



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.

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.