positions on the Board, would not benefit from inurement….); PLR 200510031 (Nov. 15, 2004)("There is not even one outside, disinterested board member to speak for the community. We must conclude that you violate the second fundamental rule for exempt organizations, and operate for private, not public benefit.)

[117] TC Memo 2008-89 (April 8, 2008).

[118] *Id.* at 6.

appears to be control [sic] by and for the one person board, officer, researcher and staff."[119]

We appreciate we have only anecdotal evidence regarding governance issues in the determination process. It is, however, our impression that the "when" and "what" are unclear and not uniformly applied. We are concerned about the IRS having this level of discretion in cajoling or requiring specific governance process, particularly in the determination phase, where there usually is no track record evidencing operational failures.

D. Governance Issues Involving Form 990 Disclosure

There has been an evolution over the last 66 years in the IRS's interest in what we would today characterize as nonprofit governance as evidenced in the Form 990, *Return of Organization Exempt from Income Tax*. The Form 990 has grown from two pages (1942 Form 990) to an eleven-page core form with Schedules A through R for 2008. On the 1942 Form 990, two officers were required to sign an affidavit. This version of the form contains only three questions about the exempt organization, including "have your articles of incorporation or by-laws or other instruments of similar import been amended since your last return was filed, if so attach a copy." In reviewing the Forms 990 since 1960, we see increased inquiry in areas directly related to inurement and the operational test. Over time, these governance-type inquiries have become more attenuated to the tax laws, presumably on the assumption that good governance practices in a general sense result in more likely tax compliance. Appendix 5 summarizes our analysis of the changing nature of the Form 990. We agree with the conclusion in the 2006 ACT report that the Form 990 should be "designed primarily to assess whether the filer is complying with federal tax requirements."[120]

The draft redesigned Form 990 for 2008 includes numerous governance questions, principally in the Part VI "Governance, Management and Disclosure" section of the core form. The Commissioner for TE/GE has, in fact, characterized this governance section as "the crown jewel" of the IRS's activity in the nonprofit governance area over the past year.[121] The principal governance additions in the redesigned Form 990 include (but are not limited to) disclosure of the following:

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[119] *Id*. at 8. After discussing the absence of concrete activities disclosed, the court stated: "Because petitioner's application lacked proposals for tangible facilities, detailed plans, and criteria for selecting activities, and because petitioner was controlled by Mr. Anderson, respondent rightfully concluded that he required additional information before issuing a determination…." *Id*. at 13-14.

[120] *Policies and Guidelines for Form 990 Revision*, June 7, 2006, http://www.irs.gov/pub/irs-tege/tege_act_rpt5.pdf, at 1, 23. While we believe that governance questions on the Form 990 are appropriate subject to the limitations set forth in the 2006 ACT report and this report, we are mindful of GuideStar's comments about the draft redesigned Form 990: "The redesigned Form 990, however, goes beyond information required by the Internal Revenue Code or the underlying regulations. Although tax-exempt organizations should certainly be cognizant of best practices, what an organization does with regard to them is a business judgment matter for the organization—and its donors—rather than an issue for tax administration. Devoting space on the Form 990 to immaterial information diverts attention from true issues of tax compliance." Letter from Robert Ottenhoff, President and Chief Executive Officer, GuideStar to Lois Lerner, Director, Exempt Organizations Division, Sept. 14, 2007, http://www.irs.gov/pub/irs-tege/redesignedform990commentsgeneral_9_14_07_i.pdf, at 106, 107.

[121] Remarks of Steven T. Miller, *supra* note 24.

- The number of voting member and number of independent members on the governing body of the organization (Core Form Part I and VI).

- Whether the organization engages in or discovers an excess benefit transaction during the reporting year (Core Form Part IV and Schedule L).

- Whether any officer, director, trustee, or key employee has a family or business relationship with each other (Core Form Part VI).

- Whether the organization delegated management duties customarily performed by officers, directors or trustees, or key employees to a management company or other person (Core Form Part VI).

- Whether the organization became aware during the year of a material diversion of the organization's assets (Core Form Part VI).

- Whether the organization has members or stockholders (Core Form Part VI).

- Whether the organization has members, stockholders, or other persons who may elect one or more members of the governing body; and whether any decisions of the governing body are subject to approval by members, stockholders, or other persons (Core Form Part VI).

- Whether the organization contemporaneously documented the meetings held or written actions undertaken during the year by the governing body, and by each committee with authority to act on behalf of the governing body (Core Form Part VI).

- If the organization has local branches, chapters, or affiliates, whether it has written policies and procedures governing the activities of such branches, chapters, or affiliates, to ensure their operations are consistent with those of the organization (Core Form Part VI).

- Whether a copy of the Form 990 was provided to the organization's governing body before it was filed; and a description of the process for reviewing the Form (Core Form Part VI).

- Whether the organization has a written conflict of interest policy; and, if so, whether officers, directors, and key employees are required to disclose annually interests that could give rise to conflicts, and whether the organization regularly and consistently monitors and enforces compliance with the policy (Core Form Part VI).

- Whether the organization has a written whistleblower policy (Core Form Part VI).

- Whether the organization has a written document retention and destruction policy (Core Form Part VI).
- Whether the process for determining compensation of the CEO, executive director, or top management official or other officers or key employees includes a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decisions made (Core Form Part VI).
- Whether the organization invested in, contributed assets to, or participated in a joint venture or similar arrangement with a taxable entity during the year; and, if yes, whether the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements (Core Form Part VI).
- Whether and how certain documents, including the organization's Form 1023, Forms 990, and 990-T, financial statements, governing documents, and conflict of interest policies, are made available to the general public (Core Form Part VI).
- Whether the organization's financial statements were compiled, reviewed or audited by an independent accountant; and, if so, whether the organization has a committee that assumes responsibility for the oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant (Core Form Part X).
- Whether in establishing the compensation of the organization's CEO/executive director the organization utilized a compensation committee, independent compensation consultant, Form 990 of other organizations, written employment contract, compensation survey, or study, approval by the board, and/or a compensation committee (Schedule J).
- Whether the organization has a gift acceptance policy that requires the review of any non-standard contributions (Schedule M).

In formulating questions for the Form 990, we believe it is important that they be expected to elicit a meaningful response related to tax compliance, that they be addressed in as neutral a manner as possible, and that the IRS expressly knowledge both the relationship of the inquiry to tax compliance and when the governance practices at issue are not required. While the caption for Part VI expressly includes the following statement: "Sections A, B, and C request information about policies not required by the Internal Revenue Code," there are governance questions on other

portions of the redesigned draft Form 990 that do not include a similar disclaimer.[122] We believe in large part the governance questions on the redesigned Form 990 for 2008 are appropriate and formulated in a relatively neutral manner, recognizing that true neutrality is an unachievable goal. Moreover, charities do have an opportunity to explain any answer on Schedule O. The inclusion of the questions, however, inherently (and intentionally) suggests that the IRS supports adoption of specific governance policies and practices. The danger then is that organizations will take the path of least resistance and adopt the policies and practices whether or not they are appropriate for the organization, or effective in their context.

E. Governance Issues in the Examination or Other Compliance Initiative Context

Governance matters also may arise in connection with the IRS examination of exempt organizations or in other compliance initiatives. As in the case of determinations, we were not able to find significant guidance as to how the IRS takes governance issues into account in the examination process. We have heard that governance concerns identified during the determination process or on the Form 990 may be taken into account in selecting organizations for examination. Once an organization is identified for audit and prior to contacting the organization, the agent typically reviews the Forms 990 filed over a several year period and has the information set forth there regarding governance, including with respect to the independence of directors and self-dealing transactions. We understand from our own experiences and from our research for this report that it is common for examining agents to ask for governance-related documents (e.g., copies of board and board committee minutes, communications from the charity's independent auditors, and conflict of interest and possibly whistleblower policies) at the commencement of an examination. The Commissioner for TE/GE recently suggested that IRS agents may start to utilize a post-exam checklist to assist in determining the impact of governance.[123]

Of course, where an examining agent has concerns about specific transactions or general operations, the agent is more apt to undertake a focused inquiry. With respect to compensation and transactions involving insiders, whether an organization met the rebuttable presumption of reasonableness is highly relevant in the context of potential excess benefit transactions under section 4958.[124] Examining agents typically ask about independent decision-making, use of comparability data or valuations, and contemporaneous minutes in the context of compensation or transactions with

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[122] For example, Question 2 on Part XI of the core form asks whether the organization's financial statements were compiled, reviewed or audited by an independent accountant and, if so, whether the organization has a committee that assumes responsibility for oversight of the audit, review or compilation and selection of an independent accountant; and Question 31 on Schedule M asks whether the organization has a gift acceptance policy that requires the review of any non-standard contributions.

[123] *See* Remarks of Steven T. Miller, *supra* note 31: "[A] post-exam checklist, used systematically, might give us a better feel for the impact of governance in our area, and we would publicly report what we find. This would appear to be the next natural extension of our work in the governance area. You should expect to see other projects based on our analysis of data from the new 990 as well."

[124] *See supra* notes 101-03 and accompanying text.

insiders.[125] Even where the rebuttable presumption is not met, the agent will want to determine how close the organization came to meeting it, or what other procedures were employed to assure that the matter was fair to the organization. In the case of conflicted transactions, the agent may consider not only whether the organization had a conflict of interest policy, but how it operated in the specific context (*e.g.*, was the board aware of the conflict and the key facts relevant to the conflict, was the conflicted person present during the deliberations and vote, did the conflicted person exercise undue influence, did the board follow the procedures set forth in the policy, was the board independent, and, if the board waived the conflict, is its rationale articulated and fair to the organization).

In some circumstances, an organization may use its existing governance procedures as a way of framing its response to inquiries by the examining agent. This is most apparent in the section 4958 context, where compliance with the rebuttable presumption procedures affords considerable protection to the organization and its disqualified persons. The same may also be true, for example, in circumstances involving transactions where the organization can demonstrate clear adherence to the letter and spirit of its conflicts of interest policy; or, the organization can demonstrate that its whistleblower policy identified inappropriate activities and that prompt action was taken to address the circumstances.

On examination, where the IRS believes that an organization is not in compliance with the requirements for tax exemption, it must determine whether to revoke exemption or to require actions that seek to ensure compliance on an on-going basis.[126] While governance is only one of a number of relevant factors, including the magnitude of the organization's contributions to the public good and the likelihood that the organization will be compliant in the future, it can be a core issue, possibly even the issue that tips the balance. In fact, we understand from interviews we conducted for this project and our own collective experience that it is not uncommon for the IRS in the context of a culpable charity to require the organization to make governance changes as a condition of the IRS agreeing not to seek revocation or other penalties against the organization; or alternatively, a charity may bring its own misconduct to the IRS with a corrective action plan that includes significant changes. In the usual case, such matters are confidential, settled with a non-public closing agreement or on a less formal basis.

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[125] The Hospital Compliance Project initiated by the Exempt Organizations Division of TE/GE in 2006 involved sending a Compliance Check Questionnaire for Tax-Exempt Hospitals, Form 13790 (May 2006), to approximately 500 hospitals, asking, among other things, whether the hospital had a formal written compensation policy, whether compensation was approved in advance by individuals who did not have a conflict of interest with the compensation arrangement being approved, and a series of questions about the use of comparability data. Part I of the Executive Compensation Compliance Initiative initiated by the Exempt Organizations Division of TE/GE in 2004 involved sending compliance check letters, Letter 3878 (June 2004), together with an Information Document Request, Form 4564 (June 1988), to over 1,200 exempt organizations that similarly asked about whether the requirements for the rebuttable presumption of reasonableness under section 4958 were met, whether the board approved the compensation and benefits, whether the organization had a written conflicts of interest policy, whether disqualified persons recused themselves from discussions and voting on their own compensation or tried to influence the board, and a series of questions about the use of comparability data, among other questions. Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II (March 2007), http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.

[126] The IRS also may seek financial penalties as a condition of continued exemption up to the amount the organization would have paid had it lost its exemption for some period.

There are, however, occasional cases that are public. The required public release of the Hermann Hospital closing agreement, discussed in Appendix 3, is one example.

Perhaps the best-known instance of the IRS requiring governance changes as a condition of continued exemption is the Kamehameha Schools / Bishop Estate matter, as described in the book *Broken Trust.*[127] In that matter, which has come to be known as the Bishop Estate, the IRS required the wholesale removal of a charity's governing body as a condition of not revoking the charity's tax-exempt status.[128] The closing agreement between the Bishop Estate and the IRS required the charity to agree to adopt and implement a number of significant governance changes, in addition to the removal of the then current trustees.[129]

As with determinations, there also are occasional private letter rulings and technical advice memoranda[130] where the IRS determined that an organization did not qualify for tax exemption under section 501(c)(3), at least in part because its governance structure resulted in private inurement or private benefit. In a technical advice memorandum released in 2004, the IRS looked at whether a closely-controlled church organization had violated the conditions of tax-exempt status on various grounds. In analyzing whether a substantial non-exempt purpose existed, the IRS focused on the organization's accumulation of substantial investment and commercial assets. The IRS concluded that the asset accumulation was appropriate given the organization's reasonable anticipated needs for financial reserves. In confirming that the organization did not have a substantial non-exempt purpose, the IRS commented:

> Small, closely-controlled exempt organizations—and especially those that are closely controlled by members of one family—with related business entities require thorough examination to insure that the arrangements serve charitable purposes rather than private interests. Qualifying for exemption is a facts and circumstances test. There is nothing that precludes an organization that is closely controlled or has related for-profit organizations from qualifying, or continuing to qualify, for exemption. However, the lack of institutional protections, that is, a board of directors composed of active, disinterested persons, and the potential for such organizations to be abused requires IRS to closely examine actual

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[127] Samuel P. King & Randall W. Roth, Broken Trust: Greed, Mismanagement and Political Manipulation at America's Largest Charitable Trust (2006). All facts in this discussion of the Bishop Estate are taken from *Broken Trust* and from the B. P. Bishop Estate, Closing Agreement, August 18, 1999.

[128] But *see* reservations expressed in Evelyn Brody, "A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?," 21 U. Haw. L. Rev. 537, 545-46 (1999), reprinted at 29 Exempt Org. Tax Rev. 397 (2000).

[129] These included: a new trustee selection process that included an independent appointment committee; a new management structure making clear that the trustees are responsible for establishing policy, not for managing the charity's day-to-day operations, and assigning responsibility for those operations to a new Chief Executive Officer position who would review and supervise other executives; any changes in this structure during the five years immediately following the execution of the closing agreement required notice to the IRS; a system of checks and balances on the powers of the trustees and senior executives, including the newly created CEO position; a conflict of interest policy; a compensation review process for the trustees and for senior executives; an annual financial statement audit, with the statements being made publicly available on the charity's website and on request; and re-implementing an internal audit function with certain protections designed to secure the independence of the internal auditor.

[130] *See supra* note 116.

> operations to analyze whether they continue to serve exclusively charitable purposes.[131]

Accordingly, as with determinations, the IRS considers governance in the audit or other compliance initiative context. However, this context differs significantly from determinations in that the organization has a track record and the IRS is, or should be, considering the organization's actual operations in ascertaining whether the organization qualifies for exemption. Thus, where there are actual violations of the standards for exemption, the IRS rightfully has a greater interest and duty and, correspondingly, increased latitude to address misbehavior. Nevertheless, the absence of guidelines in this area is troubling.

F. Governance Issues in Education and Outreach

In recent years, the IRS, and occasionally Treasury, has been quite vocal in addressing governance issues as part of its education and outreach efforts. Although these initiatives do not have the force of law, the structure of these pronouncements can and does signal IRS expectations regarding the behavior of charitable organizations. While this is an important and complex topic, we believe two generalizations are worth noting. First, the stakeholder audience for this type of signaling is very broad—charities, IRS employees, members of Congress and their staff, the media, watchdog groups, and the public. Second, the very fact of discussing general or particular governance topics signals that the IRS believes the topic should be carefully considered by charities; and, in fact, may suggest that failure to conform is itself misgovernance. To minimize the *in terrorem* effect, the manner in which the message is delivered is important. It is highly preferable for the IRS to take a more neutral approach (*e.g.*, charities should give consideration to the board size and composition best-suited to carry out their mission), as opposed to being highly directive (*e.g.*, charity boards should be limited to not more than 15 members, at least 60 percent of whom should be independent, and should include at least one independent member who is expert in each of the following areas: financial accounting and internal controls, the charity's mission-specific activities, fundraising, and public relations/communications).

Appendix 6 includes selected examples of this "soft regulation" or resort to the "bully pulpit" by the IRS in its efforts to promote enhanced governance practices by tax-exempt organizations, including presentations by senior executives of the IRS. Of particular interest are: the "Governance and Related Topics – 501(c)(3) Organizations" supplement to the Life Cycle on-line educational tool released on February 14, 2008; its predecessor draft, Good Governance Practices Discussion Draft released in February of 2007; the Anti-Terrorist Financing Guidelines released in November of 2002; and the very recent speeches by the Commissioner for TE/GE at the Georgetown Tax Conference.

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[131] TAM 200437040 (June 7, 2004).

VIII. Why Treasury/IRS Should Proceed With Caution in Promoting Nonprofit Governance

The IRS's power to interpret its statutory mandate by the issuance of regulation and formal guidance is unquestionable.[132] That implementing authority includes the latitude to promote governance mechanisms to ensure that underlying statutory objectives are achieved. Similarly, the IRS has broad power to inquire about matters of governance in the contexts of applications for recognition of tax-exempt status, informational reporting by exempt organizations, and demands posed in audits and other exercises that monitor the conditions of exempt status[133] Finally, the IRS's authority to interpret and opine, outside of the vehicles of regulation and formal guidance, through educational materials and public statements, though not specifically articulated in law, rests upon an absence of any prohibition against use of the "bully pulpit" beyond the statutory confidentiality accorded to individual taxpayer information.[134]

The greatest possibilities for harm arise at the outer edge of the IRS's delineated interests. Because the formal statutory limits on its role in addressing concerns about nonprofit governance apply to regulatory interactions with specific tax-exempt organizations, the IRS certainly has many opportunities to promote better behavior among nonprofit boards. At the same time, that absence of a guiding and constraining framework creates the potential that the IRS may inadvertently undermine the effectiveness of its own efforts without careful consideration of the premises and likely impact of its inquiries and pronouncements. In focusing its broad discretion on nonprofit governance, a set of concerns should guide the IRS in selecting the issues, adopting positions, and communicating those views in individual inquiries or public declarations.

- **Beware the law of unintended consequences.** When articulated by a regulatory agency with vast authority, every question has the potential to affect the behavior of the regulated—even when articulated without intentional bias. While some inquiries may be intended to drive the behavior of nonprofit boards to adopt certain policies that are sound or implement certain practices that are commendable, unintended consequences arising from misinterpretation of the meaning or weight of these ideas are more likely the further that the IRS moves from the explicit requirements of the tax code. One of the potentially disturbing consequences could be discouraging volunteer

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[132] Administrative Procedure Act, 5 U.S.C. § 553.

[133] The authority to inquire, at least in the audit and enforcement context, is broad but not without limits. *See*, *e.g.*, United States v. Powell, 379 U.S. 48, 56 (1964)(rejecting a probable cause standard in connection with the IRS' demand in an audit for information relevant to time periods ostensibly beyond the statute of limitations, but noting "… the responsibility of agents to exercise prudent judgment in wielding the extensive powers granted to them by the Internal Revenue Code."). IRC section 6033(a) grants authority to the IRS to mandate the filing of returns to collect information for "the purpose of carrying out the internal revenue laws." However, the IRS's authority to seek information in required filings by taxpayers, including informational returns filed by exempt organizations, must be "materially related" to the tax code. *See Incomplete Returns,* GCM 36506 (December 8, 1975); *Incomplete Returns Program Correspondence Examination Program,* GCM 37785 (December 12, 1978). *See* also Marcus S. Owens, *Charities and Governance: Is the IRS Subject to Challenge?* Tax Notes Today, 2008 TNT 93-38, DOC 2008-9664, May 13, 2008.

[134] IRC section 6103. In recent years, the IRS has become more active not only in developing useful educational materials to guide exempt organizations in remaining compliant with the tax code, *see, e.g., the Life Cycle* project posted on the IRS web site, http://www.irs.gov/charities/article/0,,id=169727,00.htm, but also to address governance issues that go beyond the Code's specific requirements, see *Governance and Related Topics – 501(c)(3) Organizations, supra* note 22. Similarly, IRS officials have given public speeches that are not limited in scope to the tax code, but address broader governance issues. *See, e.g.,* Appendix 6.

board members from service, particularly with smaller organizations, because of the burdens flowing from encouraging unnecessarily extensive governance reforms.[135]

- **The power to inquire is the power to punish.** Asking for information about governance practices not only drives behavior through the power of suggestion, it also drives behavior through fear of entanglement with enforcement and concern that the organization may be perceived by important constituencies as misgoverned. For newly formed organizations seeking recognition of tax-exempt status or existing organizations completing annual information returns, every question that is intended to drive governance practices carries a cost-benefit equation weighing acquiescence to the suggested governance behavior with the time and expense of creating and maintaining those practices. Particularly for smaller organizations, the costs of adopting some practices, which may be advisable for larger nonprofits, may not be worth the benefits, and will consume charitable assets that would otherwise be devoted to the organizations' programs.

- **Governance is an unfunded mandate.** The development and implementation of specific governance polices and practices typically entail costs, including with respect to the infrastructure that is needed to sustain better governance practices. Not only are grantmakers and other donors reluctant to fund these types of administrative costs, a substantial portion of "administrative overhead" in any organization's annual expenditures is taken as a sign of inefficiency that can deter future contributions.[136] Smaller and less well-off organizations may simply lack the capacity to implement "best practices." Increased expectations cannot result in improved governance without the resources to meet the challenge, and the use of resources for governance may reduce the dollars available for charitable activities. This is not to suggest that most organizations should not expend resources to enhance their governance. Rather, the amount of resources to be devoted to governance and their application constitute a business judgment for the governing body, requiring consideration of the cost and benefits of specific practices, as well as available resources.

- **One size does not fit all.** The diversity of the nonprofit sector in this country is the envy of the civilized world. While small organizations may represent the overwhelming majority in number, larger exempt organizations

[135] *See* 2007 Urban Institute Study, *supra* note 40, at 16 (reporting that "70 percent of the nonprofits say that it is difficult to find board members and 20 percent say that it is very difficult.").

[136] "Watchdog" groups regularly devote special attention to the extent to which exempt organizations' resources are devoted to program services rather than administrative expenses – including the costs of implementing enhanced governance practices. *See, e.g.,* BBB Standards for Charity Accountability (requiring that organizations spend at least 65% of total expenses on program expenses); Charity Navigator's ratings on "organizational efficiency" (comparing charities' administrative expenses to total functional expenses), *supra* notes 79 and 85, respectively. In addition, ratios of program expenses to total expenses are commonly utilized by federated campaign organizations, such as the Combined Federal campaign and the United Way. These types of metrics can, of course, result in an unwarranted denigration of many charities.

disproportionately hold the assets. Trying to craft governance models that are as appropriate for urban hospitals as they are for rural soup kitchens fails to appreciate that the diversity of the sector calls for differences in governance practices. An effort to identify standard governance practices for the entire sector is bound to result in a set of common denominators that are too basic for large and complex organizations and unduly burdensome for small volunteer-driven organizations.[137]

- **Conventional wisdom is not empirical evidence.** Reliance on certain indicators of good governance as proxies for more accountable and legally compliant exempt organizations is premised upon a faith that a board's appreciation of its duties of care and loyalty will be enhanced if those specific behaviors are encouraged. While that may be correctly assumed about certain practices, it is not supported by empirical research.[138] Moreover, standards for what constitutes good governance are not static; best practices evolve as the nonprofit sector changes and as new governance innovations are conceived.[139] Behavior in untested directions may be wasteful and counterproductive when the particular governance indicator is not explicitly found in the tax code and has not been empirically evaluated—and all too often the only cited support is isolated anecdotal examples of scandalous behavior, which assume that had specific governance practices been in place the problems would have been avoided.

- **Good governance cannot be captured in a "punch list."** No matter how extensive, a list of indicators offers only limited examples of what should be expected of nonprofit boards, and the conceptual underpinning—the duty of care and the duty of loyalty—must be absorbed, understood, and applied in innumerable circumstances that cannot be anticipated in advance. Promoting governance indicators without emphasizing those underlying conceptual premises, although they are matters of state law and not derived from the tax code, may inadvertently send an incomplete message to nonprofit boards and leave them unprepared for governing in the real world, or cause them to believe that governance is more a question of specific policies and procedures than of values, will, and commitment.

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[137] *See*, for example, the discussion of the sample conflict of interest policy included as Appendix A to the Form 1023 instructions, *infra* at notes 142 and 151 and accompanying text. Similarly, the *Governance and Related Topics – 501(c) Organizations*, *supra* note 22, suffers from trying to address a broad swath of public charities so that it is too complex for some charities and insufficiently sophisticated for others.

[138] Assumptions about even the correlation between commonly accepted indicators of good governance and effective governance may prove to be misplaced when subjected to empirical scrutiny. For example, the recent study by the Urban Institute found, contrary to popular convention, that larger nonprofit boards were not less engaged than smaller governing bodies *See* 2007 Urban Institute Study, *supra* note 40 ("While large board size may contribute to problems at some nonprofits, our findings do not indicate that larger board size *per se* detracts from board engagement. Indeed, to the extent that it had any association with activity levels (and usually it did not), it was a positive one: board size was positively associated with board activity in fundraising, educating the public about the organization and its mission, and trying to influence public policy."). *See* also Section V.C. above.

[139] For example, in 1996 the IRS considered requiring reporting a change of accounting firm on the Form 990 because it believed that suggested there might have been a disagreement on an audit opinion. See 15 EXEMPT ORG. TAX REV. 219-20 (1996). In its Good Governance Practices Discussion Draft (Feb. 7, 2007), the IRS suggested the advisability of changing audit firms every five years. Yet, the empirical evidence does not yet support either position. *See* Appendix 6.

- **Policies are not practices.** Many of the good governance indicators upon which the IRS has focused call for policies to be adopted, but do not examine the practices in which an exempt organization engages in adhering to those policies, or in otherwise meeting the underlying objectives of the policies. Unless implemented and applied in circumstances that warrant that application, those polices may be no more than pieces of paper left in a file cabinet. One challenge for the IRS in promoting good governance outside the boundaries of practices specified in the tax code is in inquiring about conduct in ways that will prompt more than self-serving and general affirmative responses.

- **Bad policies can lead to bad practices.** Adopting and implementing a particular policy that promotes more attentive board governance may actually be counterproductive if that policy is misguided or even legally defective. Whether that policy correctly reflects IRS and state legal requirements is a threshold question. While raising consciousness about governance issues by asking about the existence (but not the content) of policies may have a value of its own, it may lead organizations to check off a box without actually improving their governance, either by adopting flawed policies or by adopting policies that are not effectively implemented. Additionally, in a world where the majority of smaller tax-exempt organizations simply do not have access to qualified counsel, the right answers may be elusive for them and the wrong ones may create liability.

- **The bully pulpit is a form of regulation.** The IRS's ability to shape governance behavior informally may be its most flexible tool, but also carries the potential for unintended consequences. In raising consciousness in the sector through the use of the "bully pulpit" in speeches and other forms of public comment, representatives of the IRS should consider the extraordinary diversity of the sector, how its message will be received, and whether it may have any counterproductive effects.

- **Exempt organizations are governed by boards, not by the IRS.** Finally, increasing concerns about the adequacy of nonprofit governance and the lengthening list of indicators that are advocated as the solution to those problems may, at some level, serve to undermine the autonomy of nonprofit boards and blunt the critical exercise of their judgment. While most governance indicators are process prescriptions that do not obviously encroach upon decision-making, even choices about governance practices are and should be an area for the exercise of business judgment by a board and reflect the needs of the specific organization. Discouraging that exercise of discretion by prescribing extensive lists of preferred practices may suggest that boards have no obligation to consider which policies and practices are appropriate for their organization. Substituting the judgment of the regulators undermines board autonomy and may discourage board recruitment.

These concerns should be considered by the IRS in any instance in which the IRS inquiries or opines about matters of nonprofit governance. However, the inherent risks and the need for caution are not of equal sensitivity in all circumstances. Therefore, we offer a framework and recommendations that take these concerns into account in our consideration of the appropriate role of the IRS with respect to nonprofit governance.

IX. Recommendations

We begin our recommendations by again acknowledging the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. As we stated in the introduction, the IRS's view that "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance"[140] seems self-evident. But efforts to promote good governance are fraught with complexity. While we may all agree that governance matters, the empirical evidence does not support the proposition that requiring specific governance practices results in greater compliance with the tax laws. Effective governance likely is much more a question of the attitude of responsibility and accountability of those in charge than the adoption of specific policies and practices. Given the diversity of the sector and the varying, and often unpredictable, challenges facing an organization, the organization's governing board generally is in the best position to determine what the most appropriate practices are for its organization. We are very mindful of the fact that even the most modest level of prescription from a regulatory body such as the IRS regarding what constitutes "good" governance can undermine the fundamental and wholly legitimate authority of the organization's governing board and can suggest a one-size-fits-all approach that can place undue burdens on an organization, divert the organization's attention from meaningful governance to polices and procedures, and do damage to the uniquely diverse and vibrant charitable sector in this country.

Accordingly, we believe that the IRS should approach the governance area with caution. We recommend that in each instance the IRS is considering involvement in a specific governance issue it should consider the importance of the specific governance practice to compliance with the laws under its jurisdiction and then balance that against potential countervailing considerations (*e.g.*, will it elicit or promote a meaningful response related to tax compliance and what harm might flow) in determining whether to proceed. We believe the context in which the IRS is operating—in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach—is relevant to this balancing. We conclude our report with 12 recommendations we hope the IRS will find useful as a framework in helping it navigate appropriately between its mandate to ensure compliance with the tax laws and the broader and more aspirational goal of promoting good governance in the sector. We recognize that in a number of instances the IRS already follows or substantially follows these recommendations, but we include all 12 to ensure a complete framework.

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[140] *Governance and Related Topics – 501(c)(3) Organizations*, supra note 22, at Preface.

(1) **The IRS Should Continue to Work Collaboratively With The Tax-Exempt Community In Connection With Its Governance Initiatives.** The IRS's approach to the redesigned Form 990 for 2008 has been a model of inclusiveness and collaboration. After releasing a draft redesigned Form 990 for public comment in June of 2007, the IRS reached out broadly to the nonprofit community and the public to discuss the draft and solicit input. The IRS ultimately received over 650 comments, amounting to more than 3,000 pages, much of which was reflected in the revised redesigned Form 990 released in December of 2007. The result is a substantially better form, including with respect to the governance questions contained therein. In April of 2008, the IRS continued this exemplary process, releasing draft instructions, including a draft glossary, for public comment. The "Governance and Related Topics – 501(c)(3) Organizations" materials added to the Life Cycle are useful and a significant advancement over the earlier draft. But we believe they could have been even better if they had the benefit of more input. For example, we believe the document structure should, with respect to each subpart, relate the recommended practice to the tax rules and state with respect to each practice that it is not required for exemption; focus more on practices than policies; focus on charitable purposes and not "mission;" include either more explanation or delete the recommendation to keep fundraising costs "reasonable;" and include either more explanation or delete the recommendations for an audit by independent auditors overseen by an independent audit committee. We believe that the sample conflict of interest policy in Appendix A to the instructions of the Form 1023, as well as the inquiries in the Form 1023 about whether a policy "consistent with the sample conflict of interest policy" could be improved upon with input from the tax-exempt community.[141] If IRS agents are going to utilize a post-exam checklist to assist in determining the impact of governance, we would hope that the IRS would seek input from the nonprofit community with respect to both the checklist and the process employed. The desirability of both collaboration[142] and an opportunity for comment in the governance arena is particularly strong because the IRS involvement in governance is discretionary, the subject is not mainstream to IRS expertise, there are a significant number of substantive experts in the field, and there are numerous viewpoints reflecting both the diversity of the sector and the dearth of empirical evidence.

[141] The IRS does not explain in connection with the Form 1023 what parts of the sample conflict of interest policy it considers critical or what "consistent with the sample conflict of interest policy" means. For example, unless an organization simply adopted the IRS sample policy, it would be unusual for a conflict of interest policy to call for "periodic reviews" of compensation arrangements and benefits or partnerships, joint ventures, and arrangements with management organizations to "ensure that the Organization operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status," and to authorize the use of "outside experts" (confusingly denominated as "outside advisors" in the immediately prior sentence). Moreover, if an organization follows the rebuttable presumption of reasonableness under IRC section 4958 it is not clear why such a compensation review is necessary; nor is it clear why routine management arrangements for food service, security, parking, or laundry necessarily merit such a review.

[142] The Exempt Organizations Division may want to discuss with the Officer of Inspector General of the Department of Health and Human Services its experiences in releasing three publications on governance jointly with the American Health Lawyers Association. *See* Appendix 3.

(2) Specific Governance Practices Should Be Mandated Only In Rare And Limited Circumstances. We do not believe specific governance standards should be a *per se* prerequisite to the granting of tax exemption. There are nonprofit organizations with model governance practices that fail to serve their charitable purposes, comply with the requirements for exemption, or abide by legal obligations, just as there are nonprofit organizations with minimal formal "good governance" practices that perform in an exemplary manner. While our "gut" may tell us that organizations that have adopted "best" practices are more likely to be compliant, as discussed at length previously, this is not supported by empirical evidence. Further, even conceding the big picture proposition, which "best" practices are really "best" also remains an open issue. To the extent that the IRS is reflecting a congressional finding, it is on safer ground. In enacting section 4958, Congress found that organizations are more likely to make better decisions about the fairness of insider compensation and the fairness of certain transactions involving insiders if those decisions are made by independent directors or committee members who rely on comparability data and who contemporaneously document their decisions. However, Congress rewarded, but did not require, independence, use of comparability data, and contemporaneous documentation. Thus, it is likely that the IRS would be going beyond what Congress thought was appropriate if it sought to mandate even these governance practices with congressional imprimatur.

We believe that no mandated governance practice ensures compliance with the requirements for tax exemption and that various approaches may give sufficient comfort that an otherwise qualifying organization is unlikely to violate the proscriptions against private inurement or more than incidental private benefit. Mandating such governance practices usurps the proper role of the governing body to choose from among a wide variety of suitable governance practices permitted under state law based on the distinctive aspects of the organization and also has the greatest potential for harm to the diverse, vibrant, and flexible charitable sector, particularly when there is little or no empirical support supporting specific nonprofit governance practices. Moreover, should the IRS seek to implement specific governance standards as a condition for exemption, we urge it do so through the regulatory process, thereby ensuring an opportunity for public comment.

As discussed previously,[143] there are only a limited number of situations where the IRS has issued precedential or non-precedential guidance to the effect that it is mandating specific governance practices as a condition for exemption. We appreciate the reasons that the IRS has sought to create governance litmus tests in complicated areas such as health care, and we agree, for example, that an independent governing body can be viewed as a favorable factor in determinations, but we encourage the IRS to utilize more flexible standards that allow for consideration of all the facts and circumstances in determining whether

[143] *See supra* notes 107-09 and accompanying text.

the standards for exemption have been met. In addition to these documented attempts by the IRS to mandate specific governance practices, there is significant anecdotal evidence that the IRS is requiring new organizations to adopt a conflict of interest policy as a condition for exemption. There even are reported instances where the IRS required its form of conflict of interest policy to be adopted. Again, while the existence of a conflict of interest policy may appropriately be viewed as a favorable factor on determination, we do not believe it should be a *per se* requirement.

The one situation where we believe it is appropriate for the IRS to have latitude in seeking to impose specific governance practices is where the IRS has identified an organization that has committed one or more grievous violations of the standards for tax exemption. One example is an organization that violates the inurement proscription and where the IRS has the right to revoke exemption in addition to imposing section 4958 excise taxes.[144] In such a case, and subject to our recommendations with respect to consistency and fairness below, we believe the IRS should have discretion in determining whether to propose revocation of exemption of a culpable organization or to allow the organization to undergo sufficient changes that its charitable mission can be preserved in a context that makes future violations highly unlikely. In fact, we hope that where there is sufficient charitable mission to preserve that the IRS will seek to create conditions that allow the organization to continue. In this regard, we think it is appropriate for the IRS, in its judgment, to seek to condition continued exemption on the adoption of extensive governance changes that are reasonably implicated in the charity's wrongdoings. These could include, for example: requiring a change in directors, officers and/or senior managers; imposing independence requirements for the board as a whole and/or in connection with various decisions of the organization such as executive compensation, joint ventures, and financial oversight; mandating approval processes that assure involvement of directors or key employees; requiring adoption of various policies such as a conflicts of interest policy and/or whistleblower policy; requiring the governing board and senior managers to undertake training on their respective roles and responsibilities; and requiring greater transparency. In making its determination, we believe the IRS should take into account self-initiated changes the organization has voluntarily undertaken, particularly when undertaken before government contact. Of course, if the organization does not voluntarily agree to make the changes, the IRS cannot force it to do so; it can instead revoke the organization's exemption, and the organization, in turn, has the right to challenge that determination in court.

A more challenging situation for us is where the compliance initiative shows evidence of operational concerns but not at a level that would result in revocation. This might include, for example, an instance where there was a purchase of property from a person involved with the organization who was not a disqualified person at a price just in excess of fair market value, without a formal

[144] 70 Fed. Reg. 53599 (March 27, 2008).

valuation or other safeguards. In cases such as these, although we are concerned about over-reaching, we think it is appropriate for the examining agent or other IRS personnel to encourage, but not require, improved governance practices related to specific deficiencies of the organization. The examining agent or other IRS personnel should, however, make it clear to the organization that it is encouraging, but not requiring, improved governance practices.

(3) **The Closer The Nexus To Tax Compliance, The More Appropriate The Governance Inquiry Or Recommendation.** In our view, the involvement of the IRS in governance issues is most appropriate when those issues are directly related to compliance with existing tax laws. Correspondingly, that involvement is more problematic, and potentially inappropriate, the further a governance inquiry or recommendation strays from compliance with the tax laws. The weaker that nexus, the less justification the IRS has to seek to usurp the central responsibility and autonomy of governing bodies to exercise business judgment in administering their organization's affairs, including their governance choices, to seek primacy over other regulatory and non-regulatory sources of authority that have expertise on these issues, and to endanger the unique, diverse, vibrant and flexible charitable sector in this country.

(4) **The IRS Should Explain The Specific Relationship Between Tax Compliance And Each Governance Practice About Which It Is Inquiring Or Which It Is Addressing.** Related to our recommendation that a government inquiry is more appropriate when it has a closer nexus to tax compliance is our recommendation that the IRS should in all situations actually articulate the relationship between the governance practice and tax rules. We believe this helps the IRS to assure there is a sufficiently strong relationship between governance and tax compliance, educates the sector as to the goal of the governance practice, and creates the appropriate message that the IRS is first and foremost an agency focused on tax compliance. The IRS does this, for example, in the Form 1023 determination context when it asks whether the applicant organization has a conflict of interest policy.[145] On the other hand, the current draft instructions for the governance questions in Part VI of the core redesigned draft Form 990 make no effort to relate the specific questions to the tax rules, including in connection with the questions relating to conflict of interest or other policies about which it inquires in Section B. The "Governance and Related Topics – 501(c)(3) Organizations" addition to the Life Cycle is inconsistent in explaining the specific relationship between each recommended governance practice and the tax rules.[146]

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[145] *See supra* note 115..

[146] *Governance and Related Topics – 501(c)(3) Organizations, supra* note 22. For example, it does not relate mission, board size, conflict of interest, investments, fundraising, minutes, financial statements, or providing the Form 990 to the governing body and management to tax compliance, but does, at least to some extent, relate organizational documents, a governing board that does not tolerate a climate of secrecy or neglect, board composition, and executive compensation to tax compliance.

(5) **Compliance Questions Or Commentary Are More Appropriate Than Governance Questions Or Commentary.** A corollary to the recommendation that a governance inquiry or comment is more appropriate when it has a closer nexus to tax compliance is our observation that compliance inquiries, which inherently relate to tax compliance, are more appropriate than governance questions, where we believe the IRS should be more circumscribed. Although we acknowledge that the line between them can be blurred, in the usual case, we consider a question that asks for data or other information that is central to a judgment about tax compliance or that asks whether specific tax rules were violated or complied with to be compliance questions; whereas we generally consider questions that ask about practices, procedures, and policies that are not required under the tax laws to be governance questions. Examples of compliance questions include: whether the organization engaged in, or become aware that it had engaged in, an excess benefit transaction with a disqualified person during the reporting year; whether the organization was a party to a prohibited tax shelter transaction during the year; whether the organization provided goods or services in exchange for any contribution of $75 or more and, if so, whether the organization notified the donor of the value of the goods or services provided; whether the organization engaged in direct or indirect political campaign activities on behalf of or in opposition to candidates for public office; and whether the organization complied with backup withholding rules for reportable payments to vendors and reportable gaming (gambling) winnings to prize winners. On the other hand, examples of governance questions on the redesigned Form 990 for tax years beginning in 2008 include: whether the organization has a written conflict of interest policy, whistleblower policy, document retention and destruction policy, gift acceptance policy, and joint venture policy; whether the organization contemporaneously documented the meetings or written actions undertaken by its governing body and each committee with authority to act on behalf of the governing body; whether a copy of the Form 990 was provided to the organization's governing body before it was filed; whether the process for determining compensation for the organization's CEO, other officers, and key employees include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision; and a description of whether, and if so how, the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.[147]

(6) **Governance Inquiries Should Be Made and Comments Addressed In As Neutral A Manner As Possible Under the Circumstances.** The manner in which the IRS poses questions and delivers information is critical. The IRS's merely asking about a specific governance practice is inherently prescriptive, with the ability not only to impact behavior in a manner that can be harmful to the

[147] Occasionally a question is a mixed compliance and governance question, such as requiring an organization to check each method (own website, another's website, upon request) by which it makes its Forms 1023/1024, 990, and 990-T (in the case of a section 501(c)(3) organization) available for public inspection.

sector, but also to inappropriately suggest to the public and watchdog groups that the absence of specific governance policies or practices is in effect misgovernance. The harm that can arise from the IRS appearing to mandate specific practices can, however, be minimized by the manner in which the question is asked. While no question is truly neutral, we recommend that questions be asked in the most neutral and least value-laden manner possible. For example, "Is a majority of your governing body comprised of independent persons?" is a loaded question, whereas asking, as the redesigned Form 990 does, about the number of voting members on the governing board and the number of voting members that are independent is a significantly more neutral approach; although each inquiry suggests, to varying extents, that it is desirable to have independent governing body members. In each case, the IRS should consider the best way to address a governance inquiry and then whether the prospective benefits hoped to be obtained from asking a question in the preferred way sufficiently outweighs the potential harms. The answer may suggest in specific cases that even the most central governance question should not be asked.

On balance, we believe the governance questions on the redesigned Form 990 for 2008 are relatively neutral; in addition, charities do have an opportunity to explain any answer on Schedule O. There are, however, questions that we would recommend be rephrased to more effectively promote compliance and to recognize the differences among exempt organizations, such as the inquiry relating to whether a copy of the Form 990 was provided to the organization's governing body before it was filed. Asking an organization to describe the process, if any, used to review the Form 990 is a less value laden inquiry than whether a copy of the Form 990 was provided to the organization's governing body before it was filed, although both are asked on the redesigned Form 990 for tax years beginning in 2008. Pre-filing review may be an acceptable approach for some organizations, but it is not necessarily the best approach for all organizations. The Form 990 is a sizeable and complicated document that is laden with technical terms and code or regulation sections. The volunteer governing body for a small organization may feel overwhelmed by the obligation to "review" the form, may expend limited resources that are better utilized for charitable purposes to have professionals assist the governing body, may be concerned about potential liability, or may be deterred from service as governing body members. In the case of large, complex organizations comprised of multiple entities, governing board members are likely to be overwhelmed by the quantity of paper, may miss the key aspects of the returns due to an inability to "see the forest from the trees," and also may be concerned about whether their review subjects them to liability in the case of errors and thereby expend unnecessary external resources or be deterred from service. In this latter case, a better practice may be for management to cull the sensitive information in the Forms 990 and to present that information to the governing body, or a committee of the governing body.

(7) Questions That Ask About Practices And Approaches Are Typically Better Than Questions That Ask About Policies. One aspect of neutrality is to focus on the practices and approaches employed by a charity, as opposed to whether it has adopted certain policies. As noted above, policies are not practices and bad policies can lead to bad practices. Even where a policy has been adopted, that policy may not be well conceived, the existence of a policy does not mean that employees and other constituencies are aware of or understand the policy, and the policy may not be enforced in a manner that achieves its intended objectives. Moreover a poorly crafted policy or one that the organization is not in a position to enforce can create liability. It also must be appreciated that the creation and enforcement of a policy may be a significant burden to small charities or to certain other types of charities, diverting critical financial and human resources away from their charitable activities with little or no corresponding benefit.

While we believe, on balance, that the governance questions on the redesigned Form 990 for 2008 are relatively neutral, we do have significant reservations about the questions relating to the whistleblower policy and the document retention and destruction policy. Neither has an explicit relationship to the tax rules (we would, of course, feel otherwise if the document retention and destruction policy focused on tax documents); while they may be important for certain large organizations, they are likely to present an unnecessary burden for smaller and certain other types of organizations; and hospitals (and perhaps other large organizations) typically have such policies in place and therefore do not need the IRS to encourage them to do so.[148] We also note that while the redesigned Form 990 asks about five different policies (gift acceptance, whistleblower, document retention, conflict of interest, and joint venture arrangements), it attempts to confirm adherence to the policies only in the last two instances. The sample conflict of interest policy included with the Form 1023 instructions goes well beyond the basics that would be appropriate for a small organization.[149] Moreover, the policy is less inclusive than one would expect in the case of many universities, hospitals, and large organizations, suggesting to these organizations that the IRS sees no need for their more extensive protections.[150]

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[148] *See supra* Section VI.B. and *infra* Health Care Appendix 3.

[149] *See*, *e.g.*, *supra* note 142.

[150] For example, the sample policy applies only to a "director, principal officer, or member of a committee with governing board delegated powers." Many universities, hospitals, and large organizations subject all employees, or employees at the director level or higher, to their conflict policy. Putting aside the lack of clarity as to what constitutes a "principal officer," in many large organizations senior managers other than the president (or possibly the chief financial officer and/or chief operating officer) are not "officers" within the meaning of state law, which requires that they be so designated in the organization's governing documents. Many other persons who might constitute "disqualified persons" or "insiders" also would not be included. While the sample policy may be broader in some respects from excellent forms of conflict of interest policies, it also may be narrower in other respects. For example, such policies might speak to conflicts involving use of organization information for personal benefit, soliciting for the benefit of, or otherwise assisting, another entity to the detriment of the organization, or usurping for personal gain an opportunity to the detriment of the organization. We note, however, that *Governance and Related Topics – 501(c)(3) Organizations*, *supra* note 22, does state: "Organizations are urged to tailor the sample policy to their own particular situations and needs, with the help of competent counsel if necessary."

(8) The IRS Should Expressly Acknowledge When Governance Practices About Which It Is Inquiring Or Which It Is Addressing Are Not Required. The IRS should expressly acknowledge where practices are not required. In this regard, we commend the IRS for including in the caption of the Governance, Management and Disclosure section (Part VI) of the redesigned core Form 990 the express statement that "Sections A, B, and C request information about policies not required by the Internal Revenue Code." However, there are governance questions on other portions of that Form 990 that did not include a similar disclaimer.[151] In other IRS governance initiatives the IRS often, but not always, includes an express statement that recommended policies and the like are not required.[152]

(9) The IRS Should Expressly Acknowledge that Governance Practices About Which It Is Inquiring Or Which It Is Addressing May Be More Appropriate For Some Types Of Organizations Than For Others And Respect The Role Of The Governing Body In Making Those Decisions.

The tax-exempt sector is hugely diverse in terms of size, sophistication, location, resources and activities. What may work for one organization, may not work for another, or may be outweighed by countervailing considerations. The IRS should acknowledge that it is entirely appropriate for a governing body to choose from among a wide variety of suitable governance practices permitted under state law based on the distinctive aspects of the organization. In some instances, particularly with small organizations, that will entail a cost-benefit analysis.[153] Encouraging an organization's governing body to consider what types of governance practices are best for its organization is in our view typically the more appropriate message and is supportive of the fundamental and wholly legitimate authority of the organization's governing board.[154]

(10) Taking Into Account The Absence Of Certain Governance Practices In Determining Whether To Audit Or Take Other Compliance Actions May Be Appropriate in Certain Circumstances. We would consider it appropriate for the IRS to make the absence of certain governance procedures a factor that increases the likelihood of audit if they are relevant to specific inurement or

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[151] *See supra* note 123.

[152] *See supra* note 115 regarding the IRS express statements that the conflict of interest policy included with the Form 1023 is not required. In connection with its *Governance and Related Topics – 501(c)(3) Organizations*, *supra* note 22, the IRS states in the Preface that "the tax law generally does not mandate particular management structures, operational policies, or administrative practices. . . ." This statement is not, in our view, explicit enough to obviate the need to state with respect to each recommended practice that it is not required. The IRS specifies that certain practices are not required, such as governance and management policies, but not with respect to other matters such as board size, board independence, board composition, fundraising costs, audits, and transparency with respect to fundraising expenses, conflict of interest policy, and financial statements.

[153] *See*, for example, *supra* notes 136-38 and accompanying text.

[154] For example, *see* GuideStar's comments about the draft redesigned Form 990, *supra* note 121. The *Governance and Related Topics – 501(c)(3) Organizations*, *supra* note 22, states: "Depending on an organization's specific situation, some of the recommended policies and practices will be more appropriate than others." *Id.* at Preface. In connection with the recommendation that organizations adopt a conflict of interest policy, the IRS does suggest that the governing board tailor the policy to the organization's needs. *See supra* note 151.

private benefit concerns identified in connection with a particular organization's operations or proposed operations and if those concerns are not otherwise addressed by the organization. This could include, depending upon the specific operational concerns, the absence of a conflicts of interest policy, independent board, or review of insider transactions by independent persons, failure to use comparability data, or contemporaneously documenting the review. Where the issue arises on determination, the IRS could if it chose slate the organization for an early audit or other compliance initiative where the IRS can evaluate whether the organization is meeting the operational test based on its actual track record. We believe this is a preferable approach to requiring or "jawboning" specific governance practices in the determination phase, although we are concerned that this will cause charities to adopt unproven practices that may not make sense in their context. In any event, we believe it should be limited to situations where there are real and specific operational issues that are identified in the context of a particular organization and where the organization has not taken other steps to address the concerns.

(11) Consistency and Fair Treatment are Critical. Based on our interviews and personal experiences, we are concerned that well-meaning determination specialists, auditing agents, and other IRS personnel may sometimes be inappropriately requiring organizations to adopt specific governance practices. While organizations represented by sophisticated lawyers and accountants are likely to know they can successfully challenge such demands (although they too may succumb to the path of least resistance), that is less apt to be the case for smaller organizations, which are more prone to be representing themselves or to have a volunteer lawyer or accountant assisting who is not necessarily experienced in exempt organization matters. Thus, we have concerns about consistency and potentially disparate treatment, or the perception of unfairness, in connection with both the determination and the audit/compliance processes. Accordingly, we encourage the IRS to consider how to best assure consistency and guard against disparate treatment. In cases involving whether to condition exemption or continued exemption on the adoption of specific governance practices, and the conditions to be imposed, the matters might be reviewed by one office within the IRS based on specific guidelines, with records summarizing past practices and a mandate to strive for consistency. For example, it is not clear to us whether there is a requirement that new organizations seeking determinations under section 501(c)(3) have a conflicts policy, whether a policy is only required based on specific facts and circumstances (and, if so, what they are), or whether there is more randomness to the requirement, based on the determination specialist. Similarly, on audit or in the context of another compliance initiative, we do not know if there are standards as to what governance practices may be required and under what circumstances.

Important aspects of ensuring consistency and fair treatment are transparency and training of IRS personnel. The application of governance principles in the determination process and on audit/compliance initiatives need to be clear and transparent both to charitable organizations and to determination specialists,

auditing agents, and other IRS personnel. We believe that, in the absence of guidance, well-intentioned IRS employees are more likely to impose governance standards that may be ill-advised and most certainly are not required by law. This is particularly true in the context of widespread public commentary by senior IRS officials, which seems likely to influence the actions of IRS personnel on determinations and on audit. Because the agents and other IRS personnel involved in examinations and other compliance initiatives rely on the Internal Revenue Manual, Audit Guidelines, and Training Programs, we recommend that these resources set forth the IRS's positions on when revocation is appropriate and when other actions may be considered in lieu of revocation, the process for referring cases where there are significant concerns about an organization meeting the operational test that could be addressed through the adoption of specific governance procedures, any other processes for ensuring consistency, when and how specific governance practices should be recommended, whether and under what circumstances organizations are at an increased risk of audit because they have failed to adopt specific governance practices, and an explicit statement that specific governance practices are not required for exemption. While the Internal Revenue Manual and Audit Guidelines are relatively accessible, Training Program materials, checklists, and other internal guidance tools can be more challenging to obtain. The IRS should assure that all materials relating to governance are readily assessable to charities and the public without the need for a Freedom of Information request.

(12) <u>Education, Implemented Thoughtfully, Is More Appropriate Than Pressuring Change</u>. We believe that the IRS has an appropriate educational role with respect to governance. We view there being less danger of harm to the sector here than in the other four IRS touch points (*i.e.*, in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; and in 990 reporting). In addition, in the usual case, educational and outreach presentations and materials allow for a full and fair elucidation of important nuances pertaining to specific governance practices, which also minimizes potential harm to the sector. Nevertheless, thoughtfulness is important because pronouncements from the IRS even in this context can be viewed as prescriptive, impacting behavior in a manner that can be harmful to the sector, and inappropriately suggesting to the public and watchdog groups that the absence of specific governance policies or practices is in effect misgovernance.[155] We have three specific recommendations with respect to education and outreach.[156] First, the IRS might do better to target smaller organizations than larger ones. As discussed previously, many sophisticated and complex organizations are subject to regulation and/or are accredited and, in

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[155] The reach and impact of a speech by senior IRS personnel is considerably broader than the live audience who heard it. Even where not posted to the IRS website, such speeches typically are reported by the trade press, and even if they are not, attendees may include representatives of law firms, accounting firms or trade associations who disseminate the remarks to their clients and constituencies.

[156] *See supra* note 91.

any event, have numerous governance resources available to them.[157] In 2004, more than 74 percent of public charities that filed tax returns reported annual expenses of less than $500,000; and less than four percent had expenses greater than $10 million.[158] Small organizations are considerably less likely to have the luxury of governance resources or specialized lawyers and accountants available to them. If the IRS is going to go beyond core tax compliance, it may find that emphasizing basic issues is more useful and effective, such as the importance of the governing body members understanding the purposes of the organization and their responsibilities as governing body members, including through orientation and regular education, receiving and reviewing in advance of meetings an agenda and relevant materials, determining the direction of the organization, and being alert to issues that may require their involvement. It is critical, of course, that the IRS is sensitive to the fact that the costs of adopting practices that may be advisable for larger nonprofits simply may not be worth the benefits, and the reality that the costs of governance will consume charitable assets that could otherwise be devoted to the organizations' programs. Second, the IRS might consider sending all new section 501(c)(3) organizations educational information about the importance of an organization's governing body adopting good governance practices as appropriate for the organization, either in the determination letter, or as an attachment to that letter. Third, all education and outreach, including those involving our modest suggestions, should be prepared in collaboration with the tax-exempt community and its content should be consistent with the recommendations set forth herein.

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[157] *See supra* Section VI.B. and *infra* Health Care Appendix 3.

[158] *Independent Sector Facts and Figures about Charitable Organizations*, January 4, 2007, http://www.independentsector.org/programs/research/Charitable_Fact_Sheet.pdf, at 3.

APPENDIX 1. SOURCES CONSULTED FOR THIS REPORT

This Appendix is organized into the following four categories:

A. THOSE INTERVIEWED FOR THIS REPORT

B. OCTOBER 4, 2007 MINI-CONFERENCE: *INTERNAL REVENUE SERVICE ROLE IN CORPORATE GOVERNANCE OF NONPROFITS.*

C. JANUARY 16, 2008 MINI-CONFERENCE: *IMPROVING GOVERNANCE IN NONPROFITS: DO WE KNOW HOW? DO FOR-PROFITS PROVIDE LESSONS?*

D. WRITTEN MATERIALS

A. THOSE INTERVIEWED FOR THIS REPORT

ACT members obtained information and perspectives about governance issues and practices through interviews with IRS and Treasury staff, charities' experts in state attorneys general offices, academics, and practitioners in the field (including exempt organization and other attorneys, accountants that work with nonprofit organizations, those involved with the promotion of voluntary standards in the nonprofit sector, and other experts and stakeholders). The interviews explored the history of the IRS's involvement in governance issues with respect to exempt organizations, any empirical evidence regarding the efficacy of specific governance practices, and the interviewees' perspectives on what is meant by good governance and the appropriate role of the IRS in this area.

Internal Revenue Service

Rob Choi, Director, EO Rulings and Agreements

Marvin Friedlander, Manager, EO Technical, EO Rulings and Agreements

Lois G. Lerner, Director, Exempt Organizations

Catherine E. Livingston, Deputy Division Counsel/Deputy Associate Chief

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Steven T. Miller, Commissioner, TE/GE

Ronald J. Schultz, Senior Technical Advisor, TE/GE

Cindy Westcott, Manager, Exempt Organizations Determinations

Roberta B. Zarin, Director , EO Customer Education and Outreach

Department of Treasury

Susan Brown, Deputy Tax Legislative Counsel

Eric A. San Juan, Deputy Tax Legislative Counsel

National Association of State Charity Officials

Eric Carriker, Massachusetts

Chris Cash, Colorado

Michael DeLucia, New Hampshire

Therese Harris, Illinois

Belinda Johns, California

Hugh Jones, Hawaii

Terry Knowles, New Hampshire

Karin Kunstler Goldman, New York

Mark Pacella, Pennsylvania

Susan Staricka, Texas

Jody Wohl, Minnesota

Selected Experts in the Field

Evelyn Brody, Professor of Law, Chicago-Kent College of Law, Illinois Institute of Technology

Laura Brown Chisolm, Professor of Law, Case Western Reserve University

Marian R. Fremont-Smith, Senior Research Fellow, The Hauser Center for Nonprofit Organizations, Harvard University

Janne Gallagher, Vice President and General Counsel, Council on Foundations

Mindy Hatton, General Counsel, American Hospital Association

Cindy M. Lott, Project Consultant, Oversight & Regulation of Charitable Organizations Program at Columbia University

Maureen Mudron, Washington Counsel, American Hospital Association

Tam Ormiston, Project Consultant, Oversight & Regulation of Charitable Organizations Program at Columbia University.

David E. Ormstedt, Project Consultant, Oversight & Regulation of Charitable Organizations Program at Columbia University

James Tierney, Director of the National State Attorneys General Program, formerly Attorney General of the State of Maine

ACT members also benefited from the perspectives of many more professionals and practitioners through their participation in the two mini-conferences listed below.

B. OCTOBER 4, 2007 MINI-CONFERENCE: *INTERNAL REVENUE SERVICE ROLE IN CORPORATE GOVERNANCE OF NONPROFITS, NEW YORK UNIVERSITY NATIONAL CENTER ON PHILANTHROPY AND THE LAW*

The ACT benefited from the perspectives of many professionals and practitioners through their participation in this mini-conference convened, at the suggestion of the ACT, by the National Center on Philanthropy and the Law at New York University Law School, in New York City, on October 4, 2007. Special thanks to Professor Harvey P. Dale and Professor Jill S. Manny for organizing this conference. The agenda and list of participants is below.

AGENDA

NATIONAL CENTER ON PHILANTHROPY AND THE LAW
MINI-CONFERENCE
INTERNAL REVENUE SERVICE ROLE IN
CORPORATE GOVERNANCE OF NONPROFITS

October 4, 2007

10:00 a.m. – 10:15 a.m.	Welcoming Remarks and Introduction: H*arvey P. Dale*
10:15 a.m. – 11:15 a.m.	Role of the Internal Revenue Service in Nonprofit Governance Historically and Today.
11:30 a.m. – 12:45 p.m.	Arguments For and Against Internal Revenue Service Regulation of Nonprofit Governance.
12:45 p.m. – 1:45 p.m.	LUNCH
1:45 p.m. – 2:45 p.m.	Who Else Can Regulate Nonprofit Governance?
3:00 p.m. – 3:45 p.m.	Vehicles for Internal Revenue Service Regulation of Nonprofit Governance.

LIST OF PARTICIPANTS

- Betsy Buchalter Adler, Esq., Silk, Adler & Colvin
- Ms. Diana Aviv, Independent Sector
- Victoria B. Bjorklund, Esq., Simpson, Thacher & Bartlett LLP
- Bonnie S. Brier, Esq., The Children's Hospital of Philadelphia
- Professor Harvey P. Dale, New York University School of Law
- Sean C. Delany, Esq. Lawyers Alliance for New York
- Marion R. Fremont-Smith, Esq., The Hauser Center for Nonprofit Organizations
- Fred T. Goldberg Jr., Esq., Skadden, Arps, Slate, Meagher & Flom

- Karin Kunstler Goldman, Esq., Charities Bureau, New York State Department of Law
- Rochelle Korman, Esq., Patterson, Belknap, Webb & Tyler LLP
- Lois G. Lerner, Esq., Internal Revenue Service
- Catherine E. Livingston, Esq., Internal Revenue Service
- Professor Jill S. Manny, National Center on Philanthropy and the Law
- Steven T. Miller, Esq., Internal Revenue Service
- Marcus S. Owens, Esq., Caplin & Drysdale
- Celia A. Roady, Esq., Morgan, Lewis & Bockius LLP
- Ronald J. Schultz, Esq., Internal Revenue Service
- Thomas Silk, Esq., Silk, Adler & Colvin
- Professor John G. Simon, Yale Law School
- Jonathan A. Small, Esq., Debevoise & Plimpton, LLP
- Professor Linda Sugin, Fordham University School of Law
- Ms. Ana Thompson, Charles and Helen Schwab Foundation

C. JANUARY 16, 2008 MINI-CONFERENCE: *IMPROVING GOVERNANCE IN NONPROFITS: DO WE KNOW HOW? DO FOR-PROFITS PROVIDE LESSONS?*

URBAN INSTITUTE CENTER ON NONPROFITS AND PHILANTHROPY AND THE HARVARD UNIVERSITY HAUSER CENTER FOR NONPROFIT ORGANIZATIONS

The ACT benefited from the perspectives of many professionals and practitioners through their participation in this mini-conference convened, at the suggestion of the ACT, co-convened by the Urban Institute Center on Nonprofits and Philanthropy and the Harvard University Hauser Center for Nonprofit Organizations, in Washington, D.C. on January 16, 2008. Special thanks to Elizabeth T. Boris, Eugene Steuerle, and Francie Ostrower of the Urban Institute for helping to organize this event. The agenda and list of presenters is below.

AGENDA AND LIST OF PRESENTERS

Emerging Issues in Philanthropy Seminar Series

A joint project of the Urban Institute Center on Nonprofits and Philanthropy

and the Harvard University Hauser Center for Nonprofit Organizations

IMPROVING GOVERNANCE IN NONPROFITS:

DO WE KNOW HOW? DO FOR-PROFITS PROVIDE LESSONS?

A Roundtable Discussion

Wednesday, January 16, 2008

from 9:00 am to 3:30 pm

at the Urban Institute

Washington, D.C.

9:00-9:15 a.m. **Welcome and Ground Rules**

- Elizabeth T. Boris, *The Urban Institute*
- Marion R. Fremont-Smith, *The Hauser Center*

9:15-9:45 a.m. **Setting the Agenda**

- Fred T. Goldberg, Jr., *Skadden, Arps, Slate, Meagher & Flom LLP*
- Evelyn Brody, *Chicago-Kent College of Law*

9:45-11:15 a.m. **Nonprofit Governance: Findings and Reflections on Board Practices and Accountability**

- Moderator: Elizabeth T. Boris, *The Urban Institute*
- Francie Ostrower, *The Urban Institute*
- Paul Light, *New York University*
- Wendy Puriefoy, *Public Education Fund*

11:15-11:30 a.m. **Break**

11:30 – 1:00 p.m. **Business Governance Practices**

- Moderator: Joseph J. Cordes, *George Washington University*
- Hank Barnette, *Skadden, Arps, Slate, Meagher & Flom LLP*

- Carolyn Brancato, *The Conference Board*
- Lena G. Goldberg, *FMR Corporation*

1:00-1:30 p.m. **Lunch**

1:30 – 3:15 p.m. **Transferable Lessons & Unique Sector Characteristics**

- Moderator: Evelyn *Brody*, *Chicago-Kent College of Law*
- Charles O. Rossotti, *The Carlyle Group*
- Marion R. Fremont-Smith, *The Hauser Center*
- Michael Klausner, *Stanford Law School*
- Nell Minow, *The Corporate Library*

3:15 – 3:30 p.m. **Future Research and Practice Agendas**

Moderator: Elizabeth T. Boris, *The Urban Institute*

D. WRITTEN MATERIALS

The ACT reviewed general and specialized publications (including articles, books, and special reports relating to governance in the for-profit and nonprofit sectors); materials, publications, forms, rulings, and advice issued by the IRS and Department of Treasury; publications and speeches by senior IRS officials; congressional testimony and reports; case law; and other materials. A detailed bibliography of certain written materials consulted in the preparation of this report is included below.

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APPENDIX 2. FOR-PROFIT CORPORATE GOVERNANCE

A. Enron, Sarbanes-Oxley and For-Profit Governance

Corporate governance "best practices" in the nonprofit sector today borrow heavily from the for-profit world.[159] The history of regulation, and the pressure for greater self-regulation, in both sectors ebbs and flows, emerging most strongly in the face of public indignation over abuses and crises, real or perceived, and the belief—or at least hope—that imposing additional "safeguards" can forestall similar occurrences in the future.[160] In fact, it is virtually tautological that a significant failure by an organization is a failure of governance.

The enactment of groundbreaking federal securities laws often was prompted by profound failure or crisis:[161]

- The passage of the Securities Act of 1933[162] (the first general federal law to regulate the issuance of securities, requiring among other things that certain issuers of securities file registration statements with the Federal Trade Commission and provide a prospectus with specified information to investors and prohibiting misrepresentations and other fraud in the sale of securities) and the Securities Exchange Act of 1934 (the first federal law to regulate the trading of securities, it created the Securities and Exchange Commission, gave the SEC the power to regulate the securities' exchanges and prohibited insider trading and a number of other trading practice schemes) were possible only because of the public's loss of confidence in the public markets after the stock market crash of 1929 and the Great Depression.

- The enactment of the Public Utility Holding Company Act (which gave the SEC power to limit the size and organization of utility holding companies) in 1935 was the direct result of unfair practices by gas and electric companies, including excessive rates, self-dealing and unreliable service that hurt consumers and investors.

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[159] *See*, *e.g.*, *supra* notes 40, 42-43, and 47 and accompanying text.

[160] Of course, as today, resources and politics play an important role in the extent to which Congress and regulators decide to adopt "reforms" and/or aggressively enforce existing rules and regulations. Thus, for example, in 1955, the SEC was faced with such severe staffing shortages that it issued a memorandum encouraging its regional offices to rely upon state authorities to investigate and prosecute securities cases. Its resulting ineffectiveness was the subject of criticism by the press (*see*, *e.g.*, Time Magazine, *Protection for Investors: The SEC is Unequal to the Job*, July 16, 1956, http://www.time.com/time/magazine/article/0,9171,936723,00.html) and then Congress (*see*, *e.g.*, Report of the House Select Subcommittee on Legislative Oversight, H.R.Rep. No. 2711, 86th Cong., 1st Sess. (1959)) for failing to aggressively prosecute cases, particularly cases against large firms, and for failing to uncover the breadth of illegal activity by the American Stock Exchange ("AMEX") when it brought an administrative action against a number of members of the AMEX, resulting in relatively light penalties. In 1961, a report requested by President Kennedy on federal regulatory agencies, including the SEC, emphasized the importance of adequate personnel and resulted in increased staffing for the SEC. *See* http://www.sechistorical.org/museum/timeline/index.php.

[161] *See* generally, http://www.sec.gov/about/whatwedo.shtml; http://www.sechistorical.org/museum/timeline/index.php; http://www.fuqua.duke.edu/conference/dei/nyse/docs/cautious_evolution_or_perennial_irresolution.pdf .

[162] Despite the cataclysmic events that produced these laws, Wall Street protested the passage of the Securities Act of 1933 by refusing to bring new stock issues to the market in 1933. http://www.sechistorical.org/museum/timeline/index.php.

- The passage of the Investment Company Act and Investment Advisers Act in 1940 (requiring investment companies and their directors, managers and advisers to register with the SEC and prohibiting a number of abusive practices) followed a major investigation by the SEC that showed serious self-dealing and other abuses.

- The SEC adopted Rule 10b-5 (prohibiting insider trading) in 1948 in response to the president of a company misrepresenting the prospects of his company and then buying stock below what its market value would otherwise have been.[163]

Governance rules promulgated by the exchanges often followed the same pattern—enacted only as reactions to massive failures.[164] For example, in 1938, only after a scandal involving the embezzlement of funds and securities by the former president of the New York Stock Exchange ("NYSE"), with allegations that NYSE members knew and remained silent, and under intense pressure from the SEC, did the NYSE reorganize its governance structure, creating a new constitution that provided for a full-time salaried president with a professional staff, requiring that three members of the public sit on the governing board and changing the method of electing governors.[165]

Of course, the Sarbanes-Oxley Act of 2002[166] was Congress' response to the Enron, WorldCom , Adelphia, Tyco, Global Crossing and other corporate scandals, and was enacted promptly after Enron and WorldCom collapsed in 2001 to forestall further erosion in the public's confidence in the public markets. The fact that SOX imposed many substantive governance requirements on publicly-traded corporations distinguishes it from prior federal legislation, which typically was limited to disclosure requirements. In fact, a number of the provisions in SOX previously were proposed, but were not implemented until after these catastrophic failures occurred.[167]

The stated purpose of SOX is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes"[168] and, with the exception of three criminal provisions in two areas, SOX applies only to publicly-traded companies.[169] Thus, Congress designed SOX to increase the accountability of the board, senior managers, auditors and others within

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[163] *See*, *e.g.*, http://books.google.com/books?id=UwwKFDTLO48C&pg=RA2-PA73&lpg=RA2-PA73&dq=1942+%2210b+5%22&source=web&ots=GiqH37th7X&sig=_X_gGA9VizN8PBVksaNq4pX02lI

[164] Regarding the NYSE, *see*, *e.g.*, http://www.hnet.org/~business/bhcweb/publications/BEHonline/2003/Traflet.pdf.

[165] *See*, *e.g.*, http://www.sechistorical.org/museum/timeline/index.php.

[166] *See supra* note 2.

[167] *See*, *e.g.*, Romano, *supra* note 43, at 1523-24.

[168] SOX, *supra* note 2, at 745 (Title clause).

[169] Three criminal provisions in SOX apply to all organizations, including nonprofit corporations: Sections 802 and 1102 make it a felony to knowingly alter, destroy, create or conceal documents that would interfere with an existing or contemplated federal investigation or official proceeding or otherwise obstruct, influence, or impede an official proceeding; and section 1107 of SOX makes it a felony to knowingly retaliate against a whistleblower who provides truthful information to a law enforcement officer about the possible commission of a federal offense.

the organization to improve internal financial controls[170] and to make prompter and more comprehensive public disclosures, particularly with respect to financial reporting problems.[171] Public company boards are required, among other things, to form an audit committee comprised wholly of independent directors to hire, supervise, and review the performance of outside auditors and to disclose whether there is a financial expert on the audit committee. Public company executives must certify responsibility for financial reports; disclose material weaknesses; and assess the internal controls on financial reporting. Outside auditors are prohibited from providing most non-audit services; lead auditors must rotate every five years, and the audit firm must report directly to the audit committee. The corporation must adopt a code of conduct applicable to its CEO and financial personnel and personal loans to executives and directors are prohibited.

SOX also required the exchanges to implement certain changes in their rules. Perhaps because of the magnitude of the failures, the NYSE[172] and other exchanges went well beyond what was required and imposed landmark governance reforms on their members. For example, the NYSE requires that the boards of most publicly-traded companies be comprised of a majority of independent directors, have audit, governance, and compensation committees comprised solely of independent members, and undertake specified tasks, including conducting an annual self-evaluation, that must be set forth in a charter that is posted on the corporation's website.

Two questions then are: (1) what empirical data exists about the efficacy of these various corporate "best practices;" and (2) assuming there is evidence of their effectiveness in the for-profit world, will adoption of those "best practices" by nonprofit organizations similarly achieve positive results.

Professor Robert Clark, in a 2005 paper,[173] considered the empirical studies involving SOX-type governance measures and publicly-traded corporations then to date and concluded that "the search for strong empirical evidence supporting a belief that key items in the recent wave of corporate governance changes will have a major positive impact is generally disappointing."[174] For example:

- **Internal Controls – Section 404.** Regarding the internal controls requirements of section 404 of SOX, the analysis suggested that the benefits of lower-level fraud detection are modest and he questioned whether these internal control provisions would indeed prevent the high-level fraud seen in

[170] Based on our experience and interviews for this report, public accountants representing both publicly-traded corporations and exempt organizations that the financial requirements of SOX, particularly involving internal controls, have impacted exempt organizations; while exempt organizations are not expected to meet the strict requirements of section 404 of SOX, accountants are much more focused on their internal controls, including in management letters.

[171] *See*, *e.g.*, Oxholm, *supra* note 42, at 357.

[172] The NYSE final governance rules enacted in response to the corporate failures beginning with Enron and the passage of SOX can be found at http://www.nyse.com/pdfs/finalcorpgovrules.pdf. Other NYSE rules and regulations can be found at http://www.nyse.com/regulation/rules/1145486472038.html.

[173] *See* Clark, *supra* note 43.

[174] *Id.* at 308.

the Enron and WorldCom scandals that inspired SOX. Moreover, he noted that the first-year costs of complying with the section 404 provisions, as estimated by the Financial Executives International survey, was nearly 50 times greater than that originally estimated by the SEC ($60 vs. $1.2 billion); and the costs also were regressive, being not proportional to company size.[175]

- **Auditors' Non-Audit Services.** In a survey of 25 empirical studies on the issue of auditors providing non-audit services, Professor Robert Romano reported that the overwhelming majority (19) found no negative impact and stated: "the conclusion that audit quality and auditor independence are not jeopardized by provision of non-audit services is supported not only by the great majority of studies, but by those that use the most sophisticated techniques and whose findings are most robust to different specifications of their models."[176]

- **Independent Directors.** While there were a number of studies finding some positive impact with independent directors, evidence from the first large-scale long-time horizon study of the relationships among board independence, board size and the long-term performance of large American firms indicated that firms with more independent boards did not achieve improved profitability.[177]

- **Audit Committee Composition to Include Only Independent Directors.** Professor Roberta Romano in a review of 16 studies involving audit committees reported that the majority, especially those studies using more sophisticated techniques, do not support the hypothesis that an audit committee composed only of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance.[178]

- **Disclosure.** One area where the empirical evidence did indicate a correlation with positive effects for shareholders involves disclosure-related governance practices. None of the studies available at that time, however, considered the specific disclosure requirements mandated by SOX. Professor Clark cites, for example, a study examining the positive effect of

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[175] *Id.* at 291-95.

[176] *Id.* at 295-97. *See* also Romano, *supra* note 43, at 1535-37. Professor Romano's fine article also provides a thorough and careful review of studies on independent audit committees, executive loans, and executive certification of financial statements, as well as an analysis and critique of the legislative process leading to SOX. A less formal but wider overview of the empirical evidence, which cites some intriguing additional studies, is given in Larry Ribstein, *Sarbanes-Oxley after Three Years*, (draft of June 20, 2005), abstract and paper available at http://papers.ssrn.com/abstract_id=746884.

[177] *Id.* at 298-302. *See* also Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 Iowa J. Corp. L. 231-72 (2002). In the nonprofit context, *see* Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 Fordham L. Rev. 795 (2007); Kathleen M. Boozang, "Does an Independent Board Improve Nonprofit Corporate Governance?," 75 Tenn. L. Rev. 83 (2007).

[178] *Id.* at 302. *See* also Romano, *supra* note 43.

the 1964 extension of mandatory disclosure requirements to over-the-counter ("OTC") stocks to a dramatic reduction in the volatility of those stocks.[179]

Professor Clark also reviewed the specific "good governance practices" advocated by the rating agencies, including:

- a supermajority of independent directors;
- a relatively small board size;
- a separate (*i.e.*, independent, non-CEO) board chairman;
- a specified number and length of meetings;
- regular executive sessions (at which company officers are not present);
- regular evaluations of the CEO;
- regular self-evaluations of the board;
- minimum stock ownership requirements for directors; and
- limits on director tenure (term limits and/or retirement ages).

Citing a plethora of studies examining these and similar "good practices," Professor Clark concluded: "For most of these practices, the empirical evidence bearing on their correlation with shareholder value is limited or mixed or both, and does not prove decisively that they cause increases in value."[180]

In some sense, this is not surprising. For example, on paper, Enron had in place a rigorous conflict of policy and other controls. The problems related to implementation, including the board not demanding or ensuring it understood the pertinent information, the board waiving conflicts that should not have been waived, and the board not responding appropriately once problems began to emerge.[181] Anecdotal evidence such as this may indicate that good governance in the end is a question of the values, active engagement and accountability of those in charge, rather than the adoption of specific practices or policies. *

Even if empirical evidence suggested that certain "best practices" were "best" for business corporations, it is not at all clear that this would translate to nonprofit corporations.[182] The benchmark for success in these studies involving for-profit

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[179] *Id*. at 304-05. *See* also Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, Olin Paper No. 453 (2004), http://www.law.harvard.edu/programs/olin_center/corporate_governance.

[180] *Id*. at 303.

[181] *See supra* note 46.

[182] *See*, *e.g.*, Reiser, *supra*, note 47.

corporations was shareholder value. One dramatic difference between business corporations and nonprofits is that the former has almost a singular purpose—the overarching purpose of business corporations is to promote the welfare of shareholders, specifically to maximize shareholder value. The objective of corporate governance initiatives in this sector then is to protect investors and promote fair and efficient markets that both encourage investors to provide capital and protect investors who do so. For example, such initiatives endeavor to protect shareholders from attempts by management to benefit itself to the detriment of shareholders, to prevent insiders from trading on non-public information, and to require timely public release of accurate financial information that investors should have in determining whether to buy, sell or hold securities. But even with that more limited and approachable standard, the empirical data involving the for-profit sector either fails to support or is inconclusive or controversial with respect to the efficacy of many "good governance practices."

The nonprofit world, on the other hand, is virtually bereft of studies examining the efficacy of specific governance practices.[183] The purposes of nonprofit organizations are more diverse and complicated and, concomitantly, the roles of their boards are broader and more nuanced. This may suggest that specific good governance practices are even less likely to be effective in the nonprofit context. [184]

[183] *See supra* notes 39-40 and accompanying text.

[184] *See* Reiser, *supra* note 47.

APPENDIX 3. HEALTH CARE

The law of charity has always evolved to reflect the changing needs of society and that flexibility has been critical in considering under what circumstances hospitals and other health care organizations qualify for exemption.[185] The voluntary hospital of today operates very differently from Pennsylvania Hospital in 1751 or even the typical community hospital of the 1950s;[186] and other types of health care organizations that could not have been imagined five, ten, twenty or forty years ago have developed over the years. Thus, the IRS has been required to distinguish a health care organization that qualifies for exemption from one that is merely the for-profit practice of medicine. In various situations, the IRS has imposed such governance requirements as a community or independent board, mandated specific board approval of transactions, and required adoption of a conflict of interest policy.

In Revenue Ruling 56-185,[187] the IRS established for the first time a specific standard for nonprofit hospital exemption, relying principally on the "relief of poverty" rationale. However, with the passage of the Medicare and Medicaid statutes in 1965, which provided for government reimbursement of a substantial portion of the free care previously subsidized by tax-exempt hospitals, the IRS rethought the basis for hospital exemption. The challenge was to acknowledge that "promotion of health" was a type of community benefit, like the "relief of poverty," that could constitute the basis for exemption, while at the same time distinguishing a hospital organized and operated for charitable purposes from one that primarily served private interests. In Revenue Ruling 69-545,[188] the IRS provided an example of a hospital qualifying for exemption and an example of a hospital that did not qualify for exemption. One of the factors the IRS cited as distinguishing the "good hospital" from the "bad hospital" was that the former was governed by a board of trustees comprised of independent civic leaders. The emphasis on a community board can be viewed as an early foray into imposing a governance

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[185] *See*, *e.g.*, Mary Jo Salins et al., *Evolution of the Health Care Field*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program 1992 at 157, 158-59.

[186] For an historical discussion of the law of charities as applied to hospitals, *see*, generally, Robert S. Bromberg, Tax Planning for Hospitals and Health Care Organizations (1977), Chapter 7; Douglas Mancino, *Income Tax Exemption of the Contemporary Nonprofit Hospital*, 32 St. Louis U. L.J. 1015 (1988).

[187] Rev. Rul. 56-185, 1956-1 C.B. 202. The IRS set forth a number of criteria for exemption, including: the hospital must "be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able to pay;" the hospital must not restrict the use of its facilities to a particular group of physicians and surgeons to the exclusion of all other qualified doctors; and the hospital may set aside earnings to be used for improvements and additions to hospital facilities.

[188] Rev. Rul. 69-545, 1969-2 C.B. 117, contrasted two hospitals, one that qualified for exemption and one that did not. The key factors in the IRS's favorable ruling were: the hospital operated a full-time emergency room that treated all persons requiring emergency care regardless of ability to pay; the hospital provided care to all persons in the community who could pay for services, either by themselves or through private health insurance or public programs such as Medicare and Medicaid; medical staff privileges were available to all qualified physicians in the area, consistent with the hospital's size and the nature of its facilities; the hospital was governed by a board of trustees comprised of independent civic leaders; transactions between the hospital and members of the medical staff were at arm's length; and the hospital used its surplus of receipts over disbursements to improve the quality of patient care, expand facilities and advance its medical training, education and research programs. The emergency room requirement stemmed from the fact that indigent persons who were not covered by Medicare or Medicaid (or cared for in public hospitals) tended to receive their care in hospital emergency rooms or on admission to the hospital through the emergency room. Many hospitals only provided emergency care for indigents and then transferred poor uninsured patients to public hospitals or other hospitals that served charity cases. Subsequently, in Revenue Ruling 83-157, C.B., 1983-2 94, the IRS acknowledged that the operation of an emergency room is not an absolute requirement for exemption. While Medicaid is not explicitly referenced in the revenue ruling, the IRS applies this requirement equally to Medicaid. *See*, *e.g.*, Salins, *supra*, note 186, at 159.

requirement. The origin of the specific concern was that it was not uncommon in the 1950s, 1960s and 1970s for hospitals to be owned by a small group of community physicians; and a number of these hospitals came to seek tax exemption but operated so as to serve the private interests of their founders.[189] Thus, the requirement was imposed to show that the hospital would be operated for charitable purposes.

Over the years, the IRS has imposed additional governance-type requirements on health care organizations as a condition of exemption, in each case trying to distinguish those that not only promote health but also are organized and operated for charitable purposes from those that serve private purposes. The most common requirement has related to an independent board. The IRS has been particularly leery of physician-controlled health care organizations,[190] especially where the physicians determine their own compensation.[191] Courts, however, have been more lenient in awarding exemption to physician-controlled practice entities, at least where compensation safeguards are in place. Thus, the courts have granted exemption to faculty practice plans controlled by physicians despite the IRS's view to the contrary.[192] In the context of integrated delivery systems, the IRS has limited physician representation on the board of directors to a stricter 20 percent.[193]

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[189] *See*, *e.g.*, Harding Hospital, Inc. v. Comm'r, 505 F.2d 1068 (6th Cir. 1974); Kenner v. Comm'r, 33 TCM 1239 (1974); Sonora Community Hosp. v. Comm'r, 397 F.2d 814 (9th Cir. 1968) (mem.), aff'g 46 TC 519 (1966); Lowry Hospital Ass'n v. Comm'r, 66 TC 850 (1976); Maynard Hosp., Inc. v. Comm'r, 52 TC 1006 (1969). *See* also the non-qualifying hospital example in Rev. Rul. 69-545, 1969-2 C.B. 117.

[190] In fact, there have been practitioners who encouraged for-profit physician groups to consider tax exemption for their group practices. *See*, *e.g.*, Konrad Friedmann, *Tax Exempt Status for Medical Clinics: A Complex, Rewarding Option*, HealthSpan, July/August 1990, at 11 reprinted in 3 Exempt Org. Tax Rev. 1233 (1991).

[191] *See*, *e.g.*, Rev. Rul. 69-266, 1969-1 C.B. 151 (clinic created and controlled by physicians not exempt as does not differ significantly from private practice of medicine for profit); Lorain Ave. Clinic v. Comm'r, 31 TC 141 (1958); Fort Scott Clinic and Hosp., Corp. v. Broderick, 99 F. Supp. 515 (D. Kan. 1951); Labrenz Found. v. Comm'r, 33 TCM 1374 (1974).

[192] *See*, *e.g.*, the three initial cases involving academic physician practice plans: B.H.W. Anesthesia Found., Inc. v. Comm'r, 72 TC 681 (1979), nonacq., 1980-2 CB 2; University of Mass. Medical School Group Practice v. Comm'r, 74 TC 1299 (1980), acq., 1980-2 C.B. 2; University of Md. Physicians, P.A. v. Comm'r, 41 TCM 732 (1981). See also, Akron Clinic Found. v U.S., 64-1 USTC ¶ 9233 (ND Ohio 1964)(clinic).

[193] In the early 1990s, the IRS was confronted with the establishment of integrated delivery systems that included the creation of networks comprised of one or more hospitals and one or more groups of employed or captive physicians. Ultimately, the IRS ruled favorably but it took the aggressive step of limiting physician control of the combined entity to 20 percent of the board. *See*, *e.g.*, Charles F. Kaiser & T.J. Sullivan, *Integrated Delivery Systems and Health Care Update*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 1996 384; Charles F. Kaiser et al., *Integrated Delivery Systems and Joint Venture Dissolutions Update*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 1995 153; Charles F. Kaiser & John Francis Reilly, *Integrated Delivery Systems*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 1994 212; *IRS Officials Alert Hospitals to Current Concerns*, 7 Exempt Org. Tax Rev. 713 (1993). For a short period, the IRS included all financially interested persons within its 20 percent maximum,(Rockford Memorial Health Services Corp. of Rockford, Illinois. *See*, *e.g.*, Paul Streckfus, *Another IDS Ruling Released by IRS National Office*, 9 Exempt Org. Tax Rev. 992 (1994); *Integrated Delivery System, System Joining Clinic, Hospital, Managed Care Entities Wins Exemption*, 3 Health L. Rep. (BNA) 498 (1994), although it later relented, including within the 20 percent only physicians selling assets to, or providing professional services in conjunction with, the integrated delivery system and characterizing the 20 percent limit as a "safe harbor" applicable to organizations without a track record. *See*, *e.g.*, Charles F. Kaiser & T.J. Sullivan, *Integrated Delivery Systems and Health Care Update*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 1996 384, 390-91. In one case that may be aberrational, the IRS applied the 20 percent limitation to a for-profit physician hospital organization (PHO). *See Participation in PHO Will Not Jeopardize Tax-Exempt Status*, 10 Exempt Org. Tax Rev. 1323 (1994); Burda, "IRS Gives Nod to PHO, But Physicians Say No," Modern Healthcare 3 (Oct. 24, 1994); 4 Health L. Rep. (BNA) 151 (1995).

The IRS also tightened the control requirements for joint ventures between exempt hospitals and for-profit persons.[194] In Revenue Ruling 98-15,[195] the IRS considered whether a tax-exempt entity that operated a hospital jeopardized its exemption when it transferred its hospital assets into a joint venture entity owned equally by it and by a for-profit entity (known as a "whole hospital" joint venture). In the "good" fact pattern the exempt entity maintained governance control over the joint venture entity (the exempt entity chose a majority of the joint venture governing board and each of those board members were independent community leaders); maintained control over the day-to-day operations of the joint venture entity; conflicts of interest were minimized (the officers, directors and key employees of the hospital were independent of the for-profit entity and none of the hospital officers, directors or key employees involved in the decision to form the joint venture was promised employment or offered other inducements); and safeguards were in place intended to assure that the joint venture would operate to further charitable purposes and not just to maximize profits. By contrast, in the "bad" fact pattern, the IRS found that the hospital failed to establish it would be operated exclusively for exempt purposes, and therefore no longer qualified for exemption, where the hospital chose only half of the governing board members (each of whom was an independent community leader); the chief executive officer and chief financial officer for the joint venture previously work for the for-profit entity; the joint venture engaged a subsidiary of the for-profit entity to serve as manager pursuant to a contract that could be renewed indefinitely at the manager's discretion; and there were no assurances that the joint venture would serve charitable purposes over maximizing profits .

In Revenue Ruling 2004-51,[196] the IRS set a somewhat more relaxed control standard in the context of an "ancillary" joint venture (*i.e.*, a joint venture that is not a substantial part of the exempt entity's charitable activities). In this ruling, a university entered into a 50-50 joint venture with a for-profit entity specializing in conducting interactive video training programs limited to offer teaching training seminars at off-campus locations using interactive video technology. The IRS found that the university was engaged in an activity substantially related to its exempt purposes, and the inurement and private benefit prohibitions were not implicated where the exempt organization and for-profit entity each appointed half of the joint venture governing board. Safeguards showing sufficient control by the university to ensure that the joint venture operates for its exempt

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[194] For a general discussion about IRS's evolving view on joint ventures between tax-exempt and for-profit entities, *see*, *e.g.*, MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS (2007); McDermott Will & Emery *IRS Revenue Ruling Approves Tax-Exempt Organization Participation in Ancillary Joint Ventures,*" http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/6f1f3160-b371-4660-9e2f-eda902fd1494.cfm (May 13, 2004).

[195] Rev. Rul. 98-15, 1998-1 C.B. 718. *See* also Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff'd per curiam, 242 F. 3d 904 (9th Cir. 2001), finding that participation in an ambulatory surgical center joint venture did not qualify for exemption because control by the for-profit venture partners constituted substantial private benefit; St. David's Health Care System, Inc. v. United States, 2002-1 USTC ¶50,452 (W.D. Tex. 2002), *rev'd and remanded,* 349 F.3d. 232 (5th Cir. 2003), *St. David's Health Care System v. United States of America,* Civil Action No. A-01-CA-46 JN, reported at 2004 TNT 46-4, (W.D. Tex), where a federal district court jury ultimately determined that the exempt entity had maintained sufficient control over the whole hospital joint venture with a for-profit hospital company to assure that the joint venture was operated for charitable purposes, despite the Fifth Circuit's suggestion that it would be difficult to make such a determination.

[196] Rev. Rul. 2004-51, 2004-1 C.B. 974.

purposes included: exclusive control by the university over the content of the seminars (which was the same as its on-campus seminars), instructors, training materials, and the standards for successfully completing the seminars; while the for-profit entity alone determined video link locations and approved personnel other than instructors, the parties shared equal control with respect to other issues; ownership interests were proportional to capital contributions, returns of capital, allocations and distributions; and the governing documents precluded the joint venture from engaging in any activities that would jeopardize the university's tax exempt status and required all contracts and transactions be at arm's length and at fair market value.

In the physician recruitment context, the IRS has suggested several corporate governance safeguards, including board involvement, written agreements, and market surveys. In Revenue Ruling 97-21,[197] the IRS provided four situations in which a hospital's payment of physician recruitment incentives is deemed not to violate the hospital's exemption (and a fifth situation where it does violate the hospital's exemption). In each of the four favorable situations, the incentives were approved by the hospital's board of trustees or its designees; all incentives were set forth in a written agreement; and the incentives that included a guaranteed net income fell within the range reflected in regional or national surveys regarding income earned by physicians in the specialty. The physician recruitment ruling followed the publication of a closing agreement entered into between the IRS and Hermann Hospital to resolve certain physician recruitment and retention arrangements and other transactions with the hospital. Because the hospital was resolving transgressions, the IRS was in the position to extract additional commitments. The corporate governance aspects of the agreement included increased board involvement, greater oversight by senior management and legal and tax counsel, and required documentation and record keeping. Pursuant to the closing agreement, the hospital paid substantial penalties; agreed to follow specific physician recruitment guidelines included as an attachment to the closing agreement for ten years (and agreed the guidelines would be adopted by the hospital's executive committee before signing the closing agreement and be ratified by the hospital's full board at its next meeting); agreed that physician service agreements other than recruitment agreements would be reviewed and approved by the hospital's legal counsel, vice president, medical director, CEO and, if involving more than $250,000 per year, the executive committee of the board; agreed to exercise reasonable good faith efforts to comply with all employment tax requirements; and agreed to make the closing agreement public. Among the requirements in the attached physician recruitment guidelines are: the recruitment incentives must be in writing, approved by the hospital board, and reviewed by hospital legal counsel or tax advisor; all incentives must be reported on Form W-2 or Form 1099; and specified documentation and recordkeeping requirements.

Finally, the IRS has focused on health care organizations in its efforts to encourage exempt organizations to adopt a conflict of interest policy. The IRS released its first

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[197] Rev. Rul. 97-21, 1997-1 C.B. 121.

sample conflict of interest policy for hospitals in 1997[198] and over the years has issued revised versions of that policy.[199] Today, as discussed previously, the policy is in Appendix A to the instructions of the Form 1023 first released in October of 2004.[200]

We also note that health care is a highly regulated area, including with respect to its governance. Rigorous accreditation is, for all practical purposes, required for hospitals and it carries the force of law with sanctions for violations.[201] Pursuant to the Deficit Reduction Act of 2005, any entity that receives at least $5 million of Medicaid funding annually is required to comply with certain standards, including having policies that provide detailed information about the False Claims Act, any state laws pertaining to false claims and statements and whistleblower protections under such laws, and to educate employees and vendors about such policies.[202] Related, are provisions of state false claims acts and guidance issued by state Medicaid agencies to enforce this Deficit Reduction Act of 2005, which can impose additional requirements as to what must be included in hospital policies. Hospitals also routinely meet the Federal Sentencing Guidelines' standards for an effective compliance and ethics program.[203] They require, among other matters, board oversight, having and publicizing a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation, communicating standards and procedures and many other specific aspects of a compliance and ethics program. The Office of Inspector General of the Department of Health and Human Services ("OIG") has issued compliance program guidance for hospitals,[204] which sets forth its views detailed recommendations, including policies and procedures, hotlines and the like. These practices typically are required in the context of corporate integrity agreements with entities that are the subject of enforcement actions. The OIG also has published three guides for health care boards of directors jointly with the American Health Lawyers Association.[205] State regulations also commonly impose specific governance requirements.[206]

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[198] *See* Lawrence M. Brauer & Charles F. Kaiser, *Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 1997 17, at 25.

[199] *See*, *e.g.*, Lawrence M. Brauer & Charles F. Kaiser III, *Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy*, Exempt Org. Continuing Prof. Educ. Tech. Instruction Program for FY 2000 45.

[200] *See supra* notes 113-15 and accompanying text. *

[201] Typically, Medicare, Medicaid, state regulatory agencies, and others rely on accreditation. *See supra* notes 77-79 and accompanying text.

[202] *See* Deficit Reduction Act of 2005, Pub. L. No. 109-171, sec. 6032 (2006).

[203] United States Sentencing Commission, Guidelines Manual, § 3E1.1 (Nov. 2007), at section 8B.2, http://www.ussc.gov/2007guid/GL2007.pdf. Meeting these standards would allow for a reduced sentence for an organization in the case of a successful prosecution.

[204] 63 Fed. Reg. 8987 (Feb. 23, 1998), as supplemented by 70 Fed. Reg. 4858 (Jan. 31, 2005).

[205] *Corporate Responsibility and Health Care Quality: A Resource for Health Care Boards of Directors* (2007), http://oig.hhs.gov/fraud/docs/complianceguidance/CorporateResponsibilityFinal%209-4-07.pdf; *An Integrated Approach to Corporate Compliance, A Resource for Health Care Organization Board of Trustees* (2004), http://oig.hhs.gov/fraud/docs/complianceguidance/Tab%204E%20Appendx-Final.pdf; *Corporate Responsibility and Corporate Compliance: A Resource for Health Care Board of Directors* (2003), http://oig.hhs.gov/fraud/docs/complianceguidance/040203CorpRespRsceGuide.pdf .

[206] For example, Pennsylvania requires adoption of a conflict of interest policy. 28 Pa. Code 103.8.

APPENDIX 4. TRANSPARENCY AND DISCLOSURE REQUIREMENTS

In 1972, the Filer Commission, a commission convened with congressional encouragement to recommend ways of strengthening charitable giving and the "voluntary sector," explained how transparency can lead to flourishing public charitable governance:

> [I]n the case of nonprofit institutions and of philanthropy, there has never been a mechanism as simple, as comprehensible, in theory, at least, as voting or buying that is supposed to keep this area in tune with public purposes… . The proposals that the Commission has considered … may be all the more important for the world of voluntary organizations and philanthropy, because they are at the heart of a process that does, after all, exist to guide this world toward filling public needs… . For this process to work well, in terms of filling social needs, there must be as much openness, as much give and take as functionally possible. There must be freedom of access for those seeking funds, for instance, to make known their needs and to attempt to persuade fund providers of the priority of those needs. There must be a free flow of information between donor and donee, between voluntary groups and the public at large, including government, between fund-solicitors and the public. There must also be a wide range of choice for those who give time and money, as to where they will give and why. And there must be a genuine willingness to consider new avenues and new goals.[207]

The Filer Commission recommended a series of reforms—including public detailed annual reports, uniform accounting measures, annual public meetings for large charities—designed to improve transparency in the sector. According to the report, the Commission believed that increased transparency would signal successful public governance of charities.

The Filer Commission concluded that transparency and public oversight is critical to enabling charities to serve the public interest most effectively. Without input from the general public, charities risk having a narrowness of vision. Transparency enables a "free flow of information" and allows charities the opportunity to "consider new avenues and new goals."[208] In so doing, transparency strengthens the charitable sector in a democratic society whose public institutions advance the interests of the country's citizens.

To achieve the virtues of transparency in the nonprofit sector, Congress enacted two provisions of the Code, sections 6033 and 6104, to require tax-exempt organizations to file and publish information returns and other foundational documents. Section 6033

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[207] Commission on Private Philanthropy and Public Needs, *Giving in America: Toward a Stronger Voluntary Sector* (1975), at 160 (the "Filer Commission Report").

[208] *Id*. at 161.

requires tax-exempt organizations to file information returns and details the information that such organizations must provide as part of this process. Section 6104 provides for the public inspection and dissemination of information from tax-exempt organizations, including both the Form 990 (Annual Information Return) and Form 1023 (Application for Tax-Exempt Status).

The legislative history of sections 6033 and 6104 reveals Congress's efforts to require tax-exempt organizations to disclose information both to the IRS and to the public. The legislative history of these provisions often recites the view that increased disclosure of the activities of tax-exempt organizations encourages compliance with the law, enhances accountability, and facilitates IRS oversight. The legislative history demonstrates Congress's view that in addition to the IRS, "State officials" and the "public," broadly defined, have a substantial stake in the workings of tax-exempt organizations, and that federal tax law should provide each category of stakeholders with access to certain information about these organizations.

Congress first required that certain tax-exempt organizations file information returns under the Revenue Act of 1943 as a reaction to concern about widespread commercial activities on the part of tax-exempt organizations.[209] Congress hoped that requiring these organizations to file information returns would contribute to "closing this existing loophole and requiring the payment of tax, and the protection of legitimate companies against this unfair competitive situation."[210] The Revenue Act of 1943 implemented section 54(c) of the 1939 Code to provide that certain tax-exempt organizations must file annual information returns known then, as now, as "Form 990." The legislation treated these returns as public records, but at that time, members of the public could only access Forms 990 by authorized order of the President.[211]

In the Revenue Act of 1950, Congress expanded the information required to be included on the Form 990 and permitted members of the public to inspect the Form 990 by submitting a written request to the Service, again in response to perceived problem of abuses on the part of tax-exempt organizations.[212] In an address to Congress, President Truman asserted that "the exemption accorded charitable trust funds has been used as a cloak for speculative business ventures, and the funds intended for charitable purposes, buttressed by tax exemption, have been used to acquire or retain control over a wide variety of industrial enterprises"[213] Following President Truman's remarks, the House Committee on Ways and Means sponsored a series of hearings on abuses in the tax-exempt sector, and at these hearings, several witnesses spoke in

[209] Revenue Act of 1943, Pub. L. No. 78-325, sec. 117 (1943). *See* also Joint Committee on Taxation, Study of Present-law Taxpayer Confidentiality and Disclosure Provisions As Required by section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1988. JCS-1-00 (Jan. 28, 2000).

[210] H.R. Rep. No. 78-841, at 24-25 (1943).

[211] IRC section 55(a)(1)(1939).

[212] Revenue Act of 1950, Pub. L. No. 81-814, sec. 75 (1950).

[213] Message from the President, January 23, 1950.

support of increased public disclosure from exempt organizations.[214] Congress responded to this public attention by enacting the Revenue Act of 1950, which mandated that tax-exempt organizations already required to file information returns provide additional information on those returns, including: (i) the organization's gross income for the year; (ii) expenses attributable to such income; (iii) disbursements out of income within the year for the organization's exempt purposes; (iv) accumulation of income within the year; (v) aggregate accumulations of income at the beginning of the year; (vi) disbursements out of principal in the current and prior years for its exempt purpose; and (vii) a balance sheet showing assets, liabilities, and net worth of the beginning of each year.[215]

Congress further expanded the disclosure and information reporting rules for exempt organizations, as part of the Technical Amendments Act of 1958. In addition to requiring filers to report the total of contributions and gifts received during the year on the Form 990, the legislation provided for public disclosure of the applications for tax exemption and supporting documents, such as the Form 1023, at the IRS National Office and the appropriate IRS field service office.[216] The legislation carved out an exception for information that "might be harmful to the organization or to national defense."[217] The Senate report for the bill explained that making the Form 1023 applications available to the public "will provide substantial additional aid to the IRS in determining whether organizations are actually operating in the manner in which they have stated in their applications for exemption."[218]

The Tax Reform Act of 1969 was yet another response by Congress to perceived abuses on the part of tax-exempt organizations. In the years leading up to the Act's passage, the Treasury issued a report on private foundations, and several congressional committees held extensive hearings focused in particular on the activities of private foundations. Many members of Congress emerged from these hearings with the view that "prior law had been inadequate to prevent the use of foundations for controlling business enterprises and benefiting substantial contributors [at] the expense of charitable programs."[219] For this reason, Congress broadened the filing and disclosure requirements to include new exempt organizations. The House Report explained that "the primary purpose of these requirements is to provide the IRS with information needed to enforce the tax laws. The experience of these past two decades has indicated that…more information is needed, on a more current basis, from more organizations, and that information must be made available to more people, especially State officials."[220]

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[214] 2000 JCT Study, *supr*a note 97.

[215] Revenue Act of 1950, Pub. L. No. 81-814, sec. 341 (1950).

[216] Technical Amendments Act of 1958, Pub. L. No. 85-866, sec. 75 (1958).

[217] *Id.* at 4884.

[218] S. REP. No. 1983 (1958), at 4883.

[219] 2000 JCT Study *supra* note 97, at 125.

[220] H.Rep. 91-413 at 224.

The Tax Reform Act of 1969 required virtually all tax-exempt organizations to file information returns.[221] In addition, the law broadened the scope of the Form 990 to include "the names and addresses of all substantial contributors, directors, and trustees, and other management officials—all of whom are 'disqualified persons' for the purpose of the new self-dealing rules and other provisions—and of highly compensated employees. Compensation and other payments to managers and highly compensated employees also must be shown."[222] The House report explained that "[t]his change is intended to facilitate meaningful enforcement of the limitations imposed by the bill, especially when combined with the publicity provisions and the sanctions for failure to file timely returns."[223] The new publicity provisions required that the Forms 990 be made available to State officials and that private foundation filers allow public inspection of their information returns at the foundation offices for at least 180 days.[224] In addition, private foundations had to publicize these forms' availability. However, the legislation also provided that exempt organizations other than private foundations should not disclose to the public the names and addresses of contributors.[225]

The next two decades saw several minor changes to the reporting requirements in the spirit of further increasing disclosure, a goal that continued to resonate across government and parts of the private sector. For example, following the Tax Reform Act of 1969, John D. Rockefeller III, with the encouragement of several government figures including then chairman of the House Ways and Means Committee, Wilbur D. Mills, and Secretary of the Treasury George P. Schultz, formed the "Filer Commission," a privately funded citizens' panel designed to study the philanthropic giving and the U.S. voluntary sector and to make recommendations to strengthen both of these. The Filer Commission included a disclosure recommendation "that all larger, tax-exempt charitable organizations except churches and church affiliates be required to prepare and make readily available detailed annual reports on their finances, programs, and priorities." The Commission believed that increased public accountability would improve the general reputation of the sector, which the Commission described as crucial:

> One of the conventional wisdoms of the 1970's is that virtually all institutions, public and private, have declined in popular esteem and trust, especially those that exercise substantial economic or political power… A major source of this skepticism is said to be the widespread feeling that our institutions are beyond society's control, that they are operating for their own purposes which are often at odds with the public interest…it is likely that the [voluntary] sector's institutions are included to some degree in Americans' doubts. Indeed, voluntary sector institutions would appear to be particularly susceptible to concerns

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[221] *Id.*

[222] *Id.*

[223] *Id.*

[224] Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 101(a)(1969).

[225] *Id.*

> about control, about whether the public interest is truly being served. This is so because, while there are clear, widely acknowledged processes by which government and business institutions should be subject to incentives and restraints that lead them to serve the interests of society, it is not readily apparent what process, if any, is guiding nonprofit activity so that it benefits society… The proposals that the Commission has considered in this regard revolve around ideas of openness, of accountability, of accessibility—of, in so many words, making the inner workings of these institutions more visible, their decisions more public and more clearly responsive to the public needs and social change.

Consistent with this pro-disclosure approach, as part of the Tax Reform Act of 1976, Congress required tax-exempt organizations filing Forms 990 to disclose lobbying expenditures.[226] In 1980, Congress simplified the reporting requirements for private foundations by combining two forms that private foundations had previously needed to file. Congress enacted this change to reduce administrative costs for foundations and increase the amount of information about foundations available for public and State inspection.[227]

In 1987, as part of the Omnibus Budget Reconciliation Act of 1987, Congress further amplified the reporting and disclosure requirements for the Form 990. According to the House Report, Congress echoed the concerns it had expressed in 1958:

> The present-law procedure under which the public can obtain copies of the exemption application and annual information returns of tax-exempt organizations through requests to the Internal Revenue Service has not proved effective. For example, the present-law disclosure procedure does not result in the full and timely public disclosure of the activities of charitable organizations, as needed to facilitate accountability of such organizations to the public from whom they solicit tax deductible funds…the increased availability of information will help assure that the double tax benefits of deductibility of contributions and exemption from income tax are limited to organizations whose assets are devoted exclusively to charitable purposes…because most such charities regularly solicit contributions or receive other support from the public, the public should have ready access to current information about the activities of these organizations.[228]

As part of this legislation, Congress added to section 6104 a requirement that tax-exempt organizations other than private foundations make copies of their three most

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[226] Sen. Rep. 94-938 (1976). The lobbying provisions changes several other times, but this memo does not review these changes in detail.

[227] Sen. Rep. 96-1039 (1980).

[228] H.R. Rep. No. 100-391, at 1612 (1987).

recent Forms 990, along with copies of their exemption applications, supporting documents, and determination letters, available for public inspection at the organizations' principal offices and certain regional or district offices during regular business hours.[229]

In 1987, as part of the Revenue Act of 1987, Congress also increased the amount of information organizations had to include on their information returns. In particular, the legislation required filers to disclose information concerning direct and indirect transfers to other tax-exempt organizations and to political organizations. According to the House Report, in Congress's view, "the [prior] annual return [did] not require sufficient information as to whether the charitable organization is affiliated with, or closely connected to, other types of exempt organizations that may engage in substantial lobbying activities or political organizations…additional information about the relationship of charitable organizations to other types of exempt organizations or political organizations—which are not eligible to receive tax-deductible charitable contributions—is needed to achieve better enforcement of the rules governing the tax-exempt status of charities."[230]

Congress further increased disclosure requirements as part of the Taxpayer Bill of Rights 2[231] in 1996 in an effort to "enhance the oversight and public accountability of tax-exempt organizations by providing increased public access to documents filed by [exempt] organizations with the IRS."[232] In that same year, as part of the Small Business Job Protection Act of 1996, Congress also clarified reporting and notification requirements for lobbying and political expenditures on the part of tax-exempt organizations. The Taxpayer Bill of Rights 2 required filers of the Form 990 (not including private foundations) to comply with requests for copies of the organization's Form 990 for the three most recent taxable years.[233] The bill required organizations receiving such requests in person to provide copies immediately and organizations receiving such requests in writing to provide copies within 30 days.[234] The legislation also forbade organizations from charging more than a "reasonable fee for reproduction and mailing costs" for the copies.[235] Organizations could meet these requirements by making copies "widely available."[236]

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[229] Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, sec. 10702 (1987).

[230] 100 H.Rpt. 391 (1987).

[231] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, sec. 1004 (1996).

[232] 2000 JCT Study *supra* note 97, at 128.

[233] Taxpayer Bill of Rights 2, Pub. L. No. 104-168, sec. 1314 (1996).

[234] *Id.*

[235] *Id.*

[236] *Id.* Treas. Reg § 301.6104(d)-2 provides that tax-exempt organization can "make its application for tax exemption and/or an annual information return widely available by posting the document on a World Wide Web page that the tax-exempt organization establishes and maintains or by having the document posted, as part of a database of similar documents of other tax-exempt organizations, on a World Wide Web page established and maintained by another entity." Many organizations currently post their Forms 990 on their own web pages. In addition, third parties such as the organization GuideStar publish Forms 990 for multiple exempt organizations on the web, although that does not current qualify as a posting for purposes of Treas. Reg § 301.6104(d)-2.

In the decade that followed, Congress made a series of additional changes to the reporting and disclosure requirements for exempt organizations. The 1996 Taxpayer Bill of Rights 2 had enacted a series of excise taxes to serve as "intermediate sanctions" for exempt organizations engaging in certain prohibited transactions. The Taxpayer Relief Act of 1997 further provided that exempt organizations owing such excise taxes disclose that fact on their Forms 990. The Tax and Trade Relief Extension Act of 1998 extended the enhanced disclosure requirements enacted in 1996 to private foundations, extensions which the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 later slightly revised to make the rules less "expensive and administratively burdensome."[237] The Tax Increase Prevention and Reconciliation Act of 2005 applied disclosure provisions regarding tax shelter transactions to tax-exempt organizations.

In 2006, as part of the Pension Protection Act, Congress set forth certain notification rules for organizations not generally required to file a Form 990. Under this law, small exempt organizations had to fill out an electronic notification giving the Service the organization's legal name, mailing address, Internet web site, and taxpayer identification number.[238] In addition, the law required organizations to provide any name under which it does business, the name and address of a principal office, and evidence of the organization's continuing basis for its exemption from the Form 990 filing requirements. This same legislation also provided for additional disclosures regarding tax exempt organizations to state officials and as part of state civil administrative and judicial proceedings pertaining to the enforcement of state laws. The legislative history for this provision does not describe its intended purpose in detail.

In summary, sections 6033 and 6104 have evolved to require tax-exempt organizations to disclose increasing amounts of information to the IRS and to make those disclosures publicly available. The development of these provisions has been driven largely by Congress's reaction to well-publicized scandals in the tax-exempt sector and the belief in a positive correlation between increasing transparency and a well functioning, well governed and compliant tax-exempt sector.

An additional important factor in the enhanced disclosure in the exempt organizations area involves lawsuits under the Freedom of Information Act.[239] The seminal case involved a lawsuit brought by Tax Analysts in 1972 to gain access to private letter rulings ("PLRs") and technical advice memoranda ("TAMs"). The court allowed access to the PLRs but not the TAMs.[240] Congress shortly thereafter mandated access to the TAMs.[241] A series of other lawsuits resulted in the public availability of field service

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[237] Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, Pub. L. No. 105-277, sec. 1004 (1999).

[238] Pension Protection Act of 2006, Pub. L. No. 109-280, sec. 1223 (2006).

[239] In most cases, disclosure is subject to deletion of certain identifying details involving the taxpayer. IRC section 6110(c)(1). Disclosure under IRC section 6104, relating to the public inspection of tax returns of exempt organizations and applications for exempt status, is excepted from the redaction requirement. IRC sections 6110(l)(1).

[240] Tax Analysts v. IRS, 505 F.2d 350 (D.C. Cir. 1974).

[241] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1660, amending IRC section 6110(b)(1)(A) to expressly include "technical advice memorandum" within the definition of "written determination."

advice memoranda prepared by lawyers in the IRS Office of Chief Counsel in response to requests for legal advice,[242] e-mails containing legal advice from lawyers in the Office of the Chief Counsel to IRS field personnel,[243] and written determinations denying or revoking tax exemptions.[244]

[242] Tax Analysts v. IRS, 117 F.2d 607 (D.C. Cir. 1997). In 1998, Congress codified the holding by amending IRC section 6110 to expressly include "Chief Counsel advice" within the definition of "written determination" and added subsection 6110(i)(1)(A), which defined "Chief Counsel advice." Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat 685, § 3509(a)(1998) and § 3509(b)(i)(1)(A), respectively.

[243] Tax Analysts v. IRS, 495 F.3d 676 (D.C. Cir. 2007).

[244] Tax Analysts v. IRS, 350 F.3d 100 (D.C. Cir. 2003).

APPENDIX 5. EVOLUTION OF FORM 990

There has been an evolution over the last 66 years in the IRS's interest in what we would today characterize as charities' governance as evidenced in the Form 990, *Return of Organization Exempt from Income Tax*. The Form 990 has grown from two pages (1942 Form 990) to an eleven-page core form with Schedules A through R for 2008. On the 1942 Form 990, two officers were required to sign an Affidavit. This version of the form contains only three questions about the exempt organization, including "have your articles of incorporation or by-laws or other instruments of similar import been amended since your last return was filed, if so attach a copy." In reviewing the Forms 990 since 1960, we see increased inquiry in areas directly related to inurement and the operational test. Over time, more of these governance-type inquiries have become more attenuated to the tax laws, presumably on the assumption that good governance practices in a general sense result in more likely tax compliance.

The 1960 Form 990-A was expanded to include fifteen questions about the organization, some of which go directly to the organizational test and, today, can be viewed as inquiring about governance practices. For example, Question 14 asked if certain persons (creator, contributor, relative of creator/contributor, or corporation owned 50% of more by creator/contributor) entered into any of the following financial transactions with the organization:

- Borrow any part of income or corpus?
- Receive compensation for personal services?
- Have any part of the organization's services made available to him?
- Purchase any securities or other property from the organization?
- Sell any securities or other property to the organization?
- Receive any of the organization's income or corpus in other transactions?

If the answer to any was "yes," a detailed statement was required.

The 1962 Form 990-A instructions required a schedule to be attached reporting "compensation of officers, directors, trustees, etc., showing name, position, time devoted to position, salary, and expense account allowances." In order to better understand the relationships surrounding the organization, the 1963 Form 990-A instructions add the reporting of "…the relationship, if any, by blood, marriage, adoption, or employment, of each such person to the creator of the organization (if a trust), to any person who has made a substantial contribution to the organization, or to a corporation controlled (by ownership of 50 percent or more) directly of indirectly, by such creator or contributor."

In 1964, the instructions for this disclosure were updated to require a schedule showing whether each official ("officer, director, trustee, etc.") was:

- The creator or a substantial contributor,
- A brother or sister, spouse, ancestor, lineal descendent of the creator or substantial contributor,
- An employee of the creator or substantial contributor or of a business venture owned 50% or more by the creator and/or substantial contributor,
- An attorney or accountant of the creator or substantial contributor or of a business venture owned 50% or more by the creator and/or substantial contributor, or
- None of the above

The 1969 instructions related to Schedule B included an update to the requirements for the schedule showing common ownership of any corporation, and required the following:

- The class of stock and number of shares owned at the beginning and end of the year by the parties described in (a) through (d), and
- To designate the parties by relationship to the organization, not by individual names.

The 1973 Schedule A included several new questions related to governance. Question 2 asked if the organization is related through common membership, governing bodies, trustees, officers, etc. to any other exempt or nonexempt organization (if "yes," identify the organization and describe relationship). Question 3 asked if the organization engaged in the following acts with a trustee, director, principal officer, creator, or any affiliated organization. or corporation: sale, exchange, leasing of property; lending of money or other extension of credit; furnishing of goods, services, or facilities; payment of compensation or reimbursement of expenses; transfer of income or assets. .

The list of Officers, Directors, and Trustees included Key Employees for the first time on the 1992 form. A "key employee" was defined in the 1992 instructions as any person having responsibilities or powers similar to those of officers, directors, or trustees.

After the enactment of Intermediate Sanctions, a series of questions was added to the 1996 Form 990 that addressed whether the organization engaged in (or became aware of) an excess benefit transaction during the reporting year. In addition, organizations are asked to disclose whether any excise tax has been remitted by the organization or its managers and to disclose whether they reimbursed a manager for such an excise tax.

In 2005, Line 75d asking about whether the organization has a written conflict of interest policy was added. In an apparent step toward determining how many board members are independent, there were two additions: Line 75a asked for the number of board members who can vote on organization matters; and Line 75b asked about

relationships among officers, directors, trustees, key employees, most highest paid employees, and highest paid contractors. We presume that the questions were designed to shed light on boards that are closely intertwined and perhaps less able to act in an independent manner. The 2005 Form 990 also brought for the first time required disclosure of payments to any former officers, directors, trustees, and key employees receiving compensation during the year.

The redesigned Form 990 for 2008 is described in the body of our report.[245] The evolution of the Form 990, and particularly the redesigned form, serve to demonstrate the growing interest on the part of the IRS in gathering information about various governance areas, including management of potential conflicts of interest, board engagement and potential risks for inurement.

[245] *See supra* Section VII. D.

APPENDIX 6. EDUCATION AND OUTREACH

The following are selected examples of "good governance" education and outreach by the IRS.

February 14, 2008, IRS "Governance and Related Topics – 501(c)(3) Organizations"

In February 2008, the IRS added a paper entitled "Governance and Related Topics – 501(c)(3) Organizations"[246] (here, the "2008 Governance Paper") to its Life Cycle on-line educational tool. The preface to the 2008 Governance Paper is worth quoting in full, as it provides the IRS rationale for its involvement in charity governance:

The Internal Revenue Service believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance. A charity that has clearly articulated purposes that describe its mission, a knowledgeable and committed governing body and management team, and sound management practices is more likely to operate effectively and consistent with tax law requirements. And while the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with the tax law. As a measure of our interest in this area, we ask about an organization's governance, both when it applies for tax-exempt status and then annually as part of the information return that many charities are required to file with the Internal Revenue Service.

The 2008 Governance Paper addresses six areas: mission, organizational documents, governing body, governance and management policies, financial statements and Form 990 reporting, and transparency and accountability. Each topic area refers, where applicable, to the line on the 2008 Form 990 where a charity will find questions related to that topic.

Topic 1: Mission

As it did in the Draft, the IRS continues to recommend that charities adopt a mission statement at the board level, noting that charities are required to describe their mission in Form 990.

Topic 2: Organizational Documents

The Draft did not address this topic. Here, the IRS notes that it will review an entity's organizing documents and bylaws when it applies for tax exemption. Organizations that must file Form 990 must "report [on the 990] significant changes to their organizational documents since the prior Form 990 was filed."

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[246] *See supra* note 22.

Topic 3: Governing Body

The 2008 Governance Paper addresses this matter in more detail than the Draft. It emphasizes what it believes is the connection between "an active and engaged board" and a charity's "compliance with applicable tax law requirements." The IRS notes what it believes are the risks of very small and very large boards. "Irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships. The Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets." This section of the 2008 Governance Paper also encourages organizations with chapters, branches, or affiliates to put policies and procedures in place to ensure that their activities are consistent with the parent's purposes.

Topic 4: Governance and Management Policies

This topic brings together seven areas of concern, five of which were addressed as separate recommendations in the Draft.

> *A. Executive compensation.* Acknowledging that the Code does not require charities to follow any particular procedures, the 2008 Governance Paper nonetheless encourages charities "to rely on the rebuttable presumption test of section 4958 of the Code and Treasury Regulation section 53.4958-6 when determining compensation of its executives." The independence of any compensation consultant, and the quality of the data on which the charity relies, are both of concern. Noting that it has seen "significant errors or omissions" in compensation reporting, the IRS warns that "executive compensation continues to be a focus point in our examination program."

> *B. Conflicts of interest.* This section opens forthrightly by stating: "The directors of a charity owe it a duty of loyalty" and encourages boards to adopt and implement a written conflict of interest policy. It also encourages charities to require periodic written disclosures of financial interests "that [any] individual [covered by the conflicts policy], or a member of the individual's family, has in any business entity that transacts business with the charity."

> *C. Investments.* Noting that charities are engaging in more complicated and sophisticated investments, the 2008 Governance Paper encourages charities "to adopt written policies and procedures requiring the charity to evaluate its participation in these investments and to take steps to safeguard the organization's assets and exempt status if they could be affected by the investment arrangement." It also reminds charities that

Form 990 asks questions about joint ventures and other complex investments.

D. Fundraising. The 2008 Governance Paper encourages charities to "adopt and monitor" policies to ensure compliance with state and federal laws on charitable solicitation and to see that their fundraising materials are "accurate, truthful, and candid." It also encourages charities to keep costs reasonable and to provide information to the public on their fundraising costs and practices.

E. Governing body minutes and records. Noting that Form 990 asks whether organizations keep contemporaneous records of board and committee actions, the 2008 Governance Paper encourages charities to maintain such records.

F. Document retention and destruction. The 2008 Governance Paper reminds charities that the Code requires a charity "to keep books and records that are relevant to its tax exemption and its filings with the Internal Revenue Service" and reminds them that Form 990 now asks whether filers have a written document retention and destruction policy. The Paper identifies the issues that such a policy should cover.

G. Ethics and whistleblower policy. The 2008 Governance Paper encourages boards to adopt a code of ethics as a way of promoting a culture of legal compliance. It also encourages boards to adopt and implement whistleblower policies to enable employees "to report in confidence any suspected financial impropriety or misuse of the charity's resources." It notes that Form 990 asks whether filing organizations became aware of any material diversion of assets and whether they have a written whistleblower policy.

Topic 5: Financial Statements and Form 990 Reporting

The 2008 Governance Paper acknowledges that although state law or non-tax federal law may require a charity to have audited financial statements, federal tax law does not impose such a requirement. However, charities "with substantial assets or revenue should consider" engaging an independent auditor to prepare an audit of its financial statements and establishing an independent audit committee to oversee the process. With regard to Form 990, the 2008 Governance Paper notes that although the Code does not require it, "some organizations provide copies of the IRS Form 990 to its governing body and other internal governance or management officials," either before or after it is filed. The Paper reminds charities that Form 990 asks whether the charity provides a copy of Form 990 to its governing body and to explain how directors or management review it.

Topic 6: Transparency and Accountability

Noting that charities are already required to make Form 1023, Form 990, and Form 990-T available for public inspection, the 2008 Governance Paper encourages charities to go further by posting these materials, as well as "annual reports and financial statements," on their public websites. Form 990 asks whether and how an organization makes Forms 1023, 990, and 990-T, governing documents, conflicts policy, and financial statements available to the public.

February 7, 2007, IRS' Good Governance Practices Discussion Draft

On February 7, 2007, the IRS released a discussion draft (the "Draft") of possible good governance practices for charitable organizations.[247] The Draft begins with general introductory language about governing boards and then lists nine recommendations that the IRS "strongly recommends" organizations review and consider adopting.[248] The Draft specifically states that, "[w]hile adopting a particular practice is not a requirement for exemption, an organization that adopts some or all of these practices is more likely to be successful in pursuing its exempt purposes and earning public support." In addition, "any decision by the Service to conduct a review of operations subsequent to exemption . . . will be influenced by whether an organization has voluntarily adopted good governance practices."[249]

Governing Boards

The introductory language of the Draft states that governing boards of charitable organizations "should be" composed of "persons who are informed and active in overseeing a charity's operations and finances." In particular, very small or very large governing boards "may be problematic."[250]

Recommendation 1: Mission Statement

The Draft recommends that a charitable organization adopt a mission statement. A mission statement should "explain and popularize the charity's purpose and serve as a guide to the organization's work." It should show "why the charity exists, what it hopes to accomplish, and what activities it will undertake, where, and for whom."[251]

Recommendation 2: Code of Ethics and Whistleblower Policies

The Draft recommends that a charitable organization adopt a code of ethics and a whistleblower policy (that is, establish procedures for employees to report in

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[247] IRS, *Good Governance Practices for 501(c)(3) Organizations*, which was *at* http://www.irs.gov/pub/irs-tege/good_governance_practices.pdf. The IRS removed this document from its website in February 2008 when it posted *Governance and Related Topics—501(c) Organizations*, *supra* note 22.

[248] *Id.*

[249] *Id.*

[250] *Id.*

[251] *Id.* at 2.

confidence suspected financial impropriety or misuse of the charity's resources). "The code of ethics should be a principal means of communicating to all personnel a strong culture of legal compliance and ethical integrity."[252]

Recommendation 3: Due Diligence

The Draft states that a director of a charitable organization "must exercise due diligence consistent with a duty of care that requires a director to act: In good faith; With the care an ordinarily prudent person in a like position would exercise under similar circumstances; In a manner the director reasonably believes to be in the charity's best interests."[253] To this end, the Draft recommends that a charitable organization adopt policies and procedures that help directors meet their duty of care. Such policies and procedures should ensure that each director: "Is familiar with the charity's activities and knows whether those activities promote the charity's mission and achieve its goals; Is fully informed about the charity's financial status; and Has full and accurate information to make informed decisions."[254]

Recommendation 4: Duty of Loyalty

The Draft states that a director of a charitable organization owes a duty of loyalty to the organization that requires the director to act in the interest of the charity rather than in the personal interest of the director or some other person or organization. To this end, the Draft recommends that a charitable organization adopt a conflict of interest policy that: "Requires directors and staff to act solely in the interests of the charity without regard for personal interests; Includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and Prescribes a certain course of action in the event a conflict of interest is identified."[255] The Draft refers to Appendix A of the Form 1023 instructions as a sample conflict of interest policy.

Recommendation 5: Transparency

The Draft recommends that a charitable organization adopt and monitor procedures to ensure that the charity's Form 990, annual reports, and financial statements are complete and accurate, are posted on the organization's public website, and are made available to the public upon request.[256]

Recommendation 6: Fundraising Policy

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[252] *Id.* at 3.

[253] *Id.* at 4.

[254] *Id.* at 4.

[255] *Id.* at 5.

[256] *Id.* at 6.

The Draft recommends that a charitable organization adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and that solicitation materials are accurate, truthful, and candid.[257] In addition, fundraising costs should be "reasonable" and paid fundraisers should be used only if registered with the state.

Recommendation 7: Financial Audits

The Draft recommends that the directors of a charitable organization with "substantial assets or annual revenue" should ensure that an independent auditor conduct an annual audit. In addition, the auditing firm should be changed "periodically"; the Draft mentions a five year period as illustrative. For a charity with "lesser assets or annual revenue", the Draft recommends that the directors should ensure that an independent certified public accountant conduct an annual audit. For "very small organizations", the Draft suggests using volunteers to review financial information and practices. These volunteers could be traded between similarly situated organizations to maintain financial integrity.[258]

Recommendation 8: Compensation Practices

The Draft states that charities generally should not compensate persons for service on the board of directors except to reimburse direct expenses of service. A director should be compensated only when the compensation is determined appropriate by a committee composed of persons uncompensated by the charity and who have no financial interest in the determination.[259]

Recommendation 9: Document Retention Policy

The Draft recommends that a charitable organization adopt a written policy establishing the standards for document retention and destruction.[260] The policy should include guidelines for handling electronic files and cover backup procedures, archiving of documents, and regular tests of system reliability. The Draft mentions IRS Publication 4221, "Compliance Guide for 501(c)(3) Tax-Exempt Organizations," as a source of more information.

November 2002, Anti-Terrorist Financing Guidelines

In November 2002, the Treasury Department released "U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities" ("Voluntary Guidelines").[261] The Voluntary Guidelines were expressly not

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[257] *Id.* at 7.

[258] *Id.* at 8.

[259] *Id.* at 9.

[260] *Id.* at 10.

[261] At http://www.treasury.gov/offices/enforcement/key-issues/protecting/docs/guidelines_charities.pdf; 39 EXEMPT ORG. TAX REV. 120, January 2003.

binding and created no safe harbors. In addition to suggesting various financial and operational due diligence procedures, Treasury also offered governance guidelines that went significantly beyond anything contained in federal laws governing nonprofit organizations.[262] After several meetings and exchanges of correspondence with representatives of the charitable sector,[263] many of whom did not find the Voluntary Guidelines to be as helpful as Treasury had hoped, Treasury twice revised the Voluntary Guidelines, most recently in September 2006.[264] These subsequent versions of the Voluntary Guidelines contained significantly less material on governance than the initial release. However, the final version of the Voluntary Guidelines continues to emphasize the importance of an active, engaged, and independent governing body for a charity's ability to comply with the law and prevent the diversion of its assets from charitable purposes.

December 19, 2007, Redesigned Form 990

On December 19, 2007, the IRS released a redesigned Form 990, effective for tax years 2008 and beyond.[265] Part VI of the form requests information regarding the governing body and management of the filing organization, as well as the organization's governance policies. This Part states that it requests "information about policies not required by the Internal Revenue Code."

June 14, 2007, Background Paper on Redesigned Draft From 990

On June 14, 2007, the IRS released a discussion draft of a redesigned Form 990 and a background paper discussing the changes.[266] Discussing the new section requiring disclosure of certain governance practices, the background paper states: "Good governance and accountability practices provide safeguards that the organizations' assets will be used consistently with its exempt purposes, a critical tax compliance consideration, especially with respect to organizations that are subject to private benefit, excess benefit, and private inurement prohibitions. In our view and experience, a well managed organization is likely to be a tax compliant organization."[267]

April 23 and 24, 2008, Speeches by Steven T. Miller

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[262] Voluntary Guidelines as released in November 2002. These governance provisions appeared to be adapted from voluntary standards published by organizations such as the Better Business Bureau.

[263] Many in the charitable sector were concerned that the Voluntary Guidelines not only went beyond the requirements of law but also would, if followed, expose humanitarian aid workers to serious risk of bodily harm. Representatives of umbrella groups such as the Council on Foundations and Independent Sector, international grantmaking and humanitarian charities, private practitioners, and academics formed a Treasury Guidelines Working Group which met with Treasury representatives on several occasions to express their concerns. This group developed an alternative document, *Principles of International Charity* (available for downloading at www.usig.org/publications.asp#legal), reflecting the efforts that charities themselves have made to protect their assets from diversion from charitable purposes.

[264] *See* http://www.treasury.gov/offices/enforcement/key-issues/protecting/charities-intro.shtml.

[265] IRS Form 990 Redesign for Tax Year 2008, http://www.irs.gov/pub/irs-tege/f990rcore.pdf.

[266] IRS, "Background Paper Redesigned Draft Form 990," http://www.irs.gov/pub/irs-tege/form_990_cover_sheet.pdf.

[267] *Id.* at 3.

Steven T. Miller, Commissioner TE/GE, IRS, spoke on each day of the two-day 2008 Georgetown Tax Conference. In his first speech[268] he addressed four issues: why governance matters to the IRS; what the IRS has done in the past year to encourage good governance; where the IRS expects to go in the governance area in the future; and what attendees can do to help their clients and organizations strengthen good governance. He set the backdrop as follows:

> Over the past year, we have said repeatedly that we care because a well-governed organization is more likely to be compliant, while poor governance can easily lead to trouble. Good governance also allows for self-identification and resolution of problems. Some disagree with us on this. My view is clear. Despite the absence of explicit federal statutory provisions setting forth clear governance standards, what I am calling jurisdictional gaps, we are not interlopers trying to regulate an area that is beyond our sphere. Rather, the effects of good or bad nonprofit governance cut across virtually everything we see and do in our work. It impacts whether the organization is operated to further exempt purposes and public, rather than private, interests. It dictates whether the organization's executives are compensated fairly or excessively. It influences whether the organization makes informed and fair decisions regarding its investments or its fundraising practices, or allows others to take unfair advantage. The question is no longer whether the IRS has a role to play in this area, but rather, what that role will be.

Miller described the governance questions on the redesigned Form 990 for 2008 as the "crown jewel" of their governance efforts over the last year and also touted the governance article that was added to the Life Cycle on-line educational tool. He emphasized the importance of board composition, including independent members, internal financial controls that serve to safeguard charitable assets, and other governance procedures that ensure that large scale decisions are reviewed. He advised that the IRS will be increasing education about governance in the determination process, continue to press for transparency in connection with the Form 990, and consider a post-exam governance checklist designed to determine if governance is a factor in compliance.

In his second speech,[269] Miller spoke both about governance and about efficiency and effectiveness. With respect to governance, his themes were similar to his earlier speech. He emphasized the IRS belief that there is a "nexus between good governance and tax compliance," and spoke to the initiatives the IRS would be taking to promote good governance, including education, transparency, and analysis through a post-exam checklist.

November 10, 2007, Speech by Steven T. Miller

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[268] See Remarks of Steven T. Miller, *supra* note 24.

[269] See Remarks of Steven T. Miller, *supra* note 31.

In a speech to the Philanthropy Roundtable on November 10, 2007, Steven T. Miller, Commissioner, TE/GE, IRS, stated that good governance policies of tax-exempt entities is within the IRS' core responsibilities.[270] "I believe that the IRS contributes to a compliant, healthy charitable sector by expecting the tax-exempt community to adhere to commonly accepted standards of good governance. For many tax-exempt organizations, governance is already very good. But in too many instances, we have found governance to be wanting. While a few continue to argue that governance is outside our jurisdiction, most now support an active IRS that is engaged in this area. . . . We are comfortable that we are well within our authority to act in these areas."[271]

October 22, 2007, Speech by Steven T. Miller

In a speech to the Independent Sector on October 22, 2007, Steven T. Miller, Commissioner, TE/GE, IRS, noted the importance of good governance in the non-profit sector and questioned what role the IRS should play.[272] "I believe that, going forward, we must continue to press for transparency and good governance practices. So the question becomes, what role should the IRS play? I think the answer is that we need to continue to promote transparency and good governance. At a minimum we must educate. . . . Do we need to go beyond education? A question I would put before you this morning is whether it would benefit the public and the tax-exempt sector to require organizations to adopt and follow recognized principles of good governance? And a related question: Who should police this area – you or the Service?"[273] Miller added the caveat: "[W]e are not trying to oversee all non-profit governance matters. . . . Business judgment and many internal governance issues properly belong to the states and to the tax-exempt organizations themselves. So, while we have a role to play, part of our challenge and responsibility is to determine what that role is and limit ourselves to it."[274]

April 26, 2007, Speech by Steven T. Miller

In a speech to the Georgetown Continuing Legal Education Seminar on April 26, 2007, Steven T. Miller, Commissioner, TE/GE, IRS, asked whether tax-exempt entities should be required to adopt and follow recognized principles of good governance.[275] Specifically, he asked "whether it would benefit the public and the tax-exempt sector to require organizations to adopt and follow recognized principles of good governance? At a minimum, should the Form 990 report and make public an organization's acceptance

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[270] *Miller Discusses IRS Function in Charitable Sector*, Tax Notes Today, 2007 TNT 223-43, Doc 2007-25673 (Nov. 10, 2007).

[271] *Id.*

[272] Steven T. Miller, Commissioner, TE/GE, IRS, Remarks before Independent Sector (Oct. 22, 2007), http://www.irs.gov/pub/irs-tege/stm_isector_10_22_07.pdf.

[273] *Id.* at 4-5.

[274] *Id.* at 5.

[275] *IRS Official Speaks on Exempt Organizations Issues*, Tax Notes Today, 2007 TNT 84-4, Doc 2007-10678 (April 26, 2007).

of certain practices that the public expects from a well-run charitable organization – the existence of a conflict of interest policy, for example?"[276]

March 28, 2006, Speech by Steven T. Miller

In a speech at the Spring Public Lands Conference on March 28, 2006, Steven T. Miller, Commissioner, TE/GE, IRS, mentioned without discussion that he and the Commissioner of the IRS are concerned about nonprofit governance.[277] "The Commissioner has been talking for 2 ½ years, as I have, about problems in [the non-profit] sector. We are concerned with what can be called lapses in organizational governance."[278]

December 14, 2005, Speech by Mark W. Everson

In a speech before the Greater Washington Society of CPAs on December 14, 2005, Mark W. Everson, Commissioner of the IRS, noted the existence of governance problems in the exempt organizations area.[279] "[S]ome of the problems that we saw in profit-making businesses – such as lax attitudes toward governance – have appeared in the non-profit arena as well."[280] In particular, he highlighted "indications that organizations have allowed key executives too great a voice in determining their own compensation or have otherwise not done due diligence in setting compensation levels."[281]

November 29, 2005, Speech by Steven T. Miller

In a speech before the Illinois CPA Society's Not-for-Profit Conference on November 29, 2005, Steven T. Miller, Commissioner, TE/GE, IRS, mentioned with little discussion that the IRS is concerned about nonprofit governance.[282] "[W]e have seen the migration of the governance problems that surfaced a few years ago in the corporate world. Weak governance and the resulting problems appear in the [non-profit] sector, evidencing themselves in such things as excess compensation and poor Form 990 reporting."[283]

October 17, 2005, Speech by Steven T. Miller

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[276] *Id.*

[277] Steven T. Miller, Commissioner, TE/GE, IRS, Remarks before the Spring Public Lands Conference (March 28, 2006), http://www.irs.gov/pub/irs-tege/miller_speech_3_28_06.pdf.

[278] *Id.* at 3.

[279] Mark W. Everson, Commissioner, IRS, Remarks before the Greater Washington Society of CPAs (December 14, 2005), http://www.irs.gov/pub/irs-tege/everson_speech_gwcpas__te_issues_121405.pdf.

[280] *Id.* at 4.

[281] *Id.* at 6.

[282] Steven T. Miller, Commissioner, TE/GE, IRS, Remarks before the Illinois CPA Society's Not-for-Profit Conference (Nov. 29, 2005), http://www.irs.gov/pub/irs-tege/stm_illinoiscpa_112905.pdf.

[283] *Id.*

In a speech to the Land Trust Alliance on October 17, 2005, Steven T. Miller, Commissioner, TE/GE, IRS, mentioned without discussion that he and the Commissioner of the IRS are concerned about nonprofit governance.[284] "The Commissioner has been talking for more than two years, as I have, about problems in the nonprofit sector. . . . [W]e are concerned with [what] can be called lapses in corporate governance."[285]

June 8, 2005, Testimony of Steven T. Miller

Responding to written questions of the Senate Finance Committee hearing, Steven T. Miller, Commissioner, TE/GE, IRS, wrote on June 8, 2005, that a charity will have a better chance of clearly distinguishing between charitable interests and the interests of those in charge of the charity if it adopts certain governance practices.[286] Specifically, he suggested: "an independent board of directors selected from the community, a strict conflict of interest policy, an annual financial review by an independent accounting firm (or an independent CPA, for smaller organizations), and executive compensation reviewed by the board of directors with advice from independent compensation consultants (or, for smaller organizations, with a review of compensation practices at similar organizations of comparable size). In their review of their own governance practices, we would encourage charities to look at various industry guidelines, including the Standards of Excellence promoted by the Independent Sector, as well as the recommendations of the Panel on the Nonprofit Sector in the governance area."[287]

June 22, 2004, Testimony of Mark W. Everson

In a written statement submitted to a June 22, 2004, hearing of the Senate Finance Committee, Mark W. Everson, Commissioner of the IRS, highlighted governance issues in tax-exempt organizations.[288] Everson noted that governance scandals are not limited to the for-profit sector: "Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives."[289] Everson noted that the issues of governance and executive compensation are "closely intertwined," and that the IRS is "concerned that the governing boards of tax-exempt organizations are not, in all cases, exercising sufficient diligence as they set compensation for the

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[284] Steven T. Miller, Commissioner, TE/GE, IRS, Remarks before the Land Trust Alliance (Oct. 17, 2005), http://www.irs.gov/pub/irs-1tege/stm_land_trust_alliance_10_17_2005.pdf.

[285] *Id.* at 2.

[286] *IRS's Miller Responds to Finance Panel's Questions on Form 990, Conservation Easements*, Tax Notes Today, 2005 TNT 154-10, Doc 2005-17009 (June 8, 2005).

[287] *Id.*

[288] News Release, IRS, Written Statement of Mark W. Everson, Commissioner of Internal Revenue, before the Committee on Finance, U.S. Senate: Hearing on Charitable Giving Problems and Best Practices (June 22, 2004), IR-2004-81, http://www.irs.gov/pub/irs-news/ir-04-081.pdf.

[289] *Id.* at 3.

leadership of the organizations."[290] In addition, Everson discussed a forthcoming plain-language brochure on good governance practices:

> - To help tax-exempt organizations, we are developing a plain-language brochure to set forth certain practices we believe will be useful in promoting good governance, ethics, and internal oversight. This brochure will be available this fall.
>
> - The publication will explore practices that are not necessarily required by law but that may elevate the standards, conduct, and workings of exempt organizations. Although the IRS does not have authority to require organizations to follow specific practices, organizations without effective governance controls are more likely to have compliance problems. The publication is intended to provide exempt organizations, and in particular public charities, with a list of practices that will help guard against abuses involving, among other things, inappropriate financial transactions and operations. Among the topics we expect to cover are standards of integrity; the role, selection and duties of the governing board; conflict of interest policies; record-keeping; checks and balances that help prevent abuses; and fundraising practices, to name a few.[291]

June 19, 1992, Speech by Jay Rotz

In a speech to the Tax Exempt Organizations Committee of the American Institute of Certified Public Accountants on June 19, 1992, four years before the passage of section 4958 intermediate sanctions, Jay Rotz, Executive Assistant, Exempt Organizations Technical Division, IRS, stated that the IRS is concerned with compensation levels in tax-exempt organizations.[292] He explained: "The problem with nonprofits is that there are no shareholders to serve as a brake; there's no one there unless there is a responsible board of directors or, as a last resort, the IRS."[293] In addition, Rotz stressed that it is doubtful the IRS would challenge compensation set at arm's length by an independent board that weighed the skills and duties of the executive.

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[290] *Id.* at 4.

[291] *Id.* at 6-7. The brochure he refers to may ultimately have been released as "Good Governance Practices for 501(c)(3)" in 2007.

[292] Paul Streckfus, *Rotz Addresses AICPA on Current EO Tax Issues*, Tax Notes Today, 92 TNT 129-8 (June 23, 1992).

[293] *Id.*

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

THE STREAMLINED CLOSING AGREEMENT FOR TAX-EXEMPT BONDS: A CURE FOR COMMON VIOLATIONS

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EXECUTIVE SUMMARY

This ACT project grows out of the perceived need for a simple, predictable, low-cost procedure for issuers of tax-exempt bonds and conduit borrowers of tax-exempt bond proceeds to voluntarily correct violations of federal tax law. After discussions with Internal Revenue Service (IRS) and Treasury personnel and representatives of various constituencies within the tax-exempt bond community, and after consideration of the IRS's existing Voluntary Compliance Agreement Program (VCAP), the ACT determined that certain relatively common violations could be dealt with on a more streamlined basis, without the need for costly, time-consuming, individualized negotiation.

The ACT recommends creation of a Streamlined Closing Agreement Program (SCAP), as a subset of the existing VCAP program. Under such a program, the IRS would identify specified Covered Violations. Such violations would be susceptible to clear description, subject to a predetermined "closing agreement amount," and subject to stated additional conditions. The ACT has included as an appendix to this report an illustrative list of violations which might qualify for such treatment.

Under the proposed SCAP, an issuer or conduit borrower would submit to the IRS a Compliance Certificate identifying a specified Covered Violation, describing the facts presented, and confirming its willingness to comply with any specified requirements as to future action, together with a check for the predetermined closing agreement amount, if any. The IRS would be required to provide a written acceptance or rejection of the offer represented by this filing within a specified, relatively short period of time.

The ACT also recommends that two additional streamlined subsets be created within the existing VCAP program. The first would cover violations based on the small dollar amount involved. The second would cover past inadequate recordkeeping and document retention. While these two sorts of violations may not fit the definitional guidelines for an SCAP Covered Violation, because of difficulties specifying in a clear and simple manner the nature of the violation and/or the terms of an appropriate settlement, the ACT believes that streamlining of the process for dealing with violations of these sorts would be possible and helpful.

The ACT strongly urges the IRS to allocate substantially more resources to its existing voluntary compliance program for tax-exempt bonds and to the programs proposed here.

Finally, the ACT urges the IRS and Treasury to identify situations in which alternative modes of compliance would be appropriate if authorized by statute and to propose such changes to Congress.

INTRODUCTION

This ACT project grows out of the perceived need for a simple, predictable, low-cost procedure for issuers of tax-exempt bonds and conduit borrowers of tax-exempt bond proceeds to voluntarily correct violations of federal tax law. The Internal Revenue Service (IRS) has stated its intention to focus its examination resources on abusive transactions. It has also made a significant commitment to encouraging voluntary compliance. However, the existing voluntary compliance program requires individual negotiation and is therefore time-consuming and expensive for both the IRS and for issuers and conduit borrowers who discover instances of good faith non-compliance with the tax law. The ACT therefore recommends creation of programs to provide for streamlined treatment of certain tax law violations, including ones that are common and can be easily identified, ones that are small in dollar amount, and ones that involve recordkeeping and document retention problems.

THE PROJECT

The ACT began this project by consulting with representatives of constituencies within the tax-exempt bond community which would be affected by this proposal. Our goal was to confirm their views as to the worth of the project, to solicit ideas as to how an effective program might work, and to identify substantive problems which might be appropriately included under such a program.

The ACT spoke initially and on numerous later occasions with Clifford J. Gannett, Director of Tax-Exempt Bonds (TEB) and Steven A. Chamberlin, Manager, Tax-Exempt Bonds, Compliance & Program Management, both of whom were extremely supportive of this project. We subsequently spoke with John J. Cross III, Associate Tax Legislative Counsel, Department of the Treasury, with the following members of the Office of Chief Counsel: Johanna Som de Cerff, Senior Technician Reviewer (Financial Institutions and Products), George Bowden, Special Counsel (Procedure and Administration), Glen Melcher, Chief, Branch 5 (Procedure and Administration), William Conroy, Staff Attorney, Branch 5 (Procedure and Administration), Timothy L. Jones, Senior Counsel (Financial Institutions and Products), and Carla Young, Staff Attorney (Financial Institutions and Products), and twice each with representatives of the National Association of Bond Lawyers (NABL), the Tax-Exempt Finance Committee of the Tax Section of the American Bar Association (ABA), the Committee on Governmental Debt Management of the Government Finance Officers Association (GFOA), and the Advocacy Committee of what is now the National Association of Health & Educational Facilities Finance Authorities (NAHEFFA). There was broad consensus that the proposal as outlined was a useful one, although more than one person commented that "the devil is in the details."

The tax-exempt bond members of the ACT also met with the employee plans members of the ACT to discuss voluntary compliance programs which have been implemented with respect to qualified employee retirement plans.

Finally, the ACT reviewed various documents reflecting previous consideration of some of the issues presented by the current proposal. We reviewed a discussion by Richard Chirls in the President's Column of The Quarterly Newsletter of the National Association of Bond Lawyers, dated May 23, 1991, as to a possible "alternative penalty system" in lieu of bondholder taxation, and an unpublished partial draft of a paper describing such a system. We reviewed the 2001 and 2004 reports of the NABL Alternative Dispute Resolution Task Force, including draft legislation proposed in 2001. We reviewed draft amendments to the Internal Revenue Manual prepared by what is now the Tax-Exempt Bond Compliance & Program Management group. We also reviewed the Employee Plans Compliance Resolution System (EPCRS) program established with respect to employee plans, as described in Revenue Procedure 2006-27, 2006-I C.B. 945.

THE PROPOSAL

Existing VCAP

In 2001, the IRS established a Voluntary Closing Agreement Program (VCAP), pursuant to Notice 2001-60, 2001-2 C.B. 304. It is administered by the Compliance & Program Management (CPM) group, originally known as the Outreach Planning and Review group. In 2003, the IRS refined and expanded VCAP by publishing detailed procedural guidelines in Part 7, Chapter 2, Section 3 of the Internal Revenue Manual (IRM). The IRM states that VCAP is intended to encourage issuers and conduit borrowers to exercise due diligence in complying with the Internal Revenue Code and applicable regulations by providing a vehicle to correct violations in furtherance of the IRS' policy of taxing bondholders as a last resort.

As described in IRM 7.2.3.1, specialists in CPM review closing agreement requests and conduct the negotiation of closing agreements with the issuer, although other parties such as an escrow agent or conduit borrower may participate. IRM 7.2.3.3 makes clear that there must be an admitted "violation" of the tax law as a prerequisite to a VCAP request. IRM 7.2.3.6 contemplates, but does not require, payment of a "closing agreement amount" as a condition for a VCAP closing agreement. Under IRM 7.2.3.5, a VCAP request may be submitted initially on an anonymous basis to discuss a generic approach to resolving identified tax issues.

In certain instances, the IRS has identified particular tax law problems which were, or were about to become, a focus of its examination program and has invited VCAP submissions, sometimes within a specified timeframe. See, for example, the program as to hospital acquisition financings, found in Announcement 2002-43, 2002-1 C.B. 792, and the more recent program as to forward float contracts, announced by press release on August 30, 2007, and posted on the IRS website. Such programs, coupled with a threat of audit, have been viewed by the bond community as semi-voluntary.

On February 27, 2008, the IRS published Notice 2008-31, 2008-11 I.R.B. 592, which modifies and supersedes Notice 2001-60. The new notice essentially updates the terminology and procedural aspects of the VCAP program and expands its jurisdiction to cover tax credit bonds. Significantly, in contemplation of this ACT report, the Notice also states that the IRS is continuing to work on more detailed procedures and anticipates specifying closing agreement terms and amounts for particular violations. The Notice solicits suggestions on this topic.

Limitations of Existing VCAP

The IRS currently assigns approximately 3-4 specialists, measured on a full-time equivalent basis, to administer the VCAP program, and the number recently had been still lower. In the fiscal year ended September 30, 2007, it entered into 23 closing agreements.

While the bond community has generally applauded the VCAP program, the ACT's discussions with various constituency groups indicated widespread concern that the process was too slow to be an effective tool in many instances. Concern was also expressed that the need for individualized negotiation resulted in it being disproportionately costly in the case of certain less significant violations. In some instances this may have led transaction participants to construct unnecessarily complex "workarounds" to remedy violations which ought to be susceptible to more straightforward correction, particularly in the context of arbitrage yield violations.

These limitations exist in the context of a $1.7 trillion market made up of 2 million separate bond issues, issued by more than 50,000 state and local entities. Securities Industry and Financial Markets Association, "About Municipal Bonds," www.investinginbonds.com. The ACT is concerned that the current VCAP program will be increasingly unable to accommodate the perceived need in light of what is expected to be a dramatic increase in systematic voluntary assessment of post-issuance tax compliance. See "After the Bonds are Issued: Then What?," Report of the Advisory Committee on Tax Exempt and Government Entities, June 13, 2007.

The ACT believes that this proposal, by providing a simple, rational procedure for dealing with certain recurring problems, will allow IRS personnel to be better utilized to deal with complex situations which require individualized resolution. It will also eliminate the criticism that results from the need to incur substantial costs in order to remediate what are perceived to be relatively insignificant "foot faults" occurring in the context of a complex system of federal tax rules.

<u>The "Streamlined Closing Agreement"</u>

The ACT proposes that the IRS announce a Streamlined Closing Agreement Program (SCAP) as a subset of its existing VCAP program. SCAP would provide a list of specified "Covered Violations" and the conditions for remedying those violations.

<u>Covered Violations</u>

As a subset of the VCAP program, SCAP would require the identification of a violation of the tax law. As under the existing VCAP program, SCAP would provide for an agreement with the IRS under which the IRS would agree that it would not challenge the tax-exemption of the bonds notwithstanding such violation. These features should avoid SCAP being considered as providing for alternative modes of tax law compliance, which is a legislative function, or clarifications of the application of current law, which is a guidance function within the responsibility of the Treasury and the Office of Chief Counsel. (Certain members of the bond community have expressed concern about the requirement for applicants under the VCAP program to admit to a violation and have suggested that the IRS could identify a violation and enter into a closing agreement without requiring an admission by the applicant. Such concerns are applicable to SCAP as well.)

A Covered Violation should be one which can be clearly described so that it is possible for an issuer or conduit borrower readily to determine that its circumstances are within the description. It is intended that Covered Violations be ones which can be described in a manner which is clear enough that the Compliance Certificate described below can state facts which make clear that the transaction in question is a Covered Violation. Thus, a Covered Violation should not be one which allows for significant variation in material facts. While Covered Violations will frequently involve so-called "foot faults," there is no reason why more significant violations could not satisfy this requirement as well.

A Covered Violation should be one as to which the conditions for a closing agreement can be readily determined. To the extent that a "closing agreement amount" will be required to be paid, it should be a readily calculable amount which the IRS concludes is appropriate in the ordinary case. There could be instances in which it is appropriate that no payment be made.

To the extent that conditions are to be imposed which ensure future compliance, they should be ones that can be clearly articulated and readily implemented. Such conditions might include operational changes as well as redemption or defeasance of all or a portion of outstanding bonds.

The ACT has included as an appendix to this report an illustrative list of tax law violations of the sort which might constitute Covered Violations. The ACT recommends that the IRS choose a limited number from among those listed, and/or others which it identifies based upon experience under the existing VCAP program, to serve as the initial identified Covered Violations. The ACT recommends that the initial list be revised and expanded by the IRS as it gains experience administering the SCAP program and in response to ongoing industry comment.

<u>The Compliance Certificate</u>

A Compliance Certificate ordinarily would be submitted by an issuer of tax-exempt bonds. In the case of an issue of conduit bonds, a Compliance Certificate would be submitted jointly by the issuer and the conduit borrower. In the case of Covered Violations under Code Section 150(b), it would be appropriate to allow a Compliance Certificate to be submitted directly by the conduit borrower, with notice to the issuer.

A Compliance Certificate first should identify the bond issue and the particular Covered Violation which is to be remediated. A copy of Form 8038 or Form 8038-G should be attached. Second, it should state sufficient facts to establish that the circumstances are squarely within the terms of the IRS's published description of that Covered Violation. Third, it should affirm that the parties to the bond issue which resulted in the Covered Violation made a good faith effort to comply with federal tax law. Fourth, it should include a covenant to implement requirements for future action, if any, included in the

IRS announcement as to the particular Covered Violation. Fifth, it should include, or state that it incorporates by reference, specific required provisions as set out in the IRS publication governing SCAP, such as the reservation of rights by the IRS to reopen an SCAP agreement based upon its conclusion that the applicant had misrepresented or omitted material facts. Sixth, a Compliance Certificate should state that its submission constitutes an offer to enter into a closing agreement to be governed by Section 7121 of the Internal Revenue Code. Finally, it should be accompanied by a check for the "closing agreement amount," if any, applicable to the particular Covered Violation.

A Compliance Certificate should not discuss special facts which distinguish the transaction in question in order to justify variations in the future actions specified by the IRS for remediation of the particular Covered Violation or a reduction in the specified closing agreement amount. Such variations would be appropriate for consideration as to a traditional VCAP request, and the IRS publication governing SCAP should make clear that inclusion of a particular violation on the list of Covered Violations does not preclude submission of a traditional VCAP request instead, if the applicant believes that particular facts justify a closing agreement with different terms.

Effective Date

The document establishing SCAP should require the IRS to give written notice to the applicant of its acceptance or rejection of the "offer" made by the applicant's signed Compliance Certificate within a specified, relatively short, period of time after its submission. An SCAP agreement would be effective upon the mailing of such acceptance.

The ACT had extensive discussions as to whether to recommend that acceptance by the IRS be deemed to occur automatically upon the passage of a specified, relatively short, period of time after submission of a Compliance Certificate, unless the IRS gave notice of its rejection of the offer. This "self-executing" feature arose from the ACT's concern that delays in operation of the existing VCAP program have greatly limited its usefulness, both to the IRS and to the bond community.

This feature met with resistance from senior personnel in TEB on policy grounds and from representatives of the Chief Counsel's office, based in significant part on concern as to whether an agreement without physical signature might fail to qualify as a closing agreement under Section 7121 of the Code. TEB has indicated that, because of the nature of the Covered Violations and the streamlined features of the SCAP program, it ordinarily should be possible for the IRS to respond to Compliance Certificate submissions within three to four weeks. (In instances in which, especially as to older bond issues, an IRS internal account may not exist or be readily identified for the particular bond issue, an additional delay of perhaps two weeks might occur).

In light of this relatively short predicted processing period, the policy and legal concerns described above, and the belief that issuers and conduit borrowers would prefer written confirmation from the IRS, the ACT decided not to propose a self-executing feature. The ACT now believes that the program described above can be operated in an efficient and timely manner and will ensure that an SCAP agreement, like the existing VCAP, will have the statutorily-based finality of a closing agreement covered by Section 7121 of the Code.

An IRS determination to decline an SCAP proposal would not preclude the applicant from refiling under SCAP with a revised Compliance Certificate. The IRS should state in its notice of rejection any specific deficiencies which prevented approval, in order to facilitate a successful refiling. A short form, perhaps with boxes to be checked, could be used for this purpose.

A notice declining to accept an SCAP proposal also should specifically state that the applicant is encouraged to submit a proposal under the traditional VCAP program.

Finally, a notice declining to accept an SCAP proposal should state that a refiling under SCAP or under the traditional VCAP program within a specified time period will relate back to the original filing date for purposes of avoiding the harsher treatment applicable to violations identified by audit.

Fees/Penalties

While a list of potential Covered Violations is appended to this report, the ACT has not attempted to propose specific terms or closing agreement amounts. The ACT suggests that such terms and amounts be established with the goal of encouraging the maximum possible voluntary correction of unintended tax law violations. "Taxpayer exposure," defined in IRM 4.81.1.23 as "…the amount of tax the Service could collect if bondholders paid tax on the interest they have earned and will earn on the bonds," which is a measure used in settling certain audit disputes, should not be the starting point for or a standard of comparison applied for this purpose. Amounts to be paid might be better thought of as fees rather than as penalties. The ACT believes that, notwithstanding SCAP's streamlining of the closing agreement process and the availability of more moderate payments, issuers and conduit borrowers will still have overwhelming incentives to achieve full compliance at the outset. The time investment necessary even for application for SCAP relief, together with the awkwardness of admitting to a violation of the law, in almost all cases will prevent SCAP from being a disincentive to original compliance.

Implementation

The ACT recognizes that introduction of a new program requires a determination as to the appropriate procedural vehicle for its establishment. The choice to utilize a formal Regulation, a Revenue Procedure, a Notice, an amendment to the Internal Revenue

Manual, or some combination of the above, must be made in the context of a determination as to authorized powers which is beyond the scope of this recommendation. Whatever procedural choice is made, a new program of this sort should be undertaken by TEB with the full support of Treasury, and of the Financial Institutions and Products and the Procedure and Administration divisions of the Office of Chief Counsel. The ACT believes that the bond community will be indifferent to the vehicle used to implement the program. Factors to be taken into account should include not only ease of initial implementation but also whether the procedure can be modified easily over time in light of program experience. In particular, additions (and deletions) to the list of Covered Violations should be able to be made on a regular basis as the IRS gains experience and confidence as to the program.

ADDITIONAL SPECIAL PROGRAMS

During the process of identifying possible Covered Violations, the ACT considered two other areas of recurring problems which seemed susceptible to the sort of streamlined, less time-consuming, less costly voluntary compliance program being proposed in this report. However, because the ACT is not convinced that these violations satisfy the requirements for SCAP, they are discussed separately here, and it is suggested that the IRS consider development of additional streamlined subsets of the VCAP program tailored to these violations.

First, some violations are simply too small in dollar magnitude to justify a major investment of resources by the IRS or by the issuer. However, as issuers and conduit borrowers are urged to devote substantially increased attention to monitoring post-issuance compliance, small dollar violations will continue to be identified. Examples of such violations include de minimis excess private use or costs of issuance. Issuers and borrowers should not be faced with a voluntary compliance program which encourages them to "run for luck" as to such violations. However, violations of this sort have only size in common, not the substance of the violations. If the IRS is not comfortable including this sort of violation in a list of SCAP Covered Violations, it should consider implementation of an alternative streamlined process, with appropriate standards and limitations, for small dollar violations.

A second type of violation considered by the ACT involves inadequate recordkeeping. Based upon discussions with IRS personnel, it does not appear that IRS enforcement actions have directly attacked bond issues based upon inadequate records kept by issuers or conduit borrowers. However, particularly as the IRS develops record-retention policies in response to the 2005 ACT Report, entitled "Tax Exempt Bonds: Record Retention Burden" (June 8, 2005), and comments received in response to Notice 2006-63, 2006-29 I.R.B. 87, issuers and conduit borrowers may want confirmation that their records are not an independent source of vulnerability for their bonds. Again, these sorts of problems are qualitatively different from those described as SCAP Covered Violations, and may involve substantial factual differences among applicants. However, again it seems to the ACT that a streamlined program could be created as a subset of the existing VCAP program to the great advantage of both the IRS and the bond community. The ACT's discussions with certain constituency groups in the bond community indicated strong demand for VCAP in this area, although concern was also expressed that issuers should not be subjected to penalty for particular deficiencies until formal guidance on recordkeeping is promulgated.

RESOURCES

As stated above in “Limitations of Existing VCAP,” resources committed to the existing VCAP program have been inadequate to allow prompt processing of applications. While the proposed SCAP is designed to allow many common violations to be processed on a streamlined basis, which will allow IRS personnel to focus attention on requests which require more individualized negotiation, the ACT hopes that the availability of simplified SCAP procedures will encourage a far greater demand for voluntary closing agreements. The net result would likely be a significant increase, not a decrease, in personnel needed to administer the program. As noted, the growing focus by the bond community on post-issuance compliance procedures also can be expected to produce a significant increase in demand for voluntary closing agreements, under existing VCAP as well as under SCAP.

The ACT urges the IRS to allocate substantially more resources to these voluntary programs. While the existence of a robust enforcement program is an essential disincentive to abusive transactions, the vast size of the State and local bond market precludes the use of audits as the principal tool to ensure tax law compliance. The ACT’s 2007 report encouraged issuers and conduit borrowers to develop better procedures to monitor post-issuance compliance, which procedures inevitably will increase the number of identified violations. Adequate procedures for timely voluntary resolution of such violations is an essential next step. It would be a severe disappointment to the bond community if, having encouraged voluntary efforts to identify tax compliance problems, the IRS were to be incapable of assisting issuers and conduit borrowers to remedy them.

STATUTORY AND OTHER CHANGES

The ACT's principal mission is to recommend changes which the Tax Exempt and Government Entities division can implement to improve its operations. To the extent that changes recommended in various ACT reports have required action by or assent or cooperation from the Department of the Treasury or the Office of Chief Counsel, the ACT has encouraged TEGE to seek it. The ACT generally has not made legislative recommendations.

In the course of this project, the tax-exempt bond members of the ACT have become aware of concerns by Treasury and by Chief Counsel that certain changes which could facilitate tax law compliance might be beyond what could be achieved by administrative action. The proposed SCAP, like the existing VCAP, depends upon an admission of violation of the tax law and a voluntary agreement under which IRS agrees that, notwithstanding the violation, the bonds will not be declared taxable. A more efficient solution to certain problems would be to provide for alternative ways for a bond issuer to voluntarily bring the bond issue in question into compliance by taking certain specified remedial actions.

An example of this sort of solution and the limitations on its implementation can be seen in the "yield reduction payment" (YRP) provisions of Treasury Regulations, § 1.148-5(c). Treasury and IRS recently have proposed a limited expansion of the YRP provisions to allow their use to achieve compliance with applicable yield restrictions when Treasury has suspended sale of its State and Local Government Series securities (SLGS) and in connection with the integration of certain interest rate swaps under rules governing "qualified hedges". See Proposed Regulations, § 1.148-5(c)(3)(viii) and (c)(3)(ix). While these were situations which would have been appropriate for treatment as SCAP Covered Violations, they are far more efficiently resolved simply by allowing the proposed yield reduction payments, which avoid rather than excuse non-compliance with statutory yield restrictions. However, since YRPs are a non-statutory vehicle, created by regulation, Treasury and IRS have been unwilling, without statutory authorization, to extend their use to the entire range of yield restriction violations.

The ACT encourages the IRS to identify situations in which alternative modes of compliance, including self-implementing remedial actions, might be helpful, and to seek to have authorizing legislation proposed by the Treasury.

In addition, as the Tax Exempt Bond branch of TEGE administers SCAP, it should be alert to identify those Covered Violations which appear to be based upon common misunderstandings of the law. Where such misunderstandings are identified, that information should be communicated to the Office of Chief Counsel with the recommendation that regulations or other formal guidance be issued to provide clarification.

APPENDIX - POSSIBLE COVERED VIOLATIONS

The following are violations which might constitute “Covered Violations” under the Streamlined Closing Agreement Program (SCAP) proposed by the ACT. The ACT recommends that IRS choose a limited number of violations from this list or based upon its experience administering the existing VCAP program. The list of Covered Violations should be subject to expansion and modification on a flexible basis over time. The violations listed below are described in relatively simple terms. It is likely that their description in the formal document governing a new SCAP program would be somewhat more detailed, so that bond issuers and conduit borrowers can know that their particular transactions qualify for SCAP treatment.

1. Failure to timely reinvest refunding escrow in State and Local Government Series securities (SLGS).

2. Non-compliance with “mixed escrow” rules in Treasury Regulations, § 1.148-9(c)(2).

3. De minimis nonqualifed use of bond-financed facilities.

4. Change of election as to applicable low-income test under IRC § 142(d) for exempt facility private activity bonds for “qualified residential rental projects”.

5. Excess use of bond proceeds to pay issuance costs in violation of IRC § 147(g).

6. Use of bond proceeds for projects not included in original TEFRA notice.

7. Violation of the 120% test under IRC § 147(b).

8. Change of use without ability to do remedial action, for example because of noncompliance with applicable time periods.

9. Change of use of financed facilities resulting in interest on bonds being subject to alternative minimum tax and not qualifying for Rev. Proc. 97-15.

10. Failure to make a timely identification of a hedge.

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

PROTECTING PLAN BENEFITS: IMPROVING GOVERNMENTAL DEFINED CONTRIBUTION PLAN COMPLIANCE

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June 11, 2008

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I. Executive Summary

Government employees serve the public in many ways. They are public safety professionals, highway engineers, clerical professionals, teachers, managers and armed services personnel. Regardless of occupation, however, public employees are passionate about employee benefits. This passion extends to their employer-sponsored defined contribution plans.

Thanks to favorable legislation, initiatives undertaken by the IRS and other regulators and increasingly professional management, governmental employers now offer defined contribution plans that are better than ever in terms of cost, quality and soundness of operations. By building on steps it has already taken to improve service, the IRS can help public sector employers take their retirement plans to the next level in terms of benefits, compliance and security.

The objective of this report is to advance the interests of governmental retirement plans and their participants by developing recommendations that will ultimately help plans sponsors achieve their compliance objectives and thus protect employees' plan benefits. The report includes information pertaining to Federal government retirement plans and State and local defined benefit plans. However, the primary focus is Internal Revenue Code Section 401(a), 401(k), 403(b) and 457(b) plans offered by the nation's 79,000 State and local governments, 560 Federally-recognized Indian Tribal Governments, 16,000 public educational employers and 1,100 public healthcare institutions[1].

Justification

The ACT believes these recommendations are well-justified and timely considering the following:

- Increased complexity in the governmental plan market place
- An expected increase in IRS governmental plan audit and examination activity
- Increased utilization of defined contribution plans by governmental employers
- History of governmental plans being underserved in terms of education, outreach and tools

As previewed to the IRS executive team in June 2007, the recommendations focus primarily on the potential establishment of a Pre-Approved Plan Program for governmental plans, tools and initiatives aimed at facilitating compliance across 401(k), 401(a), 457(b) and 403(b) plans and general discussion of governmental compliance challenges, gaps and solutions.

1 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007

Methodology

To develop its findings and recommendations, the ACT circulated surveys and articles, conducted outreach to stakeholders, aggregated data and consulted with IRS senior management. The ACT believes that its recommendations offer an opportunity to help employers better protect their employees' retirement assets. Should the recommendations be accepted, the ACT is committed to working with the IRS and the governmental plan community to develop practical implementation plans and to assist with the important dialogue the IRS has already initiated with key stakeholders.

Observations

Governmental employers and employees are an important and growing segment of the Nation's workforce. One in five employees in the United States works for a governmental entity. The number of State and local governmental employees grew by 9.6% from 1997 to 2002[2]. The Bureau of Labor Statistics estimates that the governmental workforce will grow by 8% during the 2006 – 2016 period. [3] Governmental employers have not, by and large, followed the private sector movement away from defined benefit retirement plans as is evidenced by the fact that approximately 90% of governmental employers offer such plans.[4] Despite the prominence of defined benefit plans, however, many governmental employers offer one or more defined contribution plans.

Like the employer base itself, the government retirement plan market is broad and diverse as evidenced by the following:

- State and local governments operate 2,670 defined benefit plans that cover 18.5 million individuals and hold $3.15 trillion [5]
- The federal government defined benefit system covers 12.4 million individuals and holds $1.1 trillion of assets [6]
- Over 90% of the nation's 16,000 public educational employers offer IRC 403(b) plans
- Inclusive of non-profits and churches, 403(b) plans hold $747 billion[7]
- Inclusive of non-governmental employers, 457(b) plans hold $183 billion [8]
- The Federal Thrift Savings Plan (TSP) includes 3.7 million participants and holds $207 billion of assets[9]

2 Trends in Public Sector Retirement Plans, Nationwide Retirement Education Institute, Volume II, March 2006
3 U.S. Department of Labor, Bureau of Labor Statistics
4 Trends in Public Sector Retirement Plans, Volume II, March 2006
5 What Do We Know about the Universe of State and Local Plans? State and Local Pension Plans, Center for Retirement Research at Boston College, Number 4, March 2008
6 EBRI Databook on Employee Benefits, Employee Benefit Research Benefits Institute, February 2006
7 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007
8 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007

- Employers utilize 401(a) defined contribution plans for multiple purposes including as an employer match plan, an alternative to a defined benefit and/or a supplemental plan

- State and local employee access to defined contribution plans that serve as primary retirement vehicles increased from 9% in the late 1990's to 14% in 2004 [10]

- Governmental defined contribution plans operating under IRC sections 401(a), 403(b) and 457(b), are increasing in importance due to the following:

- Favorable changes authorized under the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") of 2001 and the Pension Protection Act ("PPA") of 2006

- Increasingly professional management from within the ranks of State, local and Tribal governments

- Societal trends towards increased individual responsibility for retirement savings

- The increasing number of States, localities and Tribal governments that offer defined contribution plans as an optional, employer-funded primary retirement vehicle

Key Findings

The following governmental defined contribution plan trends are in evidence:

- Increased utilization of 457(b) plans, particularly in the educational sector where an estimated 35% - 60% of employers now offer this benefit

- Employers offering multiple categories of defined contribution and deferred compensation plans (hereinafter referred to collectively as "defined contribution plans")

- Among many small employers, a lack of knowledge of IRS regulatory requirements and of IRS Tax Exempt and Government Entities Division ("TE/GE") programs

- Among large employers, increased awareness of compliance requirements and fiduciary duty

9 EBRI Databook on Employee Benefits, Employee Benefit Research Institute, February 2006

10Trends in Public Sector Retirement Plans, Nationwide Retirement Education Institute, Volume II, March 2006

Challenges and Gaps

Governmental defined contribution plans are facing significant compliance challenges due to an increased volume of statutory and regulatory changes, service provider challenges and the fact that regulatory education has historically been oriented to private sector plans. Although they are overwhelmingly beneficial, recent laws and regulations including EGTRRA, PPA and the new 403(b) rules have necessitated significant plan amendment activity and will place unprecedented responsibility on public educational employers. Further, governmental 401(a) plans, which are individually designed, are approaching the determination letter cycle that requires plan submissions by no later than January 31, 2009. While large employers often possess the resources and expertise to deal with these challenges, small employers do not. In any event, it is more critical than ever that the IRS deliver programs, products and services to help governmental employers protect their employees' benefits.

IRS Governmental Plan Initiatives

The IRS has taken a number of significant actions to address governmental plan challenges and gaps. These actions include the issuance of increased guidance (from IRS and Treasury) to provide clarification on new and existing laws and regulations. The IRS has also increased its employer outreach through the TE/GE web site, newsletters and staff visibility. Industry experts have also observed an increase in the development of government plan-oriented educational materials, which assist plan officials and service providers in addressing the sometimes unique challenges associated with public sector plan administration. In the area of plan design, the issuance of a 403(b) sample plan and EGGTRA model amendments for 457(b) plans is assisting employers and service providers in developing plans that incorporate the up-to-date requirements and benefits. The IRS TE/GE Division has also increased its partnerships with governmental employers, practitioners and industry organizations, a step that is necessary to understanding employer needs and delivering high quality, cost-effective programs.

Recommendations

Notwithstanding the positive steps, gaps and challenges remain. Therefore, the ACT recommends that the IRS take the following actions: (1) Establish a Pre-Approved Plan Program for Governmental Plans; (2) enhance the Employee Plans' Compliance Resolution System, (3) Develop additional Educational Tools Tailored to Governmental Plans and; (4) Build on Initiatives to Partner with Governmental Plan Sponsors and Practitioners.

Establish a Pre-Approved Plan Program Oriented to Governmental Plans

The ACT recommends that the IRS extend its pre-approved plan document program to governmental 401(a) defined contribution plans in the near-term and further extend the program to 457(b) plans, if possible, and to 403(b) plans over time. Although the existing program is far from perfect, it delivers benefits and efficiencies to small employers as well as standardization in plan design that could avert the incidence of

plan document errors in the governmental sector. A pre-approved plan document program would provide governmental employers with a cost-effective means for meeting plan document requirements, which may encourage increased plan formation. Importantly, a pre-approved plan document program would put public sector plans on an equal footing with their corporate counterparts within this service category.

Enhance the Employee Plans Compliance Resolution System (EPCRS)

This report reiterates government plan-related recommendations included in the 2008 ACT report, "Improving the EPCRS: A Roadmap for Greater Compliance." Specifically, the ACT recommends that the IRS enhance EPCRS to include coverage of IRC 457(b) plans, permit correction of IRC Section 403(b) plan document failures and reform the VCP fee structure to encourage greater participation among small employers. As noted previously in this report, governmental 457(b) and 403(b) plans are an important and growing segment of the retirement plan community. Employers that offer these plans are becoming increasingly sophisticated and are committed to proactive compliance.

Develop Additional Educational Tools Tailored to Governmental Plans

Governmental employers face challenges in administering multiple categories of plans and in interpreting guidance tailored to corporate plans. The ACT recommends, therefore, that the IRS develop a Multiple Plan Administration Guide, Governmental Question and Answer ("Q&A") Guides and several other educational tools to assist governmental plans' compliance efforts.

Build on Initiatives to Partner with Governmental Plan Sponsors and Practitioners

The IRS TE/GE team has already embarked on an initiative to work more effectively with the governmental plan community toward the end of assisting employers in achieving their compliance objectives. To achieve this objective most effectively, the IRS should follow through on its planned development of a government plans survey, employing an approach that provides comfort to respondents about the consequences of information sharing. In addition, the IRS should partner with governmental employer organizations, which have State-level affiliates the IRS may utilize as cost-effective channels for distributing mutually beneficial educational programs to local employers.

II. Background

Public employees generally choose public sector work out of a desire to serve the public. They are also drawn by attractive benefits. One such benefit is retirement plans. To ensure these plans deliver their benefits, employers, service providers (e.g., practitioners, third party administrators, etc.) and regulators work together to facilitate each plan's adherence to relevant statutes, including applicable sections of the Internal Revenue Code (IRC).

Objective

The objective of this report is to advance the interests of governmental retirement plans and their participants by developing recommendations that help plans sponsors achieve their compliance objectives and thus protect employees' plan benefits.

Consistent with this objective, this report includes an overview of the government retirement plan market, along with separate sections regarding the following:

- Governmental Market Trends (section III)
- Results of Data Gathering (Section IV)
- IRS Programs, Products and Services (Section V)
- Governmental Plan Challenges and Gaps (Section VI)
- IRS Governmental Plan Initiatives (Section VII)
- Recommendations (Section VIII)
- Conclusion (Section IX)

Scope

For the purpose of this report, governmental employers are considered to include:

- Federal government entities
- State and local governments
- Indian Tribal Governments
- Public educational and healthcare employers

Although the introduction includes background information on federal governmental retirement plans and state and local defined benefit plans, the focus of the report is as follows:

- Defined contribution plans operating under IRC sections 401(a), 401(k), 403(b) and 457(b)
- Employers encompassing 79,000 state and local entities, Indian Tribal Governments, 14,000 school districts, 2,000 higher education institutions and 1,100 healthcare employers

For the purposes of delivering the most impact, the scope of this report extends beyond the statutory definition of "governmental plans," which is otherwise limited to 401(a) plans.

Governmental Retirement Plan Overview

In the government sector, retirement plans most often take the form of a primary defined benefit plan and one or more defined contribution structures. A number of States have implemented defined contribution plans as an optional employer-funded primary retirement vehicle, but this is not yet a widespread trend.

The defined benefit plan continues to be the predominant retirement vehicle for most governmental employees. However, defined contribution plans play an increasingly important role as a supplemental, if not primary vehicle. Moreover, defined contribution plans are gaining in importance as favorable regulatory changes, improved management and cultural trends make participation more attractive.

Governmental Defined Benefit Plans

There is no underestimating the importance of the governmental defined benefit plan system. The nation's 2,670 State and local retirement systems are estimated to cover 90% of all active governmental employees or 14.7 million individuals, which translates into 12% of the workforce. These plans hold $3.15 trillion of assets. Federal Governmental defined benefit plans are estimated to hold $1.1 trillion of assets.

Governmental Defined Contribution Plans

Due to the historical prominence of defined benefit plans, governmental employers have typically offered defined contribution plans as a voluntary supplemental retirement benefit. Defined contribution plans, however, are growing in prominence. Defined contribution plans offered by governmental entities consist of 457(b) deferred compensation plans, 403(b), 401(a) and grandfathered 401(k) defined contribution plans and the Federal Thrift Retirement Plan (TSP).

Precise statistics regarding participation in governmental defined contribution plans are not widely available. However, the data below provide a useful abstract of the size of the public sector retirement plan market as well as trends relative to the larger corporate defined contribution market:

US Retirement Plan Assets*[11]

Category	Assets 1994	Assets 2006	Increase %
Private DC	$1.16T	$3.28T	183%
403(b), 457(b)	$0.24T	$0.85T	254%

11 Investment Company Institute

IRA/KEO	$1.06T	$4.22T	298%
Federal Thrift Plan	$0.06T	$0.17T	183%
DC Subtotal	$2.52T	$8.52T	238%
Total Ret. Assets	**$5.88T**	**$16.22T**	**176%**
DC % of Ret Assets	42.9%	52.5%	NA

*Does not include non-457(b) state and local defined contribution plan assets
*Inclusive of non-governmental 403(b) and 457(b) plans
*Excludes governmental 401(a) and 401(k) data

The following provides a snapshot of the governmental defined benefit plan market.

Defined Benefit Statistics[12]

	Assets (000,000)	**Participants**
State & Local Defined Benefit	$3,150,000	18,484,000
Federal Defined Benefit	$1,100,000	12,428,000
Total Governmental DB	**$4,250,000**	**30,912,000**

Categories of Governmental Defined Contribution Plans

The following is a brief description of categories of governmental defined contribution plans

457(b) – IRC section 457(b) deferred compensation plans are available to employees of government agencies as well as to any tax-exempt 501(c) organization including private foundations and endowments. As of 2005, 31,450 state and local governmental employers were offering such plans[13]. Public sector 457 (b) plans are typically offered as a supplement to existing defined benefit systems. Favorable regulatory changes including EGTRRA have improved the features of these plans leading to an increase in adoptions as well as increased participation. With respect to regulatory oversight, it is noteworthy that the IRS TE/GE Division has audit jurisdiction over 457(b) plans, while IRS Counsel maintains jurisdiction with respect to rulings.

The following are relevant data:

- Assets held in 457(b) plans totaled $144 billion in 2005 and are estimated to have totaled $183 billion at the end of 2007 [14]

12 EBRI Databook on Employee Benefits, Employee Benefit Research Institute, February 2006
13 Trends in Public Sector Retirement Plans, Nationwide Retirement Education Institute, Volume II, March 2006
14 Non-Profit Sector DC Plans, Public Elementary/Secondary School Systems, Spectrem Group, 2008

- Section 457(b) plans are expected to experience the highest growth rate of any category of defined contribution plan between now and 2011 with the exception of the Federal Thrift Savings Plan [15]

- Due to the elimination of the coordination of contribution limits under EGTRRA, a significant number of educational employers began to add 457(b) plans in 2002

- A recent report found that 37% of public sector K-12 employers offered section 457(b) plans in addition to 403(b) plans [16]

403(b) – Section 403(b) plans are available to employees of educational organizations as well as charitable entities that fall under Internal Revenue Code 501(c) (3). Depending on the employer category, these plans may fall under the Employee Retirement Income Security Act (ERISA). Unlike other employer-sponsored defined contribution plans, 403(b) plans were not required to operate under a written plan document. This distinction will be eliminated with the scheduled implementation of new 403(b) regulations in January 2009. Generally, the new regulations make 403(b) plans more closely resemble their 401(k) counterparts. For higher education employees, the 403(b) is typically a primary retirement vehicle, while K-12 employers typically offer the 403(b) plan as a supplement to an existing defined benefit plan. The following are relevant data:

- K-12 and Higher Ed employees (governmental and non-governmental) account for 25% and 50% of total 403(b) participants[17]

- Over 90% of the nation's 14,000 public sector K-12 employers offer 403(b) plans[18]

401(a) – Governmental 401(a) defined contribution plans may be offered by government entities including States, Tribes or any subdivisions or agencies thereof. These plans may be offered as a supplement to existing defined benefit plans, as a conduit for employer contributions to match 457(b) deferrals or, as an alternative or replacement to pre-existing defined benefit plans. Reliable statistics for 401(a) defined contribution plans are not available. However, in the National Association of Government Defined Contribution Administrator's (NADGCA) 2006 Match Plan Profiles report, five (5) states and one state university reported offering a 401(a) match a plan. The following are additional data:

- 6% of public K-12 employers reported offering 401(a) DC plans[19]

- In response to NADGCA's 2007 Defined Contribution Plan Survey, 14% of surveyed employers reported offering 401(a) defined contribution plans

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15 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007
16 Non-Profit Sector DC Plans, Public Elementary/Secondary School Systems, Spectrem Group, 2008
17 Non-Profit Sector DC Plans, Public Elementary/Secondary School Systems, Spectrem Group, 2008
18 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007
19 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007

401(k) – Governmental employers which formed 401(k) plans before May 1986 may offer such plans, but formation of governmental 401(k) plans was precluded thereafter. Congress amended IRC Section 401(k) in 1996 to clarify that Tribal Governments may establish 401(k) plans. "Grandfathered" 401(k) plans are offered by a number of State, local and Tribal governments. In response to NAGDCA's 2007 Defined Contribution Plan Survey, 14% of respondents reported offering this benefit.

Federal Thrift Savings Plan - The Thrift Savings Plan (TSP) is a 401(k)-like defined contribution plan offered to Federal employees. It operates under regulations published in Title 5 of the Code of Federal Regulations, Parts 1600 – 1690 and as a trust under IRC section 401(a). As the largest defined contribution plan in existence, the TSP includes approximately 3.7 million participants and $210 billion of assets.

III. Trends

This section references trends impacting governmental plans, which include the role of industry organizations, the impacts of recent pension legislation and developments that are specific to individual categories of plans.

Industry Organizations

Due to the efforts of industry organizations and increasingly professional staff, large public sector defined contribution plan sponsors are more aware than ever of their fiduciary duties and their responsibilities under the IRC. This is exemplified in part by the work of NAGDCA an organization made up of 50 States and 100 local government entities as well as private sector service providers. As evidenced by its website, NADGCA employs an array of media and onsite meetings to educate members about such policy issues as pending pension legislation, 403(b) regulations, investment advice and Department of Labor (DOL) guidance on Qualified Default Investment Alternatives (QDIA). The IRS has partnered with NAGDCA effectively in recent years by participating in NAGDCA's annual conference and most recently by including NAGDCA members in the Governmental Plans Roundtable. There are a number of similar governmental employer organizations who advocate effectively. They also provide an opportunity for forming partnerships between regulators and other governmental plan stakeholders.

Legislation

Although the Pension Protection Act ("PPA") and 403(b) regulations have dominated headlines, EGTRRA most profoundly changed governmental defined contribution plans for the better.

Among other benefits, EGTRRA provided for:

- Increased regular deferral limits and additional catch-up contribution limits
- Distribution flexibility and elimination of the irrevocable election rule for 457(b) plans

- Asset portability to include purchase of permissive service credits from defined benefit plans

This report does not provide analyses of legislation, but rather attempts to estimate its impact on governmental plan formation and employer needs that are relevant to the IRS.

Trends Specific to 457(b) Plans

With the implementation of beneficial legislation, the number of governmental defined contribution plans has grown, perhaps most significantly among 457(b) plans. Since most states and large localities operated 457(b) plans prior to 2002, it is likely that growth has been most pronounced among small employers who typically rely on vendors rather than internal resources for compliance and operational expertise. Based on that assumption, anecdotal evidence that 40% - 60% of public K-12 employers offer 457(b) plans indicate a significant increase in plan formation beginning in 2002, the year most provisions under EGTRRA became effective.

Trends Specific to 403(b) Plans

Although growth is not projected to be as high among 403(b) plans in terms of employer adoptions, the new 403(b) regulations will test employers' and their service providers' ability to adopt required changes for existing plans. The new regulations will also likely result in a profound change to service provider structure, investment structure design and governance. Increased employer involvement necessitated by the new regulations may result in ramped-up marketing and thus greater participation. Further, providers will be relied upon to offer specialized compliance services, similar to those they have long delivered in the 401(k) market.

Trends Specific to 401(a) Plans

Though data on 401(a) plans is scarce, Pensions & Investments (P&I) reported asset growth of 52% for these plans for the three years ended December 31, 2007[20]. P&I further reported predictions of rapid future growth driven by growth in match plans and the creation of defined contribution alternatives to existing governmental defined benefit plans. Although not a clear trend, state governments have increasingly made 401(a) or grandfathered 401(k) defined contribution plans available to their employees as a primary retirement vehicle. State and local employee access to an employer-funded defined contribution plans that served as a primary retirement vehicle increased from 9% in the late 1990's to 14% in 2004.[21]

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20 Pension Investments,401(a)s get an "A" for rapid asset growth, August 6, 2007

21 Trends in Public Sector Retirement Plans, Nationwide Retirement Education Institute, Volume II, March 2006

Impact of Size

Due to limited resources, lesser expertise and a lower level of awareness of IRS programs, compliance challenges are most pronounced in the small plan market. These challenges are likely exacerbated by the volume of statutory changes since 2001. Within the public K-12 segment of the 403(b) market, which comprises 14,000 school systems, 75% of employers have 500 employees or less. In a recent survey only 11% of public K-12 plan sponsors considered themselves to be very familiar with 403(b) regulations, a number that dropped to 4% among employers with fewer than 100 employees[22].

Multiple Plans Offered by One Employer

Governmental employers that offer multiple categories of plans appear to be the rule rather than the exception. At a minimum, most large State and local governments offer a defined benefit plan and an optional 457(b) deferred compensation plan. In the public K-12 market, it is estimated that, in addition to offering a DB plan, 40% of employers offer two or more defined contribution plans[23]. While some jurisdictions have set up a single agency to administer all categories of plans, anecdotal evidence suggests that accountability for plan administration is disbursed across different agencies in most other jurisdictions. Interaction among these agencies is required to ensure adherence to rules governing contribution limits, purchase of permissive service credits and plan loans across different categories of plans.

IV. Results of Data Gathering

The ACT engaged in the development and analysis of extensive background information from both the IRS TE/GE Division as well as from outside parties to develop its recommendations. The collection of background information focused on three communities involved in the design, operation and regulation of governmental defined contribution plans: (1) organizations and practitioners that administer governmental plans ("service providers"), (2) governmental employers that adopt and operate plans and (3) the IRS.

The following means were used to gather information:

- Issuance of Surveys and Publication of Industry Articles
- Outreach to plan sponsors, industry consultants and other service providers
- Aggregation of data from industry publications, reports and statistical analyses
- Consultation with IRS senior management

22 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007

23 State of the 403(b) and 457 Marketplace, Challenges and Opportunities, Cerruli Associates, 2007

Surveys and Articles

Benefits Link Governmental 401(a) Defined Contribution Plan Survey

The ACT considered it important to attempt to obtain information from the employers, service providers, and organizations which either adopt or support government plans. To that end, the ACT posted a survey on the BenefitsLink website in the spring of 2007. BenefitsLink is a website which caters to the employee benefits community. It is a source of benefits information and it also offers a forum for discussion and analysis of various plan-related issues. The site is frequented by employers sponsoring plans, as well as the professionals who provide legal counsel or administrative and testing services to plan sponsors.

While many of the respondents were not employers sponsoring government plans, they were professionals who work closely with such employers and are therefore familiar with the issues confronting them. The survey asked respondents to provide recommendations to improve document and operational compliance in the governmental sector with a specific focus on 401(a) plans. The questionnaire and responses are included in Appendix B to the report.

The following are examples of compliance challenges identified in the survey:

- Plans failed to cover all eligible employees
- Plan documents never amended, especially when specimen plans were used
- Plan documents were improperly amended

Respondents made the following suggestions to improve operational or plan document compliance for sponsors of governmental 401(a) defined contribution plans:

- Suggested that the IRS create a pre-approved plan program for governmental 401(a) defined contribution plans
- Suggested that IRS communications include cautions about using specimen plans, since these plans often are not often kept current with tax law changes, unless a practitioner, law firm or consultant is involved

Other Surveys and Articles

In addition to issuing the governmental defined contribution 401(a) survey through Benefits Link, the ACT publicized the same survey on the National Association of Governmental Contribution Administrators (NADGCA) web site in March 2007, included an article regarding the ACT's governmental plan recommendations for publication in the April 4, 2008 NAGDCA newsletter and issued an announcement through the NADGCA Listserv in late April 2008. Although the ACT received a modest level of responses from these publications, the partnership with NAGDCA provided an opportunity to publicize the ACT's activities within the governmental plan community

and to establish a dialogue with governmental plan advocates. These outreach activities also confirmed support for a pre-approved plan program for governmental plans.

Outreach to Plan Sponsors, Consultants, Service Providers

The ACT reached out to a number of experts to obtain input on both the idea of recommending the IRS establish a Pre-Approved Plan Program (sometimes referred to as a “prototype system”) for governmental defined contribution plans and the question of what other actions the IRS might take to assist governmental defined contribution plans’ compliance efforts.

These outreach activities included the following:

- Conference call with members of the NAGDCA industry group on March 18, 2008, which included representatives from Fidelity, Great West, ING, ICMA, Nationwide Retirement Solutions, Prudential and TIAA – CREF
- Outreach to several leading governmental defined contribution plan executives with oversightresponsibility for State Plans in Maryland, New York and Ohio
- Solicitation of input from leading governmental plan consultants, Willett Consulting and Segal Advisors
- Review of positions pertaining to 403(b) Regulations submitted by the Society of Professional Asset Managers and Recordkeepers (SPARK) Institute and by Fidelity Investments
- Review of written comments developed for ACT by Willet Consulting

The following themes emerged from these outreach activities:

- Support for the idea of a Pre-Approved Plan Program for governmental employers
- Need for the IRS to develop more governmental plan-oriented communications
- Need for communications to assist employers in administering multiple categories of plans
- Low level of awareness of IRS requirements and programs among small employers
- Concerns about employers’ preparedness for the new 403(b) regulations

Aggregated Data from Industry Publications, Reports and Statistical analyses

In an effort to discern governmental market characteristics and trends the ACT consulted a number of analyses. These analyses included: The Cerulli Report, State of the 403(b) and 457 Marketplace: Challenges and Opportunities; NADGCA’s Defined Contribution Plan Survey and Match Plan report; Trends in Public Sector Retirement

Plans published by the Nationwide Retirement Education Institute and; State and Local Pension Plans, Center Retirement Research at Boston College.

Themes emerging from the statistical analyses included the continued prominence of defined benefit plans, growth in the section 457(b) market, governmental employers operating multiple categories of plans and the expectation that educational employers will face significant challenges in preparing for the new 403(b) regulations

Meetings with IRS Senior Management

The ACT solicited comments from the Internal Revenue Service senior management team and participated in the Internal Revenue Service-led Government Roundtable program held on April 22, 2008. It is noteworthy that the Governmental Plans Roundtable drew representation from representatives of some of the Nation's largest governmental defined contribution and defined benefit plans and was significantly oversubscribed.

General observations and recommendations from these meetings are summarized below:

- Absence of statistics on governmental plans due to lack of 5500 filing requirements
- IRS acknowledgment that the governmental plan community has been underserved
- IRS plans for stepped up audit and examination activity
- Encouragement for governmental 401(a) plans to use EPCRS to self-correct compliance errors
- The IRS's initiatives aimed at partnering with the governmental plans to help them succeed
- Plans to develop a survey of governmental plans to learn more about public sector challenges
- Employers' concerns about reconciling IRS regulations to State constitutional protections and legislative processes; concerns about unintended consequences of information sharing

V. IRS Programs, Products and Services

The Internal Revenue Code applies a complex set of rules to ensure that employers and employees covered by retirement plans enjoy the benefits offered by these plans. These rules are implemented through a series of regulations, rulings and other IRS guidance. The Code requirements include rules regarding (i) eligibility to participate, (ii) vesting of benefits, (iii) accrual of benefits or allocation of employer and employee contributions, (iv) prohibitions on discrimination in favor of highly-compensated employees, (v) distribution of benefits, (vi) use of plan assets for the exclusive benefit of

plan participants, and (vii) obligations and timing of required amendments to the plans. This series of lengthy and complex requirements imposed on qualified retirement plans, including the large number of permitted alternatives, requires knowledgeable expertise in the design, implementation and ongoing administration of those plans. The requirements and benefits (i.e. mandatory and permissive provisions) of the Code are set forth at the plan level in the plan document.

Stakeholders in the retirement plan community work together for the benefit of plan participants to ensure that plans remain compliant with the Code. To accomplish this, plan officials must accurately and practically interpret applicable statutes and rules, construct a plan document that is up to date with IRS requirements, implement and operate the plan in adherence to plan-level provisions and communicate the availability of the plan to eligible employees. Plan sponsors and service providers must also identify and correct plan errors in a cost-effective manner, should they occur.

Plans operating under IRC 401(a), 401(k), 403(b) and 457(b) share many of the same features even though they are governed by different sections of the Code. By definition, they have some unique provisions and are subject to different rules. As one example, Section 457(b) plans are not qualified plans under the IRC, but rather are categorized as eligible non-qualified plans. As another example, non-discrimination rules apply to corporate 401(k) plans, but do not apply to 401(a), 401(k) and 457(b) plans offered by government employers. Technically, section 414(b) defines governmental plans as only 401(a) plans, but as mentioned previously this report uses a more expansive definition to better address the employer segment.

Consistent with its service mission, the IRS delivers a series of programs, products and educational tools to assist plan sponsors and practitioners in complying with applicable provisions and rules of the Code. Due in part to statutory limitations these programs are not available across every category of plan. In some cases, communications that describe them are oriented more towards corporate 401(k) plans. The IRS provides information about these programs through IRS Revenue Procedures, Notices, Publications and other communications. All are designed to give plan sponsors the ability to preserve the tax-favored status of their employees' benefits by designing and operating compliant plans and by making corrections when necessary.

IRS programs, products and services include, but are not limited to:

- Employee Plans Compliance Resolution System (EPCRS)
- Determinations Programs
- Educational Services
- Master and Prototype Plan Document System
- Model Plans and Model Plan Provisions

The following table illustrates the variation in applicability of certain Code rules and IRS programs across categories of plans:

	401(a)	**457(b)**	**403(b)**	**401(k)**
Rev. Proc. 2003-44 EPCRS	Yes	No (special 180 day rule)	Yes	Yes
Pre-Approved Plan Program	No (LRMs not available)	No	No – under consideration	Yes
Model Language/ Model Amendments	None	Rev. Proc. 2004-56 w/respect to EGTRRA	Sample Plan Issued	
Determination Letter	No, but can seek PLR	No, but can seek PLR	Yes	Yes
IRS Correction Programs	Yes	Yes	Yes	Yes

As noted in the table above, the IRS Pre-approved Plan Program, which provides employers with a means for adopting a standardized plan, is generally tailored to corporate 401(k) plans. Another well-regarded IRS program, the Employee Plans Compliance Resolution System (EPCRS), is also not widely available across governmental plans. The ACT believes that both programs could benefit governmental plan sponsors. Both are described in more detail below.

Pre-Approved Plan Document Program (Prototype System)

Generally, there are two classifications into which all qualified retirement plans can be divided, pre-approved plans and individually designed plans ("IDPs"). Pre-approved plans are plans which are submitted to the IRS by a sponsoring organization (e.g. Third Party Administrator, Practitioner, etc.) and receive an opinion letter or advisory letter pre-approving the plan's language. Pre-approved plans consist of Master and Prototype ("M&P") plans and Volume Submitter ("VS") plans. The IRS Pre-approved Plan Document program is available to qualified plans, but is oriented through its documentation to corporate plans. The program is not available to IRC section 457(b) plans. As reported in the next section of this report, the fact that the Pre-Approved Plan Document program is oriented towards corporate 401(k) plans is considered to be a compliance gap for governmental defined contribution plans.

In contrast to a pre-approved plan, an IDP is a plan which is specifically designed for one employer or a group of employers and then submitted to the IRS for a determination letter. In the case of 457(b) plans, an IDP may be submitted to the IRS for a favorable private letter ruling (PLR). The purpose of the document approval process is to provide plan sponsors and practitioners with assurance that their plan document complies with the requirements of the Code and other IRS guidance. When they have received a favorable Determination Letter or PLR, the employer or practitioner has achieved a degree of confidence that their plan document design will protect the tax

favored status of participants' accounts. As reported by the ACT in its 2007 report, "Improving Compliance for Adopters of Pre-approved Plans," the IRS estimates that 94% of all qualified retirement plans are pre-approved plans.

Benefits of the Pre-Approved Plan Program

Pre-approved or M&P plans consist of a basic plan document and an adoption agreement with the plan document containing only standard provisions. Plans adopted under the prototype system may be standardized or non-standardized, with the former providing greater security. Both M&P and Volume Submitter (VS) Plans are submitted under the IRS Volume Submitter Program.[24]

A pre-approved plan document program provides a standardized form of agreement for employers and may facilitate a lower cost of adoption as well as a reduced need for employer-initiated amendments as tax laws change. These features may be particularly advantageous to small employers who possess limited resources and expertise. In addition to addressing compliance challenges, such a system may encourage more employers to adopt plans. In summary, the following are benefits associated with pre-approved plans.

- Offer an economical way for employers to meet plan documentation requirements and to obtain the security of IRS approval for the form of their plan
- Benefit small plan sponsors whose resource constraints may preclude them from retaining outside counsel to design an IDP
- Allows employers to avoid the PLR request filing process and to avoid incurring professional and filing fees that might otherwise be necessary to gain assurance of plan document compliance

As reported by the ACT in 2007, there are challenges associated with the current Pre-Approved Plan Program. These include compliance problems resulting from sponsoring organizations' failure to meet the requirements of Rev. Proc. 2005-16 and instances where organizations sponsoring an M&P plan oversell their services, leading adopting employers to underestimate their compliance responsibilities.[25] Unfortunately, the Defined Contribution Listing of Required Modifications (LRMs), which are designed to assist service providers in drafting pre-approved plans, include only corporate 401(k) information. The absence of governmental plan LRMs can cause confusion and errors committed by practitioners attempting to use the prototype system to design a governmental 401(a) defined contribution plan.

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24 Improving Compliance for adopters of pre-approved plans, IRS Advisory Committee on Tax-Exempt and Governmental Entities, 2007

25 Improving Compliance for adopters of pre-approved plans, IRS Advisory Committee on Tax-Exempt and Governmental Entities, 2007

History of Pre-Approved Plans

The concept of Pre-Approved plans dates back to the early 1960's. Originally, a master or prototype plan was a standardized form of a qualified plan that could only be made available by a trade or professional association, bank, insurance company, or regulated investment company and was intended to be used by groups of self-employed individuals. A more extensive history of the prototype system is detailed in Appendix E.

Today, Rev. Proc. 2005-16 sets forth the IRS's current procedures for issuing opinion and advisory letters regarding the qualification of pre-approved plans under Sections 401(a) and 403(a) of the Code. It delineates the requirements and responsibilities of Sponsoring Organizations and Adopting Employers in connection with the establishment, qualification and operation of pre-approved plans.

The Rev. Proc. further provides that a Sponsoring Organization's failure to comply with any requirement delineated, including the notice and recordkeeping requirements, may result in the loss of the ability to maintain a Master and Prototype plan or the revocation of an existing opinion letter.

Employee Plans Compliance Resolution System (EPCRS)

EPCRS is a collection of three programs which allow employers, plan sponsors, investment companies, third party administrators and entities that provide administrative services to qualified plans (403(b), SEP, or SIMPLE-IRA) to correct plan failures. The current requirements of EPCRS are set forth in Rev. Proc. 2006-27[26].

The three correction programs include:

Self-Correction Program (SCP) – The plan sponsor discovers the failure(s) and corrects the failure(s) without IRS involvement. Generally, this program is available to correct insignificant operational failures or any other failure discovered and corrected by the end of the second plan year following the year in which the failure occurred. This program is available even for plans with insignificant failures that are under audit by the Employee Plans Division of the IRS.

Voluntary Correction Program (VCP) – The plan sponsor discovers the failure(s) and corrects the failure(s) with IRS approval. A compliance fee is due based on the number of participants in the plan. This program is generally available for operational failures, document failures, demographic failures, and employer eligibility failures.

Audit Closing Agreement Program (Audit CAP) – This program is an option that is available for the purpose of resolving qualification failures identified by the IRS during an audit of the plan. All types of failures are available for this program. Under this program, the plan sponsor is required to pay a negotiated monetary sanction which

26 Improving the EPCRS: A Roadmap for Greater Compliance, IRS Advisory Committee on Tax-Exempt and Government Entities, 2008

represents a negotiated percentage of the tax the IRS could collect if it disqualified the plan.

EPCRS is the subject of another 2008 ACT report. As reported by the project leaders, this program in its current form does not cover governmental 457(b) plans and does permit correction of 403(b) plan document failures.

The general principles of EPCRS are to encourage Sponsors of qualified retirement plans, 403(b) plans, SEPs, and SIMPLEs to establish administrative practices and procedures that ensure that plans are operated properly in accordance with the tax qualification requirements. Sponsors and other administrators of qualified retirement plans should maintain plan documents satisfying the tax qualification requirements and make voluntary and timely correction of any plan qualification failures. Timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment.

VI. Governmental Plan Challenges and Gaps

As noted in section IV, the ACT information gathering process identified a number of compliance challenges and gaps faced by governmental defined contribution sponsors. Some of these challenges are common to all categories of defined contribution plans while others are specific to a single category.

Challenges and Gaps Common Across Categories of Plans

Challenges faced across all categories of governmental defined contribution plans include preparedness for an anticipated increase in IRS audits and examinations, misinterpretation or misuse of 401(k) plan-oriented materials and programs and the absence of a Pre-Approved Plan Program. In addition, governmental employers are challenged by demands of administering interaction between multiple categories of plans, a low level of awareness of IRS programs and services (small employers) and a low level of utilization of voluntary correction procedures.

In addition, the following conditions challenge all stakeholders in the governmental plan community:

- Scarcity of resources and expertise particularly among small employers
- Absence of coordination across State and local agencies
- Lack of employer involvement, particularly among smaller plans

The summary below provides additional information regarding these challenges and gaps:

Preparedness for Audits & Examinations

As noted by industry experts and IRS officials, IRS services have historically been oriented towards private sector plans. While this may be justified in part by the larger size of the corporate market and a higher potential for abusive transactions, the emphasis puts governmental plans in a potentially precarious position with respect to audit and examination activity. As the IRS knows, lack of preparedness for IRS audits and examinations not only increases the probability of findings detrimental to governmental plans, it also drives up audit cycle time, an important IRS service metric. As evidenced by comments from TE/GE Commissioner Miller, the IRS recognizes these challenges and has articulated plans to assist governmental plans in addressing them. This is evidenced by recent IRS TE/GE-led governmental plan outreach initiatives, and by TE/GE Commissioner Miller's emphasis on encouraging employer initiated corrections.

Misinterpretation or Misuse of 401(k) Guidance

A number of experts interviewed for this report noted that the IRS and Treasury have increased their guidance projects in recent years to the benefit of the retirement plan community. That said, communications regarding guidance initiatives are often geared toward private sector plan sponsors. As a result, governmental plans wishing to make use of this guidance may be confused by or incorrectly utilize guidance that would otherwise assist them in averting plan document and operational failures.

Absence of a Pre-Approved Plan Document Program

As described in subsequent sections of this report, corporate 401(k) plans have available a prototype plan document system which allows employers to adopt a pre-approved plan document and avoid the process of developing individually designed plans. The current Pre-Approved Plan Program is tailored to these plans and therefore may be used erroneously by 401(a) plan practitioners who incorporate LRMs that do not apply to governmental plans (e.g. non-discrimination testing provisions). The program may not be utilized by 457(b) plans and is under consideration for 403(b) plans. The absence of a prototype system for governmental plans may increase the necessity of employer-initiated amendments, which could increase the potential for plan failures and thus discourage governmental employers from offering a defined contribution plan, particularly among small employers.

Administration of Multiple Plans

A number of governmental plan experts advocated for an IRS approach that would provide employers who sponsor multiple categories of plans with guidance on how such plans are meant to interact with one another. There are no comprehensive statistics available, but it is known that a high percentage of public educational employers offer at least two types of defined contribution plans as do many state and local governments. Multiple categories of plans need to coordinate contribution limits, administer loan provisions and facilitate permissive service credit purchases across plans.

Governmental Plans' Lack of Awareness of IRS Programs & Services

Many experts contacted by the ACT expressed the opinion that that the governmental plan community does not realize the full benefits of services the IRS has added. Again, this is particularly true among smaller employers. These employers, and perhaps even their service providers, are less apt to be aware of the IRS EP web site and of IRS outreach and education activities. Small plans, which are largely dependent on the expertise of their service providers, would likely benefit from any effort that resulted in improved awareness of IRS requirements and programs. To the extent that such observations are accurate, increased outreach through groups such as State chapters of governmental employer organizations, retirement plan associations, school boards associations and school administrators associations will provide some market penetration with smaller employers.

Low Utilization of Voluntary Corrections Procedures

The IRS provides correction procedures for written plan document failures to 401(k) plans in the form of Employee Plans Compliance Resolution System (EPCRS). This system is not available for 457(b) plans. However, 457(b) plans may pursue corrections through other means. If applied to 403(b) EPCRS may need to be modified to fit specifics of 403(b) (e.g. potential failure by one participant w/small balance in a failed annuity contract). The IRS has developed a 401(k) Fix-it Guide, which would also be a useful correction tool for governmental plans if it were designed as such. Generally, most experts contacted by the ACT believe that IRS correction programs are either not oriented adequately to the governmental sector or the benefits of these programs are not well understood in the government sector or they are inadequately marketed.

The following challenges and gaps are specific to specific categories of plans:

403(b) Plans

Employer preparedness for the new 403(b) regulations represents a significant challenge. A number of industry groups, including the SPARK Institute, have advocated for a postponement of the effective date of the new 403(b) regulations to beyond January 2009. Assuming the effective date of January 1, 2009, stakeholders have expressed concerns about the absence of a remedial amendment period ("RAP") for 403(b) plans, the absence of prototype or pre-approved plan document system, shortcomings in the model 403(b) plan document language and shortcomings in correction procedures. As noted in section V of this report, the IRS is considering a Pre-Approved 403(b) Plan program.

401(a) Defined Contribution Plans

As evidenced by responses to the ACT Benefits Link survey, the following challenges were in evidence for 401(a) defined contribution plans:

- Erroneous inclusion of 401(k) plan provisions due to erroneous use of the pre-approved plan program

- Utilization of a flawed specimen plan
- Documents incorrectly amended or not amended when tax laws change

The ACT and the IRS have received anecdotal information and comments that point to confusion in the area of qualified plans adopted by governmental entities caused in part by the fact that the current pre-approved plan document program does not provide information on the Code provisions that do or do not apply to governmental entities. As the 401(a) survey results pointed out, 401(a) plan document failures occur because practitioners mistakenly utilize the 401(k) prototype system when the provisions (LRMs) clearly do not apply (e.g. non-discrimination testing).

457(b) Plans

Challenges for IRC section 457(b) plans related to a lack of coverage under EPCRS, the absence of a comprehensive publication that describes 457(b) plans and confusion about the distinctions between governmental versus non-governmental section 457provisions.

VII. IRS Government Plan Initiatives

This report does not provide detail on initiatives the IRS TE/GE Division has undertaken to assist governmental plans in their mission of protecting employee plan benefits. However, the IRS has undertaken a number of initiatives and programs that were cited by governmental plan advocates as providing a strong foundation and having a positive impact on employers.

IRS-led initiatives include the delivery of increased guidance (from IRS and Treasury) to provide governmental employers with clarification on new and existing laws and regulations. The IRS has also significantly increased its outreach to employers through its web site, electronic newsletters and staff presentations at various conferences around the country. Recently, the IRS TE/GE Division added new and useful governmental plan information to the EP section of its web site. During the course of the ACT's data gathering, industry experts noted an increase in the amount of IRS publications that are useful to retirement plan service providers. One such publication is the "Choose Retirement Plan for Employees of Government and Tax-Exempt Employers" brochure.

In the area of plan design, the issuance of a 403(b) sample plan and EGGTRA model amendments for 457(b) plans is assisting employers and service providers in developing plans that incorporate up-to-date requirements and benefits. The IRS TE/GE Division has also increased its partnerships with governmental employers, practitioners and industry organizations, a step that is necessary to understanding employer needs and delivering high quality, cost-effective programs. This was most recently evidenced by the IRS-led Governmental Plans Roundtable, which was held on April 22, 2008.

VIII. Recommendations

The ACT makes the following recommendations that fall into four basic categories:

- Establish a Pre-Approved Plan Document Program for governmental plans
- Enhance the Employee Plans Compliance Resolution System (EPCRS) to assist governmental plans
- Develop Government Plan-oriented educational tools
- Build on the IRS-led initiative to partner with governmental plans sponsors and practitioners

These recommendations are described in more detail in the pages that follow.

Establish a Pre-Approved Plan Program Oriented to Governmental Plans

The ACT recommends that the IRS extend its pre-approved plan document program to governmental 401(a) defined contribution plans in the near-term and further extend the program to 457(b) plans and 403(b) plans over time. Implementation would necessitate drafting of a Listing of Required Modifications (LRMs), as well as procedures, with which ACT members could assist. Although the existing program is far from perfect, it delivers benefits and efficiencies to small employers as well as standardization in plan design that could avert the incidence of some Plan document errors in the governmental sector. The IRS's estimate that 94% of qualified plans are pre-approved plans provides evidence of general marketplace demand for the program.

Importantly, the availability of a pre-approved plan document program would put public sector plans on an equal footing with their corporate counterparts within this service category just as EGTRRA put governmental plans on a par with corporate plans with respect to distribution flexibility. While it is possible that some industry participants (e.g. TPAs) will continue to offer only individually designed plans, the benefits that would inure outweigh less than 100% participation from service providers. A reduction in the number of uniquely designed plans should reduce the risk of plan document and operational failure in the market place, lower the cost of adoption and encourage employers to adopt plans. In summary, a Pre-Approved Plan Program would deliver the following benefits to governmental 401(a), 403(b) and 457(b) plans:

- Provide employers with a standardized form of agreement for which IRS approval may not be needed
- Provide a lower cost of adoption
- Minimize the need for employer-initiated amendments when tax laws change
- Minimize failures attributable to 401(a) plan service providers' misuse of current LRMs.

The ACT is encouraged that the IRS is currently considering a Pre-Approved Plan Program for 403(b) plans. On the other hand, the ACT recognizes a challenge with respect to 457(b) plans since the IRS TE/GE Division evidently lacks rulings jurisdiction for these plans.

Enhance the Employee Plans Compliance Resolution System (EPCRS)

The 2008 ACT Report entitled "Improving the Employee Plans Compliance Resolution System: A Roadmap for Greater Compliance" contains a full set of well-developed recommendations for improving EPCRS. This report does not attempt to duplicate the depth of these recommendations. However, as that report states, EPCRS is an important tool in assisting plan sponsors to voluntarily comply with IRS requirements. As effective as EPCRS is, many governmental plans are not utilizing it due to its current limitations. Therefore, this report reiterates the recommendation that EPCRS be enhanced for the benefit of governmental plans by:

- Expanding EPCRS to include coverage of IRC section 457(b) plans[27]
- Expanding EPCRS to permit correction of IRC section 403(b) plan document failures[28]
- Reforming the VCP fee structure to encourage greater participation among small employers[29]

In addition to availing governmental plans of correction tools that are already available to corporate plan sponsors, expanding EPCRS coverage to 457(b) plans and 403(b) plan document failures would likely reduce the confusion a governmental plan sponsor may otherwise experience in attempting to navigate IRS voluntary correction-related materials. As noted previously in this report, governmental 457(b) and 403(b) plans are an important and growing segment of the retirement plan community. Employers that offer these plans are becoming increasingly sophisticated and are committed to proactive compliance.

In addition to expanding coverage of EPCRS and developing a sliding fee schedule that would encourage increased EPCRS utilization, the IRS should consider developing a correction tool for governmental plans that is similar to the "401(k) Fix-it Guide." The addition of these tools would not only provide a resource for governmental plans, it would also send a message that the IRS is increasingly committed to assisting governmental employers' voluntary compliance efforts.

Develop Educational Tools tailored to Governmental Plans

The IRS has developed a number of tools, communications and products that are helping both governmental and non-governmental plans achieve their compliance

27 Improving the EPCRS: A Roadmap for Greater Compliance, IRS Advisory Committee on Tax-Exempt and Government Entities,

28 Improving the EPCRS: A Roadmap for Greater Compliance, IRS Advisory Committee on Tax-Exempt and Government Entities, 2007

29 Improving the EPCRS: A Roadmap for Greater Compliance, IRS Advisory Committee on Tax-Exempt and Government Entities, 2007

objectives. However, experts contacted by the ACT indentified some unmet needs that the IRS could address in an economical way. These needs include an absence of information about how to coordinate certain provisions of 401(a), 403(b) and 457(b) plans that may be offered by one employer and confusion over how a governmental plan sponsor should interpret IRS guidance.

Multiple Plan Administration Guide

As stated previously a large number of governmental entities offer multiple categories of plans. Employers and participants can be confused as to how these plans should interact. The confusion and risk of operational failure is exacerbated where three different government agencies and plan service providers may be responsible for administering defined benefit, 457(b) and 403(b) plans. The ACT's recommendation is that the IRS, develop a publication that sets forth requirements for coordinating the interaction of certain provisions between plans including contribution limits, purchase of permissive service credits, plan loans, rollovers and plan amendments. Additionally, the IRS should coordinate with State retirement plan agencies or industry organizations to distribute such a multiple plan administration guide.

Governmental Plan Q & A Publication

To address the issue of misuse or misinterpretation of guidance designed for corporate 401(k) plans, when necessary, the IRS should develop an accompanying Q&A for governmental employers to assist them in interpreting sections of the guidance that apply to their governmental plans.

Additional Publications

Publication 571, which describes provisions for the 403(b) plan, is seen as a useful tool. Given the projected growth rate for 457(b) plans and recent trends in plan formation, the IRS should consider creating a similar document for 457(b) plans. More broadly, the topic of publications and tools highlights the absence of uniformity in how IRS resources are presented to plan sponsors across the governmental and non-governmental sectors. With the understanding that the IRS is already making progress in this area, the ACT would be happy to work with the IRS on how communications, tools and publications are presented to different segments of the retirement plan market.

Build on Initiatives to Partner with Governmental Plan Sponsors and Practitioners

The IRS TE/GE team has already embarked on an initiative to work more effectively with the governmental plan community to assist governmental plans in achieving there compliance objectives. As noted by Commissioner Miller at the April 22, 2008 Governmental Plans Roundtable, the IRS is undertaking an effort to obtain more factual information about the governmental market so that it can more effectively serve it. Additionally, governmental employers, particularly at the local level, would benefit greatly by learning more about the IRS service mission and about the rules that govern their plans. To achieve this objective most effectively, the IRS should take the following steps:

- Follow through on planned development of a government plans survey
- Develop the survey with input from governmental plan stakeholders using an approach that provides comfort to respondents about how the information that they share will be used
- Partner with governmental employer organizations which are interested in retirement plan issues and which have State-level affiliates that can be leveraged to educate local employers
- Either through direct outreach or through national organizations, partner with large State agencies who often run seminars to educate local jurisdictions on retirement plan issues

Governmental employer organizations and State fiscal agencies are strong and effective partners, particularly when they perceive an opportunity to advance the interests of their members and constituents.

The ACT will work with the IRS to maximize such partnering opportunities with the belief that the approach to compliance that best serves employees involves partnering, mutual education and delivery of IRS services that position governmental plans to succeed.

IX. Conclusion

Thanks to favorable legislation, initiatives undertaken by the IRS and other regulators and increasingly professional management, governmental employers now offer defined contribution plans that are better than ever in terms of cost, quality and soundness of operations. By building on steps it has already taken to improve service, the IRS can help public sector employers take their retirement plans to the next level in terms of benefits, compliance and security. The ACT's recommendations are respectfully submitted with the goal of enhancing and protecting the improved defined contribution benefits now available to governmental employees.

Appendix A Data Sources (Partial List)

- Benefits Link Survey Comments (Appendix A)
- Comments from Governmental Plans Roundtable (April 22, 2008)
- SPARK Comments on IRS 403(b) Plan Rules (March 19, 2008)
- Fidelity Investments Comments on Rev Proc 2007-71 (March 14, 2008)
- Trends in Public Sector Retirement Plans, Nationwide Retirement Education Institute, Volume II (March 2006)
- What Do We Know about the Universe of State and Local Plans? State and Local Pension Plans, Center for Retirement Research at Boston College, Number 4, (March 2008)
- New 403(b) Rules Present Challenges, Opportunities; Ignites (April 15, 2008)
- Non-Profit Sector DC Plans, Public Elementary/Secondary School Systems (2008)
- NAGDCA Match Plan Profiles (November 2006)
- NAGDCA Defined Contribution Plan Survey (March 2008)
- EBRI Databook on Employee Benefits (Various)
- Memo from Willett Consulting (March 31, 2008)
- IRS TE/GE Communications and Educational Material (Various)
- Agenda and Minutes for Meeting with NAGDCA Industry Group (March 18, 2008)
- The SPARK Institute on IRS 403 (b) Plan Rules (March 19, 2008)

Appendix B. Copy of ACT Survey on BenefitsLink

Improving Compliance for Governmental 401(a) Qualified Plans - Are an attorney, accountant, actuary, consultant, third-party administrator, financial services provider, or other kind of retirement plan practitioner? Are you a governmental employer that sponsors a section 401 tax-qualified retirement plan? Please help an official IRS advisory group supply the IRS with cost-effective ideas for increasing compliance (for plan documents or in operation) by governmental employers sponsoring section 401 tax-qualified retirement plans, by completing this online survey.

Re: IRS Advisory Committee Survey of Governmental 401(a) Plans

Dear Retirement Plan Practitioner:

The members of the IRS Advisory Committee (ACT) on Tax Exempt and Government Entities serve as an advisory group for the Commissioner, Tax Exempt and Government Entities Division of the IRS.

The ACT is currently undertaking a project that is aimed at identifying cost effective ideas for further increasing Governmental 401(a) plans operational and document compliance with IRS requirements. The ACT is undertaking a number of activities to develop "best practices" recommendations for 401(a) plan sponsors and 401(a) plan practitioners. Potential recommendations were reported at the June 2007 ACT public meeting. The final recommendations will be presented to the IRS in June of 2008.

The survey is aimed at assessing compliance challenges encountered by Governmental 401(a) Plans as well as at generating ideas for improving operational and document compliance for adopters of governmental 401(a) plans.

If you have any questions about this project, please contact any of the undersigned by email.

Thank you for your help.

Very truly yours,

Susan D. Diehl
sdiehl@penserv.com

Julian M. Regan
Julian.regan@fmr.com

Governmental 401(a) Qualified Plans Compliance and Document Survey
Demographics

1. Do you practice with or are you employed by:

- a law firm

- an accounting firm
- an actuarial or retirement plan administration firm
- a financial services provider
- a consulting firm
- A third party administrator
- Other (specify):

2. **Does your firm offer a "401(a) specimen" Defined Contribution Plan?**
   - Yes
   - No
3. **If the answer to Item 3 is yes, what type of 401(a) Defined Contribution Plan does your firm offer?**
   - Money Purchase Pension
   - Profit-Sharing
   - Both
   - Other (Specify):
4. **If the answer to Item 3 is yes does your firm (answer all that apply):**
   - Update the specimen document based on legislative changes
   - Inform the employers that they are responsible for future amendments/compliance
   - Notify employers when a legislative change is made that they must update document, forms, etc.
5. **Do your clients often utilize "Pre-approved Plans" (Prototype Plans) to adopt a governmental 401(a) plan?**
   - Yes
   - No
6. **Do your clients often utilize "Pre-approved Plans" (Prototype Plans) and:**

- Eliminate provisions that do not apply to governmental entities
- Leave the document intact and ignore provisions that do not apply to governmental entities
- Other (Specify):

7. **What recommendations would you make to improve *document* compliance for adopters of Governmental 401(a) Plans? (*OK to enter as much text as desired*)**

8. **What recommendations would you make to improve *operational* compliance for adopters of Governmental 401(a) Plans? (*OK to enter as much text as desired*)**

As members of the ACT, we greatly appreciate your assistance with respect to this project.

Susan D. Diehl 215-444-9812
Julian Regan 508-787-6163

Summary of ACT Survey Responses from BenefitsLink

The respondents indicated that the most frequent qualification failures included:

- Document modified incorrectly. Money Purchase features inserted in a Profit-Sharing Plan
- Plan Document: When we are contacted by a prospect, the first thing we usually find is that they have failed to timely update the plan document for all of the required changes ("no one knows who is supposed to have been doing that")
- Eligibility failures
- The documents have not been updated for any laws. It is pages paper clipped that don't make any sense whatsoever, or they have no document at all and everything is done because the person who was there before them told them that is how it was done
- Operational failures. Misinterpretation of plan relating to eligibility - such as excluding employees because human resources designates them as "not benefits eligible" without any real criteria. but this is not particular to governmental plans
- If one assumes that a breach of a plan's trust terms tax-disqualifies the plan, the most frequent failure is investments precluded by the trust instrument or State law
- When we takeover a plan, we find that many have adopted a pre-approved prototype document and are not following all of the terms of the document
- Plan includes provisions not applicable to governmental plans, but these are operationally ignored
- NO Trust
- Failure to properly maintain the document. With the current rapid pace of statutory and regulatory changes, it is becoming impossible to keep up with plan amendments and notices to participants
- Failure to make contributions on a "regular" basis. Plans are established and contributions are often made only one time for a selected group, or one time for a group that changes each year (retirees, terminated employees, employees that reach specific age and service formula) with no additional contributions for employees in that group

- Failure to clearly define eligible employees is common. Non-concurrence with employer policy and procedures based upon a poor understanding of the document by administrative employer staff is a result of this problem

The second most frequent qualification failures include:

- Not covering all eligible employees
- Operational: We have seen provisions in the plan that define specific actuarial equivalence definitions for determining alternate forms of benefits payable at retirement, but, amazingly, the actuary performing the calculations was using a different set of assumptions, both mortality and interest rates for these numbers, "based on a conversation we had with the client about 10 years ago"
- Coverage discrimination
- The governmental entity does not follow the provisions of the Plan. They just make it up as they go along. They let people in early, change the forms of distributions, and allow in-service distributions when they are not allowed
- I've had a couple adopt plans that they weren't eligible to adopt - a 401(k) plan and a 403(b) plan. The advisors did this
- Pre-effective date service is credited under DB plan and employer failed to recognize 415(b) limits
- No 415 Language
- Failure to operate the plan document according to the plan language. Because the IRS has been making rapid changes to plan documents, mistakes are made when interpreting plan language because the language changes so frequently. Just checking the language in the plan document leads to error because it misses the changes made by the amendments
- Failure to maintain documents. "Specimen" documents are provided to governmental employers by product providers or consultants, but are not maintained or updated. Since approved "prototype" documents are not very helpful for this group of employers, most documents do not get updated or amended after the initial adoption
- We are aware that many governmental employers have relied upon "Specimen" documents supplied by investment product providers without proper legal advice or plan design. A prototype plan would provide a simple and effective solution to this problem

The third most frequent qualification failures include:

- Documents never amended after adoption, especially when employer has adopted a "specimen plan"

- Compensation definitions and average compensation definitions - some documents seem clear, but the actuary has completely interpreted the definition in another way; which would be ok if the plan actually had the language to support it

- The smaller the governmental entity the worse the compliance is; they don't usually have a full time benefits person

- Not really any significant document failures because I deal primarily with defined benefit plans, and the rules for governmental plans allow almost everything. The IRS rules for governmental plans are mostly boilerplate

- No 401(a)(31)rollover language

- Failure to properly calculate participants benefits under USERRA. Small municipalities with participants called up to active duty not providing the proper information to participants in Iraq and Afghanistan and not providing those participants with proper allocations and vesting credit

- Problems with excluding those portions of the plan; that are not applicable to governmental employers. Many "advisors" to governmental plan sponsors are unable to provide adequate information on the plan provisions that are not applicable to governmental plans. Thus, the plans often include requirements that the governmental employer cannot or will not satisfy

The respondents indicated the following recommendations to improve operational or document compliance for adopters of Governmental 401(a) Plans:

- IRS should create a prototype system for governmental 401(a) plans. Use of current LRMs would make it easy to delete those provisions that do not apply and require submission of the documents. This would also eliminate the problems that occur when firms provide specimen documents that employers do not understand

Secondly, provide on the IRS website, cautions in utilizing specimen plans, since these are not very often kept current or updated for any law changes, unless a law firm or consulting firm or TPA is involved:

- Have pre-approved prototypes for governmental 401(a) plans (i.e. give employers options within the prototype document to have certain ERISA provisions apply or not)

- Make a totally separate code section for the rules for governmental plans and non-electing church plans. Where do you look up the rules for a governmental

plan now (all over the place)? Some or all of these do not apply: 401(a)(10), 416, 401(a)(11), 417, 401(a)(12), 414(l), 401(a)(13), 401(a)(14), 401(a)(15), 401(a)(19), 401(a)(20), 401(a)(29), 410, 411, 412, 414(p), 4975, 4980, 6057, 6058, 6059, Form 5500. Why not make separate code sections for governmental plans and a corresponding regulation section. While you're at it, why not do the same for non-electing church plans? We find there is generally a lot of confusion as to what applies and what does not apply. I believe that would greatly help the document providers to write the documents better, which is where the real answer to this question lies. Yes these code sections may then be redundant, but the method by which the code is organized in and of itself appears to be causing a lot of the confusion

On a humorous note: ask Congress to require all government employers (other than the Federal government) to comply with IRC 412 (soon to be IRC 430), that way they will be terminating their large DB plans too like the rest of the country, in order to avoid raising a lot of new taxes (usually raising taxes hurts you in the next election), thus avoiding a large future tax burden for us regular non-governmental folks. If this can happen, then perhaps we can work on the same requirement for some of those federal agencies later on.

- They need more frequent guidance that they can understand. It is like dealing with children they want it there way and disregard any provisions they don't "like"

- I don't think that governmental employers, at least in my state, do badly with the current system

- The simplest way to improve compliance for all kinds of retirement plans (not just governmental) is for the IRS to abolish the pre-approved regime

- Provide a pre-approved governmental 401(a) plan document for money purchase plans, plans with non-elective contributions (profit sharing) and grandfathered 401(k) plans

- Eliminated 415(b) 10-years of participation phase-in for governmental plans

- Allow an easy mechanism to use standard prototypes but eliminated provisions not applicable to Government plans

- Let the benefits community know that IRS will be enforcing 401(a) compliance by governmental plans

- A more reasoned approach to statutory and regulatory changes. Plan sponsors are overwhelmed by the last three years of changes. If a more comprehensive time table had been developed by the IRS on what plans needed to be amended; less errors would have occurred

- Create prototypes designed for use by governmental employers so that the document and the administration of the plan coordinate

- Provide options that make sense for governmental employers. More plans are now being adopted by "local" governmental entities rather than "Statewide" entities. These smaller employers need simple options that are easy to administer and monitor. For example, many of these plans are NOT used for large groups of employees. They may only be available to employees in a common classification (police officers) or after a period of years which may be linked to another benefit program that has been modified due to funding issues. The issues for governmental plans are very different that those faced by nongovernmental entities. Therefore, any prototype should reflect the governmental plan issues and not be based on the standard prototypes which are cumbersome and difficult to read and understand

- Our clientele includes over 70 public education employers, K-12 and colleges, representing over 400,000 employees. We can assure you that these governmental employers need a prototype 401(a) plan with flexibility for various situations. Standard plans (those not intended specifically for governmental employers) are cumbersome and prone to errors in design for this group

IRS Advisory Committee Finalizes Governmental Plan Recommendations

The IRS Advisory Committee on Tax-Exempt and Government Entities (ACT) is seeking input as it finalizes governmental defined contribution plan recommendations the committee will deliver to the IRS Executive Team in early June.

The objective is to advance the interests of governmental defined contribution plans and their participants by delivering recommendations that will facilitate plan sponsors' operational and plan document compliance efforts.

Recommendations will likely focus on the following initiatives for the IRS's consideration:

- Establishment of a prototype (standardized) plan document system for certain categories of plans

- Education and guidance tailored to assist governmental plans in their compliance efforts

- Tools to assist employers in administering interaction between multiple categories of plans

To date, the ACT has received valuable ideas from industry experts, organizations and practitioners, many of whom are advancing the interests of the governmental plan community through separate, but related initiatives. The ACT wishes to thank these individuals for their time and insights.

If you wish to add comments please send them to ACT members Julian Regan or Susan Diehl by no later than April 28 at the email addresses below:

Julian Regan (julian.regan@fmr.com)
Susan Diehl (sdiehl@penserv.com)

The ACT serves as an advisory group to the Commissioner, Tax-Exempt and Government Entities Division of the IRS and includes members from the employee retirement plan, exempt organization and government entities communities.

Appendix D

The ACT spoke, on a confidential basis, with a number of retirement plan and governmental employer experts to receive input in developing these recommendations. We are grateful to the time and effort they provided in support of this report. The following is a partial list:

IRS TE/GE Division

Joseph Grant, Deputy Commissioner, IRS TE/GE Division
Michael Julianelle, Director of Employee Plans Division
Andrew Zuckerman, Esq. Director, Employee Plans Rulings and Agreements
Monika Templeman, Esq., Director, Employee Plans Examinations
Mark F. O'Donnell, Director, Employee Plans Customer Education and Outreach
Sunita Lough, Director, Federal, State and Local Governments

Industry Consulting Firms

Mary Willet, President, Willett Consulting
Cathie Eitelberg, Segal Company

Industry Organizations

M. Kristi Cook, National Tax Sheltered Accounts Association
Robert Hansel, National Association of Government Defined Contribution Administrators

Governmental Defined Contribution Plan Officials

Michael Halpin, Executive Director, Maryland Supplemental Retirement Plans
Keith Overly, Executive Director, Ohio State Deferred Compensation Program
Edward J. Lilly, Executive Director New York State Deferred Compensation Board

Service Providers (attendees for 3/18 call)

Timothy Rouse, Fidelity Investments
Marilyn Collister, Great West Retirement Services
Rod Crane, TIAA-CREF
Janet Kendall - ING
Brian McCleave – Prudential
Brenda Anderson, Nationwide Retirement Solutions
Kerry Robinson – Nationwide Retirement Solutions
Eric Stevenson – Nationwide Retirement Solutions
Eric Judge – Hartford Life
Frances Dayne - ING
Robert Kaplain - ING
Linda Seigelman - ING

Contributions

Thomas Peller, Fidelity Investments
Weiyan Jonas, Fidelity Investments

Appendix E

Internal Revenue Service's Pre-Approved Qualified Plan Program

Over the past 20 years, the use of Master and Prototype plans ("M&P plans") and Volume Submitter plans ("VS plans" and together with M&P plans referred to hereinafter as "Pre-approved Plans") has increased dramatically. The Internal Revenue Service estimates that at least 94% of all qualified retirement plans are Pre-approved Plans.

In order for employer-sponsored retirement plans, such as 401(k) plans, profit-sharing plans and defined benefit pension plans (including cash balance plans), to enjoy the tax benefits offered to those employers and to employees covered by those plans, the Internal Revenue Code imposes a complex set of rules, which are implemented through a series of regulations, rulings and other IRS guidance. These Code requirements include rules regarding (i) eligibility to participate, (ii) vesting of benefits, (iii) accrual of benefits or allocation of employer and employee contributions, (iv) prohibitions on discrimination in favor of highly-compensated employees, (v) distribution of benefits, (vi) use of plan assets for the exclusive benefit of plan participants, and (vii) obligations and timing of required amendments to the plans.

This series of lengthy and complex requirements imposed on qualified retirement plans, including the large number of permitted alternatives, requires knowledgeable assistance in the design, implementation and ongoing administration of those plans.

The ACT and the IRS has received anecdotal evidence as well as comments received in the surveys described later in this report that there has been much confusion in the area of qualified plans adopted by governmental entities. Part of the confusion stemming from the fact that the current pre-approved program does not provide information on the Code provisions that do or do not apply to governmental entities.

Generally, there are two classifications into which all qualified retirement plans can be divided, pre-approved plans and individually designed plans ("IDPs"). Pre-approved plans are plans which are submitted to the IRS by a sponsoring organization and receive an opinion letter or advisory letter pre-approving the plan's language. An IDP is a plan which is specifically designed for one employer or a group of employers and then submitted to the IRS for a determination letter. The purpose of the document approval process is to provide employers and plans assurance that their plan document complies with the requirements of the Code and other IRS guidance.

Generally the approval process for a pre-approved plan is based on a 6-year approval cycle.[30] Sponsoring organizations were required to submit defined contribution Pre-approved plans to the IRS for EGTRRA and other requirements (outlined in the 2004 Cumulative List)[31] by January 31, 2006. Those plans have received the new EGTRRA approval letters on March 31, 2008, and may now be used by Employers to restate their

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[30] Rev. Proc. 2005-66, 2005-37 I.R.B. 509
[31] Notice 2004-84, 2004-52 I.R.B. 1030

current plans generally by the end of 2010. The next submission deadline for Pre-approved plans will be January 31, 2012. For certain intervening legislative changes and other guidance issued by the IRS, interim amendments may be required.

The determination letter process for Individually designed plans is based on a 5-year cycle.[32] These 5-year cycles are determined by the last digit of the employer's EIN. The cycles are based on the following schedule:

Year 1 - EINs ending in 1 & 6 (Cycle A)
Year 2 - EINs ending in 2 & 7 (Cycle B)
Year 3 - EINs ending in 3 & 8 (Cycle C)
Year 4 - EINs ending in 4 & 9 (Cycle D)
Year 5 - EINs ending in 5 & 0 (Cycle E)

The deadline for Cycle A submissions was January 31, 2007. Cycle B plans will be due on January 31, 2008, and so on. There are also special exceptions for certain types of plans, such as multiple employer plans, collectively bargained plans, and plans maintained by controlled groups of businesses. Employers are also permitted to submit "off-cycle;" however, in many instances these plans will only be reviewed after the "on-cycle" plans have been completed.

Government Plans that maintain an Individually Designed Plan must submit their plan under Cycle C which has a deadline of January 31, 2009.

An employer that maintains an IDP and desires to "convert" to a Pre-approved plan may execute, along with the Sponsoring Organization of the pre-approved plan, an IRS Form 8905 no later than the end of their submission cycle. In the case of a government plan, form 8905 could be executed by January 31, 2009 and then the governmental entity may in lieu of adopting and submitting the IDP for a determination letter during its submission cycle, adopt a pre-approved plan instead.

History of Pre-Approved Plan Program

Pre-Approved type plans conceptually date back to the early 1960's. Originally, a master or prototype plan was a standardized form of a qualified plan that could only be made available by a trade or professional association, bank, insurance company, or regulated investment company, and was intended to be used by groups of self-employed individuals.[33] Master plans were those standardized form plans that had a related form of trust or custodial agreement, that was administered by a bank or insurance company which acted as a funding medium to provide the benefits on a standardized basis; whereas a prototype plan need not have included a form of trust agreement, was only for use by employers without modification, and was not administered by the Sponsoring Organization.[34] Rulings as to the acceptability of the

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[32] Rev. Proc. 2005-66 at §9.01
[33] *Id.* at §2.02
[34] *Id.*

Master and Prototype Plans were made by the National Office of the IRS, and a separate determination letter was required as to the qualification of the plan as adopted by a particular employer. During 1964 these plans were required to be filed with the District Office for opinion letters as to the acceptability of the form of plan. Then in 1972 the approval process was moved again to the National Office.

After receiving repeated requests to create procedures for processing M&P plans to be adopted by corporate employers (as opposed to only employers with self-employed individuals), the IRS developed procedures for a prototype system that could be offered by corporate employers. After the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), the IRS developed guidelines that could be used for both Self-employed plans and Corporate plans with respect to new plans.

Until this time it was only specific "sponsoring organizations" that could apply and receive an IRS approval letter on qualified plans. Sponsoring Organizations only included banks, insured credit unions, insurance companies, regulated investment companies, certain investment advisors, and certain principal underwriters.[35] The Mass Submitter Program was intended as an experimental program to reduce the IRS's paperwork burden in addressing the required plan amendments to comply with TEFRA's qualification changes.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[36] largely eliminated the distinctions between Corporate Plans and Keogh plans.[37] As a result, the IRS issued Rev. Proc. 84-23 and removed the distinction between the two types of M&P plans, referring to them collectively as "Master and Prototype Plans."[38]

Following the changes to qualification requirements imposed by the Tax Reform Act of 1986, which had a specific provision requiring the IRS to accept applications for opinion letters for Prototype plans that included cash or deferred arrangements (CODAs), the IRS issued model amendments for Sponsoring Organizations to use to conform their plans to the new law.

In 1989, due to pressure from law firms and other firms, the IRS created a program for "regional prototype plans," which lessened the requirements otherwise applicable to uniform plans and allowed practitioners to sponsor Prototype plans, in addition to institutional sponsors. Regional prototype plans were not required to use the top-heavy vesting requirements contained in Section 416 of the Code in all cases, and adopters of regional prototype plans were able to retain their prototype status and reliance following changes in the law if certain requirements were met. Additionally, the regional prototype plan was intended to increase flexibility for Adopting Employers and provide reciprocity among IRS regions once a plan was approved in one region. A sponsor of a regional prototype plan was defined as a firm which "(1) has an established place of business in

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[35] *Id.* at §17.01-03
[36] Pub. L. 97-248, 1982-2 C.B. 462
[37] Rev. Proc. 84-23 §3.01
[38] *Id.* at §4.01-02

the United States where it is accessible during every business day, and (2) either has at least 30 clients that have their principal place of business within the jurisdiction of not more than two regions of the IRS and are expected to adopt the sponsor's regional prototype plan, or has at least three clients that are expected to adopt a "mass submitter regional prototype plan."[39]

The regional prototype plan program and the M&P plan program operated separately, each being amended a number of times thereafter as procedural requirements changed in accordance with the law, until the two were finally unified under a single Master and Prototype plan program in 2000. Stating that it was no longer practical to maintain separate programs, the IRS issued Rev. Proc. 2000-20, creating one set of requirements and procedures for all Master and Prototype plan sponsors and expanding the availability of options previously available to only one program to make them universally available under the Unified Program.

Since 2000, there have been minor amendments to the Unified Program, most notable of which was in 2005, when the IRS issued Rev. Proc. 2005-16, attempting to simplify and combine the otherwise separate programs for Pre-approved plans.

Rev. Proc. 2005-16 sets forth the IRS' current procedures for issuing opinion and advisory letters regarding the qualification of pre-approved plans under Sections 401(a) and 403(a) of the Code. It delineates the requirements and responsibilities of Sponsoring Organizations and Adopting Employers in connection with the establishment, qualification and operation of pre-approved plans.

The Rev. Proc. further provides that a Sponsoring Organization's failure to comply with any requirement delineated, including the notice and recordkeeping requirements, may result in the loss of the ability to maintain a Master and Prototype plans or the revocation of an existing opinion letter.

[39] *Id.* at §4.02

Appendix F

IRS Advisory Committee seeks input on Public Sector Plan Recommendations

Provided by: Julian Regan

The IRS Advisory Committee on Tax-Exempt and Government Entities (ACT) is reaching out to industry leaders including NADGCA to ensure public sector defined contribution plan recommendations the committee is developing incorporate expertise from across the government plan community. NAGDCA members who have not done so already may send comments to the ACT at one of the email addresses identified below by April 11, 2008.

The ACT serves as an advisory group to the Commissioner, Tax-Exempt and Government Entities Division of the IRS and includes members from the employee retirement plan, exempt organization and government entities communities.

ACT recommendations are aimed at facilitating improved compliance for public sector defined contribution (DC) plans. They will be finalized in late April for presentation to the IRS at a public meeting in June.

The recommendations will likely encompass the following topics:

- Potential establishment of a prototype system for public sector 401(a) DC plans.
- Educational tools and initiatives the IRS might undertake to further facilitate compliance across all categories of DC plans (e.g. 401(k), 401(a), 457, 403(b)).
- General discussion of public sector compliance challenges, gaps and solutions.

As many NAGDCA members know, a prototype system, such as the system currently available to corporate 401(k) plans, provides a standardized form of agreement and may facilitate a lower cost of adoption as well as a reduced need for employer-initiated amendments as tax laws change. In addition to addressing compliance challenges, such a system may encourage more employers to adopt plans, particularly among smaller entities. The ACT recommendations will weigh these potential benefits, along with input from stakeholders and the implications to the IRS of administering such a system.

Beyond exploring the concept of a prototype system, the ACT will recommend cost-effective initiatives the IRS might undertake to serve the needs of the public sector plan community across all categories of plans. Such initiatives may include tools to assist employers and service providers in understanding and executing against statutory requirements. It should be noted that the IRS is already taking action in these areas. The ACT recommendations are intended to complement these efforts.

The ACT first contacted NAGDCA on this project in the spring of 2007 and NAGDCA immediately assisted by posting a survey to its web site. Beyond obtaining input from

surveys, the ACT is meeting with industry experts and recently met with senior management from the IRS to stay abreast of IRS-led initiatives such as the Government Plans Roundtable the IRS will conduct on April 22.

As a final step in the outreach process, the ACT will include information through the NAGDCA Listserv. We encourage all members to send any comments to me at julian.regan@fmr.com or, to my fellow ACT member Susan Diehl at sdiehl@penserv.com.

The ACT looks forward to delivering cost-effective recommendations that will advance the interests of governmental employers and their hard-working employees who are saving for retirement.

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

TAX TREATMENT OF CELLULAR TELEPHONES AND INTERNET-PROVIDER ALLOWANCES

Nicholas C. Merrill, Jr. and Steven W. Hoffman,

Project Leaders

June 11, 2008

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I. EXECUTIVE SUMMARY

The Internal Revenue Service (IRS) FY 2008 Federal State and Local Government Work Plan, (IRS Work Plan) dated October 1, 2007, includes a statement in its Executive Summary which says that "The Office of Federal, State and Local Governments (FSLG) supports the Internal Revenue Service (IRS) and the Tax Exempt and Government Entities (TEGE) Division strategic goals of:

1) Enhancing Enforcement of the Tax Laws;
2) Taxpayer Education and Outreach; and
3) Modernizing the IRS through its People, Process and Technology."

The IRS Work Plan goes on to describe the various work plan areas which will be addressed, including the general steps which are expected to be taken to accomplish the goals of the IRS. The ultimate goal, of course, is to have greater taxpayer compliance in the recording and reporting of all matters involving the Internal Revenue Code (IRC).

One particular area of transaction recording and financial reporting which has been problematic for many employers, both governmental and non-governmental, has been that of employer-provided cellular telephones and internet provider allowances. The difficulty in properly recording and reporting these transactions stems from some general lack of awareness about "listed property" (see IRC Section 280F), and the advances made in the cellular telephone and internet provider industries over the past decade. The advancements in technology have resulted in a number of employers changing their traditional definition of "workplace", which no longer requires that an employee sit at a desk in a "brick and mortar" building. The advent of new technologies has allowed for a huge expansion in the availability of cellular telephones, and internet provider allowances for employees. These employer-provided tools have also created a recording and reporting fiasco for employers.

The purpose of this year's report of the FSLG Subcommittee of the IRS Advisory Committee on Tax Exempt and Government Entities (ACT), is to: a) raise awareness that the inclusion of cellular telephones and internet provider allowances as listed property in IRC Section 280F may be outdated given the technological advancements that have occurred within the respective industries; and b) offer a comparison and contrast with the permissive de minimis allowances of personal use of the desktop telephone and computer within the IRC. The report will also offer several options for consideration by the IRS as to how best to administer the IRC as it is currently written, raise the awareness of the recording and reporting requirements with employers to encourage better compliance; and, suggest that the Department of Treasury consider a legislative change which would remove cellular telephones and internet provider allowances from the definition of listed property included in IRC Section 280F.

II. INTRODUCTION

The invention of cellular telephones (or cell phones) and the development of a worldwide web called the “internet” have dramatically changed the way many people around the world, in particular the United States, live, work, and play, everyday of their lives. The cell phone emerged around the same time as the Internet went public.[1]

Cell phones were first made available to the public in 1984. Back then, they were very large, expensive instruments.[2] It has been estimated that there were more than 219 million cell phones in use in the United States as of 2005, and over 2 billion worldwide.[3] The first cell phone caused a fundamental technology and market shift toward the person and away from the place. Motorola introduced the 16-ounce “Dyna TAC” phone into commercial service in 1983, with each phone costing the consumer $3,500. It took seven additional years before there were a million subscribers in the United States. **Today, there are more cellular subscribers than wireline phone subscribers in the world, with mobile phones weighing as little as 3 ounces**[4] (emphasis added).

In 1989, the Internal Revenue Service designated cell phones as “listed property”. The designation recognizes that employers give mobile communication devices to employees for business purposes, but because of their very nature, they also could be used for personal use.

As a result, to exclude the use by an employee from taxable income, employers must be able to track and substantiate their employees’ usage of mobile communications devices. Technically, the law excludes any personal calls or e-mails, in the case of Blackberries, as a deductible expense.[5]

With the proliferation of cell phones and internet usage in the workplace, the issue of tax-related parity with other common “business-purpose” tools such as the office desktop telephone and access to the internet via the office computer has surfaced and needs to be addressed in the Internal Revenue Code.

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[1] Website www.historicaltextarchive.com

[2] Website www.library.thinkquest.org

[3] Website www.infoplease.com

[4] Website www.thehistoryof.net

[5] Bureau of National Affairs (BNA), Daily Tax Report, 26-DTR G-6, February 8, 2008

III. SCOPE OF THE PROBLEM

Personal use and the taxation of cell phones is specifically referred to in IRS Code Section 280F(d)(4)(A)(v), (see Appendix for IRS Code Sections). That reference to IRC Section 280F is cited specifically in IRS Code Section 274(d)(4), which is part of IRS Code Section 274(d) Substantiation Required.

Sec 274(d) indicates no credit shall be allowed:

> unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified non personal use vehicle (as defined in subsection (i)).

IRC Section 274(d) is generally referred to as the "Accountable Plan Rule". The requirements for documentation to apply are not conducive to cell phone usage by individuals employed and in possession of an employer provided cell phone. In fact, we assert these rules are administratively burdensome for any employer, regardless of the number of employees. To comply with this IRS Code Section, employers need to review each and every line item on each and every cell phone bill received and distinguish those calls that are personal in nature from those calls that are business related. The employer would then be required to seek reimbursement for the personal phone calls from the employee.

This treatment of identifying personal phone calls differs radically from an employee who is employed at his employers' place of business and has a land line telephone on their desk. In this scenario, the employee is permitted to make infrequent use of the telephone for personal reasons and no reimbursement is required of this desk bound employee as the IRS Code identifies certain fringe benefits as not subject to taxation (See IRS Code Section 132(e)). This treatment is disparate to employees who are performing the same actions but who happen to have received a cell phone from their employer. We believe there is a presumption of primary business use when a cell phone is provided to an employee.

Since 1989, cellular phones and telecommunications equipment (including PDA's and Blackberrys) have been included in the definition of "listed property" under Section 280F of the Code (See Appendix), which limits the amount of depreciation for certain property

that can be used for personal purposes. This designation as listed property in section 280F(d)(4)(A)(v) has implications for both business deduction and fringe benefit purposes, because of the detailed recordkeeping requirement with respect to such property.

The detailed substantiation rules set forth specifically apply to "any listed property (as defined in section 280F(d)(4))." See Section 274(d)(4) of the Code. Under the regulations, deductions for expenses attributable to the business use of cellular phones are disallowed unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement the amount of the expenses, the time and place of the use of the list property, and the business purpose of the expense. See Generally Treas. Reg. 1.1274-5T(b)(6) and 1.274-5T(c).

Cellular phone expenses include the purchase price of the equipment (or annualized 'lease value' approximation of that price), monthly service charges and any additional per minute, roaming, long-distance or other operating charges. See, e.g., Treas. Reg. 1.274-5T(6)(i).

There is an interaction with the working condition fringe benefit exclusion of section 132(d) and "accountable plan" rules of section 62(c) of the Code. If an employer provides a cellular phone and a service plan to an employee (by either paying for the benefits directly or reimbursing the employee), the exclusions set forth in section 132(d) for working condition fringe benefits and in section 62(c) for tax-free expense reimbursements under the accountable plan rules apply only to the extent that records (including records of both incoming and outgoing calls) are kept to substantiate the business use each calendar year.

> Note: The exclusion for working condition fringes generally covers any property or services provided to any individual (including independent contractors) currently performing services for the employer to the extent the expenses would have been deductible under Section 162 or 167 of the Code (including section 274, when required to be applied), if the individual had paid for the benefit and the expenses relate to the employer's business. Sections 132(a)(3) and 132(d) of the Code; Treas. Reg. 1.132-5. Likewise, one of the required elements for excluding and expense reimbursement from the employee's income and wages under Section 62(c) of the Code is compliance with the detailed substantiation requirements of Section 274(d), when applicable. See Treas. Reg 1.62-2(e)(1) and -2(e)(2).

If insufficient or no records are kept, the exclusions for working condition fringes and accountable plan reimbursements will not apply to exclude the business use of the cellular phone (and the related service plan expenses) from the employee's gross income. Therefore, the value of the benefits must be included in the employee's gross income and treated as wages for payroll tax purposes. See Treas. Reg. 1,724-5T(e).

There are no streamlined substantiation rules for cell phones as there are for vehicles. No personal use or de minimis personal use policies are authorized under the section 274(d) substantiation rules.

The substantiation rules do not permit employers to adopt "no personal use" or "de minimis personal use policies" with respect to cellular phones, such as the rules permitting reliance on written policies for "vehicles not used for personal purposes" and "vehicles not used of personal purposes other than commuting," which streamline or at least minimize the recordkeeping requirements. Treas. Reg. 1.274-6T(a)(2) and 1.274-6T(a)(3).

> Note: If the employer implements such a policy with respect to its cellular phone program, reliance on same will not qualify as sufficient evidence corroborating the employee's own statement and, therefore, will not satisfy the substantiation requirements of section 274(d) for purposes of excluding the business use as a working condition fringe benefit or a tax-free business expense reimbursement. In such a case, the result is that the entire value of the benefits (that were treated as tax-free) become taxable and subject to the retroactive imposition of payroll taxes if the IRS successfully challenges the program in an employment tax examination.

Although the regulations permit taxpayers to substantiate the business use of a cellular phone by maintaining adequate records for a portion of the year, an employer relying on such a 'sampling' method would still be advised to collect the records pertaining to the sampling period and also be prepared to demonstrate that the records are representative of the use for the calendar year. See, e.g., the rules for 'substantiation by other sufficient evidence' in Treas Reg. 1.274-5T(c)(3), which permits the use of sampling for listed property if the taxpayer can demonstrate by other evidence that the periods for which and adequate record is maintained are representative of the use for the year.

There has been some recent IRS examination activity in this area. Over the years, the Tax Court has sustained the requirements of detailed substantiation under section 274(d) with respect to cellular phones. See, e.g., Vaksman v. Commissioner, T.C. Memo. 2001-165, aff'd 90 AFTR2d 2002-7639 (5th Cir. 2002); Woods v. Commissioner, T.C. Memo. 2004-114; Megibow v. Commissioner, T.C. Memo. 2004-41; Nitschke v. Commissioner, T.C.Memo. 2000-230; and Ramsey v. Commissioner, T.C. Memo. 1996-189. Therefore, if the IRS were to review an employer's cellular phone program and determine that the substantiation requirements had not been met, judicial precedent exists in favor of the government.

There are references to cell phones in The IRS Audit Techniques Guide on Fringe Benefits. In a section entitled, "Employee Use of Listed Property," IRS examiners are advised by the Guide that cellular phones are listed property and subject to detailed

substantiation requirements of IRC section 274. Consequently, the issue of cellular phones is being raised routinely in executive compensation examinations, both of the corporate side with respect to the company's deduction treatment and on the payroll tax side.

Anecdotally, we have received information from a number of governmental employees who have reported on two major components of this project, mainly: a) recordkeeping and transaction reporting requirements; and b) audit results.

A synopsis of the "typical" responses which were received is as follows:

Recordkeeping and Transactions Reporting

- I am the County auditor of xx, and as such am required to review the cell phone bills of employees that are provided cell phones by the County. This review is very tedious and time consuming and basically unfair because I am not required to monitor employee land line use for the same activity. Employees who are not tied to a desk are penalized and taxed more than their desk bound counterparts.

- I am very happy to see someone working on eliminating this time consuming, archaic requirement.

- Some of us have cell phones policies that allow for limited personal use- similar to the limited personal use we have for our desk phones- and just hope this passes a federal auditors' review.

  Then the board thanked me for the information and changed our policy to say- "limited personal use"- knowing that I had warned them that we might have a problem with the IRS.

  PDA's have just compounded the problem. We don't get any information about where and e-mail went or who it came form- it just lists the amount of time on the system.

- The Business Manager is responsible for internal review of cell phone invoices.

- For the district, the financial impact is virtually a wash. I think the amount of time and trouble that we spent on it, though, probably greatly exceeds my amount that would have ever been realized by the IRS.

- To fix this problem, and keep us out of hot water with the IRS, we came up with an expensive solution. I include the entire cost of their blackberries as W-2 wages.

- What a nightmare! We do not have staff to sift through cell phone bills and try to determine what is business and what is personal.
- The law needs an overhaul that reflects the new technology and purposes of conducting business via office phones, PCs, cell and Blackberry as an extension of their desk phone and computer.

AUDIT RESULT

- In each audit, the use of employer provided cell phones and laptops were an issue. A letter has been issued by the IRS closing the audits of 5 of the colleges. In each case discrepancies were noted with respect to compliance with IRS regulations related to listed property and in one a liability of $2,519 was assessed.

Other financial implications:

Some states, for example, the State of Illinois, are required by State law to use gross compensation as the basis for contributions to state retirement funds. Thus, the value of the cell phone added to an employee’s wages is used to calculate wages subject to retirement contributions and future benefits. This situation presents disparate treatment for an employee not issued a cell phone by the same employer. It also increases the amount of contributions paid by the employing state agency and presents an unfair burden on state budgets.

By contrast, the State of Ohio Public Employees Retirement System only views true compensation for services as includible in retirement and distribution calculations – i.e., there are items of ‘non includible income’ for purposes of the state retirement system. Thus, we have disparate treatment of employees in the same organization and disparate treatment of employees by state of employment.

This issue of taxation of personal vs. business cell phone usage is a broad, and ranges from the smallest employer to the large multi-national corporations. The issue spans all individual taxpayers, all organizations regardless of type of organizational entity and impacts all public and private sector employers.

IV. RECOMMENDATIONS

The IRS has the authority to issue guidance to interpret the Code. Guidance is needed by all taxpayers for the dilemma of personal usage of employer provided cell phones. It is clear that when the 'listed property' provision of the Code specifically included 'cell phones' there was no method to determine the extent of the popularity of the cell phone and its use for business purposes. There is a presumption of business use when an employer provides an employee with a cell phone. This presumption is undeniable in its nature – there is a business purpose. To require an over burdensome process of attempting to identify each and every incoming and outgoing phone call to meet the accountable plan rules is not current with the business environment as it exists today.

We suggest the IRS issue interpretative guidance that would permit an employer to perform statistically valid sampling and this sampling method be described by the IRS in its guidance. Further, this prescribed method of sampling would suffice an examination by the IRS. Lastly, these samplings need only be performed once over a time period such as every 2 – 4 years and retain its validity for examination purposes. This sampling is the same effort the IRS performs during an exam on this issue and a benefit would be a shorter cycle time for the completion of an exam by the IRS if the sampling method was described adequately in the guidance.

We also suggest that external groups such as the Government Finance Officers Association (GFOA), the National Association of State Comptrollers and Treasurers (NASACT), and various other trade and industry groups pursue an effective lobbying effort to change the legislation to reflect current business operating conditions to recognize the extent of cell phone usage by businesses. That is, we are recommending that cell phones be removed from 'listed property' as defined in the Code. This will provide a commonality of tax treatment among all taxpayers that are now being treated differently depending on their work location or if they are issued a cell phone.

It is also worth noting that on February 7, 2008, Treasury Secretary Henry Paulson indicated that "… he was interested in a congressional proposal designed to modernize the Internal Revenue Code to recognize the growth of business-use mobile communications devices". This issue has been noticed by House Ways and Means Committee member Sam Johnson (R-Texas) and was the topic of his discussion at a House Ways and Means hearing on President Bush's fiscal year 2009 budget proposal. In this regard, Representative Johnson (R-Texas) introduced H.R. 5450 to amend the Internal Revenue Code of 1986 to remove cell phones from listed property under IRC Section 280F. The FSLG Subcommittee commends this action and would support its extension to include the removal of computer or peripheral equipment (as defined in Section 168(i)(2)(B)), which appears as "listed property" at IRC Section 280(d)(4)(A)(iv).

IRC, 2007-CODE-VOL, SEC. 280F. LIMITATION ON DEPRECIATION FOR LUXURY AUTOMOBILES; LIMITATION WHERE CERTAIN PROPERTY USED FOR PERSONAL PURPOSES.

Regulations Committee Reports

SEC. 280F. LIMITATION ON DEPRECIATION FOR LUXURY AUTOMOBILES; LIMITATION WHERE CERTAIN PROPERTY USED FOR PERSONAL PURPOSES.

280F(a) LIMITATION ON AMOUNT OF DEPRECIATION FOR LUXURY AUTOMOBILES. --

280F(a)(1) DEPRECIATION. --

280F(a)(1)(A) LIMITATION. --The amount of the depreciation deduction for any taxable year for any passenger automobile shall not exceed --

280F(a)(1)(A)(i) $2,560 for the 1st taxable year in the recovery period,

280F(a)(1)(A)(ii) $4,100 for the 2nd taxable year in the recovery period,

280F(a)(1)(A)(iii) $2,450 for the 3rd taxable year in the recovery period, and

280F(a)(1)(A)(iv) $1,475 for each succeeding taxable year in the recovery period.

280F(a)(1)(B) DISALLOWED DEDUCTIONS ALLOWED FOR YEARS AFTER RECOVERY PERIOD. --

280F(a)(1)(B)(i) IN GENERAL. --Except as provided in clause (ii), the unrecovered basis of any passenger automobile shall be treated as an expense for the 1st taxable year after the recovery period. Any excess of the unrecovered basis over the limitation of clause (ii) shall be treated as an expense in the succeeding taxable year.

280F(a)(1)(B)(ii) $1,475 LIMITATION. --The amount treated as an expense under clause (i) for any taxable year shall not exceed $1,475.

280F(a)(1)(B)(iii) PROPERTY MUST BE DEPRECIABLE. --No amount shall be allowable as a deduction by reason of this subparagraph with respect to any property for any taxable year unless a depreciation deduction would be allowable with respect to such property for such taxable year.

280F(a)(1)(B)(iv) AMOUNT TREATED AS DEPRECIATION DEDUCTION. --For purposes of this

under section 168.

280F(d)(2) SUBSEQUENT DEPRECIATION DEDUCTIONS REDUCED FOR DEDUCTIONS ALLOCABLE TO PERSONAL USE. --Solely for purposes of determining the amount of the depreciation deduction for subsequent taxable years, if less than 100 percent of the use of any listed property during any taxable year is used in a trade or business (including the holding for the production of income), all of the use of such property during such taxable year shall be treated as use so described.

280F(d)(3) DEDUCTIONS OF EMPLOYEE. --

280F(d)(3)(A) IN GENERAL. --Any employee use of listed property shall not be treated as use in a trade or business for purposes of determining the amount of any depreciation deduction allowable to the employee (or the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property) unless such use is for the convenience of the employer and required as a condition of employment.

280F(d)(3)(B) EMPLOYEE USE. --For purposes of subparagraph (A), the term "employee use" means any use in connection with the performance of services as an employee.

280F(d)(4) LISTED PROPERTY. --

280F(d)(4)(A) IN GENERAL. --Except as provided in subparagraph (B), the term "listed property" means --

280F(d)(4)(A)(i) any passenger automobile,

280F(d)(4)(A)(ii) any other property used as a means of transportation,

280F(d)(4)(A)(iii) any property of a type generally used for purposes of entertainment, recreation, or amusement,

280F(d)(4)(A)(iv) any computer or peripheral equipment (as defined in section 168(i)(2)(B)),

280F(d)(4)(A)(v) any cellular telephone (or other similar telecommunications equipment), and

280F(d)(4)(A)(vi) any other property of a type specified by the Secretary by regulations.

280F(d)(4)(B) EXCEPTION FOR CERTAIN COMPUTERS. --The term "listed property" shall not include any computer or peripheral equipment (as so defined) used exclusively at a regular business establishment and owned or leased by the person operating such establishment. For purposes of the preceding sentence, any portion of a dwelling unit shall be treated as a regular business establishment if (and only if) the requirements of section 280A(c)(1) are met with respect to such portion.

IRC, 2007-CODE-VOL, SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

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SEC. 274.DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

274(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION. --

274(a)(1) IN GENERAL. --No deduction otherwise allowable under this chapter shall be allowed for any item --

274(a)(1)(A) ACTIVITY. --With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

274(a)(1)(B) FACILITY. --With respect to a facility used in connection with an activity referred to in subparagraph (A).

In the case of an item described in subparagraph (A), the deduction shall in no event exceed the portion of such item which meets the requirements of subparagraph (A).

274(a)(2) SPECIAL RULES. --For purposes of applying paragraph (1) --

274(a)(2)(A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.

274(a)(2)(B) An activity described in section 212 shall be treated as a trade or business.

274(a)(2)(C) In the case of a club, paragraph (1)(B) shall apply unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business.

274(a)(3) DENIAL OF DEDUCTION FOR CLUB DUES. --Notwithstanding the preceding provisions of this subsection, no deduction shall be allowed under this chapter for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

274(b) GIFTS. --

274(b)(1) LIMITATION. --No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter, but such term does not include --

274(b)(1)(A) an item having a cost to the taxpayer not in excess of $4.00 on which the name of

the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer, or

274(b)(1)(B) a sign, display rack, or other promotional material to be used on the business premises of the recipient.

274(b)(2) SPECIAL RULES. --

274(b)(2)(A) In the case of a gift by a partnership, the limitation contained in paragraph (1) shall apply to the partnership as well as to each member thereof.

274(b)(2)(B) For purposes of paragraph (1), a husband and wife shall be treated as one taxpayer.

274(c) CERTAIN FOREIGN TRAVEL. --

274(c)(1) IN GENERAL. --In the case of any individual who travels outside the United States away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary, is not allocable to such trade or business or to such activity.

274(c)(2) EXCEPTION. --Paragraph (1) shall not apply to the expenses of any travel outside the United States away from home if --

274(c)(2)(A) such travel does not exceed one week, or

274(c)(2)(B) the portion of the time of travel outside the United States away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time on such travel.

274(c)(3) DOMESTIC TRAVEL EXCLUDED. --For purposes of this subsection, travel outside the United States does not include any travel from one point in the United States to another point in the United States.

274(d) SUBSTANTIATION REQUIRED. --No deduction or credit shall be allowed --

274(d)(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

274(d)(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

274(d)(3) for any expense for gifts, or

274(d)(4) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business

relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).

274(e) SPECIFIC EXCEPTIONS TO APPLICATION OF SUBSECTION (a). --Subsection (a) shall not apply to --

274(e)(1) FOOD AND BEVERAGES FOR EMPLOYEES. --Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees.

274(e)(2) EXPENSES TREATED AS COMPENSATION. --

274(e)(2)(A) IN GENERAL. --Except as provided in subparagraph (B), expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages).

274(e)(2)(B) SPECIFIED INDIVIDUALS. --

274(e)(2)(B)(i) IN GENERAL. --In the case of a recipient who is a specified individual, subparagraph (A) and paragraph (9) shall each be applied by substituting "to the extent that the expenses do not exceed the amount of the expenses which" for "to the extent that the expenses".

274(e)(2)(B)(ii) SPECIFIED INDIVIDUAL. --For purposes of clause (i), the term "specified individual" means any individual who --

274(e)(2)(B)(ii)(I) is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer or a related party to the taxpayer, or

274(e)(2)(B)(ii)(II) would be subject to such requirements if the taxpayer (or such related party) were an issuer of equity securities referred to in such section.

For purposes of this clause, a person is a related party with respect to another person if such person bears a relationship to such other person described in section 267(b) or 707(b).

274(e)(3) REIMBURSED EXPENSES. --Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person, but this paragraph shall apply --

274(e)(3)(A) where the services are performed for an employer, only if the employer has not treated such expenses in the manner provided in paragraph (2), or

274(e)(3)(B) where the services are performed for a person other than an employer, only if the taxpayer accounts (to the extent provided by subsection (d)) to such person.

274(e)(4) RECREATIONAL, ETC., EXPENSES FOR EMPLOYEES. --Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other

168(h)(8) REGULATIONS. --The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

168(i) DEFINITIONS AND SPECIAL RULES. --For purposes of this section --

168(i)(1) CLASS LIFE. --Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets. The reference in this paragraph to subsection (m) of section 167 shall be treated as a reference to such subsection as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990.

168(i)(2) QUALIFIED TECHNOLOGICAL EQUIPMENT. --

168(i)(2)(A) IN GENERAL. --The term "qualified technological equipment" means --

168(i)(2)(A)(i) any computer or peripheral equipment,

168(i)(2)(A)(ii) any high technology telephone station equipment installed on the customer's premises, and

168(i)(2)(A)(iii) any high technology medical equipment.

168(i)(2)(B) COMPUTER OR PERIPHERAL EQUIPMENT DEFINED. --For purposes of this paragraph --

168(i)(2)(B)(i) IN GENERAL. --The term "computer or peripheral equipment" means --

168(i)(2)(B)(i)(I) any computer, and

168(i)(2)(B)(i)(II) any related peripheral equipment.

168(i)(2)(B)(ii) COMPUTER. --The term "computer" means a programmable electronically activated device which --

168(i)(2)(B)(ii)(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

168(i)(2)(B)(ii)(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

168(i)(2)(B)(iii) RELATED PERIPHERAL EQUIPMENT. --The term "related peripheral equipment" means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

168(i)(2)(B)(iv) EXCEPTIONS. --The term "computer or peripheral equipment" shall not include --

168(i)(2)(B)(iv)(I) any equipment which is an integral part of other property which is not a computer,

168(i)(2)(B)(iv)(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

168(i)(2)(B)(iv)(III) equipment of a kind used primarily for amusement or entertainment of the user.

168(i)(2)(C) HIGH TECHNOLOGY MEDICAL EQUIPMENT. --For purposes of this paragraph, the term "high technology medical equipment" means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

168(i)(3) LEASE TERM. --

168(i)(3)(A) IN GENERAL. --In determining a lease term --

168(i)(3)(A)(i) there shall be taken into account options to renew,

168(i)(3)(A)(ii) the term of a lease shall include the term of any service contract or similar arrangement (whether or not treated as a lease under section 7701(e)) --

168(i)(3)(A)(ii)(I) which is part of the same transaction (or series of related transactions) which includes the lease, and

168(i)(3)(A)(ii)(II) which is with respect to the property subject to the lease or substantially similar property,

168(i)(3)(A)(iii) 2 or more successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property shall be treated as 1 lease.

168(i)(3)(B) SPECIAL RULE FOR FAIR RENTAL OPTIONS ON NONRESIDENTIAL REAL PROPERTY OR RESIDENTIAL RENTAL PROPERTY. --For purposes of clause (i) of subparagraph (A), in the case of nonresidential real property or residential rental property, there shall not be taken into account any option to renew at fair market value, determined at the time of renewal.

168(i)(4) GENERAL ASSET ACCOUNTS. --Under regulations, a taxpayer may maintain 1 or more general asset accounts for any property to which this section applies. Except as provided in regulations, all proceeds realized on any disposition of property in a general asset account shall be included in income as ordinary income.

168(i)(5) CHANGES IN USE. --The Secretary shall, by regulations, provide for the method of determining the deduction allowable under section 167(a) with respect to any tangible property for any taxable year (and the succeeding taxable years) during which such property changes status under this section but continues to be held by the same person.

Employee Cell Phones

Government employers frequently provide their employees with cellular telephones and pagers to employees to conduct business. This can raise special tax concerns, due to the fact that these items are listed property under the Internal Revenue Code, and because employees may use them for business as well as personal use.

What is Listed Property?

"Listed property" includes items obtained for use in a business but designated by the Internal Revenue Code as lending themselves easily to personal use. This includes automobiles, computers, and entertainment or recreation-related items. In 1989, cellular telephones were added to this category. Although the use of these phones is much more widespread and economical today, they remain listed property and are subject to these restrictions.

For a for-profit business, the designation of an item as listed property has implications for depreciation deductions taken by the business and the computation of net income. However, this article focuses on the employment tax issues raised for employees of government entities.

Substantiation Requirements

To be able to exclude the use by an employee from taxable income from an employer-owned cell phone, the employer must have some method to require the employee to keep records that distinguish business from personal phone charges. If the telephone is used exclusively for business, all use is excludable from income (as a working condition fringe benefit). The amount that represents personal use is included in the wages of the employee. This includes individual personal calls, as well as a pro rata share of monthly service charges.

In general, this means that unless the employer has a policy requiring employees to keep records, or the employee does not keep records, the value of the use of the phone will be income to the employee.

At a minimum, the employee should keep a record of each call and its business purpose. If calls are itemized on a monthly statement, they should be identifiable as personal or business, and the employee should retain any supporting evidence of the business calls. This information should be submitted to the employer, who must maintain these records to support the exclusion of the phone use from the employee's wages.

The following situations illustrate the application of the rules:

Example 1: A municipal government provides an employee a cell phone for business purposes. The government's written policy prohibits personal use of the phone. The government routinely audits the employee's phone billings to confirm that personal calls were not made. No personal calls were actually made by the employee. The business use of the phone is not taxable to the employee.

Example 2. A municipal government provides an employee a cell phone for business purposes. The government's written policy prohibits personal use of the phone. However, the government does not audit phone use to verify exclusive business use. The fair market value of the phone, plus each monthly service charge and any individual call charges are taxable income to the employee, reportable on Form W-2.

Example 3: A state agency provides an employee with a cell phone and pays the monthly service charge. The employee is required to highlight personal calls on the monthly bill. The employee is then required to timely reimburse the agency for the cost of the personal calls, and the employee is charged a pro rata share of the monthly charge. The value of the business use portion of the phone is not taxable to the employee.

Employee-Owned Telephones

If the employee owns the phone, the listed property requirements do not apply. Any amounts the employer reimburses the employee for business use of the employee's own phone may be excludable from wages if the employee accounts for the expense under the accountable plan rules. See Publication 15, Employer's Tax Guide (Circular E), for more information about the accountable plan rules.

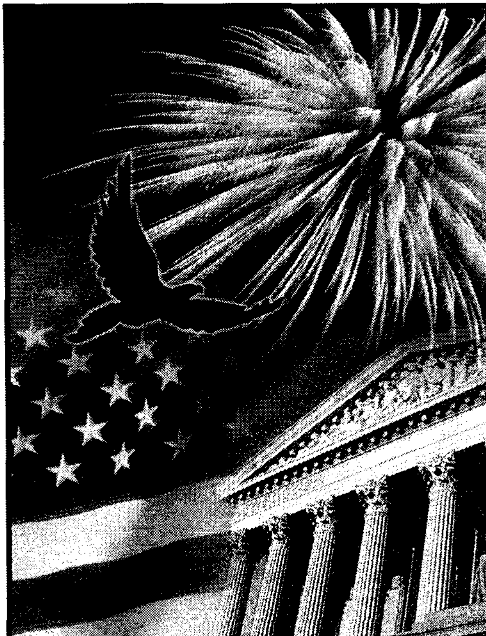
Department of the Treasury
Internal Revenue Service

Publication 15
Cat. No. 10000W

(Circular E), Employer's Tax Guide

(Including 2008 Wage Withholding and Advance Earned Income Credit Payment Tables)

For use in **2008**



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What's New

Social security and Medicare tax for 2008. Do not withhold social security tax after an employee reaches $102,000 in social security wages. There is no limit on the amount of wages subject to Medicare tax. Social security and Medicare taxes apply to the wages of household workers you pay $1,600 or more in cash. Social security and Medicare taxes apply to election workers who are paid $1,400 or more.

Disregarded entities and qualified subchapter S subsidiaries (QSubs). The IRS has published final regulations (T.D. 9356) under which QSubs and eligible single-owner disregarded entities are treated as separate entities for employment tax purposes. For more information, see *Disregarded entities and qualified subchapter S subsidiaries* in the Introduction.

Verification of social security numbers. The SSA offers employers and authorized reporting agents three methods for verifying employee SSNs.

- **Internet.** Verify up to 10 names and numbers (per screen) online and receive immediate results, or upload batch files of up to 250,000 names and numbers and usually receive results the next government business day. Visit *www.socialsecurity.gov/employer* and click on the *Verify SSNs Online* link.
- **Telephone.** Verify up to five names and numbers by calling 1-800-772-6270 or 1-800-772-1213.
- **Paper.** Verify up to 300 names and numbers by submitting a paper request. For information, see *Appendix A* in the Social Security Number Verification System (SSNVS) handbook at *www.socialsecurity.gov/employer/ssnvs_handbk.htm#appendix.*

Some verification methods require registration. For more information, call 1-800-772-6270.

5. Wages and Other Compensation

Wages subject to federal employment taxes generally include all pay that you give to an employee for services performed. The pay may be in cash or in other forms. It includes salaries, vacation allowances, bonuses, commissions, and fringe benefits. It does not matter how you measure or make the payments. Amounts an employer pays as a bonus for signing or ratifying a contract in connection with the establishment of an employer-employee relationship and an amount paid to an employee for cancellation of an employment contract and relinquishment of contract rights are wages subject to social security, Medicare, and federal unemployment taxes and income tax withholding. Also, compensation paid to a former employee for services performed while still employed is wages subject to employment taxes.

More information. See section 6 for a discussion of tips and section 7 for a discussion of supplemental wages. Also, see section 15 for exceptions to the general rules for wages. Publication 15-A provides additional information on wages, including nonqualified deferred compensation, and other compensation. Publication 15-B provides information on other forms of compensation, including:

- Accident and health benefits,
- Achievement awards,
- Adoption assistance,
- Athletic facilities,
- De minimis (minimal) benefits,
- Dependent care assistance,
- Educational assistance,
- Employee discounts,
- Employee stock options,
- Group-term life insurance coverage,
- Health Savings Accounts,
- Lodging on your business premises,
- Meals,
- Moving expense reimbursements,
- No-additional-cost services,
- Retirement planning services,
- Transportation (commuting) benefits,
- Tuition reduction, and
- Working condition benefits.

Employee business expense reimbursements. A reimbursement or allowance arrangement is a system by which you pay the advances, reimbursements, and charges for your employees' substantiated business expenses. How you report a reimbursement or allowance amount depends on whether you have an accountable or a nonaccountable plan. If a single payment includes both wages and an expense reimbursement, you must specify the amount of the reimbursement.

These rules apply to all ordinary and necessary employee business expenses that would otherwise qualify for a deduction by the employee.

Accountable plan. To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all three of the following rules.

1. They must have paid or incurred deductible expenses while performing services as your employees.
2. They must adequately account to you for these expenses within a reasonable period of time.
3. They must return any amounts in excess of expenses within a reasonable period of time.

Amounts paid under an accountable plan are not wages and are not subject to income tax withholding and payment of social security, Medicare, and federal unemployment (FUTA) taxes.

If the expenses covered by this arrangement are not substantiated (or amounts in excess of expenses are not returned within a reasonable period of time), the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan. This amount is subject to income tax withholding and payment of social security, Medicare, and FUTA taxes for the first payroll period following the end of the reasonable period.

A reasonable period of time depends on the facts and circumstances. Generally, it is considered reasonable if your employees receive their advance within 30 days of the time that they incur the expenses, adequately account for the expenses within 60 days after the expenses were paid or incurred, and return any amounts in excess of expenses within 120 days after the expenses were paid or incurred. Also, it is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.

Nonaccountable plan. Payments to your employee for travel and other necessary expenses of your business under a nonaccountable plan are wages and are treated as supplemental wages and subject to income tax withholding and payment of social security, Medicare, and FUTA taxes. Your payments are treated as paid under a nonaccountable plan if:

- Your employee is not required to or does not substantiate timely those expenses to you with receipts or other documentation,
- You advance an amount to your employee for business expenses and your employee is not required to or does not return timely any amount he or she does not use for business expenses, or

- You advance or pay an amount to your employee without regard for anticipated or incurred business expenses.

See section 7 for more information on supplemental wages.

Per diem or other fixed allowance. You may reimburse your employees by travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you if your reimbursement does not exceed rates established by the Federal Government. The 2007 standard mileage rate for auto expenses was 48.5 cents per mile. The rate for 2008 is 50.5 cents per mile. The government per diem rates for meals and lodging in the continental United States are listed in Publication 1542, Per Diem Rates. Other than the amount of these expenses, your employees' business expenses must be substantiated (for example, the business purpose of the travel or the number of business miles driven).

If the per diem or allowance paid exceeds the amounts specified, you must report the excess amount as wages. This excess amount is subject to income tax withholding and payment of social security, Medicare, and FUTA taxes. Show the amount equal to the specified amount (for example, the nontaxable portion) in box 12 of Form W-2 using code L.

Wages not paid in money. If in the course of your trade or business you pay your employees in a medium that is neither cash nor a readily negotiable instrument, such as a check, you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair market value of such payments at the time that they are provided is subject to federal income tax withholding and social security, Medicare, and FUTA taxes.

However, noncash payments for household work, agricultural labor, and service not in the employer's trade or business are exempt from social security, Medicare, and FUTA taxes. Withhold income tax on these payments only if you and the employee agree to do so. Nonetheless, noncash payments for agricultural labor, such as commodity wages, are treated as cash payments subject to employment taxes if the substance of the transaction is a cash payment.

Moving expenses. Reimbursed and employer-paid qualified moving expenses (those that would otherwise be deductible by the employee) paid under an accountable plan are not includible in an employee's income unless you have knowledge that the employee deducted the expenses in a prior year. Reimbursed and employer-paid nonqualified moving expenses are includible in income and are subject to employment taxes and income tax withholding. For more information on moving expenses, see Publication 521, Moving Expenses.

Meals and lodging. The value of meals is not taxable income and is not subject to income tax withholding and social security, Medicare, and FUTA taxes if the meals are furnished for the employer's convenience and on the employer's premises. The value of lodging is not subject to income tax withholding and social security, Medicare, and FUTA taxes if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

"For the convenience of the employer" means that you have a substantial business reason for providing the meals and lodging other than to provide additional compensation to the employee. For example, meals that you provide at the place of work so that an employee is available for emergencies during his or her lunch period are generally considered to be for your convenience.

However, whether meals or lodging are provided for the convenience of the employer depends on all of the facts and circumstances. A written statement that the meals or lodging are for your convenience is not sufficient.

50% test. If over 50% of the employees who are provided meals on an employer's business premises receive these meals for the convenience of the employer, all meals provided on the premises are treated as furnished for the convenience of the employer. If this 50% test is met, the value of the meals is excludable from income for all employees and is not subject to federal income tax withholding or employment taxes. For more information, see Publication 15-B.

Health insurance plans. If you pay the cost of an accident or health insurance plan for your employees, including an employee's spouse and dependents, your payments are not wages and are not subject to social security, Medicare, and FUTA taxes, or federal income tax withholding. Generally, this exclusion also applies to qualified long-term care insurance contracts. However, for income tax withholding, the value of health insurance benefits must be included in the wages of S corporation employees who own more than 2% of the S corporation (2% shareholders). For social security, Medicare, and FUTA taxes, the health insurance benefits are excluded from the wages only for employees and their dependents or for a class or classes of employees and their dependents. See Announcement 92-16 for more information. You can find Announcement 92-16 on page 53 of Internal Revenue Bulletin 1992-5.

Health Savings Accounts and medical savings accounts. Your contributions to an employee's Health Savings Account (HSA) or medical savings account (Archer MSA) are not subject to social security, Medicare, or FUTA taxes, or federal income tax withholding if it is reasonable to believe at the time of payment of the contributions that they will be excludable from the income of the employee. To the extent that it is not reasonable to believe that they will be excludable, your contributions are subject to these taxes. Employee contributions to their HSAs or MSAs through a payroll deduction plan must be included in wages and are subject to social security, Medicare, and FUTA taxes and income tax withholding. However, HSA contributions made under a salary reduction arrangement in a section 125 cafeteria plan are not wages and are not subject to employment taxes or withholding. For more information, see the Instructions for Form 8889.

Medical care reimbursements. Generally, medical care reimbursements paid for an employee under an employer's self-insured medical reimbursement plan are not wages and are not subject to social security, Medicare, and FUTA taxes, or income tax withholding. See Publication 15-B for an exception for highly compensated employees.

Military differential pay. Military differential payments are made voluntarily by an employer to make up some or all of the difference between the regular salary of an employee called to military active duty and the amount being paid by the military if the regular salary was higher. It also includes military continuation pay and active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Military differential payments are not wages and are not subject to social security, Medicare, or FUTA taxes or to income tax withholding. Employers should report military differential pay on Form 1099-MISC in box 3, Other income. For more information about the tax treatment of military differential pay, visit the IRS website at *www.irs.*

15. Special Rules for Various Types of Services and Payments

Section references are to the Internal Revenue Code unless otherwise noted.

Special Classes of Employment and Special Types of Payments	Treatment Under Employment Taxes		
	Income Tax Withholding	**Social Security and Medicare**	**Federal Unemployment**
Aliens, nonresident.	See pages 14 and 16 and Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, and Publication 519, U.S. Tax Guide for Aliens.		
Aliens, resident			
1. Service performed in the U.S.	Same as U.S. citizen.	Same as U.S. citizen. (Exempt if any part of service as crew member of foreign vessel or aircraft is performed outside U.S.)	Same as U.S. citizen.
2. Service performed outside U.S.	Withhold	Taxable if (1) working for an American employer or (2) an American employer by agreement covers U.S. citizens and residents employed by its foreign affiliates.	Exempt unless on or in connection with an American vessel or aircraft and either performed under contract made in U.S., or alien is employed on such vessel or aircraft when it touches U.S. port.
Cafeteria plan benefits under section 125.	If employee chooses cash, subject to all employment taxes. If employee chooses another benefit, the treatment is the same as if the benefit was provided outside the plan. See Publication 15-B for more information.		
Deceased worker:			
1. Wages paid to beneficiary or estate in same calendar year as worker's death. See the Instructions for Forms W-2 and W-3 for details.	Exempt	Taxable	Taxable
2. Wages paid to beneficiary or estate after calendar year of worker's death.	Exempt	Exempt	Exempt
Dependent care assistance programs (limited to $5,000; $2,500 if married filing separately).	Exempt to the extent that it is reasonable to believe that amounts are excludable from gross income under section 129.		
Disabled worker's wages paid after year in which worker became entitled to disability insurance benefits under the Social Security Act.	Withhold	Exempt, if worker did not perform any service for employer during period for which payment is made.	Taxable
Employee business expense reimbursement:			
1. Accountable plan.			
a. Amounts not exceeding specified government rate for per diem or standard mileage.	Exempt	Exempt	Exempt
b. Amounts in excess of specified government rate for per diem or standard mileage.	Withhold	Taxable	Taxable
2. Nonaccountable plan. See page 10 for details.	Withhold	Taxable	Taxable
Family employees:			
1. Child employed by parent (or partnership in which each partner is a parent of the child).	Withhold	Exempt until age 18; age 21 for domestic service.	Exempt until age 21
2. Parent employed by child.	Withhold	Taxable if in course of the son's or daughter's business. For domestic services, see section 3.	Exempt
3. Spouse employed by spouse. See section 3 for more information.	Withhold	Taxable if in course of spouse's business.	Exempt
Fishing and related activities.	See Publication 334, Tax Guide for Small Business.		
Foreign governments and international organizations.	Exempt	Exempt	Exempt

Taxable Fringe Benefit Guide

FEDERAL, STATE, AND LOCAL GOVERNMENTS
THE INTERNAL REVENUE SERVICE

January 2008

Periodic Statement Method

Under this method, substantiation and return of excess is within 120 days after the employer provides employee with a periodic statement (at least quarterly) stating any excess amounts are required to be returned. *Reg. §1.62-2(g)(2)(ii)*

Note: Maximum number of days for advance is 210 (90 days for the calendar quarter plus 150 days maximum for settlement).

The determination of a reasonable period of time will depend on the facts and circumstances. The timelines provided by the Regulations are intended as safe harbors for employers. *Reg. §1.62-2(g)(1)*

Other Reasonable Method

If an arrangement doesn't meet one of the safe-harbor methods, it may still be considered timely, if it is reasonable based on the facts and circumstances. *Reg. §1.62-2(g)(1)*

Example: An employee on an extended travel assignment might have a longer period to substantiate expenses and return any excess allowance than an employee on a single overnight trip.

More Information on Accountable Plans

Other Rules for Employer Accountable Plan(s)

- Employers can have multiple expense allowance policies.
- Employers can have both accountable and nonaccountable plans for different types of reimbursements.
- Employers may establish more restrictive conditions for the plan than imposed the accountable plan requirements.
- Employees cannot compel the employer to establish a plan. *Reg. §1.62-2(j)*

Nonaccountable Plan

A nonaccountable plan is an allowance or reimbursement program that does not meet all three requirements for an accountable plan. Payments made under a **nonaccountable** plan are taxable wages when paid or when constructively received by an employee. The employee may be able to deduct these expenses as itemized deductions on their individual tax returns. R*eg. §1.62-2(c)(3)*

ACCOUNTING RULES

Withholding Requirements

When to withhold depends on whether payments are made under an accountable or nonaccountable plan. *Reg. §1.62-2(h)*

Under an Accountable Plan

If an employer has an accountable plan but an employee does not timely account for expenses or return excess amounts, the employer must withhold employment taxes no later than the first payroll period following the end of the reasonable period. *Reg. §1.62-2(h)(2)(i)*

Under a Nonaccountable Plan

If advances and reimbursements are made under a nonaccountable plan, they are treated as wages and withholding is required when the advances or reimbursements are made to the employee. *Reg. §1.62-2(h)(4)(ii)*

Late Substantiation or Return of Excess

If an employee substantiates expenses and returns excess advances *after* the employer has treated amounts as a wage, the employer is not required to return any withholding or treat amounts as nontaxable. *Reg. §1.62-2(h)(2)*

Travel Advances

To prevent a financial hardship to employees who will be traveling away from home on business, employers will often provide advance payments to cover the costs incurred while traveling. There must be a reasonable timing relationship from when the advance is given to the employee, when the travel occurs and when it is substantiated. There must also be a relationship between the size of the advance and the estimated expenses to be incurred.

Accountable plan advances

Travel advances are not treated as wages and are not subject to income and employment taxes when they are paid under an accountable plan. They must be for travel expenses related to the business of the employer, substantiated by the employee, and any excess returned in a reasonable period of time. *Reg. §1.62-2(c)(4)*

If an employee does not timely substantiate expenses or return excess advances, the advance is includible in wages and subject to income and employment taxes no later than the first payroll period following the end of the reasonable period. *Reg. §1.62-2(h)(2)*

Working Condition Fringe Benefits

Working condition fringe benefits include property or service which, if the employee had paid for, he or she could have deducted the cost as a business expense on his or her individual income tax return. Therefore, if the cost of an item is deductible by an employee as a business expense, it may be excludable from the employee's wages if provided by the employer. *IRC § 132(d)*

General Rules for Working Condition Fringe Benefits

- Benefit must relate to employer's business
- Employee would have been entitled to an income tax deduction
- Business use must be substantiated with records
- Certain benefits have additional requirements, i.e., employer-provided vehicles or clothing

Definition of Employee

All of the following are considered employees for purposes of working condition fringe benefits: *Reg. 1.132-1(b)*

- Current employees
- Partners
- Directors of the employer
- Independent contractors
- Volunteers

Although not employees for most employment tax purposes, independent contractors are eligible to receive nontaxable reimbursements as working condition fringe benefits because they are treated as employees for this purpose.

Note: Taxable fringe benefits for employees are reportable on Forms W-2/W-3. Taxable fringe benefits for independent contractors are reportable on Form 1099.

Cash payments or cash equivalents are not working condition fringe benefits, unless they represent reimbursements paid under an accountable plan.

De Minimis Fringe Benefits

De minimis fringe benefits include property or services provided by an employer for an employee that has small value and accounting for it is unreasonable or administratively impractical. The value of the benefit is determined by the frequency provided to each

individual employee, or if this is not administratively practical, by the frequency provided to the whole workforce. IRC § 132(e)

Example: An employer gives employees snacks each day valued at 75 cents. Even though small in amount, the benefit is provided on a regular basis and is, therefore, taxable as a wage.

The IRS has given advice at least once (ILM 200108042) that a benefit of $100 did not qualify as de minimis. However, this technical advice addresses a specific situation and cannot be relied upon in addressing another specific situation.

Examples of Excludable De Minimis Fringe Benefits: *Reg. §1.132-6(e)(1)*

Occasional (infrequent), ***not routine***

- Personal use of photocopier (with restrictions)
- Group meals, employee picnics
- Theater or sporting event tickets
- Coffee, doughnuts, or soft drinks
- Flowers, fruit for special circumstances
- Local telephone calls
- Traditional birthday or holiday gifts (not cash) with a low FMV
- Commuting use of employer's car if no more than once per month

Benefits Not Qualifying as De Minimis Fringe Benefits

- Cash - except for occasional and infrequent meal money to allow overtime work
- Cash equivalent (i.e., savings bond, gift certificate for department store or allowing "cash back")
- Certain transportation passes or costs
- Use of employer's apartment, vacation home, boat
- Commuting use of employer's vehicle more than once a month. *Reg. §1.132-6(d)(3)*

Definition of Employee for De Minimis Fringe Benefits

Any individual receiving a de minimis fringe benefit is an employee for this purpose *Reg. §1.132-1(b)(4)*

Cliff Provision

If a benefit does not qualify as a de minimis fringe benefit, the entire benefit is taxable, not just the portion that exceeds the de minimis limits. *Reg. §1.132-6(d)(4)*

NO- ADDITIONAL COST FRINGE BENEFITS

No-Additional-Cost Benefits

A service provided to employees that does not impose any substantial additional cost may be excludable as a no-additional-cost fringe benefit. The service must be offered to customers in the ordinary course of the line of business in which the employee performs substantial services.

No-additional-cost services occur frequently in industries with excess capacity services, such as transportation tickets, hotel rooms, entertainment facilities, etc.; however, they may occur with governmental facilities as well (for example, a municipal golf course or recreation center).

For more information on no-additional-cost benefits and restrictions that apply to them, see Publication 15-B. *IRC* The determination of a reasonable period of time will depend on the facts and circumstances. The timelines provided by the Regulations are intended as safe harbors for employers. *§132(a)(1)*

Qualified Employee Discounts

In some cases, employees may be able to purchase goods or services from the employer at a lower price than offered to the general public. In general, the amount of the discount on services is excludable if it is no more than 20% of the price charged to the general public for the service.

For merchandise or other property, generally the excludable discount is limited to the employer's gross profit percentage times the price charged to the public for the property.

For more information, see Publication 15-B. *IRC §132(a)(2)*

Equipment and Allowances

This section discusses some common cases involving equipment and supplies, or allowances provided by an employer to pay for them. As with ordinary and necessary business expenses, allowances paid or reimbursed by an employer on behalf of an employee are excludable to the employee, if payments meet the rules of an accountable plan. *IRC §162*

In summary, the accountable plan requirements are:

- Business Connection
- Substantiation of amount, date and time, place, and business purpose
- Excess returned within a reasonable time *Reg. §1.62-2(c)(1)Reg. §1.274-5T; Reg. §1.274-5T(b)(2)*

Under the business connection requirement, the expenses must qualify as a business expense to the employer and as a deduction on the employee's Form 1040 as an employee business expense, if the employer did not reimburse the expense.

Work Clothes and Uniform Allowances and Reimbursements

Clothing or uniforms are excluded from wages of an employee, if they are:

- Specifically required as a condition of employment, and are
- Not worn or adaptable to general usage as ordinary clothing.

Accountable plan rules must be met. *IRC §162; Reg. §1.62-2(c)(1)*

Note: If the clothing qualifies as excludable, then the cleaning costs are also excludable.

Example: Periodic allowance payments are made to employees for the purchase and maintenance of specific articles of *employer required* uniforms. The allowances are not taxable to the employees provided the uniforms are not adaptable to general usage, and are, in fact, not worn for general usage. In addition, the employees must substantiate the expenses. If the employer does not require substantiation, the allowance is taxable as a wage to the employees when paid.

Example: An agency is required to reimburse certain employees for shoes under a union contract. The shoes are not safety shoes. If the shoes are not safety shoes and are adaptable for general wear, the reimbursements are included as a wage to the employees even if the employer is required to make the payment.

EQUIPMENT AND ALLOWANCES

Example: A premium per working hour is paid for employees who provide their own tools. Premium pay does not meet the accountable plan rules and, therefore, is additional compensation includible in income and fully taxable as a wage. The employees retain ownership and control of their tools and there is no accountability to the employer. The employees are not required to substantiate the cost of each of their tools. The premium is not specifically related to the employees' expenses. Reimbursements based on the hours worked cannot meet the accountable plan requirements. The employees may be entitled to claim an employee business expense deduction on their personal 1040 tax returns (Form 2106 and Schedule A.)

Safety Equipment

Safety equipment is excludable from employee wages if:

- The equipment helps the employee to perform his/her job in a safer environment, and
- The equipment does not have to be required by the employer.

The accountable plan rules must be met. *IRC § 162; Reg. §1.62-2(c)(1)*

Common examples include hardhat, anti-glare screen for computer, safety shoes

Example: Paying employees on an annual basis for part of the cost of safety equipment not required by employer. The payments may be excludable even though the safety equipment is not required by the employer. If the equipment helps the employee perform his/her job in a safer environment, it may qualify as an employee business expense. If the expenses are substantiated, the reimbursement would be excludable to the employee.

Mileage Allowances

Mileage allowances should be treated under the rules for automobile expense reimbursements discussed earlier.

Example: An employer provides employee with a car or mileage allowance and no substantiation is required. The car allowance is fully taxable as wages to the employee since the business use has not been substantiated. The accountable plan rules have not been met.

Cell Phones /Electronic Devices/Computer

Employers often provide employees with certain electronic and telecommunication equipment for use outside of the employer's premises in the performance of their duties. These items (and

other items listed in IRC § 280F) are considered "listed property." Because the nature of the property lends itself to personal use, strict substantiation requirements are in place. Employees are required to account for business and personal use. *IRC § 274(d); IRC § 280F(d)(4); IRC § 132(d)*

Examples: Cell phones, automobiles, computers, internet provider allowances

"Listed Property" *IRC § 280F(d)(4)*

- Business use is excludable from the wages of the employee as a working condition fringe benefit.
- Personal use is included in the wages of the employee.
- If substantiation requirements are not met, all use is included in the wages of the employee.

Substantiation Requirements

Records of business and personal use must be kept by the employee in order to determine whether the value of any of the use is included in the employee's wages. *IRC § 274(d)*

Example: An employer provides an employee with a cell phone and pays the monthly charges. The employer requires the employee to highlight personal calls on the monthly bill. The employer includes the direct charges for personal use and a pro rata share of monthly fees and services in the wages of the employee. The business use is not taxable to the employee.

Cell phone allowances paid to employees

Because they are considered "listed property," cell phones are subject to the special substantiation rules. Employees are required to keep records of business and personal calls. Reimbursement for *personal* usage should be included as wages to the employee. If records are not kept of business and personal use, the value of all use is included in the wages of the employee.

ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

GOVERNMENTAL RELATIONSHIP AND COMMUNICATION BETWEEN THE INTERNAL REVENUE SERVICE AND INDIAN TRIBAL GOVERNMENTS

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June 11, 2008

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I. EXECUTIVE SUMMARY

The Federal Government maintains a government-to-government relationship with over 560 federally recognized Tribes each with their own unique culture and traditions. There are many challenges to effective government-to-government relationships with Tribal Governments, with effective communication and overcoming a long history of basic distrust by the Tribes being key challenges.

The IRS, like all other federal agencies, must relate to its Tribal Government customers within a government-to-government relationship. While the IRS Office of Indian Tribal Governments ("ITG") works hard to maintain and enhance these government-to-government relationships, during our research for last year's report the ACT discovered some areas of concern in these relationships that needed further analysis. This report will highlight areas of the IRS's government-to-government relationships with Tribes that appear to be working and those areas that need improvement, in some cases substantial improvement.

Consultation is a cornerstone of the Federal Government's government-to-government relationship with Tribes. We have serious concerns regarding the lack of any publication or implementation of the Department of the Treasury's little-known consultation policy applicable to the development of regulations affecting Tribal Governments. The Treasury Department policy should be publicized to the Tribal Governments, as well as fully implemented. There is no excuse for the Treasury Department's apparent conclusion that the policy did not apply with respect to a number of important regulatory initiatives that will have profound impacts on Tribal Governments.

Likewise, we have serious concerns regarding the IRS's long delay in adopting its own consultation policy, as it informed the Tribes it was committed to do during a nearly two-year process that took place in 2003 and 2004. The IRS should resume its efforts to adopt the consultation policy that was drafted by a joint IRS-Tribal working group and circulated to all of the Tribes in 2004, for application to matters affecting the Tribes to which the Treasury Department policy does not apply.

We also have recommendations for improving some of ITG's existing mechanisms for ensuring strong day-to-day relationships with Tribal leaders and Tribal finance personnel on matters of more routine tax administration. We believe that these improvements will provide a better environment for carrying out true and respectful government-to-government relationships with the Tribes, and for achieving maximum tax compliance. In addition, in an improved environment, Tribes will have a better forum for raising their concerns on tax administration and policy matters, having them heard, and having them "trickle up" or "trickle over" from the specialist level to the Director of ITG to other divisions and officials in the IRS and the Treasury Department if appropriate, which will facilitate meaningful consultation. The most significant of these recommendations, all of which are explained in more detail below, are as follows:

- Maximize face-to-face meetings and other personal, immediate contacts between ITG personnel and the Tribes; minimize contacts by U.S. mail
- Adjust protocols used in ITG's periodic "listening meetings," so that Tribes have a better chance through such meetings to learn about IRS initiatives that might affect them, leading to more meaningful, two-way consultation
- Increase cultural awareness training to ITG staff
- Increase and improve outreach contacts with Tribal Governments
- Make IRS protocols for day-to-day dealings with Tribal Governments available on ITG's website
- Develop a plan to better ensure that IRS personnel outside of ITG who deal with Tribes and Tribal matters follow these protocols, consistently work within respectful government-to-government relationships with Tribal Governments, and understand their obligations to coordinate with ITG

II. PROJECT PROCESS

We sought to obtain information from both the Tribes and the IRS so that we could assess the state of the government-to-government relationships between the Tribes and the IRS from the perspectives of both the Tribes and the IRS. As discussed in more detail below, we gathered a variety of types of information from a variety of sources.

A. Tribal Government Surveys

We developed a written survey that we sent to all of the 690 federally recognized Tribal Governments and Navajo Chapters with which ITG maintains contacts. The survey set forth 13 questions designed to elicit information about the respondent's perception of the state of the relationship between the Tribe and the IRS.

We sent the survey to the IRS's primary contact at each Tribe and Navajo Chapter, with a cover letter explaining the purpose for the survey as well as the fact that the Project Team would not share with the IRS any details of the survey responses that would identify the survey respondent or the Tribe. If the IRS's primary contact was not an elected Tribal official, we also sent a copy of the cover letter and survey to this elected official with an additional cover letter to the elected official explaining the Project. A copy of the survey and the cover letters is attached as Exhibit A.

The initial response rate to the survey was low, a factor which we presumed resulted at least in part from the fact that the stated deadline for returning the survey was soon after the survey was mailed. In an effort to gather more survey responses, we attempted to reach by telephone each of the IRS's primary contacts at the Tribes that had not yet responded to encourage the Tribe to respond to the survey. We succeeded in speaking with the primary contact or other appropriate person at many of these Tribes, encouraged the Tribe to respond, and e-mailed to the Tribe another copy of the survey. A number of additional responses to the survey were received as a result of these telephone contacts. (Many of the persons we spoke with in these follow-up calls indicated that the appropriate contact person had not in fact received the survey that was sent by mail.)

All told, we received 40 responses to the survey, for an overall response rate of 5.8%. Although we were disappointed in the overall response rate, we were pleased that the response rate was 10% in three of the five geographic regions within ITG, encompassing all the states other than California, Nevada, Alaska, Idaho, Oregon, and Washington. It is also worth noting that the relatively low response rate illustrates the challenge for the IRS in communicating with the Tribes by mail. We followed up by e-mail with additional questions for those initial respondents that provided an e-mail address seeking additional information. A copy of the follow-up questions is attached as Exhibit B.

We also reviewed the tabulated results from ITG's own surveys of Tribal Governments' customer satisfaction with ITG for 2005 to 2007, the earliest of which is attached as Exhibit C and the later two of which are posted on the ITG website at <http://www.irs.ustreas.gov/pub/irs-tege/itg_customer_satisfaction_survey_report_2006_0107.pdf> and <http://www.irs.ustreas.gov/pub/irs-tege/itg_customer_satisfaction_survey_1107.pdf>.

B. Survey of ITG Specialists and Their Managers

ITG employs specialists who work with assigned Tribal Governments to assist them in improving their tax compliance through outreach, as well as to perform compliance checks and examinations. As with the Tribal Governments, we developed a written survey that the Director of ITG sent to all of the ITG specialists who are assigned to specific Tribes in the five geographic regions within ITG and their managers, as well as to the specialists and their manager on the Abuse Detection and Protection Team ("ADAPT") and the manager in the Compliance and Program Management group. The survey set forth 14 questions designed to elicit information about the respondent's perception of the state of the relationship between the Tribe and the IRS. A copy of the survey is attached as Exhibit D. The Director of ITG instructed the survey recipients to send their responses directly to the Project Team and informed them that identifying details regarding their responses would not be shared with the IRS. Consistent with the IRS's collective bargaining agreement, the Director also informed the survey recipients that their participation in the survey was entirely voluntary.

Overall, 55 surveys were sent out and 23 were returned, for a response rate of 42%. From the specialists and their managers in the five geographic regions within ITG, who have the most significant and continual relationships with the Tribes to which they are assigned, the response rate was 40%. We were disappointed that not all of the specialists and their managers responded, but the response rate was better than the Tribes' response rate. The response rate also was better from some regions than others, as noted below:

AREA	STATES COVERED	# TRIBES IN AREA	# SPECIALISTS AND MANAGER	RESPONSE RATE
7280[1]	Alabama, Connecticut, Florida, Louisiana, Maine, Massachusetts, Mississippi, New York, North Carolina, Oklahoma, Rhode Island, South Carolina, Texas	60	8	12.5% (1 response)
7281	Iowa, Kansas, Michigan, Minnesota, Montana, Nebraska, North Dakota, South Dakota, Wisconsin, Wyoming	50	8	50% (4 responses)
7282	Arizona, Colorado, New Mexico, Utah	51	8	37.5% (3 responses)
7283	California, Nevada	122	10	60% (6 responses)
7284	Alaska, Idaho, Oregon, Washington	38 in lower 48 states, 238 Alaska Villages	9	33.3% (3 responses)

We followed up by telephone with seven of the specialists and managers to further explore their responses to the written survey and their perspectives on the state of the government-to-government relationships between the Tribes and the IRS. The Director of ITG facilitated these calls, but she did not participate in them and she again informed the specialists and managers that identifying details regarding their responses would not be shared with the IRS.

We attempted a similar survey of other IRS personnel who have regular contacts with Tribal Governments, who principally consist of personnel in the Small Business/Self Employed division who perform examinations of the Tribes' Bank Secrecy Act ("BSA") compliance and of personnel in Collection. (ITG personnel do not undertake any actual collection activities with respect to Tribal Governments.) The Director of ITG sent the survey to the national manager of BSA examinations, who knew who was involved in Tribal cases, and we understand that the manager invited the involved examining agents and supervisors to complete and return the survey to the Project Team. However, none of these agents and supervisors responded to the survey. The Director of ITG determined that it would be impractical to send the survey to Collection, because

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[1] These are numbers that the IRS has assigned to each geographic region for administrative purposes.

it would have been necessary to send it to all supervisors nationwide. Thus, we received no feedback from any of the IRS personnel involved in BSA examinations or collection activities with the Tribes.

C. Other Information Gathered

In addition to the surveys and attempted surveys described above, we gathered the following additional Information for this report:

- We developed a written survey for the Director of ITG on a variety of topics, including (a) the assignment and reassignments of ITG specialists to Tribes, (b) the specialists' training and experience in communications with Tribal leaders, (c) selection criteria for the specialists, and (d) the Director's own contacts with Tribes in the last year. The Director provided us with a written response.

- We asked the Director of ITG a number of follow up questions to the survey as well as questions throughout the year regarding a variety of topics including hiring and retention issues, specialist job descriptions and performance criteria, and budget constraints, to which she responded with helpful information.

- Finally, we relied on our own experiences with the IRS and other formal and informal feedback from our own contacts with Tribal Governments and their tax advisors.

III. DISCUSSION

A. Development of ITG

ITG was established in late 1999 to help Indian tribes deal with their federal tax matters, as part of a broader reorganization of the IRS and creation of the Tax Exempt/Government Entities division ("TE/GE"). During the planning and creation of this office the IRS made a point of soliciting input from Tribal Governments and Tribal associations, with a view to achieving a better understanding of the specialized needs of Tribal Governments. From the outset of the organization of ITG, the IRS has recognized that a strong government-to-government relationship between the IRS and Tribal Governments is an essential building block for meeting federal tax administration goals. For example, the Internal Revenue Manual section on Indian Tribal Governments Administration provides:

> The ITG office will be guided by principles of respect for Indian tribal self-government and sovereignty. ITG will develop a functional and interactive government-to-government relationship between the IRS and Indian tribal governments.

I.R.M. 4.86.1.1.

ITG was designed to provide a single point of contact for Tribes to obtain assistance and service from the IRS. As noted above, five field groups organized by region provide primary front-line service. These field groups consist of ITG specialists and their direct supervisors who work in locations relatively near the seats of the Tribal Governments they serve. As noted on the IRS website, "[o]ur specialists can address issues and provide guidance unique to Indian country. Issues may relate to tribal governments as employers, distributions to tribal members, and the establishment of governmental programs, trusts and businesses." <http://www.irs.ustreas.gov/govt/tribes/article/0,,id=96135,00.html> ITG also has two other groups performing important functions. The first of these, the ADAPT group, employs nine specialists and their direct supervisor, and its primary function is to identify potential tax frauds and abusive tax schemes at Tribal facilities and conduct compliance checks and examinations designed to identify and curtail – or rule out the existence of – such frauds and schemes. The second of these, the Compliance and Program Management group, employs ten people and their direct supervisor, and its primary functions are to maintain ITG's tribal contact database, coordinate the implementation of ITG's Annual Work Plan, select cases for compliance checks and examinations using ITG's critieria for case selection, maintain ITG's web pages within the IRS website, and similar functions.

B. IRS Protocols for its Day-to-Day Dealings with Tribal Governments

In recognition of the government-to-government relationships that exist between the Federal Government and Tribal Governments, the IRS has established important protocols for its day-to-day dealings with Tribes. These protocols, which are now contained in Sections 4.86.1.2 and 22.41.1.2 of the Internal Revenue Manual, were first developed in 2000, soon after ITG was established. While not phrased in mandatory language, the protocols provide that when scheduling a visit to a Tribal entity, IRS personnel should (a) contact the responsible Tribal official(s) via telephone or mail and set a convenient time to meet, (b) inform the official(s) of the purpose of the appointment and whether it is an education/outreach endeavor, compliance check, or examination, and (c) express a willingness to repeat the information to the Tribal Council or other Tribal representatives if requested. The protocols further describe how the initial meeting with the Tribal official(s) or their designee(s) should be conducted and how the assignment should be completed. The protocols specify that "[p]ersonal contact is essential to obtain an understanding of tribal perspectives and concerns." I.R.M. §§ 4.86.1.2, 22.41.1.2. ITG has implemented these protocols by asking each Tribal chairperson for direction regarding the Tribal officials who should be contacted, and by communicating directly with the Tribal chairperson any time an examination is planned. In the absence of tailored instructions from the Tribal chairperson, ITG's policy is to initiate all contacts with the Tribe at the level of the Tribal chairperson. Although it appears that most ITG specialists follow these protocols, we are aware of occasions when IRS agents outside of ITG have ignored the protocols and proceeded in a manner not acceptable to Tribal Governments.

C. Selection, Training, Expectations, and Retention of ITG Specialists

One key component for successful government-to-government relationships between the IRS and Tribal Governments, at least with respect to day-to-day tax administration matters, are the ITG specialists who constitute the day-to-day points of contact between the IRS and the Tribes.

ITG specialists are GS-12- or GS-13-level personnel on the Federal Government's general federal pay schedule, a higher level than is required for examining agents in other divisions of the IRS. Because of this, all of the ITG specialists have come to ITG from other positions within the IRS, rather than from outside the IRS. There is a five-page written job description for the position. Among the six categories of knowledge required for the position, knowledge relating to the unique government-to-government protocols and to an understanding of diverse Tribal cultural backgrounds that apply to work in ITG is listed last. Although listed last in the formal job description, the Director of ITG emphasized in her response to our written survey that in hiring new ITG specialists she focuses on whether the person is flexible, can "think outside the usual revenue agent IRS box," can "deal with the variety of cultural situations required," can "communicate at a variety of levels so that they can do effective outreach and training," and "want[s] to work with this customer base and in this atmosphere."

While the IRS is prohibited from using a hiring preference for Native Americans, the Director of ITG informed us that she believes that approximately eight of the current 48 ITG specialists (including ITG specialists in the ADAPT group) are Native Americans.

After ITG was established, ITG did its initial hiring of specialists and managers in two large waves. For each of these groups of initial hires, ITG conducted a three-day orientation session and an eight-day training session. These sessions, held in Washington, D.C. and Tulsa, Oklahoma, were universally praised by the attendees. The eight-day training session was developed and delivered with the assistance of an outside, Tribally-owned consultant, and it covered a wide range of appropriate subject matter including pertinent technical tax topics, federal Indian law and policy, Tribal history, law, and culture, and protocols for contacts with Tribes. A variety of outside speakers were presenters at the training session, including Tribal leaders. From our conversations with the Director of ITG, specialists, and their managers, it appears to us that the eight-day training session contributed importantly to a culture of respect within ITG for Tribal Governments and the government-to-government relationships within which the IRS must operate.

Substantially fewer resources are made available today for orientation and training new ITG hires than were made available when ITG hired its initial staff. Today, these sessions are three days in length and are taught by IRS personnel, primarily the Director of ITG and one of her top managers. Generally, an outside speaker representing Tribal Governments will appear as part of the program, but newer hires did not often praise this training in their survey responses.

In addition to the orientation and training provided for new ITG hires, ITG specialists and managers are required to attend three days of internal technical training periodically, which ITG endeavors to hold annually. This training session is referred to as "Continuing Professional Education" or "CPE." The training is held in one location for all personnel and is the only opportunity that ITG has for a gathering of all of its staff. The agenda is set by the Director of ITG after soliciting suggestions from staff.

ITG's managers in each geographic region hold one regional meeting each year for all the specialists in the region to meet together and discuss issues of common concern. The annual regional meetings are three days in length.

A few specialists indicated in their responses to our survey that they have supplemented their formal training with research on their own regarding their assigned Tribes, sometimes done through accessing information regarding Tribal history from the Tribes' websites. The Director of ITG informed us that specialists and their managers have access to *Indian Country Today*, a well-known national newspaper covering the Tribes and events and issues in Indian Country, and that she expects them to read it regularly.

ITG's work force of specialists and their managers is relatively stable in comparison with the work force in many other groups within the IRS. ITG's work force reports a higher level of employee satisfaction in IRS's survey of its employees' satisfaction than the average satisfaction level within the IRS.

Assignment shifts do occur from time to time for Tribes from one ITG specialist or manager to another, usually as a result of employee turnover.[2] ITG has lost 26 members of its initial 68-member staff, approximately 16 of whom were specialists or their managers. Twelve of them left for promotional opportunities within the IRS and 11 of them retired or resigned. Thirteen members of ITG's staff are currently eligible for retirement and may decide to announce their retirement at any time, and several more will become eligible for retirement over the next year. Of those currently or soon eligible for retirement, approximately 10 are specialists or their managers.

Budgetary constraints have placed limits on new ITG hiring. ITG's staff is currently comprised of 74 members, with three recent additions. ITG had hoped to add 15 staff members in the current fiscal year, but a shortfall in hoped for budget allocations required ITG to scale back its new hiring.

D. ITG's Work Plan and Increasing Emphasis on Enforcement Activities in Indian Country

ITG sets forth its work priorities in an Annual Work Plan that it posts on its website. ITG's current plan can be found at <http://www.irs.ustreas.gov/pub/irs-tege/fy_2008_itg_work_plan.pdf>. Much of the work that ITG performs involves

2 Assignment shifts also occur because IRS procedural rules place certain limitations on the ability of the same specialist to perform consecutive examinations of returns involving the same Tribal Government.

contacts with Tribal Governments that are classified either as "outreach" contacts or as "enforcement" contacts. ITG defines "outreach" for this purposes as "an interaction with an ITG entity/stakeholder group on a governmental tax issue under the jurisdiction of ITG, the primary purpose of which is to educate the entity to improve their federal tax/BSA compliance, via a structured event or activity planned in advance of the actual delivery." Enforcement contacts are those which occur in compliance checks and examinations.

Since approximately 2005, there has been an increasing emphasis in the IRS, and in TE/GE in particular, away from outreach and toward examinations and compliance checks. The number of examinations performed within ITG has steadily increased in recent years, while outreach contacts have declined. The following table captures this trend:

ITG Event	FY 2005	FY 2006	FY 2007
Outreach contacts	6,360	5,400	4,133
Completed compliance checks	334	226	153
Closed examinations	284	466	553

In our view, more and broader outreach may be needed with Tribes than with other IRS customer groups to assist Tribes in understanding their obligations and staying in compliance, due to the uniqueness of Tribal Governments and the lack of educational opportunities regarding Tribal tax matters outside the IRS. Also, many Tribal Governments perceive that examination rates are higher for Tribal Governments and Tribal Entities than for other customer groups within TE/GE, given that there are only approximately 560 federally recognized Tribes in the United States and 2,519 additional Tribal Entities, and they question whether they have been singled out unfairly for examinations. It may be beneficial to the IRS's relationships with Tribal Governments for ITG to take advantage of appropriate opportunities to explain to Tribal Governments the factors that have resulted in high examination rates in Indian Country.

E. "Consultation" Between IRS and Tribal Governments

The Federal Government, including the IRS, has an obligation to consult with Tribal Governments on all matters that affect them. Federal Government departments and agencies must undertake "regular and meaningful consultation and collaboration with tribal officials in the development of federal policies that have tribal implications." Executive Order 13175, Consultation and Coordination with Indian Tribal Governments (Nov. 6, 2000). "Each executive department and agency shall consult, to the greatest extent practicable and to the extent permitted by law, with tribal governments prior to taking actions that affect federally recognized tribal governments. All such consultations are to be open and candid so that all interested parties may evaluate for themselves the

potential impact of relevant proposals." Executive Memorandum of April 29, 1994, on Government-to-Government Relations with Native American Tribal Governments.

If a regulation, policy, or program is developed without meaningful consultation and collaboration, the affected Tribes are likely to conclude that the federal agency has failed to meet its obligations under federal law. The development of a regulation, policy, or program without meaningful consultation and collaboration also is likely to result in skepticism on the part of the Tribes regarding whether the regulation, policy, or program will be beneficial for them.

The first group of public reports of the ACT issued in June 2002 included a report recommending that the IRS develop a written consultation policy. The IRS immediately began to implement that recommendation. ITG held 12 regional "listening" meetings in 2003 to secure input and recommendations from Tribal leaders and representatives on the scope of such a policy and on the process to be used in its development and implementation. Pursuant to a suggestion emanating from these meetings, a joint IRS/Tribal committee was created to prepare an initial draft policy. ITG sent the draft policy to all of the Tribal Governments in September 2004, with a request that additional feedback be provided to the working group by October 16, 2004. ITG informed the Tribal Governments that the working group would be meeting shortly thereafter to attempt to finalize the document. A copy of the draft consultation policy and transmittal letter sent to Tribal leaders is attached as Exhibit E.

Among other provisions, the draft consultation policy that was circulated in September 2004 stated that it would apply "to all IRS programs, policy initiatives, administrative guidance, rule making or similar activities or actions . . . arising out of Title 25, Title 26 or Title 31 of the United States Code that may affect federally-recognized Indian Tribal Governments." The draft policy defined "consultation" as follows:

> "Consultation" means the direct and interactive involvement of Indian Tribes in the development and implementation of IRS actions. Consultation is the active, affirmative process of identifying and seeking input from Indian Tribes, and considering their interests as a necessary and integral part of IRS's decision-making process. . . . The goal is to provide an opportunity for input and feedback that maximizes the ability to meet mutual needs, and minimizes the potential for unintended adverse impacts.

The draft policy further provided that "[e]ach IRS office, division and department and all IRS personnel are subject to and bound by this consultation policy," and that "Regulations, Revenue Procedures and Revenue Rulings are examples, but not an exhaustive list, of the types of actions that would be covered by the consultation process."

The IRS has not yet adopted a consultation policy. One reason for the delay is that it was discovered after preparation of the draft policy that the Department of the Treasury

has a consultation policy applicable to the development of regulations. At our request, the Director of ITG provided us with a copy of Treasury's consultation policy, which we understand has not been made generally available to the public or to the Tribal Governments. The copy that we were provided, which is not dated, is attached as Exhibit F. The Treasury Department policy was intended to implement both Executive Order 13132 regarding federalism and Executive Order 13175 regarding consultation with Tribal Governments.

With respect to Tribal Governments, the Treasury Department consultation policy is triggered only by regulations projects "that have substantial direct effects on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes," and then only if the Treasury Department determines that consultation is required. We understand that the Treasury Department never has determined that consultation is required under this policy, including with respect to the development of "integral part" and Pension Protection Act regulations that we understand are currently under development and the development of regulations interpreting the "essential governmental function" requirement of Section 7871 of the Code for the issuance of tax-exempt bonds by Tribal Governments that recently resulted in the issuance of an advance notice of proposed rulemaking.

We understand that the IRS is currently working to gain the Treasury Department's approval of procedures that will allow the IRS to interact with Tribes on tax administration matters in a manner consistent with Executive Order 13175. The IRS has stated that the Treasury Department will remain the Department specified for consultation on regulatory matters.

Although the IRS does not currently have a written consultation policy, ITG holds periodic "listening" meetings with ITG representatives to provide Tribal representatives the opportunity to raise questions and offer suggestions on methods to enhance federal tax administration affecting Tribes. Up to four such meetings are held each year in various locations throughout the country. Meetings are announced on ITG's website and in ITG's regional newsletters. In addition, the Tribes located in the area of each meeting receive a direct mailing to the Tribal leader. ITG does not circulate agendas for these meetings, because ITG does not want to "taint" the process by pre-ordaining the subject matter of the meetings. According to ITG, the primary purpose of the meetings is to listen to the Tribes' concerns about matters of federal tax administration and tax policy.

In addition to the listening meetings, ITG has notified Tribes on its website about opportunities for "issue-based consultation." Such consultation may be invoked by a request by e-mail to the Director of ITG by a Tribe or group of Tribes with respect to any issue or IRS action that may impact, or is impacting such governments, or where a Tribe desires to seek the input of the IRS on the potential federal tax consequences of economic opportunities, local laws, agreements, or similar matters that may affect, or be of interest to, the Tribe.

F. ITG's Primary Methods of Communicating with Tribes

In addition to the periodic listening meetings and opportunities for issue-based consultation, ITG communicates with Tribal Governments in the following principal ways:

Specialist Contacts: As noted above, ITG employs a number of specialists who are assigned as the primary contact for a Tribal Government with ITG. There is an expectation, but no formal requirement, that specialists will have one or more in-person and a number of telephone contacts each year with each of the Tribal Governments to which they are assigned. According to our surveys and interviews with Tribes and ITG personnel, however, this is not always the case. Some Tribes have had no contact with their ITG specialist in well over a year.

Although specialists may interact with elected Tribal leaders, they more commonly deal with a Chief Financial Officer or other finance department personnel. The specialists' managers occasionally are involved in these in-person meetings and telephone contacts. Most ITG specialists are responsible for Tribal Governments throughout a wide geographic area. This means that in-person contacts with their assigned Tribes often require overnight travel, which requires prior approval and can become very costly.

Specialist contacts with Tribes include "outreach" contacts and contacts in compliance checks and examinations, as well as more informal contacts that are not considered to be sufficiently prestructured or preplanned to constitute outreach.

Most notices and letters from ITG that are mailed to Tribes are sent by the specialists or their managers.

Public Appearances: ITG representatives, and in particular the Director of ITG, make a number of speeches and other public appearances each year. For example, the Director of ITG spoke at the recent annual conference of the Native American Finance Officers Association in San Diego, California, and one of the managers of ITG specialists spoke at last year's annual conference of the National Intertribal Tax Alliance in Tulsa, Oklahoma.

ITG's attendance at several regional and national meetings to educate its customers often occurs in one of several break out sessions, which means that participants are forced to choose among important topics in order to attend an ITG session. This form of outreach is more cost effective for the IRS than one-on-one discussions but for a variety of reasons may be more limited in its effectiveness. In our surveys of Tribes we explored ideas regarding alternative methods of outreach.

ITG News: ITG publishes regional quarterly newsletters for eight regions of the country. These newsletters provide information about current developments and upcoming events of interest to all Tribal Governments, as well as information tailored specifically for the identified region. The newsletters are sent out electronically to all those who request it and also are posted on ITG's website. Most IRS newsletters, including the

FSLG newsletter, can be subscribed to by clicking on a link on the IRS website. This is not the case with the ITG newsletter, which can only be obtained by first calling or e-mailing the IRS to request automatic receipt or by checking the website regularly for its posting.

ITG Website: ITG maintains an extensive website at <http://www.irs.ustreas.gov/govt/tribes/index.html>. Several Tribes use this website for research on tax issues affecting them. Therefore, it is important that the IRS keep the website up to date on all tax matters.

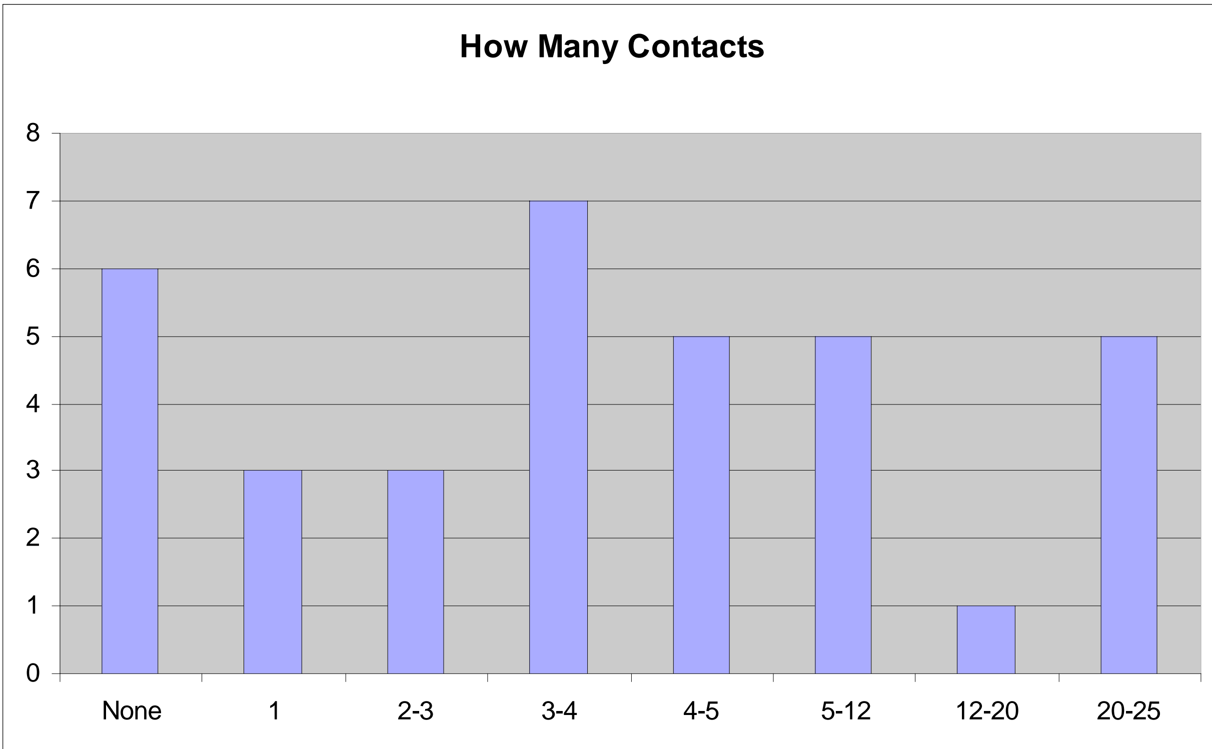
G. IRS Contacts with Tribal Governments at Points Outside ITG

As noted above, there are IRS personnel outside of ITG who have contacts with Tribal Governments, principally SB/SE personnel who perform BSA examinations and Collection personnel. The IRS protocols for its day-to-day dealings with Tribes apply to *all* IRS personnel, not just those in ITG. In addition, in order to ensure that the protocols are satisfied and that the government-to-government relationships between the IRS and the Tribes are respected and preserved, the Internal Revenue Manual states emphatically in a number of places that IRS contacts involving Tribes *must* be coordinated with ITG. For example, the Internal Revenue Manual states that "ITG Specialists must stay involved in material interactions between the tribal government and the IRS" (IRM § 4.86.1.1.3), "[t]he [ITG] office… coordinates all aspects of tax administration as it impacts Indian Tribes" (IRM § 5.1.12.21), "[t]he ITG office serves as the central point for all Service contacts with Federally recognized Indian tribes" (id.), "ITG has been vested with the responsibility of ensuring that the Service is in compliance with the various Executive Orders outlining the relationships and protocols required in working with Indian tribes" (id.), Collection officers must "[c]ontact the local area ITG Group Manager *before* making initial contact on Indian tribal government accounts. The ITG Manager will assign an ITG specialist to work with the Revenue Officer" (IRM § 5.1.12.21.3 (emphasis in original)), and "[s]ummonses issued on a tribal government or a third party for information concerning a tribal government must be approved by the ITG Director before being served" (id.).

We are concerned about reports suggesting that some IRS personnel outside of ITG either are not aware of the protocols and their responsibility to coordinate with ITG, or prefer to flout these obligations. We are aware of one instance recently, for example, in which an IRS Collection agent and his manager arrived unannounced at a Tribal Government headquarters prepared to serve a summons on the Tribe in connection with a collection matter involving a Tribal member, with no advance warning or even contemporaneous notice to the Tribe's authorized representative. We also are aware that SB/SE personnel performing BSA examinations have made far-reaching requests for information and documents that appear to go well beyond the appropriate scope for such examinations, suggesting a failure to coordinate with ITG.

H. Tribal Perspectives on Their Relationships with IRS

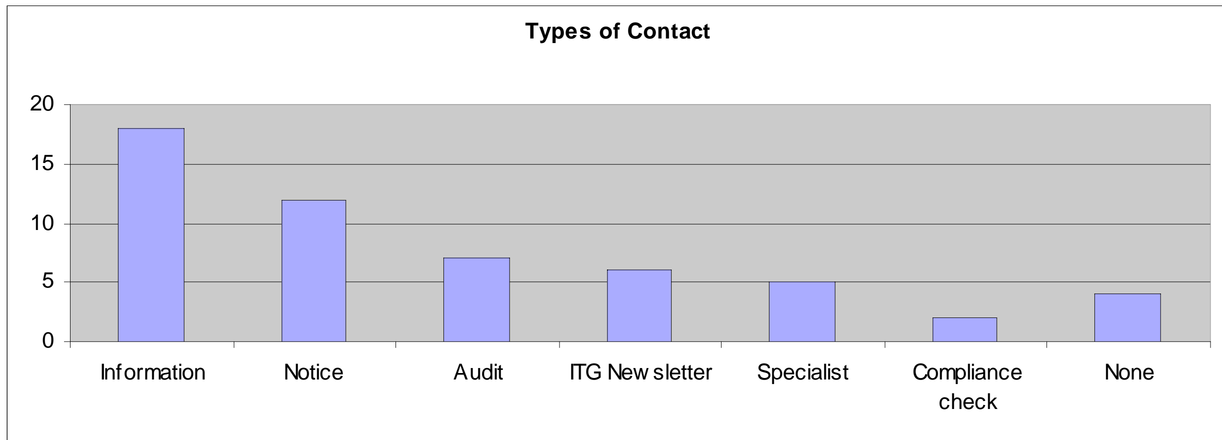
We obtained a great deal of interesting and helpful information from our Tribal survey. The respondents reported a wide range in the number of contacts that their Tribe had with the IRS in the year before the survey. The respondents from six Tribes reported having no contacts with the IRS in the past year, and on the other end of the spectrum the respondents from five Tribes reported having 20 to 25 contacts with the IRS in the past year. The following graph illustrates the full range of responses regarding the number of contacts in the past year:



Thirteen of the respondents stated that one or more of the contacts during the past year included Tribal leadership, and 21 respondents stated that none of these contacts included Tribal leadership.

Nine of the respondents reported that all of the contact(s) between the Tribe and the IRS that occurred during the year were initiated by the Tribe, 12 reported that all of the contact(s) were initiated by the IRS, and 17 reported that contacts were initiated by both parties.

The respondents reported that the contacts were of varying types, as follows[3]:



Most of the respondents expressed satisfaction with the results of the contacts with the IRS. Respondents who were satisfied provided answers such as “necessary information was provided,” “the specialist came and met with me and has also been available by phone,” and “the audit went well.” A number of the satisfied respondents made a point of identifying their specialist by name. Those who reported negative outcomes or appeared to be unsatisfied provided answers such as “penalties were not abated,” “fines and penalties reduced federal grant income,” “problems with repeated erroneous Service Center notices not resolved,” and “IRS does not give definitive answers.”

3 Some of these categories overlap (e.g., “specialist provided information we requested”), and some respondents reported multiple types of contacts.

The respondents gave a variety of responses to our question seeking the respondent's perspective on the meaning of consultation,[4] falling into the following categories:

Response	**# of Respondents**
Government-to-government discussion between Tribes and IRS	14
IRS provides help resolving problems	8
IRS provides information regarding its rules	7
IRS asks for advice from Tribes	5
IRS provides information regarding tax law changes	4

Of the 30 respondents who answered the question whether any of the Tribe's contacts with the IRS during the past year met the respondent's definition, 18 said "no" and 12 said "yes."[5]

We found the following responses to the questions about consultation to be particularly interesting:

Definition of "consultation"	**Did contacts during past year meet definition?**
"Govt. to Govt. discussion or negotiation in regard to policies or regulations"	No
"[A] peer to peer meeting to discuss common concerns"	No
"If they contacted me by phone and spoke to me directly about any changes that they were proposing which might affect our tribal government"	No

4 It is likely that a substantial number of the Tribal finance department personnel who responded to the survey are not familiar with Executive Order 13175 or with the meaning given to "consultation" by Tribal leaders and the federal government, which may account for the wide variation in the definitions given by the respondents.

5 Some respondents who said that the contacts met the respondent's definition of "consultation" also said that Tribal leaders were not involved in any of the Tribe's contacts with the IRS in the past year, another indication that these respondents may not be familiar with Executive Order 13175.

Definition of "consultation"	Did contacts during past year meet definition?
"They ask my opinion."	No
"Having the IRS treat the Tribe as an equal."	No
"In consultation, they should meet with Tribes to obtain input prior to making decisions or implementing policy. The co[n]sultation process should be able to influence the decisions or policy before these matters are cast in stone."	No contacts with IRS in past year
"'Consultation' is considered an exchange between the two entities where issues and concerns can be shared and then entered into a process whereby they can be addressed, explained, and/or corrected."	Yes
"IRS informs you of the rules."	"Yes; they don't help much; just verbally inform you of rules."

Our survey results are reinforced by an upward trend in the disagreement expressed by the Tribes that responded to ITG's own customer satisfaction survey with the statement "The Office of ITG works with the Tribe on a government-to-government basis," from 6.4% expressing disagreement in 2005 to 11.6% expressing disagreement in 2007.

To the question whether the Tribe would welcome more contacts with the IRS, 12 respondents said "yes," eight answered "maybe," and eight answered "no." Most of those who indicated they would welcome more contacts noted either that they would like to have more in-person and telephone contacts (e.g., "[p]ersonal visits from the specialist," "phone or face to face contact, "roundtable discussions," "one-on-one meetings") or that they would like to have the specialists provide them with information about new developments as they arise and similar outreach (e.g., "information on policies/regulations we should be aware of," "updates on items of interest to Tribe," "in person when new developments surface," and "you might try providing more informational sessions at regional gatherings"). A number of those who stated they would not welcome more contacts did not appear to be dissatisfied with ITG; rather, these respondents indicated that that they already have frequent contacts and are satisfied. Four respondents provided answers that suggest they may be dissatisfied with ITG or find ITG contacts to be unnecessarily intrusive, as follows:

- "They aren't helpful."
- "Unless there is something that is specifically pending that calls for consultation, we'd prefer not to interact with them."
- "This Council would welcome more contacts that are positive[,] not confrontational."
- "Sovereignty [is the reason that we do not welcome more contacts]."

I. ITG Employees' Perspectives on IRS Relationships with Tribes

Most of the ITG specialists and managers who completed our survey of ITG personnel and responded to our follow-up telephone calls gave extensive answers to our questions, providing a wealth of valuable feedback regarding the state of the IRS's relationships with Tribes. In this section of the report, we provide a synthesis of the responses to the survey and our follow-up questions as well as discuss specific responses that illustrate broader themes, issues, and concerns.

To the questions regarding who is contacted at the Tribe, we received a variety of answers. Several specialists stated that they always contact the elected Tribal chairperson at the outset of any specific assignment, suggesting that they follow the IRS protocols for contacting Tribes to the letter. Others follow the protocols at the outset of their relationship with the Tribe, initially contacting the Tribal chairperson and thereafter contacting the person designated by the Tribal chairperson. Some specialists gave responses that do not clearly indicate whether the specialist routinely follows the protocols (e.g., the specialist stated that he or she determines who to contact based on "ITG's database" or "the prior specialist's history with the Tribe"), and others gave responses suggesting they may not be following the protocols (e.g., the respondent stated that he or she "normally" contacted the Tribal Treasurer or CEO first, or that he or she "initially usually" contacted a "CFO, Accountant, Bookkeeper, or POA if there is one"). Nineteen of the respondents stated that they had had contact with Tribal leaders during the past year, but evidently not at every one of their assigned Tribes, and three respondents stated they had no contacts with Tribal leaders during the past year.

The specialists generally reported that the number of contacts they have had with each Tribe over the past year varies based on a variety of factors. One specialist stated: "There can be several reasons; the number of different entities at the tribe, turnover at the Tribal offices or at the IRS, new requirements affecting the Tribe, a new IRS project, etc." Another specialist pointed to the fact that some Tribes have "[o]n-going compliance checks, examinations, TRDAs [Tip Rate Determination Agreements]. Some tribes have multiple entities which increases the likelihood of contacts that the tribe initiates. Usually the better the relationship between the Tribe and the IRS representative, the more often the Tribe will initiate contact to seek assistance."

Some of the specialists appear to take more initiative than others with the Tribes to which they are assigned, which can contribute to more frequent contacts than might otherwise occur. One specialist, for example, "contacts most of my tribes 4 or 5 times a

year, but I have a couple that I interact with about 10 times a year." Another stated "I have contacted all my tribal customers." Other specialists' answers suggest that they do not take as much initiative as other specialists in contacting their assigned Tribes, because they cite the specific assignments they are given by ITG's CPM group or the Tribe's initiative in contacting the specialist as the factors that influence frequency, or they indicate that they have contacts with one or more of their assigned Tribes as few as zero or one times a year.

Regarding what works best for establishing a relationship with a Tribe and what does not work as well, the most frequent answer given by the specialists and managers is that face-to-face meetings work best, followed by telephone contacts and then e-mail, and that communicating by written notices and letters sent by U.S. mail does not work well at all. A number of the respondents noted that a courteous professional attitude is important for establishing a relationship, as are prompt and accurate responses to the Tribes' requests for information and assistance and honest and open communications. Factors cited as inhibiting the development of a relationship include position changes at the Tribes, the fact that some Tribes hire CFOs with little or no experience in Tribal matters, and the fact that some Tribes are represented by counsel. Two specialists commented specifically that the involvement of the Service Centers undermines relationship building. One noted that Service Center notices are hard to understand (even for the specialist), and the other noted that the involvement of the Service Centers undermines ITG's objective of being a "one-stop shop" and impedes timely resolution of some problems. Another respondent cited the special challenges of communicating with remote Alaska villages.

The following responses are illustrative of additional specific feedback from the specialists and managers regarding what works best and what does not work as well in establishing a relationship with a Tribe:

<u>What Works Best</u>

- "[T]reat people the way you would expect to be treated, and above all be honest."
- "Face to face contact with the Tribal Leaders would be best but it is usually hard to accomplish as they never seem to be around when I visit the Tribe."
- "Making sure they know I am the Specialist assigned to help them with any tax problem . . . ."
- "Examination is another way – some of the folks I help the most are those that I have had an audit situation with. They still call me even if I am not their official contact person."
- "[A] sincere desire to understand and work with each other."

- "Building a relationship takes time, in some cases a lot of time; especially in those cases with higher turnover in personnel."
- "Communicating the respect due the Tribe's government, our commitment to 'be there' in terms of time and assistance, and following up on those commitments."
- "[K]eep your word when you tell them something."
- "Be open, listen, caring, give them time to respond."
- "As we move more into examinations, there is a normal reluctance to accept ITG involvement as assistance. However, we approach even examinations as learning experiences and attempt to convey this. To the extent we are successful in relaying this as genuine conviction, the walls have come down and cooperation has been forthcoming."

What Does Not Work as Well

- "I had an experience with one Tribe where any correspondence from the IRS was placed in a pile. The problem was that nobody was opening the letters. Small problems became headaches."
- "[O]ur protocols call for us to address initial correspondence to the tribal chair/president, yet many times this person is not in full time attendance and the letters may be delayed or never get into the hands of this official."
- "[C]hange in employees within the IRS makes it difficult for tribes to keep up with who to contact."
- "The problems in dealing with the tribes is the IRS budget process [inhibiting] being able to meet on a personal level without Exam or Compliance check issues. In my case the assignments are not close by and there is a lot of travel involved and in the past it was authorized but no longer. The Tribe[s] need that personal contact and not be limited to specifics such as Exams or Compliance checks."

In responding to the question about whether they perceived any difficulties in their dealings with the Tribes, a number of specialists and managers responded by describing complaints or "pushback" they have received from their Tribal contacts, most arising as a result of ITG enforcement activities. These responses provide a window into the *specialists' and managers'* perspectives about the *Tribes'* perspectives of the state of the relationships between the Tribes and the IRS. The following responses are illustrative:

- "There has been a little push back on some of the exams. Part of which is attributable to not understanding what an exam is. Getting selected for an

examination does not mean you have done something wrong; it is just a way for us to determine if you are in compliance."

- "The examination issues are not working as well. No one likes to owe money, and in some cases this is very confrontational. I am looking for the day when it is not so much in my face."
- "[One Tribe in particular] believes that, as a Sovereign Nation, they should be exempt from all Federal Taxation and 'resent the IRS coming onto their lands and trying to enforce the white mans laws upon them.'"
- "I also believe some tribes are less likely to accept help from IRS. Many do not have a favorable history with the IRS so they don't see us as someone who can help them. As a revenue agent who is there to help the tribes as well as audit them, I don't think they see us as favorable as they could."
- "The job is changing from outreach to compliance. The . . . pendulum is swinging and the tribes are not happy with the change. The tribes see that there is only one specialist for the Federal, State and local governments in the state. Th[eir] audit coverage is higher in ITG than in FSLG and the tribes don't like this."

Eight of the respondents stated that they have not seen any difficulties in their dealings with the Tribes in the past year or did not answer the question.

Although the most recurring theme in our surveys and follow-up discussions with specialists and their managers was that face-to-face contacts are the most effective contacts for good relationships with the Tribes, we learned for our work on this report that specialists have varying practices when it comes to making sure they schedule face-to-face meetings with representatives of their assigned Tribes on some regular basis. At one extreme, one specialist reported that she spends 70 to 80% of her time on the road at Tribal facilities, with a large percentage of that time consisting of outreach activities. While we do not know whether she makes it a priority to schedule at least one visit to each of her assigned Tribes each year, we assume that she attempts to do so (she is the same specialist who informed us that she attempts to contact each of her assigned Tribes at least four or five times per year). Another specialist, on the other hand, informed us that he has not met some of his assigned Tribes in seven years of service in ITG.

A number of specialists and managers that we talked to cited recent budgetary constraints as having an impact on their travel to Tribal facilities, especially when such travel will involve an overnight stay. One manager we spoke with stated that it is "more effective from a tax compliance perspective to place a big importance on relationships," yet noted that a specialist's request for approval of an overnight travel request to go on the road to make one or more outreach contacts likely would be approved only if the

specialist combined the outreach visits with one or more enforcement visits on the same trip.

Some specialists continue to make outreach visits a priority under these constraints and the constraints of the increasing emphasis within TE/GE on enforcement activities, by scheduling visits with other assigned Tribes located nearby when they go on the road for a compliance check or an examination. One specialist reported that if she has to go on the road for one purpose, she "may make six visits in a two-day period." Another specialist informed us that she recently had two days on the road and visited eight different entities of three different Tribes. Another specialist reported, on the other hand, that she "has enough to do" with the travel required by specific case assignments, so she does not attempt to schedule outreach visits to her other assigned Tribes when she is out on the road.

Several specialists noted that the heavy emphasis on enforcement impeded their ability to do outreach and other relationship building activities with their assigned Tribes. A number of these specialists expressed the hope that additional emphasis could be placed on outreach to improve relationships and the Tribes' overall tax compliance. The trend in favor of enforcement contacts may help explain the net upward trend in the agreement expressed by the Tribes that responded to ITG's own customer satisfaction survey with the statement "It is hard to call and reach the Tribe's assigned Specialist," from 8.0% expressing agreement in 2005 to 18.0% expressing agreement in 2006 to 13.5% expressing agreement in 2007. The trend in favor of enforcement contacts also may help explain the upward trend in the disagreement expressed by the responding Tribes with the statement "The Office of ITG provides a timely response to the Tribe's questions," from 5.2% in 2005 to 8.3% in 2006 to 11.3% in 2007.

IV. RECOMMENDATIONS

Recommendation 1: Maximize face-to-face meetings and other personal, immediate contacts; minimize contacts by U.S. mail

As noted above, the IRS protocols for its dealings with Tribal Governments specify that "[p]ersonal contact is essential to obtain an understanding of tribal perspectives and concerns." Many of the responses to our surveys struck this same theme. The low response rate to our survey mailed to the Tribes underscores the difficulty faced by ITG in effectively communicating with the Tribes through notices and letters sent though the mail. ITG should establish a firm expectation that its specialists make an in-person visit to each Tribal Government in the lower 48 states at least annually, outside of a compliance check or examination contact, and hold the specialists and managers accountable for failure to achieve this expectation. Specialists also should offer to make an in-person visit to the Tribal Council after an election that results in new Tribal leadership and after the Tribal Council appoints any new Chief Financial Officer or other new primary IRS contact. Periodic face-to-face meetings with Tribal leadership will help bridge the "disconnect" that may exist between the perceptions of Tribal leadership on the one hand, and the perceptions of the primary IRS contact and ITG personnel on the other hand, regarding the state of the government-to-government relationships between

the Tribes and the IRS. ITG should use notices and letters to communicate with Tribal Governments only when absolutely necessary. If ITG sends a notice or letter, the specialist should follow up with a phone call and an e-mail message to make sure that the right person has received the notice or letter and to offer to answer questions. These steps will help ensure that the notice or letter will be answered and any issue or problem addressed.

Recommendation 2: Review notices and form letters originating from ITG and determine whether they can be simplified

As noted above, many ITG specialists and managers informed us that it is a huge challenge for ITG to get Tribal Governments to respond to written communications. We have heard from Tribal officials, on the other hand, that they find IRS notices and form letters to be complex and confusing, some times full of jargon and other times overly chatty. Form letters need to be clear and concise. Tribal officials are busy running their governments and need to be able to understand written communications quickly so that they may be passed on to the appropriate person. So as a corollary to our first recommendation, we urge ITG to review the notices and form letters that it uses and determine whether they can be simplified. (We realize that some form letters come from Service Centers and elsewhere, not from ITG, and that TE/GE may not be in a position to re-vamp all written communications.)

Recommendation 3: Make the Treasury Department's consultation policy available to the public and fully implement this policy

We cannot overemphasize the important role that consultation plays in a meaningful government-to-government relationship between the Federal Government and Tribal Governments. The absence of meaningful consultation, on the other hand, leads Tribal Governments to conclude that the federal policy of promoting Tribal self-government is a farce.

We were surprised to learn about the Treasury Department's consultation policy applicable to regulations. We find it unacceptable that Tribal Governments generally are not aware of this consultation policy. The IRS should send a copy of the policy to all of the Tribal Governments as well as post a copy on ITG's website.

It is also unacceptable that the policy has not been followed. It is inconceivable how the Treasury Department could possibly have concluded that the "integral part," Pension Protection Act, and "essential governmental function" regulations would not "have substantial direct effects on one or more Indian tribes" such that consultation should not be triggered under the Treasury Department's policy. The policy should be fully implemented so that consultation does, in fact, occur with respect to the development of regulations affecting Tribal Governments.

Recommendation 4: Adopt and fully implement an IRS consultation policy

We believe that the IRS should reinstitute its plan to adopt a written consultation policy. In our view, the draft consultation policy that was circulated to Tribal Governments in the

Fall of 2004 provides a good starting point for this policy. We particularly like the fact that the draft policy provides that consultation (a) applies to all types of IRS actions affecting Tribes, (b) applies to each IRS office, division, and department, and (c) means the direct and interactive involvement of the Tribes starting with the development of the IRS action in question and continuing through implementation. ITG should re-circulate the draft policy to the Tribes (incorporating any revisions made by the joint working group since then) and ask for additional feedback regarding the policy and for volunteers for a re-constituted joint working group to review the additional feedback. Once that process is complete, we hope that the Commissioner of TE/GE will vigorously urge adoption of the policy and take appropriate steps to ensure its full implementation.

Recommendation 5: Adjust protocols used in ITG's listening meetings

This is a repeat recommendation from last year's report of the ACT regarding ITG's voluntary compliance check program. We are concerned that in focusing on listening, ITG is overlooking the fact that meaningful consultation and collaboration is a two-way process, one that necessitates that the IRS inform the Tribes about new programs that are being considered and actively seek Tribal input as an integral part of the program development. We believe that the absence of agendas for these listening meetings that identify matters that ITG wishes to discuss with the Tribes makes it far less likely that there will be meaningful consultation and collaboration. Without an agenda, the appropriate Tribal representatives would not know that it might be appropriate to attend the meeting, would not hear what ITG is contemplating, and would not have the opportunity to provide their views about what the program should entail. ITG should give strong consideration to establishing and circulating agendas for the consultation listening meetings. The agendas should preserve the open-ended part of each meeting, which should continue to be devoted to listening to the Tribal Governments' important concerns, with more concrete information about the matters that ITG wishes to discuss in the other part of each meeting. The opportunity for meaningful, two-way consultation and collaboration between the IRS and the Tribes will be significantly enhanced by instituting this change. During follow-up interviews with Tribal representatives for this report, Tribal officials confirmed that an agenda could facilitate enhanced consultation.

Recommendation 6: Increase cultural awareness training to ITG staff

Early training provided to ITG staff regarding Tribal history, law, and culture was held in high regard by ITG specialists. This level of training needs to be re-established, and provided for existing as well as new staff, to improve communication and therefore compliance. To reduce costs and improve training, we recommend that ITG consider providing this type of training at annual regional meetings. Every Tribe and region of the country is unique and ITG training should ultimately reflect that fact. Tribal representatives from the region could be invited to talk at these trainings. Taking a yearly regional approach to training would allow all ITG members to remain current on Tribal issues that are focused on their region. Training regarding Tribal history, law, and culture also could be included as a component of the CPE training that occurs at the regular national ITG meetings.

Recommendation 7: Increase and improve outreach contacts with Tribal Governments

Tribal officials with whom we have spoken would like additional educational opportunities. We, too, are concerned about the declining number of outreach contacts at ITG. With insufficient outreach, the Tribes' level of tax compliance will erode over time, leading to enforcement needs that may be greater than IRS resources will be able to handle. More outreach, on the other hand, will result in more positive government-to-government relationships between the IRS and the Tribes and better overall tax compliance. We are encouraged by ITG's recent announcement in ITG News of its plans to update its "Tax Tools for Tribes" CD-Rom and its "Helpful Hints to Avoid Penalties" job aid for Tribes, but we hope that these updates will be accompanied by offers of hands-on demonstrations and explanations of the changes, to help ensure that the changes will be understood and reflected in the Tribes' own compliance efforts. We are sympathetic with ITG's budgetary and time constraints that make it difficult or impossible for ITG to train one Tribal staff at a time. Tribes have similar budgetary and time constraints that inhibit travel for training. Additional educational opportunities could be provided in the form of interactive or noninteractive video or audio training to reduce costs, which we believe Tribal officials would welcome. If these opportunities are appropriately publicized, with the ITG specialists taking the lead in the publicity efforts, we believe they would have the potential to reach a large number of participants from a number of Tribes.

Recommendation 8: Provide Tribal Governments and others the opportunity to subscribe to ITG News directly from links on ITG's website

Tribes surveyed find ITG's regional newsletters to be of great help and encourage its continued expansion. Making this newsletter more accessible would enhance its effectiveness in Indian Country.

Recommendation 9: Make the IRS's protocols for dealing with Tribal Governments available on ITG's website

We believe it would be helpful for Tribal Governments – and contribute to more positive government-to-government relationships – to know about the IRS's commitment to using special protocols in its dealings with Tribes on tax administration matters. Thus, the protocols set forth in the Internal Revenue Manual should be available on ITG's website.

Recommendation 10: Develop a plan to better ensure that IRS personnel outside of ITG follow the IRS's protocols for dealing with Tribal Governments, consistently work within a respectful government-to-government relationship with Tribal Governments, and understand their obligations to coordinate with ITG

While this is a matter that we have not explored in depth with the Director of ITG, we are concerned about reports suggesting that IRS personnel outside of ITG, particularly SB/SE personnel conducting BSA examinations and Collection personnel, do not

always follow the IRS's protocols, work within a respectful government-to-government relationship, or adequately coordinate with ITG. We urge the Director and the Commissioner of TE/GE to develop a plan to better ensure that these important objectives and obligations are satisfied, through enlistment of support from the top level officials in those divisions, better tracking of cases in those divisions that involve Tribes, improved training of personnel, and other appropriate steps.

V. CONCLUSION

We appreciate the time and support of ITG staff, especially the Director of ITG, as well as the time and comments of all those Tribal representatives and advocates who shared their views with us.

The recommendations set forth in this report are offered with respect for the IRS's good work thus far in creating ITG and operating within a respectful government-to-government relationship with Tribal Governments. This good work will be enhanced through more active and meaningful consultation and collaboration with Tribal Governments and more focused outreach and education.

EXHIBIT A

Dennis Puzz, Sandra Starnes, and Mary Streitz
Indian Tribal Government Representatives
ADVISORY COMMITTEE ON TAX EXEMPT
AND
GOVERNMENT ENTITIES

October 5, 2007

Dear Tribal Leaders,

The Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities (ACT) works on various projects that affect these communities. As representatives for Tribal Governments, we the ACT are requesting your assistance on our current project by completing the enclosed survey.

Currently we are reviewing the IRS's relationship with Tribal Governments, and we will be delivering a report to the IRS and the general public on this topic next spring. This project will require input from the Tribal stakeholders to be of any benefit to the Tribes, so the more people who are willing to participate in the ACT surveys to share any areas of concern or other input the better the representation we can give. ACT representatives will maintain your confidentiality by presenting the IRS with general information obtained through surveys and discussions without giving any information that will identify the Tribe or individual providing the information. If you choose to provide your name so we can contact you further, we will not share your name or your Tribe with the IRS.

The objective and scope of the ACT is to provide an organized public forum for discussion of relevant issues between officials of the Internal Revenue Service and representatives of the communities of tax exempt and government entities to enable the IRS to receive regular input with respect to the development and implementation of tax administration issues affecting those communities. We do not work for the IRS, and we serve on the ACT in a volunteer capacity. In our professional lives, two of us are lawyers in private practice who represent tribal governments and tribal entities. The other is a certified public accountant who is employed by a tribal government.

If you need any additional information from us please feel free to call, e-mail, or write any of us at the below contact numbers.

Sincerely,

Dennis Puzz, Jr.
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Dennis Puzz, Sandra Starnes, and Mary Streitz
Indian Tribal Government Representatives
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A similar letter and the survey materials were sent to the Tribal contact for your Tribe as supplied to us by the IRS. We sent this letter to you to ensure that the Tribal leadership was aware of this initiative. We look forward to your Tribe's input and guidance on these very important matters.

If you need any additional information from us please feel free to call, e-mail, or write any of us at the below contact numbers.

Dennis Puzz, Sandra Starnes, and Mary Streitz
Indian Tribal Government Representatives
ADVISORY COMMITTEE ON TAX EXEMPT
AND
GOVERNMENT ENTITIES

Sincerely,

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Tribal Government Survey

1. WHAT KIND OF CONTACTS HAVE YOU HAD WITH THE IRS IN THE LAST YEAR?

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2. HOW MANY CONTACTS HAVE YOU HAD WITH THE IRS IN THE LAST YEAR?

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3. DID THE TRIBE OR THE IRS INITIATE THE CONTACTS?

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4. WHAT WERE THE END RESULTS OF THOSE CONTACTS?

5. WHAT WOULD YOU CONSIDER "CONSULTATION" WITH THE IRS?

6. DID ANY OF THESE CONTACTS MEET YOUR DEFINITION OF "CONSULTATION"?

7. How could the IRS best "consult" with your Tribe?

8. Would the Tribe welcome more contacts with the IRS?
If so, what kinds of contacts? If not, why not?

9. Has the leadership of the Tribe had contact with the IRS in the last year?

10. WHAT IRS REGION IS THE TRIBE LOCATED IN?

____

____

____

11. WHAT REGIONAL OR NATIONAL GROUPS, IF ANY, DOES YOUR TRIBE PARTICIPATE IN?

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12. WOULD ANY OF THESE GROUPS BE AN APPROPRIATE PLACE FOR IRS ISSUES TO BE DISCUSSED? IF NOT, WHAT CONFERENCES/GROUPS WOULD BE APPROPRIATE?

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13. IF YOU ARE WILLING TO DISCUSS THESE ISSUES FURTHER, PLEASE PROVIDE YOUR NAME AND CONTACT INFORMATION. THIS INFORMATION WILL BE KEPT CONFIDENTIAL BY THE ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES AND WILL NOT BE SHARED WITH THE IRS.

NAME:

____

ADDRESS:

____

____

____

TELEPHONE:

____

EMAIL:

____

Please send your completed survey to any one of the following ACT representatives by January 25, 2008, for inclusion in this year's report to the IRS. Thank you for your participation.

Dennis Puzz, Jr.
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Minneapolis, MN 55402
streitz.mary@dorsey.com

EXHIBIT B

First, thank you for responding to our most recent survey; secondly may we request additional information from your tribe so that we may give the best recommendations to the IRS.

Additional Questions:

1. Listening Meetings: The IRS has quarterly listening meetings throughout the country. These meetings have no agenda because the IRS wants them to remain open so that the Tribes will feel free to bring up areas of concern to them. How does your tribe feel about listening meetings:
   a. Has a representative of your tribe gone to a listening Meeting?
   b. Would you like to see a partial agenda for the meeting leaving ample time for open discussions?
   c. Do you have any suggestions for improving the listening meetings?

2. The IRS has regional quarterly Tribal newsletter available for Tribes
   a. Does your Tribe receive the newsletter?
   b. Have you found the newsletter helpful?
   c. What additional information do you wish the newsletter would address?
   d. How did you find out about the newsletter?

3. The IRS attends various regional meetings in order to address items of concern to Tribal governments?
   a. Have you attended any of these sessions?
   b. Where they helpful?
   c. Would you be interested in IRS teleconferences on various topics?

4. The IRS maintains a web site for tribal governments
   a. Does your tribe use it?
   b. How does your tribe use it (forms, research, etc)?
   c. Do you find if helpful?
   d. How could the IRS improve?

5. Written notices and letters from the IRS have been shown to need improvements?
   a. Do you have any suggestions on how the IRS could improve their written notices and letters for better compliance/response?

6. Per the executive order 13175 consultation means "…meaningful and timely input by tribal officials in the development of regulatory policies that have tribal implications". Given this definition:
   a. Do you believe that your tribe has had consultation with the IRS?
   b. How could the IRS best consult with your Tribe

Thank you once again for assisting us with this project; we could not do it without your help.

Sincerely,

Sandra Starnes
IRS Advisory Committee Member for Tax Exempt and Government Entities

EXHIBIT C

Customer Satisfaction Survey of Indian Tribal Governments

Office of Indian Tribal Governments
Tax Exempt Government Entities Division

October 2005

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2005 ITG Customer Satisfaction Survey

Balanced Measures and the Office of Indian Tribal Governments

The Office of Indian Tribal Governments (ITG) is located within the Tax Exempt/ Government Entities (TE/GE) Business Unit. ITG's customers are 564 federally recognized tribes. ITG seeks to provide all of the services that tribes need in order to fully administer federal tax laws and to provide tribes with information they require to further their economic development without risk of federal tax concerns.

As part of the IRS, the Office of Indian Tribal Governments (ITG) is required to utilize balanced measures for employee satisfaction, business results, and customer satisfaction. The use of measures across these three areas allows the organization to better assess the effectiveness of its programs.

The balanced measure "Customer Satisfaction" is one of the "five levers of change" identified by former Commissioner Rossotti to modernize the Internal Revenue Service (IRS). Each of the Balanced Measures is supported by three strategic goals: Service to Each Taxpayer; Service to All Taxpayers; and Productivity through a Quality Work Environment. This research will allow us to determine the level of customer satisfaction espoused by our customers. It will also allow us to evaluate our programs to see where we need to improve our performance.

Purpose

ITG conducted the 2005 Customer Satisfaction Survey to obtain feedback from our customers that will allow us to measure customer satisfaction with our products and services. This research is an important part of measuring our performance within the context of the aforesaid "Customer Satisfaction" balanced measure. This report summarizes the findings ITG obtained from the survey. The information collected from this survey is important for several reasons.

> One, it will enable ITG to identify program areas where we are meeting our customers' expectations as well as those areas where improvement is needed. The survey feedback will allow ITG to reallocate/assign resources within our annual Work Plan to produce and/or improve those products/ services that are important to our customers.
>
> Two, it will allow us to contrast the level of customer satisfaction espoused by our customers with the results from an identical surveys conducted in 2003 and 2004. This annual assessment will create opportunities for us to identify areas where our initiatives are working or have failed, and will allow ITG to modify and/or design new programs and initiatives to better address our customers' needs.

Background

Our research began in April 2001, when a group of our employees met in a brainstorming session to develop a list of products and services that we thought were important to the tribal governments. We broke the list down to find the positive aspects and negative attributes of each product/service and created measures. The measures were then ranked in terms of the perceived importance to the tribes. Next, we met with representatives of the Five Civilized Tribes for a focus group to determine their needs and concerns.[1] After studying the results of the focus group we changed the ranking of our measures, as our perception of the tribes' needs was slightly different from their perception.

As part of this effort, we prioritized and selected the measures best suited to fit the needs of our customers. The aforementioned measures were then used to develop a customer satisfaction questionnaire. A copy of the questionnaire is included in the Appendix. Next, we wrote an implementation plan for the survey that included the questionnaire. A copy of the implementation plan can be obtained by calling the ITG manager for Outreach, Planning & Review. The implementation plan was subsequently approved by the Office of Management and Budget. Finally, we successfully conducted a mail survey this past summer with our customers.

Response Rate

The questionnaire was mailed out to 564 federally recognized tribes beginning on August 5, 2005. The survey officially ended on September 17th, but responses were tabulated through October 7th. The following actions were taken by ITG to boost our response rate:

- ITG management reminded the tribes about the survey, and encouraged their participation in the survey during various meetings that were held prior to the survey effort.
- ITG Specialists asked tribes to participate during all contacts with tribes during the period of the survey
- ITG News issuances for July 2005 contained a national article on the pending survey, and were used to promote the survey and seek participation.
- The Director, ITG, personally signed a cover letter that accompanied each survey mailed to tribes in which she asked for their participation.
- A mailing was made to selected tribes as a reminder to complete the survey.
- Telephone and e-mail contacts were made with tribal designees to alert them to the mailing of the survey and to encourage them to respond.

ITG received 187 responses from the tribes during this period. This results in a response rate of 33%. From "The Survey Research Handbook," by Alreck and Settle, the researchers state, "Mail surveys with response rates over 30 percent are rare. Response

[1] The Five Civilized tribes are located in Oklahoma.

rates are often only about 5 or 10 percent."[2] Previous contact with the National American Indian Housing Council indicated they have 500-600 customers and mainly deal with the housing authority within federally recognized tribes. Our contact said they have conducted many surveys and they usually receive a response rate between 7-13%.

In addition, ITG called a company named Tribal Data Resources (TDR) to discuss their experiences in contacting tribes. TDR is a privately owned company that compiles data on tribes such as tribal membership, current political leaders, etc. TDR updates their database annually, and they must contact each tribe to accomplish this task. We spoke with the office manager, who stated that anyone who achieved a response rate of 25-30% was doing "really well." Based upon the aforesaid historical response rates, ITG is pleased with a response rate of 33%, which represents an improvement from the 24% level achieved in 2003, but is a slight decrease from the 35% response rate in the 2004.[3]

Response Bias

There are a number of ways the results from a survey may contain some bias. One example might include the survey instrument itself, the questionnaire, which may be written in a manner that yields biased responses. ITG has made several efforts to try and eliminate the possibility that our survey results are biased. Some of these efforts were included in the design of the questionnaire and/or the implementation of the survey (e.g., allowing the respondents to the survey to maintain their anonymity). ITG cannot say definitively that these and other actions have precluded any response bias. Rather, ITG can say that concrete steps were taken to try and minimize the potential for response bias.

Yet another type of bias is called *non-response bias.* This situation may occur when the opinions, values, etc. expressed by the respondents are quite different from those held by the customers who did not reply. If the non-response bias is severe enough, it can render the results of the survey invalid. In other words, the results reported from the survey do not accurately reflect the opinions, values, etc. the survey researcher intended to measure for the survey group. In this survey, we are cognizant of the possibility that the opinions of the tribes that did respond to our survey may be more favorable than the opinions of tribes that did not respond. Given that 2/3rds of our customers did not respond, the reader is advised the opinions reflected in our responses may be slightly more favorable than those opinions held by tribes that did not respond. ITG has made an effort to discern if our respondents are generally representative of the different market segments of tribes that we have previously defined in our market segmentation report. For example, we used geographic location of the tribe to generate the results shown in Table 1. From Table 1, the reader can ascertain that ITG received 53 responses from tribes located in Alaska. The represents a 23% response rate for all federally recognized tribes that reside in Alaska.[4] The remaining 134 responses come from tribes located in the continental United States.

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[2] Page 35.
[3] ITG recognizes the Office of Management and Budget standards are higher. ITG will continue to look for ways to improve our response rate.
[4] 227 federally tribes reside in Alaska. Hence 53/227 equals 23%.

Table 1 Survey Responses by ITG Field Group

2005 ITG Customer Satisfaction Survey Results		
Group	Responses	Percent of Tribes Responding
7280	28	42.4%
7281	17	29.3%
7282	13	25.0%
7283	36	29.5%
7284(w/o Alaska)	40	97.6%
Alaska	53	23.6%
Total	**187**	**33.2%**

The 134 responses represent a 40% response rate for all federally recognized tribes located in the continental U.S.[5] Based upon these results, we feel that two of our market segments (i.e., tribes located in Alaska without class III gaming and tribes located outside of Alaska with or without gaming) are fairly represented. This finding is important because the needs for assistance with federal tax administration vary considerably among tribes located in these two market segments.[6] We are also cognizant that this year's survey had an inordinately high response rate from tribes in Group 7284 outside Alaska. While that may slightly skew the overall results if their responses differ significantly from other areas, ITG will need to determine the cause of the high response rate.

Findings From 2005 ITG Customer Satisfaction Survey

The Questionnaire Scale

The reader is reminded that a Likert Scale was used for most of the questions. On this scale, a "1" indicated the respondent strongly agreed with the statement. A response of "5" indicated the respondent strongly disagree with the statement. A response of 3 indicated the respondent was neutral on their agreement/disagreement with the proposed statement. For purposes of analysis, we have lumped together the "1s" with the "2s" and the "4s" with the "5s".

The reader is also reminded that some of the proposed questions (statements) were written such that an answer of "5-strongly disagree" was a good response. We have reversed the results from these statements to ensure they are readily comparable to statements that were written in the affirmative to maintain a consistent presentation of our findings. This change is reflected in the Tables.

The "lumping" of scores together is an approach the IRS has used to evaluate scores received during the Employee Satisfaction Survey. We hope the consistent use of this approach will

[5] 337 tribes reside in the continental United States. 134/337 equals 40%.

[6] The slightly lower response rate for tribes located in Alaska, 29%, is not surprising given the relatively meager staff resources these tribes have.

make it easier to understand the results from our customer satisfaction survey and enhance their usefulness.

Survey Results

The results from the survey are summarized in the following Tables 2 and 3. We created a measure equal to the difference between the aggregate number of "good" and "bad" scores. This measure is shown in the right columns of Tables 2 and 3, with results from the current survey contrasted to the results from the FY 2004 and FY 2003 surveys. The lower the difference the greater the perceived dissatisfaction expressed by our customers. The "difference" is a useful measure in that it allows one to quickly identify those areas where ITG has pronounced differences in customer satisfaction. Table 2 reflects the response rates in order of the questions (statements) asked on the questionnaire.

Table 2 2005 ITG Customer Satisfaction Survey Results-by question order

Question	Questionnaire Response Scores (percentages) for 2005			Difference (Good-Bad) FY 2005
	Good	Neutral	Bad	
1	114	46	14	100
2	103	45	28	75
3	135	27	10	125
4	100	57	14	86
5	141	22	8	133
6	81	66	27	54
7	111	47	13	98
8	101	56	13	88
9	94	57	22	72
10	87	56	28	59
11	107	47	18	89
12	86	69	17	69
13	128	37	7	121
14	109	50	11	98
15	92	60	20	72
16	118	44	10	108
17	99	65	7	92
18	131	36	5	126
19	137	33	2	135
20	99	62	11	88
21	49	115	4	45
22	77	76	18	59
23	115	48	9	106
24	93	61	17	76
25	82	76	12	70
26	123	39	10	113

One can see that in Table 3 we have taken the questions in Table 2 and rearranged them by ascending order of those that have the smallest difference between the "good" (1/2) and "bad" (4/5) scores. The narrower the difference the greater the need to address the issue raised within the question (statement). For example the lowest figure calculated in the difference column in Table 3 was 45, which occurred with question (statement) 21. Question (statement) 21 reads, "The Office of ITG treats all Tribes equally." This is one area where ITG might reexamine its products/services and the way they are delivered to see if any changes can be made that would improve the tribes' satisfaction with our performance in this area.

Table 3 2005 ITG Customer Satisfaction Survey Results-by rank

Question	Questionnaire Response Scores (percentages) for 2005			Difference (Good-Bad) FY 2005	Rank 2005	Difference (Good-Bad) FY 2004	Rank 2004	Difference (Good-Bad) FY 2003	Rank 2003
	Good	Neutral	Bad						
21	49	115	4	45	1	43	1	15	1
6	81	66	27	54	2	57	2	18	2
22	77	76	18	59	3	71	3	25	3
10	87	56	28	59	4	76	5	33	4
12	86	69	17	69	5	95	8	43	11
25	82	76	12	70	6	96	9	34	5
9	94	57	22	72	7	97	10	34	6
15	92	60	20	72	8	82	6	36	7
2	103	45	28	75	9	109	13	42	10
24	93	61	17	76	10	99	11	43	12
4	100	57	14	86	11	93	7	40	9
8	101	56	13	88	12	71	4	37	8
20	99	62	11	88	13	107	12	50	16
11	107	47	18	89	14	119	16	43	13
17	99	65	7	92	15	111	14	50	17
7	111	47	13	98	16	122	19	50	18
14	109	50	11	98	17	134	22	54	20
1	114	46	14	100	18	119	17	43	14
23	115	48	9	106	19	118	15	52	19
16	118	44	10	108	20	125	20	48	15
26	123	39	10	113	21	131	21	56	21
13	128	37	7	121	22	143	24	64	23
3	135	27	10	125	23	119	18	61	22
18	131	36	5	126	24	147	25	73	26
5	141	22	8	133	25	139	23	72	25
19	137	33	2	135	26	149	26	71	24

In examining those areas that have relatively low scores, ITG should consider several factors in evaluating what type of follow-up action is warranted. These factors include:

- The degree of control ITG has on the aforesaid area (e.g., ITG has less control over the ease of understanding forms and publications)
- The amount of resources needed to make an improvement(s) in one area where ITG scored low vis-à-vis other areas with similar scores
- The perceived impact on the IRS mission from making an improvement(s) in a given area
- The impact external factors have on customer satisfaction within the given area (e.g., tribes may view certain legislation passed by the U.S. Congress as unfair and a sign ITG does not want to work with them even though ITG had little if any influence over the legislation)

Conversely, in Table 3 one can observe the widest difference was 135, which occurred with question (statement) 19. Question 19 reads, "The Tribe will contact the Office of ITG when it has a problem and/or question". ITG scored relatively high in this area. It would be a good idea to share this information within the ITG organization to let the employees know where ITG is performing relatively well.

Table 3 also shows relative consistency of responses between the 3 surveys conducted to date. For example, questions 21, 6, 22, and 10 have ranked in the top 5 in each of the surveys, although the "difference" has improved substantially. This indicates that ITG is making progress in meeting customers needs, but remains weak in those areas as compared to others.

Table 4 2005 ITG Customer Satisfaction Survey Scores-by components of Customer Satisfaction

Area*	Questionnaire Response Scores (percentages) FY 2005			Questionnaire Response Scores (percentages) FY 2004		
	Good	Neutral	Bad	Good	Neutral	Bad
Recognition	61%	36%	3%	65%	26%	9%
Burden/Delivery of Information	64%	27%	9%	60%	31%	9%
Protocol/Horizontal Equity	65%	28%	7%	70%	25%	5%
Collaborate	54%	33%	12%	63%	34%	3%
Accuracy/Timeliness/Honesty	54%	38%	8%	60%	35%	5%

*See the ITG Balanced Measures Task Force Report for a detailed explanation of these areas.

In Table 4, we have provided the survey findings broken out among the five components that make up our customer satisfaction measure. The areas of our customer satisfaction balanced measure where ITG scored the lowest include those falling under "Collaborate" and "Accuracy/ Timeliness/ Honesty". The low scores are common across all 6 ITG areas. The specific questions in these areas with the lowest scores are numbers 10, 12, 22, and 25. These are prime areas for further study and remedial action by ITG. It should be noted that these scores correlate to responses to Question 27, with the 37% of the tribes who responded "yes" to that Question comprising a majority of those respondents who rated these areas "neutral" or "bad"[7].

Finally, in Table 5 we have provided the survey results broken out by ITG Field Group.[8] From Table 5, one can see that tribes located in Alaska have the lowest level of satisfaction with products and services produced by ITG. Only 60% of the tribes in Alaska rated their overall satisfaction with ITG's products and services as "good", however this is an increase from 2004, and continues an upward trend from that area. An even more significant finding is the 71% level of overall satisfaction from tribes in the Southwest, which is the only area where overall satisfaction significantly decreased from FY 2004. This area also continues to have to a poor response rate, which is another issue for further study.

Table 5 ITG Customer Satisfaction Survey Scores- by ITG Field Group

	ITG Field Group											
	7280		7281		7282		7283		7284 (PNW)		7284 Alaska	
	FY 2004	FY 2005	FY 2004	FY 2005	FY 2004	FY 2005	FY 2004	FY 2005	FY 2004	FY 2005	FY 2004	FY 2005
Burden/ Delivery of Information												
Satisfied	60%	69%	76%	75%	82%	64%	71%	71%	60%	59%	57%	58%
Neutral	30%	23%	18%	16%	11%	18%	22%	20%	29%	32%	32%	34%
Dissatisfied	10%	7%	6%	9%	7%	18%	7%	10%	11%	8%	12%	8%
Collaborate												
Satisfied	72%	64%	75%	65%	77%	46%	68%	64%	38%	45%	45%	50%
Neutral	22%	26%	19%	33%	21%	23%	26%	23%	54%	45%	41%	37%
Dissatisfied	6%	10%	7%	2%	2%	30%	6%	13%	9%	10%	14%	13%
Protocol/ Horizontal Equity												
Satisfied	75%	70%	80%	71%	84%	63%	76%	71%	55%	49%	58%	53%
Neutral	21%	24%	16%	27%	14%	29%	18%	28%	36%	48%	36%	44%
Dissatisfied	4%	6%	3%	3%	2%	9%	6%	1%	9%	3%	6%	3%
Recognition												
Satisfied	73%	77%	75%	82%	72%	63%	70%	73%	51%	62%	51%	53%
Neutral	25%	13%	25%	13%	22%	20%	29%	23%	46%	34%	43%	40%
Dissatisfied	2%	10%	0%	5%	6%	18%	1%	5%	3%	3%	5%	8%
Accuracy/ Timeliness/ Honesty												
Satisfied	63%	58%	68%	50%	72%	52%	66%	71%	46%	48%	45%	46%
Neutral	28%	33%	27%	47%	28%	36%	30%	23%	52%	43%	49%	45%
Dissatisfied	8%	9%	4%	3%	0%	13%	4%	5%	2%	10%	6%	9%
Overall Satisfaction												
Satisfied	77%	78%	87%	87%	92%	71%	88%	82%	57%	68%	56%	60%
Neutral	19%	17%	13%	7%	8%	14%	12%	15%	29%	24%	39%	36%
Dissatisfied	3%	4%	0%	7%	0%	14%	0%	3%	14%	8%	5%	4%

[7] 70 of the 187 respondents (37%) answered yes to Question 27.

[8] See the ITG Balanced Measures Report for a complete description of the areas that make up our customer satisfaction measure.

Recommendations

ITG should take the following actions relevant to Customer Satisfaction:

- Post the results of the survey on the ITG web site
- Share the results with all ITG employees
- Review areas where ITG scored relatively low, revisit the corresponding program/ services relevant to those areas, and develop actions to implement methods to improve performance
- Review areas where ITG scored relatively high to see what program /services are working and if any best practices might be ascertained
- Conduct some of the initial Consultation Listening meetings (scheduled to commence in FY 2006) in areas where further study is needed to ascertain the reasons for differing responses/response rates – Alaska, Pacific Northwest, and the Southwest.
- Continue to implement innovative alternative approaches for delivering products/services to tribes located in Alaska
- Develop and implement communication mechanisms to address the issue of horizontal equity, through ITG News and Consultation Listening meetings
- Review the effectiveness of the survey effort to determine what changes should be made for next year's survey

Appendix

IRS Satisfaction Survey

The Office of Indian Tribal Governments (ITG) within the IRS is asking for your input to help us evaluate how well we are serving your n
Your responses will help us identify the areas where we can improve our products/services. Thank you for your input.

Please pick a number from the scale to show how much you agree or disagree with each statement and write it in the space provided to the right of the statement.

Strongly Agree	Agree	Neutral
1	2	3

#	Statement	
1	It is hard to call and reach the Tribe's assigned Specialist.	____
2	The Tribe rarely needs to talk to more than one employee to get an answer to a question.	____
3	It is easy to access the IRS internet site.	____
4	It is hard to get the tax information by calling the Office of ITG.	____
5	Forms, Publications & other written materials are available on the IRS internet site.	____
6	Tax materials like Forms and Publications are easy to understand.	____
7	Specialist(s) provide explanations the Tribe can understand.	____
8	The IRS internet site is not user friendly.	____
9	The Office of ITG assists the Tribes in avoiding penalties.	____
10	The Office of ITG does not explain how tax law changes will affect the Tribe.	____
11	The Office of ITG works with the Tribe to help resolve any tax issues.	____
12	Assistance given by the Office of ITG interferes with Tribal sovereignty.	____
13	The Office of ITG seeks to build a respectful relationship.	____
14	The Office of ITG wants to work with the Tribe to administer the tax law.	____
15	The Office of ITG does not clarify tax issues that are unique to the Tribe.	____
16	The Office of ITG helps the Tribe comply with the tax law.	____
17	The Office of ITG is respectful of Tribal culture.	____
18	The Office of ITG is courteous in its contacts with the Tribe.	____
19	The Tribe will contact the Office of ITG when it has a problem and/or question.	____
20	The Office of ITG works with the Tribe on a government to government basis.	____
21	The Office of ITG treats all Tribes equally.	____
22	The Office of ITG works with the Tribe to explain filing requirements to tribal members.	____
23	The Office of ITG provides a timely response to the Tribe's questions.	____
24	The Office of ITG does not keep the Tribe informed of its actions to resolve an issue.	____
25	The Office of ITG fairly applies the tax law to the Tribe.	____
26	Overall, the Tribe is satisfied with the products and services provided by the Office of ITG.	____

Please answer yes or no to the following question :

27 Within the past year, has your tribe had its books and/or records reviewed in a compliance check or audit by the IRS? ☐ **Yes**

28 **Using the map on the reverse side, please provide the area where the Tribe is located:**__________

PAPERWORK REDUCTION ACT NOTICE: We estimate that the time required to fill out this questionnaire will average 10 minutes. Th
Reduction Act requires IRS to display an OMB control Number on all approved information requests. Comments should be directed to T
Documents Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001.

Please use the space provided below for comments.

____

____

____

____

AREA MAP for Question 28

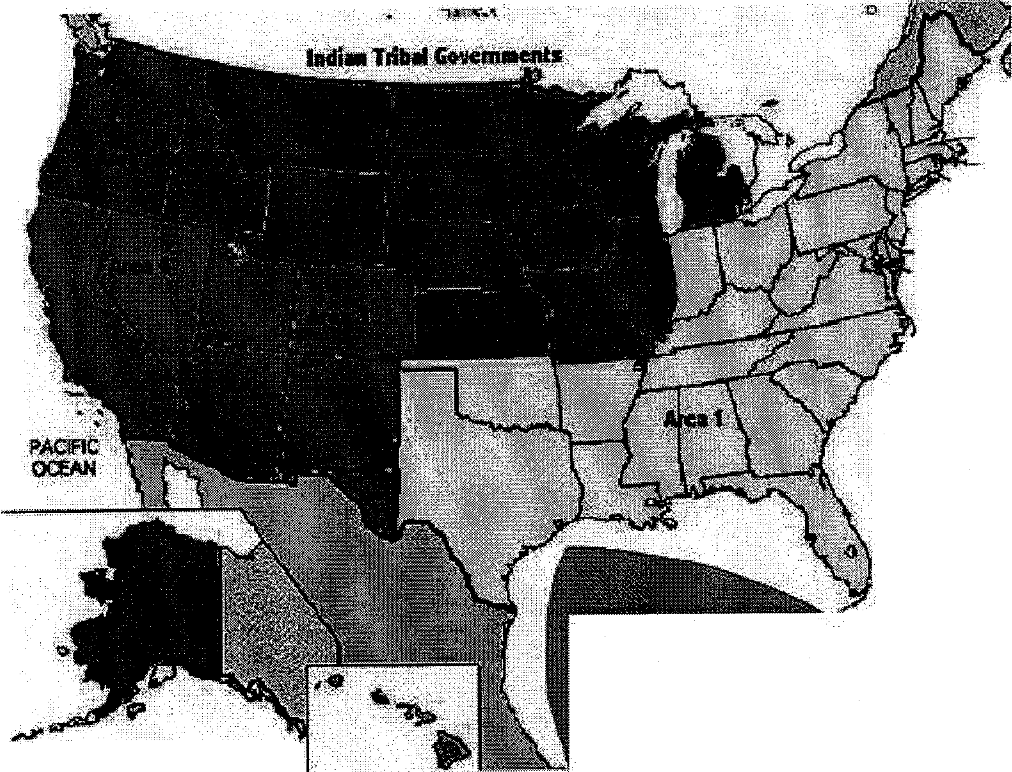


EXHIBIT D

Dennis Puzz, Jr. Sandra Starnes, and Mary Streitz
Indian Tribal Government Representatives
ADVISORY COMMITTEE ON TAX EXEMPT
AND
GOVERNMENT ENTITIES

October 5, 2007

Dear IRS personnel,

The Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities (the "ACT") works on various projects that affect these communities. As representatives for Tribal Governments, we, the ACT, are requesting your assistance on our current project by completing the enclosed survey.

Currently we are reviewing the IRS's relationship with Tribal Governments, and we will be delivering a report to the IRS and the general public on this topic next spring. This project will require input from the all stakeholders to be of any benefit to the IRS, so the more people who are willing to participate in the ACT surveys to share any areas of concern or other input, the better the representation we can give. ACT representatives will maintain your confidentiality by presenting the public with general information obtained through surveys and discussions without giving any information that will identify the individual providing the information.

The objective and scope of the ACT is to provide an organized public forum for discussion of relevant issues between officials of the Internal Revenue Service and representatives of the communities of tax exempt and government entities to enable the IRS to receive regular input with respect to the development and implementation of tax administration issues affecting those communities. We do not work for the IRS, and we serve on the ACT in a volunteer capacity. In our professional lives, two of us are lawyers in private practice who represent tribal governments and tribal entities. The other is a certified public accountant that is employed by a tribal government.

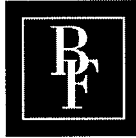
If you need any additional information from us please feel free to call, e-mail, or write any of us at the below contact numbers.

Sincerely,

Dennis Puzz, Jr.
Best & Flanagan LLP
2225 South Sixth Street, Suite 4000
Minneapolis, MN 55402-4690
dpuzz@bestlaw.com

Sandra Starnes
Port Gamble S'Klallam Tribe
31912 Little Boston Rd
Kingston WA 98346
sandra@pgst.nsn.us

Dennis Puzz, Jr. Sandra Starnes, and Mary Streitz
Indian Tribal Government Representatives
ADVISORY COMMITTEE ON TAX EXEMPT
AND
GOVERNMENT ENTITIES
Mary Streitz
Dorsey & Whitney LLP
50 South Sixth Street, Suite 1500
Minneapolis MN 55402
Streitz.mary@dorsey.com



BEST & FLANAGAN LLP
ATTORNEYS AT LAW
225 SOUTH SIXTH STREET, SUITE 4000
MINNEAPOLIS, MINNESOTA 55402-4331

MEMORANDUM

TO: Mary Streitz; Sandra Starnes; Christie Jacobs

FROM: Dennis S. Puzz, Jr.

DATE: August 21, 2007

RE: ITG Survey

1.) Name?

2.) Position?

3.) Which IRS region do you serve?

4.) What Tribes are in your service area?

5.) How do you determine who to contact at the Tribe and when to contact them?

6.) What is the position, title of the person you contact at the Tribe and what level are they in the organizational chart of the Tribe?

7.) How often have you contacted any particular Tribe in the last year?

8.) If there are Tribes that are contacted more often than others, why?

9.) What kind of contacts have you had with any particular Tribe in the last year?

10.) In your opinion, what works best for establishing a relationship with a Tribe?

11.) In your opinion, what methods of communication with the Tribes are not working as well as you would like? Why?

12.) What type of training have you received regarding Tribal culture?

13.) Have you had any contact in the last year with Tribal leadership?

14.) In the last year, have you perceived any difficulties in your dealings with a Tribe? If so, why do you think that is?

DSP:blm
017400/250001/539763_1

EXHIBIT E

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Office of Indian Tribal Governments
SE:T:GE:ITG
1111 Constitution Avenue NW
Washington, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES DIVISION

September 3, 2004

Dear Chairperson

As you may be aware, the Internal Revenue Service has been developing a Consultation Policy that will be designed to guide its interactions with Tribal governments on federal tax administration matters. This process is being guided by recommendations made by tribal representatives on the Advisory Committee to the Tax Exempt Government Entities Commissioner.

As the first step in the process, we scheduled a series of 12 regional "listening" meetings in 2003 to secure input and recommendations from tribal leaders and representatives on the scope of such a policy, and the process to be utilized in its development and implementation. A summary of the suggestions secured was posted earlier this year on our web site at www.irs.gov/tribes, and further input was received.

One of the suggestions that emanated from the meetings was the use of a joint IRS/Tribal committee to create an initial draft policy. The IRS embraced that suggestion, and volunteers from several Tribes and Inter-tribal associations met in July to create a draft IRS/Tribal Consultation Policy based on the input from the listening meetings.

The next step in the process is to share the draft policy with Tribal leaders and secure feedback. To that end, I am attaching a copy of the draft that was created by the joint working group. I have also attached a listing of the members of the group, along with their contact information. I ask that you provide any feedback you or your staff may have on the draft policy to any member of the working group by October 16, 2004. The group will be meeting shortly thereafter to attempt to finalize the document.

We value your input and appreciate the time and effort that many tribes have expended so that we can jointly create a policy that will work best for everyone.

Sincerely,

Christie Jacobs
Director
Office of Indian Tribal Governments
ID Badge # 50-03581

Government-to-Government Consultation Policy
for the
Internal Revenue Service and Indian Tribal Governments

I. Introduction/Purpose

A. The United States government has a unique relationship with Indian Tribal Governments as set forth in the Constitution of the United States, treaties, statutes, court decisions, and executive orders and memoranda. Further, federal statutes and the policies, procedures, and regulations of all executive departments and agencies are subject to, and may be limited by, treaties between the United States and an Indian nation, the sovereign status of an Indian nation, and the unique historical relationship between an Indian Tribal Government and the federal government. Consequently, each executive department and agency, to the greatest extent practicable and to the extent permitted by law, is required by presidential directive to consult with Indian Tribal Governments prior to taking actions that may impact federally-recognized Indian Tribal Governments.

B. On May 14, 1998, the President issued Executive Order 13084, "Consultation and Coordination with Indian Tribal Governments," which was revoked and superseded on November 6, 2000, by Executive Order 13175, which sets forth guidelines for all federal agencies to establish regular and meaningful consultation and collaboration with Indian Tribal Governments in the development of federal policies that have tribal implications; and to strengthen the United States government-to-government relationships with Indian Tribes. In order to ensure that the rights of sovereign Indian Tribal Governments are fully respected, all such consultations are to be open and candid so that Indian Tribal Governments may evaluate for themselves the potential impact of actions the Internal Revenue Service (the "IRS") proposes to take.

C. The "IRS" is committed to the full implementation of this directive, consistent with the federal policy of self-determination. Self-determination is a federal policy that promotes intergovernmental relations between the United States and Indian Tribes, encourages self-sufficient tribal governments, and supports the development of tribal economies. The IRS stands ready to work with Indian Tribal Governments on a one-to-one basis (a government-to-government relationship). This consultation policy serves as a cornerstone of that commitment.

D. This consultation policy establishes protocols regarding the manner in which the IRS shall interact and communicate with Indian Tribes. Further, this consultation policy applies to all IRS programs, policy initiatives, administrative guidance, rule making or similar activities or actions ("actions") arising out of Title 25, Title 26 or Title 31 of the United States Code that may affect federally-recognized Indian Tribal governments. In formulating or implementing such actions, the IRS will be guided by the fundamental principles set forth in section 2 of Executive Order 13175.

II. Definitions

A. "Consultation" means the direct and interactive involvement of Indian Tribes in the development and implementation of IRS actions. Consultation is the active, affirmative process of identifying and seeking input from Indian Tribes, and considering their interests as a necessary and integral part of IRS's decision-making process. This definition adds to any statutorily mandated procedures. The goal is to provide an opportunity for input and feedback that maximizes the ability to meet mutual needs, and minimizes the potential for unintended adverse impacts.

B. "Indian Tribe" means an Indian or Alaska Native tribe, band, nation, pueblo, village, or community that the Secretary of the Interior acknowledges to exist as an Indian Tribe pursuant to the Federally Recognized Indian Tribe List Act of 1994, 25 U.S.C. § 479a.

C. "IRS" means all components of the Internal Revenue Service, including all operating divisions, offices, and employees.

III. IRS Structure, Communications Protocols, and Tribal Contacts

A. Each IRS office, division and department and all IRS personnel are subject to and bound by this consultation policy. The office of Indian Tribal Governments ("ITG") within the Tax Exempt Government Entities operating division is hereby authorized to coordinate all actions that may affect federally-recognized Indian Tribes. No IRS office, division, department or personnel shall take any action affecting, or initiate any communication with, an Indian Tribe(s) without the prior consent of the office of Indian Tribal Governments.

B. Each Indian Tribe may submit information to the Director of the office of Indian Tribal Governments that outlines its structure, protocols, and contact point(s) for interactions with the IRS. Such information may be submitted at any time to the Office of Indian Tribal Governments. The IRS will respect those protocols in the implementation of this policy, as well as in any other contacts with the Indian Tribe. If such information is not provided, the IRS will communicate exclusively with the leadership of the Indian Tribe as can be determined from available information.

IV. Consultation Processes

A. Tribal consultation may emanate from many sources, but will be liberally employed to ensure that Indian Tribes have the maximum opportunity to be involved in actions that can be reasonably determined to have significant impact on them. Issues that are raised in consultation discussions will be protected from disclosure and release to other parties under provisions of Privacy Act and Section 6103 of the Internal Revenue Code.

B. Regulations, Revenue Procedures, and Revenue Rulings are examples, but not an exhaustive list, of the types of actions that would be covered by the consultation process. No actions will be taken by the IRS nor will any actions be published or adopted by the IRS without first subjecting them to the consultation process.

C. Time frames for consultation with respect to IRS actions will depend on the circumstances of each situation. Suggested guidelines are not less than 60 days for significant proposed actions of a national scale, 30 days for routine proposed actions, and 2-3 weeks for proposed actions with critical deadlines. These time frames may be compressed in exigent situations.

D. The following are examples of communication means by which consultation can be accomplished. The method of communication used will be determined by the significance of the consultation matter, the need to act quickly, and other relevant factors. Mechanisms may include Internet, broadcast fax, U.S. Postal Service, telephone conference calls, multimedia, direct contact, and formal meetings. Interested national or regional tribal organizations may be included as additional communication channels.

E. Consultation can be employed in several forms:

1. <u>Relational Consultation</u>

In order to maximize opportunities for dialogue, the IRS will conduct listening meetings on an annual basis in locations throughout Indian country. Such meetings will allow attendees to raise issues or questions that may not relate to any current tax issue or IRS action, or may not have been raised to date through any other process. The IRS will ensure a meeting is held at least every 36 months within each of the BIA regional areas, and a schedule of such meetings will be maintained on the web site of the office of Indian Tribal Governments. Indian Tribes may attend any meeting, although separate written notice will be sent only to those Indian Tribes within the BIA region where each meeting is scheduled. To reduce costs and conserve resources to the extent feasible, Indian Tribes and the IRS may coordinate such meetings to be part of relevant multi-agency and/or Tribal association meetings.

2. <u>Issue-Based Consultation</u>

<u>(a) Issue-Based Consultation Initiated by the IRS</u> – The IRS will invoke consultation on any action that may impact, or is impacting, an Indian Tribe or group of Indian Tribes. All Indian Tribes will be invited to consult on proposed actions and issues raised by the IRS that may impact more than one Indian Tribe, even when an issue or action may not be perceived as relevant to every Indian Tribe. The IRS will notify Indian Tribes via e-mail to the designated contact for each Indian Tribe, or via U.S. postal mail where e-mail is not available. All Indian Tribes will be invited to submit input; even if unable to attend any meeting that may be scheduled on the issue(s).

(b) <u>Issue-Based Consultation Initiated by an Indian Tribe/Group of Indian Tribes</u> – An Indian Tribe or group of Indian Tribes may invoke consultation on any issue or IRS action that may impact, or is impacting them. Such requests may be submitted in writing to the Director of the office of Indian Tribal Governments.

(c) If an Indian Tribe or group of Indian Tribes identifies a tribal-level issue or IRS action arising subsequent to the implementation of this policy, where consultation was not properly employed, the Commissioner of the Tax Exempt Government Entities Division (or, if delegation is made, the Director of the office of Indian Tribal Governments) is empowered to stay the pending IRS action in order to protect the consultation process and the interests of Indian Tribes. If stayed, such action will not be reinstated or recommenced until the consultation process has been adhered to and completed.

(d) An Indian Tribe may also request consultation where it desires to seek the input of the IRS on the potential federal tax consequences of economic opportunities, local laws, agreements, or similar issues in effect or under consideration by the Indian Tribe.

F. In all cases where an Indian Tribe(s) has been involved in the consultation process with respect to an IRS action, the Indian Tribe(s) shall be notified of the IRS decision by one or more of the communication method(s) identified above. This notification shall specifically include a discussion of the basis for the IRS decision, including Tribal comments received, relationship to the concerns raised in consultation, and any avenues available for further discussion, protest, or appeal of the decisions.

G. Where an IRS action or issue addressed through consultation has potential applicability beyond the Indian Tribe(s) involved in the consultation process, any decision resulting from consultation will, to the extent legally permissible, be communicated to all Indian Tribes through e-mail and postal mail, and will include an explanation of how Tribal input was considered in the final decision.

H. In addition to consultation methods employed on Tribal issues, the IRS recognizes that Indian Tribes have an inherent need to represent the interests of their members in regard to federal tax issues, and that such issues are often unique. Any individual federal tax matter or issue that relates to a Tribal member may be raised by the Indian Tribe to the office of Indian Tribal Governments for assistance, intervention, and resolution, where such matter or issue pertains to their status as a member of the Indian Tribe. The office of Indian Tribal Governments will coordinate the resolution with other IRS operating divisions that may have jurisdiction.

I. To the extent permitted by law or Treasury Department policy, the IRS will provide input to Indian Tribes regarding proposed legislative changes that would impact Indian Tribes. Internal IRS policies and procedures are excluded from consultation.

V. Applicability of the Federal Advisory Committee Act (FACA)

The provisions of the Federal Advisory Committee Act (5 U.S.C. App.)(FACA) do not apply to consultations undertaken pursuant to this policy. In accordance with section 204(b) of the Unfunded Mandates Reform Act of 1995 (Public Law 104-4, approved March 22, 1995), FACA is not applicable to consultations between the federal government and elected officers of Indian Tribal Governments (or their designated employees with authority to act on

their behalf). As the Office of Management and Budget stated in its guidelines implementing section 204(b):

> This exemption applies to meetings between Federal officials and employees and ... tribal governments acting through their elected officers, officials, employees, and Washington representatives, at which 'views, information, or advice are exchanged concerning the implementation of intergovernmental responsibilities or administration, including those that arise explicitly or implicitly under statute, regulation, or Executive Order. The scope of meetings covered by this exemption should be construed broadly to include meetings called for any purpose relating to intergovernmental responsibilities or administration. Such meetings include, but are not limited to, meetings called for the purpose of seeking consensus, exchanging views, information, advice, and/or recommendations; or facilitating any other interaction relating to intergovernmental responsibilities or administration. (OMB Memorandum 95-20 (September 21, 1995), pp. 6-7, published at 60 FR 50651, 50653 (September 29, 1995)).

VI. Oversight of Consultation Policy

An initial assessment of this policy will be conducted one year from its implementation, to determine its effectiveness. The assessment will be accomplished in a manner to be determined by the office of Indian Tribal Governments in consultation with Indian Tribal Governments. After the initial assessment, the IRS will conduct a bi-annual review of the policy in order to ensure that the intent of this policy is met and that its provisions continue to meet the needs of the IRS and Indian Tribes on an ongoing basis. Such review will include solicitation of feedback from all Indian Tribes, and a separate consultation meeting to allow for active participation in the review process by interested Indian Tribes.

VII. General Provisions

This document has been adopted for the purpose of enhancing government-to-government relationships, communications, and mutual cooperation between the IRS and Indian Tribes and is not intended to, and does not, create any right to administrative or judicial review, or any other right or benefit or trust responsibility, substantive or procedural, enforceable by a party against the United States, its agencies or instrumentalities, its officers or employees, or any other persons. This document is effective on the date it is signed.

Consultation Policy Drafting Group

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DEPARTMENT OF THE TREASURY

Process to Implement the Consultation Requirements of Executive Order 13132, "Federalism" and Executive Order 13175, "Consultation and Coordination with Indian Tribal Governments"

The Secretary has designated the General Counsel to be the official in the Department of the Treasury responsible for implementing Executive Order 13132, "Federalism" (August 4, 1999) and the Assistant Secretary for Economic Policy to be the official responsible for implementing and Executive Order 13175, "Consultation and Coordination with Indian Tribal Governments" (November 6, 2000) in all components of the Department other than the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[1]

Section 6(a) EO 13132 and section 5(a) of EO 13175 direct each agency to have an "accountable process to ensure meaningful and timely input by" State and local officials in the development of regulatory policies that have "federalism implications" and by tribal officials in the development of regulatory policies that have "tribal implications."

The Orders define the following terms, the understanding of which is necessary to implement effectively the requirements of each Order:

> "Policies that have federalism implications" means "regulations . . . that have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government."
>
> "Polices that have tribal implications" means "regulations . . . that have substantial direct effects on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes."
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> "States" means "the States . . . individually or collectively, and [includes] units of local government and other political subdivisions established by the States."

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[1] The Comptroller of the Currency and the Director of the Office of Thrift Supervision will each designate an official to implement the order for their respective offices.

"State and local officials" means "elected officials of State and local governments or their representative national organizations."[2]

"Indian tribe" means "an Indian or Alaska Native tribe, band, nation, pueblo, village, or community that the Secretary of the Interior acknowledges to exist as an Indian tribe pursuant to the Federally Recognized Indian Tribe List Act of 1994, 25 U.S.C. 479a."

"Tribal officials" means "elected or duly appointed officials of Indian tribal governments or authorized intertribal organizations."

The Department will utilize the following process to ensure meaningful and timely input by State and local officials, and by Tribal officials, in the development of regulations that have federalism or tribal implications, respectively:

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[2] Representative national organizations include, for example, the National League of Cities, U.S. Conference of Mayors, National Association of Counties, National Governors' Association, National Conference of State Legislatures, Council of State Governments, and International City/County Management Association.

OFFICES AND BUREAUS THAT DO NOT HAVE A REGULATORY POLICY OFFICER FOR PURPOSES OF EXECUTIVE ORDER 12866[3]

- The Chief or Legal Counsel is responsible for identifying potential federalism and tribal implications early in the development of a regulation, and throughout the development of the regulation.

- Program and policy staff involved in the development of regulations are responsible for promptly bringing any potential federalism or tribal implication to the attention of his or her Chief or Legal Counsel.

- When a Chief or Legal Counsel identifies a potential federalism or tribal implication, he or she shall discuss the matter with the appropriate Assistant General Counsel and the Senior Counsel for Regulatory and Legislative Affairs (hereinafater "Senior Counsel"). These officials, following consultation with the Counselor to the General Counsel (hereinafter "Counselor") and the Deputy General Counsel, will recommend to the General Counsel whether consultation is required by the Order. The General Counsel will make the final determination whether consultation is required by the Order.

- If the General Counsel determines that consultation is required, the Chief or Legal Counsel and the appropriate office or bureau policy officials, in consultation with the appropriate Assistant General Counsel, the Senior Counsel, and the appropriate Departmental Offices policy officials, will identify (1) the appropriate State and local officials, or tribal officials, to whom the opportunity to consult will be offered and (2) the Treasury and/or bureau personnel who will participate in the consultations.

- Chief and Legal Counsel are responsible for keeping the appropriate Assistant General Counsel and the Senior Counsel informed concerning the consultations.

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[3] Executive Order 12866, "Regulatory Planning and Review" (September 30, 1993), sets forth the Administration's regulatory philosophy and principles, and establishes the procedures by which regulatory matters are reviewed and coordinated within the Administration. The Order directs agency heads to designate a Regulatory Policy Officer (RPO) who is responsible for implementing the Order. The Secretary designated the General Counsel as Treasury's RPO. The General Counsel coordinates regulatory matters through RPOs designated by the heads of Treasury's principal regulatory bureaus, and through Chief and Legal Counsel in other offices and bureaus.

OFFICES AND BUREAUS THAT HAVE A REGULATORY POLICY OFFICER FOR PURPOSES OF EXECUTIVE ORDER 12866

- The Regulatory Policy Officer is responsible for identifying potential federalism and tribal implications early in the development of a regulation, and throughout the development of the regulation and for promptly bringing any potential federalism or tribal implication to the attention of their Chief or Legal Counsel.

- Program and policy staff involved in the development of regulations are responsible for promptly bringing any potential federalism or tribal implication to the attention of his or her Regulatory Policy Officer.

- When a Regulatory Policy Officer identifies a potential federalism or tribal implication, he or she, together with his or her Chief or Legal Counsel, shall discuss the matter with the appropriate Assistant General Counsel and the Senior Counsel. These officials, following consultation with the Counselor and the Deputy General Counsel, will recommend to the General Counsel whether consultation is required by the Order. The General Counsel will make the final determination whether consultation is required by the Order.

- If the General Counsel determines that consultation is required, the Regulatory Policy Officer, the Chief or Legal Counsel, and the appropriate office or bureau policy officials, in consultation with the appropriate Assistant General Counsel, the Senior Counsel, and the appropriate Departmental Offices policy officials, will identify (1) the appropriate State and local officials, or tribal officials, to whom the opportunity to consult will be offered and (2) the Treasury and/or bureau personnel who will participate in the consultations.

- Regulatory Policy Officers are responsible for keeping the Senior Counsel and their Chief or Legal Counsel informed concerning the consultations.

Questions concerning the consultation process, or any other aspect of Executive Order 13132 or 13175, should be directed to the Senior Counsel.

Dated: