



COMMISSIONER

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

June 28, 2007

The Honorable Charles E. Grassley
Ranking Member, Committee on Finance
United States Senate
Washington, DC 20510

Dear Senator Grassley:

I am pleased to respond to your letter of March 2, 2007, on compliance issues within the responsibility of the Tax Exempt and Government Entities Division (TE/GE) of the IRS. TE/GE's three major business units – Exempt Organizations (EO), Employee Plans (EP), and Government Entities (GE) – oversee a wide range of activities affecting taxpayers from small volunteer community organizations to sovereign Indian tribes to large pension funds. Approximately three million entities make up this sector, and these entities control over \$13 trillion in assets. Although generally not subject to federal income tax, they nonetheless pay more than \$270 billion annually in employment tax and employee income tax withholding and represent a major focus of our attention.

This letter will concentrate on certain compliance issues we are encountering in the tax-exempt sector. However, this focus should not obscure or disparage the excellent work the tax-exempt community does every day, nor should it detract from the reality that most tax-exempt entities and governments work hard to carry out their missions and comply with the letter and the spirit of the tax law. Neither should it overlook the recent positive efforts of the tax-exempt community to establish high standards for compliance, professionalism, accountability, and good governance. This trend has strengthened over the past two years. However, we must recognize that the sector continues to change, sometimes in a disquieting direction. Tax abuse, for example, persists within the sector, and we must respond to it.

We recognize that you and the other members of the Finance Committee share our commitment to promoting a tax-exempt sector that is both vibrant and compliant. Since our March 30, 2005 letter, the Congress has enacted the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) and the Pension Protection Act of 2006 (PPA), two important pieces of legislation that address a host of problems in the tax-exempt sector, including many highlighted in the 2005 letter. We appreciate your leadership, support, and assistance, as well as that of Chairman Baucus and other members of the Committee, in helping us keep this area compliant.

Introduction

As you requested, we will outline below our top compliance issues. We raised some of these issues in our 2005 letter. We have made substantial progress in compliance in the past two years, but some old problems persist and new ones have emerged.

Your letter also requests that we estimate the revenue loss attributable to the compliance issues we identify. The IRS' role in regulating tax-exempt entities is to ensure that they operate in a manner consistent with their exempt status. Where compliance issues exist, correcting the problem often will not generate large amounts of additional revenue as much as ensure that the organization remains eligible for tax-exempt status. Some issues do result in lost revenue and, therefore, may be included in the tax gap. However, we do not have specific tax gap estimates for these items.

That is not to say that revenue loss is not important to us. We focus on ensuring that tax-exempt entities pay the required taxes (e.g., employment taxes). Equally important, however, is the need to administer the tax laws to ensure that the tax expenditures attributable to the tax-exempt sector are used for the purposes the Congress intended. In selecting topics for this letter, we took revenue loss into account, but also considered other factors, such as the nature of the noncompliant behavior, whether the noncompliant behavior is on the rise, and the corrosive effect of the behavior on voluntary compliance in the sector as a whole and on public confidence in nonprofit organizations. We believe that maintaining a compliant tax-exempt sector helps prevent the erosion of the tax base, contributes to an environment of respect for the tax law, and helps assure the public benefit commensurate with the tax expenditure.

I have divided the remainder of this letter into three parts similar to our 2005 letter. First, I outline the current environment. Second, I list the top compliance issues that involve tax-exempt entities or charitable contributions and discuss the actions we have taken to date to address them. Third, I identify ongoing concerns that we believe should be part of any discussion about compliance in the tax-exempt sector.

I. Current Environment for Compliance in the Tax- Exempt Sector

Many elements define the environment for compliance in the tax-exempt sector. Taken together they describe an increasingly complex sector. Although most tax-exempt entities have operated under high standards, some remain casual, indifferent, or even callous toward compliance, while others are beginning to adopt a more structured, responsible approach. Before I outline key environmental features of specific parts of the tax-exempt sector, I will note several factors that are present throughout it.

A. Environmental Factors Present in All Parts of the Tax-Exempt Sector

1. Continued Increase in Size and Complexity of the Sector. The tax-exempt sector continues to grow rapidly, and many tax-exempt entities have also grown more complex. This, in turn, has affected the way many of them do business.

Since 1997, the number of tax-exempt organizations on the IRS master-file has increased by more than 355,000. On average, our fellow citizens created 39,465 new exempt organizations per year – 108 per day, weekends and holidays included. The total number is now approaching 1.6 million, a figure that does not include most churches. The value of the assets these organizations hold is more than \$3 trillion.

In employee plans, the number of defined benefit plans has declined by two-thirds since 1980, while the number of defined contribution plans has doubled. This means that responsibility for managing retirement assets is shifting from employers to individual employees. The Federal Reserve estimates that more than \$9.8 trillion are invested in retirement plans.

The amount of outstanding tax-exempt debt continues to climb steadily. Some forecasts predict that the tax-expenditure for municipal bonds will increase from \$37 billion this year to \$45 billion by 2012.

As to Indian tribal governments, revenue from tribal gaming operations has climbed at double digit rates. In the past two years, gaming revenue has grown from \$17 billion to an estimated \$25 billion. Tribes are using some of this money to expand into other enterprises, some of them off tribal lands.

Federal, state, and local governments continue to be among the nation's largest employers.

2. Continued Concerns about Governance. It is too soon to tell what effect our increased enforcement presence and modifications to the law have had on the lax governance practices outlined in our 2005 letter. We still observe failures in this area, both in our examinations and in the press. We see, however, some positive signs that the sector is aware and concerned about these lax practices. I mentioned above the efforts of some within the tax-exempt community to establish and gain general acceptance of high standards for governance. We remain convinced that an independent, empowered, and engaged board of directors is the key to insuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust. Unfortunately, the nonprofit community does not uniformly adhere to these principles and has not been immune from bad corporate practices. Also, given

the emergence of some questionable or abusive arrangements in employee plans, we may need to promote good governance practices by plan fiduciaries responsible for protecting retirement assets.

3. Improved Enforcement Capacity and Presence. In our 2005 letter, we acknowledged that one of the negative environmental factors was the lack of an adequate IRS enforcement presence in the sector. Under former Commissioner Everson's leadership, we believe we have made real progress in this area over the past two years. We have reinforced the infrastructure of enforcement, which includes both the changes in the laws that have addressed abuse and an effective IRS enforcement presence. This is not to deny that a great deal of challenging work remains.

Since 2005, we have continued to shift resources into compliance and enforcement. While the number of TE/GE Full Time Equivalent (FTE) employees is down slightly from 2005 to 2007, examination FTEs have increased during this period by 5.6 percent. In FY 2006, the number of examinations in TE/GE increased by 17.9 percent. In FY 2006, Exempt Organizations alone examined 7,079 returns, an increase of 43 percent from the previous year. This is the highest level since FY 2000. Moreover, we have created new offices and engineered new business processes that have broadened and strengthened our compliance presence. To cite one example, our hospital and executive compensation studies would not have been possible without the design and staffing of the Exempt Organizations Compliance Unit, one of the new offices within TE/GE.

The legal environment has improved as well. Since 2005, the Congress has enacted the TIPRA, the PPA, and other legislation aimed at ending a number of abusive practices in the tax-exempt area. While it is too early to measure specific results, the legislation has given us additional tools for shutting down certain abuses.

The adoption of the President's 2008 budget for the IRS will further advance our efforts, and I respectfully request your support. This budget supports our continued emphasis on compliance in the tax-exempt area. For FY 2008, the Administration has requested a 6.3 percent increase in the overall IRS budget. The budget includes a larger increase for TE/GE (10.8 percent or \$26.4 million), with a 12.3 percent increase in examinations and a 12.6 percent increase in determinations.

4. Abusive and Questionable Tax Practices. Because of weak governance practices and our prior lack of enforcement presence, some parts of TE/GE's regulated community remain involved with abusive or questionable transactions.

In the tax shelter area, abusive programs often require a "tax-indifferent party" to make the scheme work. Some tax-exempt customers continue to allow themselves to be used, often in new ways, as accommodation parties to enable abusive tax shelters. I will discuss some of these emerging issues in Part II of this letter. I also cannot overstate the role some professionals play in creating, promoting, and spreading tax abuse, even as others strive to prevent it. In enacting the appraisal reform provisions in the PPA, the Congress addressed an important element of the problem of professional misconduct. Further, our Office of Professional Responsibility is acting within its authority to tighten professional standards. Nonetheless, the problem persists.

B. Environmental Factors Present in Specific Parts of the Tax-Exempt Sector

1. Exempt Organizations. We have seen a rise in very large exempt organizations. Several now have economic power that matches that of some nation-states. The rise of very large organizations and the coming transfer of wealth between generations are driving considerable activity in financial and tax planning. With size comes the ability to participate in cutting edge economic transactions, from all sorts of joint ventures to participation in private equity and hedge funds. From the transfer of wealth comes the development of new planning devices for giving. I discuss the effect of both these factors below.

The Internet also has an effect on the exempt organizations environment. In addition to its obvious influences, which include its revolutionary contributions to communications and the possibility of almost real-time transparency, the Internet brings issues of web-based fundraising and virtual charities. Moreover, it is blurring the concept and importance of state and national borders, with implications for local jurisdiction over local charities.

The potential misuse of charitable structures to aid terrorism is an unfortunate environmental factor that has become more pressing since September 11, 2001, and is one we must confront. For the foreseeable future, this threat will require us to review applications for tax-exempt status and annual Forms 990, Return of Organization Exempt from Income Tax, against terrorist watch lists. We must also be alert to other meaningful actions that would contribute to the nation's comprehensive anti-terrorism program. The Treasury Inspector General for Tax Administration (TIGTA) has recently pointed out ways to improve our current processes, and we are acting on those recommendations.

2. Employee Plans. As a society, we are older and less frugal than ever. The coming class of retirees will be different in some respects from their predecessors, and we anticipate new administrative and policy concerns arising

from those differences, including: the change in who bears the risk of loss from a plan's investment performance (i.e., the change from defined benefit to defined contribution plans); the lack of sufficient savings; the persistence of abuse and misuse of tax qualified plans; and the emergence of a variety of consumer abuses directed at unwitting participants and retirees managing their own retirement accounts.

In addition, a critical element of the retirement plan environment is the complexity of the rules, and the frequency of changes to the underlying law. By some counts, the employee plans portion of the Internal Revenue Code (Code) has been significantly amended at least 23 times since 1980.

3. Indian Tribal Governments. The Federal Government has recognized 562 Indian tribes. Frequently, on the margins of the economy in the past, Indian tribal governments have sought to bolster their economies and provide jobs for tribal members. The most prominent of these efforts in recent years is gaming. At present, 225 tribes operate 442 casinos. According to National Indian Gaming Association estimates, revenues from these operations have increased to almost \$25 billion, and tribal gaming is the fastest growing segment of the gaming industry, growing at double digit rates. Other tribal enterprises exist or are under development. These include hotel convention centers, banking, and other businesses not located on tribal lands. Tax-exempt bonds finance some of these activities.

4. Tax-Exempt Bonds and Tax Credit Bonds. The amount of outstanding tax-exempt debt continues to increase. It has more than doubled since 1995, as has the number of issuances. Moreover, in recent years the Congress has established a number of highly specialized, specifically targeted classes of municipal bonds and tax credit bonds to make the benefits of tax exempt financing available for specific purposes. For example:

- In the Taxpayer Relief Act of 1997, Congress created a pilot tax credit bond program called "qualified zone academy bond" (QZABs), for certain public school purposes. QZABs provide a Federal tax credit in lieu of interest. Congress has continued to extend and expand the QZABs program, most recently in the Tax Relief and Health Care Act of 2006.
- The Gulf Opportunity Zone Act of 2005 contained multiple provisions increasing the availability of tax-exempt financing throughout the Gulf Opportunity Zone, including the creation of special exempt facility bonds, mortgage revenue bonds, tax credit bonds, and additional advance refunding bonds.
- The Energy Policy Tax Act of 2005 authorized the issuance of zero interest tax credit bonds, called "clean renewable energy bonds" (CREBs) to provide

tax credit subsidies to the financing of renewable energy projects. The Tax Relief and Health Care Act of 2006 extended and expanded the CREBs program.

- Section 11143 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 authorized the issuance of qualified highway or surface freight transfer facilities to finance certain surface transportation projects, bridges, tunnels, and rail-to-truck freight transfer facilities.

Each class of bonds has its own set of rules raising tax administration concerns. In general, special purpose tax-exempt bonds and particularly separate “one-shot” tax credit bond programs with disparate program requirements impose significant administrative burdens on the IRS and Treasury to provide separate regulatory guidance and increase complexity to the detriment of compliance. We urge consideration of the need for uniform program rules for tax-exempt bonds and tax credit bonds.

5. Federal, State, and Local Governments. Our principal responsibility for governmental entities is to collect employment taxes. The government employs a significant percentage of the U.S. workforce. As a result, a large amount of employment and withholding tax—estimated at \$270 billion—comes from this sector. A barrier to compliance for small governments (and also many small businesses) is a lack of sufficiently trained payroll personnel and a high rate of employee turnover in payroll offices. We recognize that governments can often only make necessary compliance changes in accordance with a legislative calendar, rather than immediately. Finally, some government related entities also have served as accommodation parties in abusive tax transactions.

II. Key Current Compliance Issues

In this section, I will address the identification of the key compliance issues involving entities within the jurisdiction of TE/GE or otherwise involved in charitable giving. I have included a discussion of emerging issues at the end of each section, where appropriate. These emerging issues are transactions that we are studying. At the end of some studies, we may find that current law does not preclude the transaction. I am including them here, however, to present the range of compliance issues before us.

A. Sector-wide Compliance Issues.

1. Abusive Tax Transactions and the Use of Tax Exempts as Accommodation Parties. We remain vigilant about the use of tax-exempt entities to accommodate, promote, or otherwise serve a role in abusive tax transactions. Some of the listed transactions that TE/GE taxpayers have been involved in include the following:

- Collectively bargained welfare funds under section 419
- Prohibited allocations of ESOP securities in an S corporation
- Abusive Roth IRA transactions
- Section 412(i) qualified retirement plan
- Lease-in/Lease-out (LILO) transactions
- Deductions for contributions of an employer to an Employee's Trust or Annuity Plan, and compensation under a Deferred Payment Plan – IRC section 401 and 404 Accelerator

We have worked hard to discourage TE/GE taxpayers from participating in such transactions. However, we continue to find new forms or variations of potentially abusive transactions involving the exempt community. One of these new forms involves so-called "lease remainder interests" that you discussed in your letters of April 12, 2007 and June 18, 2007. As we discussed in our letter of May 3, 2007, we are presently investigating 48 instances in which such an interest has been donated and a charitable deduction taken. We will outline additional actions that we have taken and will take in a separate response to your June 18 letter.

We also are approaching completion of the settlement initiative we introduced in November 2005, in Announcement 2005-80. Under this program, taxpayers could resolve their tax liability arising from their involvement in one or more of 21 questionable tax transactions. TE/GE has the lead responsibility for four of the 21, and is involved in four others. We have worked closely with those tax-exempt organizations, governments, and plans that came forward under the initiative. We are moving on to the next stage, which is pursuing examinations of those entities that were eligible to participate in the initiative but did not to do so. I discuss some of these transactions in greater detail below.

2. Issues involving Charitable Contributions. Charitable contributions raise a number of compliance concerns. One concern involves improper valuation, an issue that occurs in many contexts in the tax-exempt area. Additional concerns are whether a donor receives some form of consideration in exchange for a contribution, and whether a donor (including some estates) transfers a complete or only a partial interest in the contributed item. These concerns exist whether the donee is a charity or a government. Examples of valuation problems include:

Charitable Contribution Overvaluation—In General. While the PPA has provided additional tools to combat this abuse, we expect overvaluation will continue to be a significant problem in charitable contributions of property. These issues are often difficult. Overvaluations may arise from taxpayer or appraiser error, from deliberate abuse, or from aggressive taxpayer or appraiser positions. Valuation problems are greatest with non-cash charitable contributions

for which no market exists, and taxpayer failure to substantiate the value of such contributions exacerbates the problems. The issue exists everywhere, from donations of used clothing (a problem the PPA recognized) to closely held business concerns, to sophisticated real property interests. Although the problem manifests itself in various contexts, the underlying issue remains the same. Nonetheless, we are almost always at a disadvantage when challenging a taxpayer's valuation because of the need for experts on both sides, and our reluctance to pursue cases where the amounts at stake are less than the costs to audit, appraise, and litigate. The enactment of Code section 6695A in the PPA, which imposed a penalty for valuation misstatements attributable to incorrect appraisals, is an important first step to address the problem of excessive valuations. We have numerous appraiser penalty examinations in process. As we gain experience under the new law, we will be better able to assess its effectiveness. We believe the successful sanction of a few of these cases will serve as an effective deterrent to negligent or intentional misbehavior in the future.

Charitable Contribution Overvaluation—Charitable Family Limited Partnerships (CharFLP). In a CharFLP, a transfer of assets occurs in a transaction structured to look like a charitable contribution. The transactions typically involve large, questionable charitable contribution deductions and the sheltering of appreciation in a tax-exempt entity. One form of the transaction works as follows: A taxpayer transfers a limited partnership interest (e.g., 98 percent) in a family limited partnership to a charity. The donor claims a charitable income tax deduction based on the value of the donated interest which is valued for this purpose with little or no discount. The income and/or capital gain attributable to the charity's interest (e.g., 98 percent) escape taxation because the charity is tax-exempt. At the same time as the gift, the taxpayer's irrevocable trust and the charity enter into a separate buyback/put agreement, specifying the time the interest will be purchased by the trust (or put by the charity), and how to calculate the amount the charity will receive. The price the trust pays to the charity for the partnership interest reflects lack of marketability and minority interest discounts. The partnership agreement places strict limitations on the charity's right to liquidate the partnership interest other than by way of the buyback/put agreement. The claimed benefits to the donor include the charitable contribution deduction for the gift under section 170, the avoidance of income tax on income and gain attributable to the charity's limited partnership interest, and the reacquisition of the full value from the charity at a bargain price. In addition, in some versions of this transaction, the charity pays a portion of the buyback price in the form of a shared life insurance premium on the life of the donor.

We are aware that public charities, including supporting organizations, are involved in CharFLP transactions. We believe this is a promoted transaction and are identifying promoters and taxpayers for audit. Currently, we have a few CharFLP examinations underway and are addressing CharFLPs as part of an Issue Management Team concerned with family limited partnerships.

Charitable Contributions—Conservation Easements. Under current law, a taxpayer can only deduct a conservation easement if the easement promotes a “conservation purpose,” as defined in section 170(h)(4). Valuation is a key issue in most cases where we are finding problems, but other issues are also often present. For clarity, we will discuss all issues involving conservation easements under this heading.

One non-valuation issue in these cases is that applying the conservation purpose requirement is difficult. Other issues include easements “donated” in return for development rights or other *quid pro quo*; owners of land retaining the right to use land in ways inconsistent with the easement’s conservation purpose; easements not granted in perpetuity; or a donee’s lack of resources necessary to monitor and enforce the easements.

A related set of problems arises with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. The Congress addressed these easements in the PPA.

To address the problems of land conservation and façade easements, we established an Issue Management Team and have opened more than 900 examinations. We are reviewing several hundred additional returns to determine the next wave of examinations in this area. We also have conducted 15 investigations of promoters.

Another problem is that the conservation easement rules place the charity in a watchdog role. Often, however, the charity has not monitored the easements, or has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement’s restrictions. We are reviewing 28 charities in this area.

We have worked with the revenue departments of five states that contacted us with information or requests for assistance.

3. Legal Non-filers, Under-reporting, and the Absence of Transparency.

Two factors restrict our ability to establish a comprehensive picture of the tax-exempt community. First, numerous exemptions from filing exist in our communities. Some of these exemptions have their basis in well-established policy with an arguable Constitutional underpinning (e.g., churches do not have to file for exemption or annually). The rationale for other exemptions is less obvious (e.g., the lack of meaningful annual reporting in the tax-exempt bond area). Further, many in the community have a mixture of filing requirements. For example, state, local, and tribal governments have certain exacting filing responsibilities (e.g., employment tax), but may come into existence, operate, or go out of existence without notifying the IRS. Such a pattern limits our ability to identify and pursue noncompliance. The requirement in the PPA that small exempt organizations file an annual "e-postcard" with the IRS is an important step in helping to address part of this problem, and we appreciate the Committee's leadership in this area.

The second barrier to establishing a clear picture of the tax-exempt community is the imperfect quality of data we request and receive. Transparency begins with adequate reporting, but we experience problems that stem both from the design of the forms and how taxpayers fill them out. Our ongoing executive compensation compliance project presents clear evidence of this. We discovered extensive errors in response to questions about transactions with disqualified persons and excess benefit transactions. Our compliance checks show that many organizations were confused by the form, the instructions, or both. Ultimately, 31 percent of organizations filed amended returns after receiving our compliance check letters.

The executive compensation project unearthed other reporting problems. Of 50 public charities reporting officer compensation of over \$250,000, none initially filed schedules detailing compensation paid to officers and employees. In response to our compliance check letters, 41 filed acceptable amended returns. Of the private foundations we contacted, ten percent did not correctly report compensation of officers and other employees.

Clearly, many forms need revision. We are working with the Department of Labor and the Pension Benefit Guaranty Corporation to revise the Form 5500, the annual return for retirement plans, and we are revising the Form 990, the annual information return for tax-exempt organizations. This is the first overhaul of the Form 990 since 1979. As we mentioned in response to your May 29, 2007, letter on this subject, we published a discussion draft of the new Form 990 on June 14, 2007. We also are considering the degree to which regulations or regulatory policy contribute to the current legal non-filer regime. For example, as we revise the Form 990, we will look at the current filing thresholds of the "e-

postcard" (\$25,000 in gross receipts) and of the Form 990-EZ in an effort to attain the right balance between getting the information we need and not overburdening filers. We will similarly review the Form 5500-EZ.

B. Employee Plans Compliance Issues.

Below I outline current issues in employee plans. Our 2005 letter noted that we had found problems in the funding levels of certain defined benefit plans. The Congress addressed this issue in the PPA. We will continue to follow the issue of the adequate funding of defined benefit plans, including providing guidance under the PPA, accelerating our contacts with those reporting funding deficiencies, and continuing to increase coordination with the Department of Labor and the Pension Benefit Guaranty Corporation. We will wait to gauge the effect of the PPA on this issue. We also are looking at retirement plans that governments sponsor for their employees. We are reviewing what actions, if any, we may need to ensure that plan assets remain dedicated to providing retirement benefits to employees.

As in other parts of this section, each of the items I discuss below involves issues that affect the realization of the expected public benefit from the tax expenditure.

1. Use of Retirement Plans for other than Retirement Purposes. As we discussed in our 2005 letter, we found a variety of cases involving the promotion of retirement plans for abusive purposes, either to shelter income or to accelerate deductions. We described these abuses in our prior letter. We included Abusive Roth IRAs, section 412(i) plans, and various S-Corp ESOP cases. In November, 2005, we designated them as transactions eligible for resolution under the Announcement 2005-80 settlement initiative. In response to that initiative, 137 taxpayers involved with Roth IRAs, 76 taxpayers involving 53 412(i) plans, and 306 taxpayers involving 94 S-Corp ESOPs came forward.

We are examining returns of those taxpayers who had the opportunity to resolve their situations under Announcement 2005-80, but did not do so. We have selected for examination 398 returns including 225 taxpayers involving Roth IRAs, 301 returns including 240 taxpayers involving 412(i) plans, and 452 returns including 301 taxpayers involving S-Corp ESOPs. We also are conducting non-examination compliance contacts involving 320 412(i) plans and 128 S-Corp ESOPs. We believe that our work, together with the legislative changes the Congress enacted, have effectively addressed the 412(i) and S-Corp ESOP abuses. Abuses involving Roth IRAs continue in various schemes and we continue to classify cases for examination.

2. Plan Coverage. In Part I, I discussed the aging workforce and inadequate retirement income. In light of these developments, we have become increasingly concerned with plan coverage. We are looking at this issue in several areas and as part of our review of government plans. With respect to government plans in particular, we are finding coverage problems. These problems seem in many instances not to stem from an intentional disregard of the rules, but rather reflect the way many government plans operate at local levels. In our Universal Availability Project, we have sent compliance letters to 1,694 public school districts on the universal availability requirements for their section 403(b) plans. To date, we have closed 1,584 cases and have found that one quarter of the plans appear to have coverage problems. We have obtained additional W-2 information that will allow us to focus on school districts with inadequate levels of participation. On June 21, 2007, we announced that we will expand the Universal Availability Project to all 50 states.

3. Continuing Issues with the Complexity of Employee Plans Rules.

Compliance with complex rules for employee plans continues to be a problem for employers and employees. Evidence of this occurs throughout our program. For example, we have found problems in excess 401(k) deferrals, resulting in many erroneous W-2s. Through March 2007, 121 different employers have issued corrected W-2s to 14,398 employees. We expect to complete the initial wave of our work in this area in the fourth quarter of FY2007.

4. Emerging Issues. With increasing frequency, we are seeing cases in which employers and other taxpayers use tax-qualified retirement plans to provide retirement benefits, obtain tax benefits, or use plan assets in ways that are not consistent with the plans' intended purposes and the tax benefits they should provide. One new transaction that has come to our attention is structured to allow assets in excess of the plan's accrued liabilities to be withdrawn from the plan without the payment of the Section 4980 excise tax on reversions. Another transaction is intended to allow employers to use retirement plans to provide non-retirement benefits, such as severance benefits, for which the Code generally does not provide the same tax-favored treatment as it provides for retirement benefits. We are also seeing employers structure benefits to avoid section 401(a)(26) and the vesting protections of the Code and the Employee Retirement Income Security Act (ERISA).

These transactions call sharply into question the effectiveness of the tax expenditure made for them. We are examining the Section 4980 transaction. To alert employers to our concerns about using retirement plans to provide non-retirement benefits and about avoiding the vesting rules, we issued Notice 2007-14. The notice requests further information about the transactions and warns that we may consider regulations.

We also are evaluating a related but different transaction that may or may not comply with the letter of the Code. The transaction involves a prototype 401(k) or profit sharing plan that allows a plan participant to use qualified retirement plan assets to purchase a start-up business or franchise. The transaction is structured to avoid any taxes or penalties on distributions from the qualified plan. The transaction generally results in a plan whose principal asset is the start-up. Because of the risky nature of business start-ups, such plans ultimately may not provide meaningful retirement benefits. Some or all of these transactions may be permissible under some interpretations of current law, but they also call into question the effectiveness of the tax expenditure.

C. Exempt Organizations Compliance Issues

1. Charities Established to Benefit the Donor. This group of compliance issues shares a common feature: a donor claims a deduction for a charitable contribution while maintaining control over the contributed assets, and often uses them for personal benefit. An example is our continued work with Corporations Sole. We identified this and other issues in our 2005 letter, and the PPA subsequently addressed the issues in several ways. While the effect the PPA will have on this class of problems is not yet clear, we appreciate the legislation and are monitoring its result. Other examples of charities established to benefit the donor include the following categories:

Abusive Donor-Advised Fund Arrangements. As discussed in our 2005 letter, a donor-advised fund is a separate fund or account maintained by a public charity to receive tax-deductible contributions from a single donor or a group of donors. The Congress refined the definition as part of the PPA. In our examination program, we found that certain promoters encourage individuals to establish purported donor-advised funds used for a taxpayer's personal benefit. We also found that some of the charities that sponsor these funds may be complicit in the abuse. Promoters inappropriately claim that payments to these organizations are deductible under Code section 170. They also often claim that assets transferred to the funds may grow tax free and be used later to reimburse the donor for his or her expenses, or to fund his or her children's educations.

We continue to examine large national donor-advised funds. We have identified more than 200 donors for examination and are examining 11 donor-advised funds that account for a significant portion of the assets and income in the donor-advised fund universe. Thus far, we have proposed the revocation of exemption of two entities.

Section 509(a)(3) Supporting Organizations Established to Provide Benefits to Founders. This is also an item carried forward from our 2005 letter.

Supporting organizations are public charities that, in carrying out their exempt purposes, support one or more other exempt organizations, usually other public charities. Most problems we find are in the Type III organizations, where the relationship is least formalized. We have found some issues with Type I organizations as well, where a promoter may control the supported organization. In our 2005 letter, we outlined problems, including *quid pro quo* issues, with money either never actually being donated or, if donated, being returned as loans or other forms of inurement. We also discussed the promotion of these transactions. These problems and our work continue. We have conducted 119 exams over the past few years, and have revoked the tax-exempt status of 19 organizations, proposed revocation in another 38 cases and have converted seven organizations to private foundation status. We appreciate Congress' attention to the problem of supporting organizations in the PPA.

Charitable trust problems and abuses. As discussed in our 2005 letter, some promoters have set up purported charitable or split-interest trusts that a taxpayer can use for his or her personal benefit. A variety of transactions allow individuals to deduct amounts as charitable contributions that ultimately they will use for personal expenses. The trust typically is a non-exempt charitable trust, formed under state law, that serves as a holding entity of the individual's assets. Individuals retrieve these assets at will, generally through loan transactions, gifts, or by having the trust pay for expenses directly. We have also seen a variety of abusive promotions involving charitable remainder trusts, which have both charitable and non-charitable elements. Our work continues in this area.

2. A blurring of the line between the tax-exempt and commercial sector. Abuses occur in this area in a number of ways:

Commercial Operators Moving into the Charitable Sector. The movement of commercial enterprise into the charitable sector remains an issue. Various factors encourage this movement, including the absence of bright line standards in the tax-exempt area, the promise of exemption from consumer protection and similar regulatory statutes enjoyed by charities, and the economic benefit the tax exemption itself conveys. The line between commercial and charitable operations may be further blurred in certain cases where market forces, industry practice, or the non-tax regulatory environment has changed over time. For example, as we have mentioned previously, many tax-exempt hospitals are difficult to distinguish meaningfully from for-profit hospitals; many tax-exempt credit unions may be hard to distinguish from for-profit banks; and many tax-exempt and for-profit nursing homes may meet the same standards and be virtually indistinguishable.

Credit Counseling. Credit counseling is a clear and disturbing example of how commercial operators seized upon lawful tax-exempt activity and converted it into something entirely different and decidedly commercial. These operators never relinquished their claim to tax-exemption and took advantage of regulatory exceptions to operate without restriction in an otherwise highly regulated market. We conducted a vigorous examination program of the entire credit counseling industry and have proposed or revoked the tax-exempt status of 41 percent of the industry, as measured by gross receipts. Applications for determination letters for new credit counseling organizations have come virtually to a halt. The Congress has also acted in the PPA, and we believe that this action has significantly reduced the abuse in this area.

Down Payment Assistance Organizations. Down payment assistance organizations can perform a valuable role in helping low-income individuals become home owners. However, promoters have set up "charities" that allegedly aid people who need help to make a down payment for a home. In the abusive cases, the seller of the home, not the organization, actually provides this assistance. The promoter minimizes the tax-exempt purpose of helping the needy obtain a down payment for a home in favor of providing a benefit for the seller and the mortgage lender, often at the expense of the buyer who assumes responsibility for mortgage payments beyond his or her means. Again, these organizations took advantage of favorable non-tax regulations intended to be available only to true charities, and instead provided an impermissible private benefit.

We issued Revenue Ruling 2006-27 in 2006 to provide clear guidance on the subject of down payment assistance. We are auditing 100 down payment assistance organizations. To date, we have revoked or proposed the revocation of more than 25 of these organizations. Additionally, a Federal court injunction has barred one tax-exempt entity, a promoter, from further activity. Although we are working vigorously in this area, it remains a current compliance challenge.

Complexity and Administrative Difficulty of Unrelated Business Taxable Income Determinations (UBTI). A problem exists with UBTI in situations where drawing lines between "related" and "unrelated" activities and uncertainty about allocating expenses (including indirect expenses) and income between related and unrelated economic activity allows excess flexibility.

This problem is becoming more critical as tax-exempt entities provide goods or services that are similar to, or virtually indistinguishable from, those offered by the tax-paying commercial sector. This movement raises a number of concerns, including the erosion of the nation's tax base, unfair competition with the commercial sector, and potential damage to the public's support of the charitable sector.

Several examples illustrate the issue. One involves tax-exempt organizations engaging in possible tax-free commerce, e.g., museum gift and convenience shops and restaurants. Determining the circumstances under which the sale of silk scarves or ties, stuffed animals, tee shirts, baseball caps, drinking glasses, jars of jam, honey, or wine, and meals is related meaningfully to an organization's educational purposes is difficult. Travel tours are another example. Others include the sale of insurance policies to organization members and the offer by schools and other tax-exempt entities of public memberships in gyms, swimming pools, or fitness centers.

We are not declaring that an organization that engages in one of these activities cannot be tax-exempt, or that the income generated is necessarily UBTI. However, we cannot overlook the compliance issues that these and similar activities raise, or ignore the difficult administrative problems they create. As commercial and investment activity proliferates, we must determine how much activity or funding exempt organizations are dedicating to charitable purposes.

Another issue involves the number of organizations reporting losses on the Form 990T. According to recent data, approximately 50 percent of Form 990T filers report zero income or a loss in the conduct of their unrelated business activities. In 2008, we will explore the treatment and allocation of income and expenses in certain large non-profit systems.

3. Executive Compensation and Inurement. The media continues to report high salaries and generous allowances at some charities and foundations. High compensation based on the fair value of services an executive performs for the exempt organization is consistent with current law. The key to this determination is whether the compensation is comparable to what similar organizations pay for similar work. The organizations used for comparison may include for-profit as well as nonprofit organizations. The law permits reasonable compensation, even if high, however, it does not permit excessive compensation.

Since our 2005 letter, we have completed a major review of executive compensation at charities and private foundations. We looked at almost 2000 exempt organizations. We sent compliance check letters to more than 1000 public charities and 200 private foundations and conducted examinations of over 780 of them. We found that almost one-third of the organizations reported the executive compensation incorrectly or incompletely.

In March 2007, in a report on executive compensation, we noted that the exempt organizations we examined appeared to generally comply with the law in their compensation practices, but had significant reporting problems. We found instances of excessive executive compensation in 25 charities involving 40

individuals, and we assessed \$21 million in excise taxes. The project also revealed the reporting problems we discussed above, and that loans from an organization to its executives and disqualified persons may be a further problem. Follow-up work from the project is continuing and includes the redesign of the Form 990, examinations of loans to executives, and other examination work. We also are reviewing compensation as part of our ongoing study of tax-exempt hospitals, requesting information from over 500 hospitals. After reviewing that information, we began over 20 examinations of hospitals.

We expect to scrutinize executive compensation in virtually every new exempt organization's compliance initiative. As we continue to gain experience, we will review the use of comparability data to support the compensation amounts and assess the methods used to establish and approve the compensation. We will also be alert to increasing sophistication in the types of compensation exempt organizations use to pay their executives and other key personnel. The new Form 990 we have proposed will strengthen our ability to monitor this area.

4. Regulation and Reporting of Political Activities. We must also monitor exempt organizations' political activities. These activities involve two very sensitive areas.

Political Intervention. By law, charities cannot intervene in political campaigns, but every election season brings reports of charities supporting or opposing particular candidates. The number of allegations of improper activity, together with increased campaign spending, has raised concerns about whether prohibited funding and activity are growing in 501(c)(3) organizations. To address these issues, the IRS began the Political Activities Compliance Initiative in 2004.

In February 2006, we released a report on our examination of political campaign activity by tax-exempt organizations during the 2004 election campaign. The report concluded that nearly three-quarters of the 82 examinations we completed uncovered some level of prohibited political campaign activity.

We recently released Revenue Ruling 2007-41 which provides guidelines for exempt organizations on the scope of the prohibition of campaign activities by section 501(c)(3) organizations. We also have released a report on our efforts related to the 2006 campaign. In the report we drew comparisons to the 2004 cycle. We found:

- In 2004, the IRS received 166 referrals alleging political campaign intervention by section 501(c)(3) organizations, resulting in 110 examinations of exempt organizations.

- In 2006, the number of referrals increased to 237; but, the number of referrals selected for examination remained relatively constant at 100.
- In 2004 and 2006, referrals alleging violations by churches and non-churches were almost evenly split, as were the referrals ultimately selected for examination.
- In 2004 and 2006, we received allegations about similar sorts of violations, and the level of egregiousness of the violations was the same in both years.
- In 2006, we began a project to review lists of contributors compiled under state law (for years prior to 2006). The project identified 269 apparent contributions to political candidates, totaling \$343,963, from section 501(c)(3) organizations.

Initial IRS contact in these cases resulted in charities receiving over \$121,000 in refunds of political contributions.

Political Organizations and Section 527. Political Action Committees (PACs) and other political organizations must meet certain reporting requirements established under Code section 527(i) and (j). Failure to meet these reporting requirements may result in taxes or penalties. We recently issued Revenue Procedure 2007-27, providing a safe harbor and relief from penalties in cases where an entity's failure to report information on contributors is due to reasonable cause. We are continuing to work to ensure that the information these organizations filed is timely and complete.

We also have begun an initiative to determine whether organizations that claim they are Qualified State or Local Political Organizations (QSLPOs), as defined in Code section 527(e)(5), are making this claim properly. QSLPOs are exempt from the requirement under Code section 527(j) to report expenditures and contributions. We have identified a statistically valid sample of 300 organizations that have designated themselves as QSLPOs to which we will send a compliance questionnaire.

An emerging issue is the apparent attempt by some to convert section 527 political organizations to section 501(c)(4) organizations. We believe the purpose is to diminish transparency of contributors and expenditures, rather than to avoid taxes or penalties. This development means that Code section 527(f) is likely to become a greater compliance issue. This section requires an exempt organization, including those described in Code section 501(c)(4), to include in income and pay the 527(b) tax on certain political expenditures.

D. Tax Exempt Bonds Compliance Issues.

1. Transactions Designed to Earn and Divert Illegal Arbitrage.

In General. Arbitrage investment restrictions on tax-exempt bonds generally restrict yields on investments of tax-exempt bond proceeds to the effective interest rate or yield on the bonds (yield restrictions) and require that certain excess earnings on such proceeds be rebated to the Federal government, subject to certain exceptions. In response to the issues outlined below, for several years we have allocated a significant portion of our compliance resources in the tax-exempt bond area to identifying and auditing various types of potential arbitrage-motivated transactions and diversions of arbitrage-based investment profits. This effort has had a positive compliance effect on the industry. Moreover, recent legislation has imposed stricter timing requirements for loan disbursements in pooled financings. We will examine bond issues subject to this new legislation in future years to enhance compliance.

Pooled Financings. In a pooled financing, a state or local government issues tax-exempt bonds to finance loans to a group of other local governments or charitable organizations. Pooled financings allow smaller, less creditworthy entities to borrow money at reduced interest rates, and spread the costs of issuance among multiple borrowers. However, several types of transaction structures allow bond proceeds to remain invested for an extended period of time. Each of these has a common feature of either issuing bonds earlier or issuing more bonds than reasonably necessary to accomplish the governmental purpose of the transaction. In these cases, arbitrage profits have been diverted through a variety of means to fund higher-than-normal issuance costs, acquire overvalued financial products, and pay excessive fees to transaction participants.

Investment Bid Rigging. To determine compliance with the arbitrage yield restrictions and rebate rules, we must calculate the yield on investments acquired with tax-exempt bond proceeds using the fair market value of each investment. Treasury Regulations provide certain safe harbors for establishing fair market value of investments for arbitrage purposes based on purchase of investments in compliance with prescribed bidding procedures. However, when an investment is priced at above-market value, the investment yield will be artificially reduced resulting in the illegal diversion of arbitrage profits from the U.S. Treasury to the provider selling the marked-up investment.

In multiple examinations, we uncovered behind-the-scenes payments (or kickbacks) between the winning bid investment provider and the broker who managed the bidding process, suggesting the likelihood of bid rigging. Moreover, in some cases, the same broker and investment bidders cooperate to ensure that

each bidder wins an equal number of bids to provide investments at above-market prices. In some instances, the bidding documents themselves have been altered.

Emerging Issue: Overpricing of Derivatives and Other Financial Products.

The tax-exempt municipal bond market has seen a significant increase in the use of derivatives and other financial products in the structuring of bond transactions and investment escrows funded with bond proceeds. These products can serve a valuable economic purpose. For example, interest rate swaps can provide the issuer of variable rate tax-exempt debt with a hedge against rising interest rates. However, the pricing of derivatives and other financial products can have a significant impact on the application of the arbitrage yield restriction and rebate rules. Inappropriate pricing of these products can result in the manipulation of the bond and investment yields, resulting in a diversion of arbitrage to the providers of those products.

At the same time, we recognize that, in general, arbitrage considerations are different with derivatives than with investments in that issuers may lack economic incentives to earn investment earnings above the tax-exempt bond yield on investments but issuers generally have real economic investment incentives to obtain interest rate swaps and other derivatives at the most economic price. Derivatives, however, are particularly complex and there is a need for greater price transparency in this area.

We are looking closely at the potential overpricing of derivatives through focused examination work, research, and dialogue with internal and external experts and industry associations. We have formed a derivatives team to coordinate field and voluntary compliance efforts addressing this issue.

We believe that the arbitrage investment restrictions in general and the potential for arbitrage violations in various aspects of derivatives transactions in particular will be a growing focus of the tax-exempt bond program.

We have closed approximately 130 cases, with another 100 or more still open. Our work with the Criminal Investigations Division on various issues also continues.

2. Qualification Issues Related to Record Retention. We are finding problems with record keeping and record retention that result in an issuer being unable to substantiate that a bond continues to qualify for tax-exempt status after issuance. Tax-exempt bonds are subject to various Federal tax requirements that the issuer must satisfy as long as the bonds are outstanding. Post-issuance

requirements include the proper and timely use of bond-financed property and the arbitrage yield restriction and rebate rules.

While we have done a discrete number of examinations to date, we have found a significant pattern in our examinations in which issuers of tax-exempt bonds (and the borrowers of bond proceeds in conduit financings) are unable to produce adequate records to establish compliance with applicable requirements. We have 30 cases in the first phase of a review of charities involved with tax-exempt financing.

To better identify the scope of this problem, we are preparing a project that will quantify the record retention and post-issuance compliance practices of all exempt organizations that benefit from tax-exempt financing. Ultimately, we will send up to 2000 compliance questionnaires and follow up with a similar questionnaire for governmental issuers. Through these projects, we intend to improve educational and voluntary compliance programs, and develop tailored enforcement initiatives.

We also note that there is a lack of regulatory guidance tailored to the tax-exempt bond area on recordkeeping requirements. In recognition of this, in June 2006, Treasury and the IRS published Notice 2006-63 in which we solicited comments from state and local governments on suggested recordkeeping requirements and simplifying conventions for the tax-exempt bond area. We are reviewing the limited comments received, and we expect to issue further guidance on particular recordkeeping requirements for the tax-exempt bond area.

As we redesign the Form 990, we are requiring exempt organizations to indicate whether, at the end of each reporting period, they have outstanding tax-exempt debt obligations. For each such obligation in excess of \$100,000, we may ask the exempt organization to answer a series of questions on post-issuance compliance, including how they are using the bond proceeds, the financed facilities and the issuance costs, as well as whether they have paid required arbitrage to the Treasury.

E. Federal, State, and Local Governments (FSLG) Compliance Issues.

For FSLG, employment and withholding tax issues predominate. Some of these issues are unique to governments, e.g., social security coverage under section 218 agreements between a governmental entity and the Social Security Administration. We continue to encounter situations where governmental entities do not follow their 218 agreements correctly. This includes cases where workers are incorrectly included or excluded from coverage. We also encounter cases where an entity not party to a section 218 agreement, and not otherwise liable for

mandatory FICA, nonetheless erroneously withholds and pays the FICA tax, or where FICA coverage is incorrectly applied under a retroactive 218 agreement.

Other FSLG employment tax issues are common to any employer. Worker classification is one such issue. We frequently find governmental entities that misclassify large numbers of workers as independent contractors. We also have found several instances where government units that make payments to settle claims for back wages do not properly withhold from and report these payments. Such settlement payments could occur as the result of litigation, arbitration, or another method of dispute resolution. Typically, the payment of back wages requires the governmental unit to report these wages on a Form W-2, and withhold income, Social Security, and Medicare taxes from the payment made to the employees. However, governmental units sometimes fail to do so. Similarly, when a governmental unit makes a payment to cover attorney's fees or compensatory damages, it should report the payment, which is income but not wages, on a Form 1099. Governmental units sometimes fail to do this, as well. We have found failures to properly report payments in several of our large case examinations, including one where the governmental unit owed more than one million dollars in employment taxes on unreported payments.

F. Indian Tribal Governments Compliance Issues.

1. Abusive Financial Products and Abusive Schemes Offered to Tribes and Tribal Members. Promoters are marketing a number of schemes to tribes and tribal members as mechanisms to shelter distributions of net gaming revenue from current taxation. Some of these products do not meet the deferred income requirements of the Internal Revenue Code, while others do not function as advertised. In some cases, tribal members have lost hundreds of thousands of dollars to promoters in arrangements that did not operate as promised.

Tribes have contacted the IRS about some abusive schemes promoted directly to tribal members. These include:

- **American Indian Employment Credit.** Promoters are encouraging tribal members to submit returns and claims reducing taxable income by substantial amounts that cite an American Indian employment or treaty credit. Although an Indian Employment Credit is available for businesses that employ Native Americans or their spouses, no provision exists for its use by employees.
- **Lack of Federal Sovereignty.** In a somewhat similar scam, promoters have advised Native Americans that they are not subject to Federal income taxation because tribal members are nonresident aliens and tribal land has never been part of the United States. These promoters solicit individual tribal members to file Form W-8 BEN, Beneficial Owner's Certificate of Foreign

Status for U.S. Tax Withholding, seeking relief from all withholding of Federal taxation.

- **Identity Theft/"Phishing."** A recent "phishing" scheme involves promoters using false IRS letterhead to solicit personal financial information from tribal members that the promoters claim the IRS needs in order to process the tribal members' "non-tax" status.

We have referred four promoters of these schemes to the IRS Lead Development Center (LDC), which deals with promoter investigations. The LDC accepted three for assignment, and to date one has resulted in a civil injunction. Joint investigations with the Criminal Investigations Division are pending on two of the remaining referrals. We referred a fifth case, involving the misuse of IRS logos and letterhead as part of a phishing scheme, to TIGTA for investigation. We also obtained restitution and a civil injunction in a case involving a frivolous return.

2. Tribal Per Capita Payments. Under the Indian Gaming Regulatory Act, revenues from tribal gaming can be used for several authorized purposes, including funding tribal government operations, providing for the general welfare of the tribe, and making per capita payments to tribal members. Per capita distributions are subject to Federal income tax, and the issuer must report the distribution on Form 1099.

To reduce the tax consequences to tribal members, some tribes have created mechanisms to classify what should be taxable per capita payments as general welfare program payments, excludible from income, often through liberal interpretations of what constitutes a "needs-based" program. Others have created or invested in purported income deferral programs.

To address this problem we have engaged in educational and enforcement activities. We distributed educational articles on the general welfare doctrine through *ITG News*, our quarterly communication with tribes. We addressed the issue, in depth, during each of the past 3 years at 14 regional conferences on Indian gaming, attended by over 1500 tribal officials. We also initiated 139 examinations during the past two years that focused specifically on the use of net gaming revenues.

3. Indian Tribes and Employee Leasing. Federally-recognized Indian tribes are not subject to Federal Unemployment Tax when they participate in state unemployment systems. Further, to the extent of their sovereignty, tribes are not required to participate in state workmen's compensation programs for tribal employees. Individuals have taken advantage of these provisions to set up employee leasing entities that Indian tribes allegedly own, to benefit from the

reduced employment taxes and savings from high workmen's compensation rates. We are aware of several cases in which a tribe allegedly owning the employee leasing company does not exercise any oversight over the company and does not use it for its own employees. These leasing entities employ hundreds of thousands of individuals who work in the private sector and often simply absorb existing private sector employees into the leasing entity with no change in actual employment practices.

We are conducting audits in this area and asserting Federal Unemployment Tax Act (FUTA) liabilities when appropriate. We examine every case we find. To date we have closed five, and two large cases are open. We are also cooperating with state agencies.

III. IRS Focus Areas for Discussion of Reform.

In our 2005 letter, we outlined some areas that we believed should be part of any discussion of reform in the tax-exempt area. We started with a question that continues to be very relevant: Are there additional bright line tests that could aid the public in complying with, and the IRS in administering, the law. We outlined this issue in our 2005 letter and believe our analysis remains basically sound.

A. Have changes in practice or industry created gaps in the statutory or regulatory framework?

The tax-exempt sector has changed markedly over the past 40 years, but much less change has occurred in the law governing tax-exempt organizations. The PPA changes addressed major components of the charitable sector, but the law applicable to many other areas has not been comprehensively reviewed since 1969. Do these rules remain adequate and responsive to developments in the area? Do the filing requirements and exemptions remain correct? Should we do more to address commercial drift in the exempt organizations and tribal governments sectors? Has the time come to re-evaluate and re-articulate the degree to which a tax-exempt organization may engage in commercial activities that compete with, or are essentially indistinguishable from, similar activities conducted by taxable entities? Should the rules related to government plans be changed?

Compliance in parts of the tax-exempt community is difficult to ensure where the sector or sector practices have changed, but the rules remain constant decade after decade. Changes in technology, business arrangements, and property rights present the same issue. For example, how should the political activity and Unrelated Business Income Tax (UBIT) rules apply to activities conducted on the Internet? As another example, do the existing tax rules adequately address the

myriad of economic-sharing and ownership arrangements that are possible with respect to intellectual property rights, such as patents, trade secrets, and know how?

B. Does the IRS have the flexibility to respond appropriately to compliance issues?

We believe a discussion about reform should address whether we have the proper range of tools to enforce compliance in a measured way. In several areas within our jurisdiction, our remedial tools are largely ineffective. The revocation of tax-exemption – often the only available tool – is a remedy that may work a disproportionate hardship on innocent charitable beneficiaries, retirement plan participants, or bondholders. Even where we have an intermediate sanction, it may not work as intended. For example, in the areas of political activity and excessive compensation by charities, whether existing excise taxes are effective deterrents is unclear.

As we noted in our 2005 letter, some exempt organizations are significantly different – both in structure and in behavior – than they were several decades ago. A major transformation has occurred, but the rules governing tax exemption remain largely unchanged, leaving the IRS with difficult and fact-intensive administrative challenges. We have already noted several areas of concern. The leading example may be healthcare, an evolving industry that has changed dramatically over the past 40 years. Similar changes have occurred in higher education. Other areas include the determination of relatedness and the appropriate allocation of income and expenses, both essential in correctly reviewing and calculating unrelated business taxable income. Increasing complexity in the organizational structures and relationships with other entities and the rise of sophisticated financial arrangements, offshore or otherwise, make tax administration even more difficult. Also, valuation difficulties continue to permeate TE/GE matters. Proper valuation is key in the charitable deduction, executive compensation, and UBI expense allocation areas, and plays a central role in certain improper schemes, such as bid rigging and overpricing of derivatives and other financial products. It also occurs in the Employee Stock Ownership Plan area.

Finally, September 11, 2001, showed that we need to reform some of our ways of doing business to deter terrorist acts. As we mentioned in 2005, to ensure that exempt organizations do not divert funds to improper purposes, including terrorism, a legitimate question exists as to whether we have the tools to sanction public charities that fail to monitor their grants that are comparable to tools available to private foundations. For those organizations that need not file for exempt status and do not file annual returns, such as small organizations and churches, the problem is compounded because we have little ability to monitor their operations

for diversion of assets. The recently enacted e-postcard requirement, while valuable for other reasons, does not address this issue. Moreover, as we work to improve our review of Form 990 and 1023 filings to identify signs of possible involvement with terrorist financing, we must ask whether we can do more to mandate electronic filing and reporting on the foreign operations of charities.

C. Should more be done to promote transparency, good governance and efficient delivery of public benefits?

Transparency is the linchpin of compliance within the tax-exempt sector. The passage of the PPA will do much to help. We can now work more closely with state officials, and most small organizations will have to file an electronic postcard confirming key identifying information.

Outside of the PPA, we continue to pursue transparency. One of our key transparency initiatives is the electronic filing of Forms 990 and 990PF. We have mandated electronic filing for large exempt organizations. While this will markedly improve the ability of the IRS, the states, and the public to access Form 990 data in real time, statutory restrictions limit our ability to mandate e-filing for any organization that files fewer than 250 returns. The Administration's Budget proposal echoes this concern and would lower the current 250-return minimum for mandatory electronic filing, maintaining the minimum at a high enough level to avoid imposing undue burden on taxpayers. Another key transparency initiative is the Form 990 revision that we began previewing this month.

As to governance, the headlines underscore the importance of this issue. The absence of appropriate governance in the corporate world led to scandals and abuses that marked the last decade. We remain concerned that lax governance could lead to similar problems within the tax-exempt community. An engaged, informed, and independent board of directors is a strong defense against such problems. The adoption by tax-exempt organizations of formal good governance policies, such as a policy against conflicts of interest, would also help.

Earlier, we noted the steps the tax-exempt community has taken on its own initiative to address good governance, and we salute these efforts. As we review applications for tax-exempt status, we encourage applicants to follow basic good-governance policies. We are incorporating some good-governance principles in the "cyber-assistant" that we are developing as part of our program for an electronic application for tax-exempt status. While these are helpful steps, another consideration is whether all tax-exempt organizations should be required to adopt a core set of good governance principles as a condition of obtaining or retaining tax-exempt status.

We have a similar question on organizational efficiency. Should we require tax-exempt organizations to demonstrate that they are efficiently using the resources entrusted to them and the tax-expenditure made on their behalf? That is, is the organization applying an appropriate percentage of its resources to accomplish a tax-exempt purpose? Or is it consuming its resources by incurring excessive fundraising and administrative expenses, serving private interests, or by accumulating resources beyond the reasonable needs of the organization?

D. Does the IRS have the resources it needs to do the job?

We believe we have done a credible job of recognizing the task before us and preparing to meet that challenge. We would again ask the Committee to support the Administration's 2008 budget proposal, which, among other things, calls for an increase in our enforcement budget.

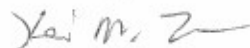
While service and enforcement remains our mission, our compliance strategy must evolve to keep pace with the changing compliance environment. We must continue to promote transparency throughout the EO, EP, and GE sectors. And we must work even harder to select and pursue cases to assure that public benefits are provided, retirement benefits are protected, and Congressional intent respected.

We will use the additional funds for TE/GE primarily for two projects. First, we will begin our study of reporting compliance by the tax-exempt sector as part of the National Research Program study. Second, we will add 109 FTE to TE/GE to strengthen both our examinations and our determinations programs. We also plan to expand the EO Compliance Unit and add staff for the EP self-correction program.

Thank you for the opportunity to highlight what we believe are our greatest compliance challenges as well as some of our accomplishments over the past two years. We look forward to working with you and the Committee on problems related to tax-exempt and governmental entities and to exploring ways to better position the IRS to deal with them.

I am also writing to Chairman Baucus. If you have any questions, please call me, or Steven T. Miller, Commissioner, Tax Exempt and Government Entities, at (202) 283-2500.

Sincerely,



Kevin M. Brown
Acting Commissioner