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Report to Sen. Russell B. Long, Chairman, Joint Committee on Internal Revenue Taxation; Rep. Al Ullman, Vice Chairman; by Elmer B. Staats, Comptroller General.

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Many charitable organizations are exempt by law from paying social security and unemployment taxes. However, the exemption from social security taxes can be waived if a written request or waiver is filed with the Internal Revenue Service. If a waiver was not filed and payments were made, the organization could withdraw any payments accepted over the last 3 years. Transcripts of the employment tax payments of 1,000 randomly selected charitable organizations were examined and waiver certificate files were reviewed. Taxpayer case files, pertinent statutes, and regulations were also examined. Findings/Conclusions: In 1975 about 12,700 to 20,200 organizations which had not waived their exemption paid social security taxes ranging from \$118 to \$369 million. Because of Internal Revenue Service administrative errors, these amounts were all refundable. Legislation signed in October 1976 designed to correct the problem stated that if charitable organizations have made social security payments for three consecutive calendar quarters, they could not withdraw their money whether or not they failed to file a waiver. Pursuant to the law, the Internal Revenue Service is taking actions which will also correct the lesser problem of improper unemployment tax collections. Recommendations: The Commissioner of Internal Revenue should make sure that all charitable organizations are identified properly and that their waiver statuses are recorded properly. Present procedures should be revised so charitable organizations are identified at the time they officially receive tax-exempt status. (Author/SC)



*REPORT TO THE JOINT COMMITTEE
ON INTERNAL REVENUE TAXATION
CONGRESS OF THE UNITED STATES*

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

Action Being Taken To Prevent
Refundable Payments Of
Social Security And
Federal Unemployment Taxes
By Charitable Organizations

Internal Revenue Service

Many charitable organizations are exempt by law from paying social security and unemployment taxes. However, the exemption from social security taxes can be waived if a written request or waiver is filed with IRS. If a waiver was not filed and payments were made, the organization could withdraw any payments accepted by IRS over the last 3 years.

In 1975 about 12,700 to 20,200 organizations which had not waived their exemption paid social security taxes ranging from \$118 to \$369 million. Because of IRS administrative errors, these amounts all were refundable.

Legislation was signed in October 1976 to correct the problem. Public Law 94-563 states that if charitable organizations have made social security payments for three consecutive calendar quarters, they cannot withdraw their money whether or not they failed to file a waiver. Pursuant to the law, IRS is taking actions which will also correct the lesser problem of improper unemployment tax collections.



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman
Joint Committee on Internal Revenue
Taxation
Congress of the United States

This report, one of a series in response to your Committee's February 28, 1975, request, addresses the cause and effect of certain procedural deficiencies with respect to the Internal Revenue Service's acceptance of employment tax payments from tax-exempt charitable organizations.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Commissioner of Internal Revenue.

James B. Stiehl

Comptroller General
of the United States

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DIGEST

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ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service

COMPTROLLER GENERAL'S REPORT
TO THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION
CONGRESS OF THE
UNITED STATES

ACTION BEING TAKEN TO
PREVENT REFUNDABLE PAYMENTS
OF SOCIAL SECURITY AND
FEDERAL UNEMPLOYMENT TAXES
BY CHARITABLE ORGANIZATIONS
Internal Revenue Service

D I G E S T

By its failure to effectively monitor the filing of waiver certificates which indicate a desire for coverage, the Internal Revenue Service (IRS) exposed social security trust funds to possible withdrawals of \$118 to \$369 million of payments made by charitable organizations and their employees during 1975. Total potential withdrawals were much more because these organizations and their employees also had the right to claim refunds for those payments accepted improperly by IRS during 1973 and 1974. (See p. 5.)

Drawing in part on information provided by GAO, the Congress passed legislation to prevent such withdrawals. Public Law 94-563, signed by the President on October 19, 1976, states that if charitable organizations have made social security payments for three consecutive calendar quarters they cannot withdraw their money regardless of whether they failed to file a waiver certificate. (See p. 1.)

Charitable organizations--operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational purposes, or preventing cruelty to children or animals--need not participate in the social security program or pay Federal unemployment taxes. They can elect to participate in the social security program by filing a waiver certificate with IRS with a list containing the signatures of all concurring employees. The list is forwarded to the Social Security Administration where a permanent record is maintained. IRS is supposed to make sure that waivers are submitted by the organizations before it accepts social security payments. (See pp. 2, 3, and 4.)

But IRS' business master file does not identify accurately all the charitable organizations it contains nor does it contain accurate information on whether organizations filed waivers. On the basis of a random sample of 1,000 organizations, GAO estimates that during 1975 some 12,700 to 20,200 charitable organizations made social security payments to IRS ranging from \$118 to \$369 million without filing waiver certificates. (See pp. 4, 5, and 13.)

Before Public Law 94-563, the Internal Revenue Code permitted the refund of money paid into the social security trust funds by organizations that had not filed waiver certificates. If corrective legislation had not been passed, many employees of these organizations may have requested withdrawal when given the opportunity to do so by their employers.

Some indication of possible withdrawals was provided by the experience of IRS' Ogden Service Center. At that center, about 65 percent of the employees--about 7,000 out of 10,700--of 25 organizations which had made social security payments without having filed a waiver certificate, withdrew when given the option by their employers. (See pp. 5 and 6.)

The need for legislation would have been somewhat less had IRS administered the law adequately. However, IRS did not act to make sure that all charitable organizations were identified properly until 1976, although it had known it needed to since 1973. (See pp. 14 and 15.)

The action now begun should help IRS detect all charitable organizations previously not identified and allow it to identify those organizations making social security payments without having waiver certificates on file. (See p. 16.)

The Commissioner of Internal Revenue should make sure that this program is completed and that charitable organizations and their waiver status are recorded properly. (See p. 18.)

The Commissioner of Internal Revenue responded that IRS is continuing to bring its business master file up to date so charitable organizations and their waiver status can be identified. During the next 6 months the organizations affected by Public Law 94-563--those making social security payments without a waiver on file--will be identified and their status recorded properly. During the following 6 months all other charitable organizations will be identified and classified. (See pp. 13, 23, and 24.)

IRS also should make sure that only proper social security payments are accepted. Its actions to date have not assured this; many charitable organizations are not identified as such because IRS personnel do not have enough data. (See p. 12.)

The Commissioner of Internal Revenue should revise present procedures so charitable organizations are identified at the time they officially receive tax-exempt status. Thus, they will be identified as organizations which must file waiver certificates to make social security payments. IRS agreed to change its procedures. (See p. 18.)

Unemployment tax returns should not be filed by charitable organizations. But GAO estimates that from 1972 through 1975 about 7,200 to 13,200 organizations made Federal unemployment tax payments ranging from \$2.8 to \$7.6 million. These payments should not have been accepted by IRS. The Commissioner should order the refund, with interest, of all such tax payments which IRS accepted over the last 3 years. (See pp. 5 and 18.)

The Commissioner of Internal Revenue said that after IRS has identified all charitable organizations, those organizations which made unnecessary Federal unemployment tax payments would be notified and refund arrangements made. (See pp. 19 and 25.)

CHAPTER 1

INTRODUCTION

Charitable organizations are not required to pay social security taxes unless they express an intention to do so by filing a waiver certificate with the Internal Revenue Service (IRS). If an organization paid such taxes without filing a waiver certificate, the monies were refundable to the payer for the 3-year period preceding detection of the payment. However, Public Law 94-563, signed on October 19, 1976, established provisions which made payment of social security taxes for three consecutive calendar quarters the equivalent of a constructive filing of a waiver certificate. This effectively prevented charitable organizations which had been making social security tax payments without filing a waiver from obtaining a refund. It also negated a potentially severe drain on the social security trust funds.

Sponsors of this legislation used the findings presented in a draft of this report to support their position that corrective action was necessary. ^{1/} This report discusses conditions which pointed up the need for such legislation.

As stated, charitable organizations are not required to make social security tax payments. Neither are they required to pay Federal unemployment taxes. Our review was made to answer such questions as:

- To what extent are charitable organizations making unnecessary social security and Federal unemployment tax payments?
- Why does this problem exist?
- What is IRS doing to correct this situation?

SOCIAL SECURITY COVERAGE--AN OPTION FOR CERTAIN ORGANIZATIONS

Social security taxes are collected by IRS and deposited in various trust funds to be used by the Social Security

^{1/}The Joint Committee on Internal Revenue Taxation released the draft report on September 21, 1976, so our findings could be used during legislative consideration of H.R. 15571.

Administration to pay retirement, survivor, disability, and medical benefits. Generally, employers are required to withhold for social security purposes 5.85 percent of the first \$15,300 (\$16,500 in 1977) earned by an employee. The employer is also required to match the employee's contribution and file a tax return with IRS on a quarterly basis.

While social security coverage is mandatory for most employees, there are two notable exceptions: employees of Federal, State, and local governments and employees of certain charitable organizations. The charitable organizations are cited in 26 U.S.C. 501(c)(3) and include:

"Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."

About one-third of the approximately 750,000 active tax-exempt organizations in IRS files are classified as charitable, and they employ an estimated 4 million persons. In addition, a large group of charitable-type organizations, such as churches, are not required to apply to IRS for tax-exempt status. As a result, IRS does not have reliable data on the total number of such organizations.

Prior to 1950, charitable organizations and their employees were excluded from the social security program. However, with enactment of amendments to the Social Security Act in 1950, individuals and organizations wanting coverage were given an opportunity to obtain it on a strictly voluntary basis. Compulsory participation was not instituted due to congressional fear that such a requirement might endanger the tax-exempt status of these organizations. As a result, the law requires an organization desiring social security coverage to file a certificate with IRS waiving its exemption from social security taxation. Employees of the organization at the time the waiver certificate is filed are given the option of participating and, if they decide to do so, must sign a form accompanying the certificate which has the effect of waiving their statutory right of exemption.

The option to obtain social security coverage applies to employees on an organization's payroll during the calendar quarter the waiver certificate is filed with IRS and former employees who had been on the payroll at any time between the effective coverage date of the certificate and the date it was actually filed. Employees hired after the calendar quarter in which the certificate is filed are automatically covered and must participate in the program. Once a waiver certificate and its addendum, a list of those who wish to participate, is approved by IRS, the addendum is sent to the Social Security Administration for its files. The list of participants may be amended up to 2 years after the calendar quarter in which the waiver certificate is filed to include eligible former employees, individuals who originally chose not to elect coverage but later reversed the decision, and employees hired in the calendar quarter the certificate was filed but after the actual filing.

After a waiver certificate has been in effect for 8 years, an organization can initiate action to terminate it with or without employee concurrence. However, IRS must be given a 2-year advance notice. The resultant 10-year period--either by coincidence or design--provides employees who have been with the organization since inception of the program the 40 quarters of coverage which is the maximum amount needed by employees to obtain minimum social security retirement benefits. But, once an organization terminates its waiver certificate, the organization can never again secure coverage for its employees by filing another waiver certificate.

To provide charitable organizations maximum opportunity and incentive to participate in the social security program, provisions have also been enacted which allow an organization to obtain retroactive coverage. Under these provisions an organization filing a waiver certificate can elect to have social security coverage retroactively effective up to 5 years before the calendar quarter in which the waiver was filed. If the retroactive payments are made by the due date of the first return after the waiver certificate is filed, IRS does not assess any interest charges.

FEDERAL UNEMPLOYMENT TAXES NOT REQUIRED OF CHARITABLE ORGANIZATIONS

Federal unemployment taxes are collected by IRS and deposited in the Unemployment Trust Fund for use by the Department of Labor to pay administrative costs of State unemployment programs. Generally employers must pay 3.2 percent of the first \$4,200 of wages paid each employee during

the calendar year; but this can be reduced by a credit of up to 2.7 percent for contributions paid into State unemployment programs. Charitable organizations represent an exception to this. They are exempt from Federal unemployment taxes (26 U.S.C. 3306(c)(8)) and are liable only for contributions to the States. Where States have unemployment programs, State collections are used to pay benefits, and if employees of charitable organizations are covered, they are eligible for them.

SCOPE OF REVIEW

Our review of the employment tax payment practices of charitable organizations was made at the IRS national office, Washington, D.C.; the Chicago District Office; the Kansas City and Ogden Service Centers; and the Social Security Administration, Baltimore, Maryland. We examined transcripts of the employment tax payments of 1,000 randomly selected charitable organizations and reviewed waiver certificate files. We also examined taxpayer case files, pertinent statutes, and regulations, and we interviewed IRS district, service center, and national office personnel.

The random sample of 1,000 was drawn by IRS and included charitable organizations from States throughout the Nation. From the data collected in this sample, we made numerical and dollar projections considered to be statistically reliable--at a 95-percent confidence level--of the approximately 242,000 active charitable organizations on the exempt organization master file as of June 1975.

CHAPTER 2

MILLIONS IN REFUNDABLE EMPLOYMENT

TAX PAYMENTS MADE TO IRS

During calendar year 1975, an estimated 12,679 to 20,233 charitable organizations made from \$118.4 to \$368.8 million in social security payments to the Internal Revenue Service without having filed a waiver certificate. 1/ Also, during the period 1972-75, an estimated 7,156 to 13,174 charitable organizations paid from \$2.8 to \$7.6 million in unnecessary unemployment tax payments which has not been refunded. It is also conceivable that churches or other nonprofit organizations that are not required to apply to IRS for tax-exempt status were making unnecessary social security and Federal unemployment tax payments. If so, it is unlikely that these organizations--which are statutorily exempt from such payments--will get a refund because IRS cannot readily identify them.

Prior to the signing of Public Law 94-563, if a charitable organization made social security payments but failed to file a waiver certificate disclaiming its exempt status under applicable provisions of the Internal Revenue Code, it was potentially detrimental to both the social security trust funds and to the organization's employees. If the waiver was not filed, the organization and its employees were entitled to a full refund of any payments accepted by the Service over the prior 3-year period--even though these payments were made with the expectation of coverage. This period represented the applicable statute of limitations for refunds of overpayments under the Internal Revenue Code. Moreover, the Social Security Administration could have refused to credit the employee's account for benefit purposes during the 3-year period, thus leaving the employee only the right to obtain a refund of his payments, plus interest, during that time. Taking the refund potential into consideration, if every one of the aforementioned organizations which had made payments but had not filed a waiver certificate decided to withdraw from the system, the monetary drain could have been approximately three times the \$118 million to \$369 million paid into the fund in 1975.

1/These projections are based on a random sample described in appendix I and are stated at a 95-percent confidence level. It excludes one charitable organization--making large payments--because of the effect its inclusion would have on our dollar projections. If included, the dollar amount cited would increase from a range of \$118 million to \$369 million to \$506.6 million with a sampling error of +\$444.8 million.

It is unrealistic to assume that every employee or organization which was eligible to leave the program would have done so. However, a substantial number of withdrawals from the program was more than just a theoretical possibility--it was a real probability. This was demonstrated in a series of events which culminated with IRS' closing of a tax loophole in 1976 which not only had been costly to the Government but, more importantly, revealed the willingness of employees of charitable organizations to divest themselves of any ties to the social security program.

During the period 1973-75, a number of charitable organizations took advantage of conflicting provisions in the tax law that allowed an organization which had been making social security payments, but had not filed a waiver certificate, to withdraw money paid over a 3-year period with interest. The principal could then be reinvested into the trust funds to obtain retroactive coverage for those employees wishing to continue in the program. The law did not require repayment of the interest, and those organizations which took advantage of these provisions made windfall interest profits. Regulations requiring organizations to pay back all interest received on any amounts reinvested for employees requesting retroactive coverage closed this loophole. However, 65 percent of the employees of organizations which claimed refunds through the Ogden Service Center left the social security program.

Specifically, our review showed that 13 large charitable organizations filing returns at IRS' Ogden Service Center used these provisions to obtain refunds of about \$17 million plus interest of \$1.7 million. These organizations reinvested \$6.2 million of the social security refunds for those employees who wished to continue in the program and kept approximately \$600,000 in interest paid by IRS on this amount. The remaining \$11 million represented matched employee/employer funds which was withdrawn for individuals who chose to terminate their participation in the program. 1/ Data from these 13 organizations plus 12 other charitable organizations which filed for refunds of social security payments at this Service Center showed that 6,991 of the 10,735 employees involved in refund claims opted for termination when given the opportunity by their employers.

1/If these employees subsequently worked for an organization that was required to pay social security taxes, they would automatically be required to participate.

Termination is rarely in the best interest of the employee. Even though an individual may be fully insured for retirement, survivor, disability, and health benefits, it is generally advantageous to remain in the program because disability benefits for a worker and his family are lost after 5 years without coverage. Moreover, the amount of retirement and survivor benefits will usually be substantially less because they are based on covered earnings over a worker's lifetime. But the law provided that such an employee had the right to make such a decision when given the opportunity by his employer. More questionable is whether the employee's rights were adequately protected by the provisions that allowed a charitable organization to (1) unilaterally withdraw from the social security program if a waiver had not been filed and (2) withdraw from the program after making social security payments for 10 years. The law, however, was written primarily to protect the tax-exempt status of the organizations, not the interests of the employees relative to social security coverage. Thus, any change in emphasis would require action by the Congress.

Public Law 94-563 overcomes one aspect of this problem by preventing organizations from unilaterally withdrawing from the program if they failed to file a waiver certificate. It provides that if a charitable organization has paid social security taxes for three consecutive calendar quarters, it is deemed to have constructively filed a waiver certificate and is not entitled to a refund. Conversely, if an organization has already received a refund and has paid social security taxes for three consecutive calendar quarters, it has 180 days in which to file a waiver certificate for the period(s) of the refund and any subsequent quarters. During this period, the organization can request its employees to pay back any money refunded to them. If the organization does not file a waiver certificate in this period, on the 181st day it is liable for the repayment of both the employer's and employee's share of the social security taxes previously refunded by IRS. 1/

HOW ORGANIZATIONS COULD OBTAIN REFUNDS
AND WHAT HAPPENED IF THEY DID

In the cases we examined, individual employees--not organizations--chose to withdraw when given the opportunity.

1/The law does not require organizations to meet this provision if they either stopped payment before the end of or received a refund for services rendered prior to the earliest calendar quarter falling wholly or partly within 3 years, 3 months, and 15 days prior to enactment of law.

However, before the change in law, the possibility existed that an organization in need of ready cash could take the initiative to remove itself and its employees from the program.

An organization that had not filed a waiver was able to request a refund of social security taxes paid to IRS during the last 3 years. The organization could unilaterally withdraw from the program, giving its employees no option to participate further, or it could remain in and allow its individual employees to decide whether they want continued social security coverage. Under the latter procedure, the organization would continue its social security tax payments for those employees who opted to stay in the program.

When an organization decided to obtain a refund, two courses of action were available. The organization could reimburse the employees the full amount paid by them over the period covered by the refund claim before it submitted the claim to IRS--a highly unlikely probability because of the amount of money the charitable organization would have to pay out of its funds before being reimbursed. In this case, the organization would obtain a written receipt from the employees and certify to IRS that the employees' share of the funds being claimed had already been repaid. If the organization did not reimburse the employees before submitting a claim--the most likely procedure--it would secure the written consent of the employees to allow IRS to make the refund to the employer and state to IRS that such concurrence had been received. In either case, the employee had to furnish a written statement to his employer that he had not claimed, and would not claim, a refund or credit of excess social security tax payments on his income tax return. Also, the employer had to provide its own identification number, the name and account number of each employee, the period covered by the claim, and the amount of wages earned and reported to IRS for each employee.

This procedure apparently would not have resulted in much problem for those employees working for the employer at the time IRS made the refund. The employer should readily know where the employees live and easily be able to contact them. But what about those people who worked for the employer sometime during the past 3 years but no longer did so? How would they get their refund or be given the option to sign a waiver addendum to assure coverage for the period in which they worked for the organization?

The answer was relatively simple. Social Security Administration officials advised us that they would not have precluded a former employee who could not be located from obtaining social security coverage if the social security taxes were

paid the organization filed a waiver certificate, and no refunds were paid to such employee. But, if the employer had not filed a waiver certificate, even though he had not obtained (1) the former employee's written consent to allow IRS to make the refund to the employer or (2) the employee's statement that he or she had not already been paid a refund, the employee would not have received social security coverage. However, this would not have been consistent with a 1968 Federal District Court decision which ordered the Social Security Administration to credit the accounts of employees of a charitable organization when social security taxes had been paid but the Administration had no record of a waiver certification having been filed. 1/

An employer would not be refunded either the former employee's share of taxes paid in or the employer's share of matching social security taxes paid for an individual who could not be located. Obviously, such an employee would not be aware of his or her option to request a refund or sign a waiver addendum, but we considered this the lesser of two evils since the employee was under the assumption that he or she was participating in the social security program while working for the employer.

Could an organization request a refund for a past employee which it cannot locate? An organization willing to commit fraud could do so. As with all tax laws, the refund system depends on voluntary compliance and integrity. If an organization certified that it had prepaid its employees, the only way IRS could assure itself that this had actually occurred would be to locate the employees and ask them if they received their refunds. It is also conceivable that an employer could prepare false documentation containing the approval of past employees to withdraw from the program when, in fact, they had not given such approval.

We are not aware of any instances when employers did not pay refunds they received from IRS to all of the appropriate present and past employees. But, in this unique situation, large sums of money were involved for both the employer and employee. Current procedures were not adequate to protect the interests of employees if an unscrupulous employer decided to withdraw from the program and not make all appropriate payments.

The potential for such abuses could easily have been overcome by having IRS make refunds directly to employees and

1/Methodist Home and Hotel Corp. v. United States, 291 F. Supp. 595 (S.D. Tex. 1968).

pay the employer for only his associated share. To accomplish this, certain changes in procedure would have been required. The changes would have applied only to charitable organizations which had not filed a waiver certificate and which decided to apply for a refund of part or all of the money invested over the previous 3 years.

Specifically, under revised procedures charitable organizations which had not filed a waiver certificate would not be allowed to prepay employees for prior overpayments of social security taxes and then claim a refund from IRS. Nor would such organizations be allowed to act as intermediaries between IRS and the employee by accepting the refund and then making distribution to the affected employees. If an organization or certain of its employees decided to withdraw from the program, the organization would be required to provide IRS its identification number and the name, social security number, last known address, social security payments made over the claim period, and wages paid each individual during this period. IRS would then verify the data, check the addresses against its own files, calculate the interest due, and mail refund checks directly to the employer and to all employees for their appropriate shares of the refund. Employees would also have received a form letter explaining the reason for the refund and informing the individual that social security coverage had been lost for that period.

In the draft of this report which was provided to IRS and the Joint Committee on Internal Revenue Taxation--prior to the signing of Public Law 94-563 on October 19, 1976--we recommended that the Commissioner of Internal Revenue revise regulations so that refund payments would be calculated by IRS and made directly to employees by IRS, with the employer receiving only his proportionate share. With passage of Public Law 94-563 this recommendation became unnecessary since no refunds would be made to any organization which had paid social security taxes for three consecutive calendar quarters. Payments made by organizations for less than three consecutive calendar quarters, and therefore refundable, would be so small that a change in procedures to cover such situations would be unwarranted.

CHAPTER 3

IRS EFFORTS TO CURB ACCEPTANCE OF REFUNDABLE SOCIAL SECURITY AND FEDERAL UNEMPLOYMENT TAX PAYMENTS

According to Internal Revenue Service officials, controls to detect refundable social security payments by charitable organizations have been in effect since at least 1966 but IRS was not aware until 1973 that the system was not working properly. Even then IRS did not take prompt corrective action because the significance of the problem was not generally recognized. However, in 1976 IRS took steps to properly identify charitable organizations on the business master file and to determine the extent to which these organizations were making social security payments without a waiver certificate on file. This action should also identify organizations making unnecessary unemployment tax payments.

These procedures are needed--despite passage of Public Law 94-563--because the law still requires charitable organizations to declare their intent to participate in the social security program by filing a waiver certificate. Because of this requirement, IRS must be able to differentiate these organizations, and their waiver status, from all other entities on the business master file. If this is not done and an organization makes payments for less than three quarters, receives no refund, and does not file a waiver certificate, its employees could ultimately find themselves in a confrontation with the Social Security Administration over their eligibility for benefits for this period.

IDENTIFICATION OF CHARITABLE ORGANIZATIONS-- A SUBJECTIVE TECHNIQUE

IRS maintains a computer tape file containing tax data on all business taxpayers. This is termed the business master file and individual organizations contained therein are identified by an identification number assigned by IRS upon application by the taxpayer. Most organizations exempt from Federal taxation are also included on this file. Because charitable organizations have the option to pay social security taxes, IRS attempts to distinguish them from other businesses on this file to assure that their tax status is properly recorded.

When applying to IRS for an identification number, every organization must state its name and the nature of its business on the application form. In the case of a potentially exempt organization, IRS personnel review this data to determine whether the organization should be classified

as charitable. When the data submitted is inconclusive, the organization is requested to send additional data. If IRS personnel deem the organization to be charitable, it is given a special employment code on the business master file. In the final analysis, the success of this system of identification depends on accurate decisionmaking by the IRS representative based on his or her interpretation of the data on the application form. Further, when employer identification numbers are assigned, the organization usually has not received an official IRS determination on its tax-exempt status; even if it had, it is not required to show this information on the application for an identification number. Thus, the data available to the IRS personnel who must make the decision is somewhat limited and errors easily occur.

When a charitable organization is properly identified and recorded on the business master file, any changes to its tax-exempt status will be readily detected. For example, if the organization files a certificate with IRS waiving its exemption from social security taxes, the employment code on the business master file is changed to reflect the organization's change in tax status. Social security payments not covered by a waiver certificate or an apparent unnecessary Federal unemployment tax payment by an organization which is identified as charitable on the business master file will be detected by the computer when it records the payment in the taxpayer's account. This will precipitate a computer printout which is forwarded to the appropriate service center for followup action.

Service center personnel research available information within IRS to make sure the organization is exempt from the tax and to see if a waiver certificate is on file. If it is determined that the organization is not charitable, has filed a waiver certificate, or is otherwise improperly identified on the business master file, the payment is accepted and the employment code on the file is corrected. However, if the service center finds the payment to be in error, remedial action is taken.

- Federal unemployment tax payments are abated and the money refunded.
- Charitable organizations making refundable social security payments are informed of the requirement to file a waiver certificate if social security

coverage is desired and of the refund procedures if coverage is not elected. 1/

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The degree of IRS' success in identifying refundable employment tax payments hinges directly on the proper identification of charitable organizations on the business master file at the time they request identifying numbers. Our review showed that, when IRS properly identifies such organizations, refundable social security and unemployment tax payments are detected.

Specifically, 6 charitable organizations, or 3 percent of the 183 organizations in our sample which were making social security payments in 1975, were recorded by IRS on its business master file as not having filed a waiver certificate as of December 12, 1975. Our followup on four of these organizations which were located in areas covered by the two service centers we visited--Kansas City and Ogden--showed that in three cases the organizations had filed waiver certificates which were being processed by IRS. The fourth case was referred to the Omaha District Office, because the organization failed to respond to the service center's followup letter, and was still open on July 16, 1976. Of the 30 organizations in our sample which IRS had properly identified as charitable on the business master file and which had made unnecessary Federal unemployment tax payments, 25, or 83 percent, received refunds.

IRS did not detect refundable social security payments by 69 charitable organizations (7 percent of our sample) which had not filed a waiver certificate as of November 1, 1975, because its business master file either did not accurately identify these organizations as charitable or did not accurately reflect their waiver status. The inability to identify a charitable organization also results in IRS' acceptance of unnecessary unemployment tax payments. We found 35 organizations (3.5 percent of our sample) which were not identified as charitable on the business master file (although so identified on the exempt organization master file) making unemployment tax payments during the period 1972-75. Only nine, or 26 percent, had received refunds.

1/The organization will no longer be notified of refund procedures if payments have been made for more than three consecutive calendar quarters since payments over such a duration are considered a constructive filing of a waiver certificate under Public Law 94-563.

An IRS official surmised that the nine organizations must have learned of the error on their own rather than through IRS detection. This is plausible since IRS tries to inform charitable organizations of their exemption through annual publications which are available to the public.

NEED FOR BETTER IDENTIFICATION OF
CHARITABLE ORGANIZATIONS RECOGNIZED BY IRS

An IRS internal audit report issued in June 1973 discussed the problem of social security payments made without benefit of a waiver certificate and unnecessary Federal unemployment tax payments by charitable organizations at the Ogden Service Center. Of the 489 charitable organizations used in IRS' sample, 44, or 9 percent, were making social security payments without having a waiver certificate on record with IRS. These refundable payments were not identified as such on the business master file. The report suggested that the exempt organization master file--which apparently has more complete data on charitable organizations--be matched against the business master file to identify such organizations and to determine whether or not they had filed a waiver certificate.

In February 1973 a similar proposal had been made to the Director, Accounts and Data Processing, national office, by the Assistant Regional Commissioner, Accounts, Collection and Taxpayer Service, Western Region. However, the Director concluded that the problem was not important enough to warrant the resource commitment needed to eliminate inaccuracies in the business master file through a matching program. At this point in time, IRS had no indication that mass monetary withdrawals would occur if employees were given an option by their employer to leave the social security program.

In December 1975 the Associate Director, Accounts and Data Processing, national office, informed the Assistant Commissioner, Accounts, Collection and Taxpayer Service, that his office was reviewing an Ogden Service Center proposal to purify business master file employment and filing requirement codes. The Assistant Commissioner was informed that there was no major problem. But because of the experiences at the Ogden Service Center, a program was proposed to determine the extent to which the business master file accurately identified charitable organizations and their waiver status.

Schedules for this work were established on July 30, 1976. The program involves two phases:

--Charitable organizations on IRS exempt organization master files are being matched against the business

master file to assure that the files are compatible and that the business master file identifies every charitable organization.

--Social Security Administration tape files containing the names and identification numbers of charitable organizations which have filed waiver certificates will be compared with charitable organizations identified on the business master file. This matching will determine which organizations have not been identified on the IRS business master file as having filed waiver certificates.

This program acknowledges that the present identification system may be less than ideal and that IRS' exempt organization master file has a more complete listing of charitable organizations than are identified in the business master file. The exempt organization master file lists organizations which have been formally granted exempt status and because of this more accurately identifies charitable organizations than does the business master file which (1) is based upon limited information in the organizations' applications for identification numbers and (2) is the best guess of an IRS employee and not the final decision of IRS on the organization's exempt status. Social Security Administration data is being used to identify charitable organizations which have waived the social security exemption because IRS' business master file records are incomplete prior to 1971.

- - - -

The employment codes on the business master file are not completely accurate. For 761 to 3,595 charitable organizations identified on IRS' business master file as having filed a waiver certificate, no record of such filing was available at the Social Security Administration, which maintains a permanent microfilm record of the names of concurring employees. Conversely, for an estimated 1,625 to 5,151 situations, IRS had not recorded that charitable organizations had filed a waiver certificate when, according to Social Security Administration records, they had.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

As noted in chapter 2, 12,679 to 20,233 charitable organizations were making social security payments without a waiver certificate on file and had not been identified as such on the Internal Revenue Service business master file. This situation was caused by an IRS procedure which requires employees to make a judgmental decision, on the basis of limited data, as to whether an organization is charitable and therefore exempt from employment taxes. If a charitable organization is not properly identified at the time it requests an identification number, the fact that a subsequent payment may be refundable will not be recognized because there is nothing to distinguish the organization from business enterprises which are liable for such taxes. This also affects the detection of unnecessary unemployment tax payments since the organization must be identified as charitable before it can receive a refund of such payments.

Public Law 94-563 takes care of problems created by charitable organizations that have made social security payments without having filed a waiver. But it is still desirable that IRS improve its procedures so it can be assured that charitable organizations follow the proper procedures when making social security payments. The law still requires that a waiver be filed by charitable organizations if they want to make social security payments. If IRS procedures are adequate, it will not accept such payments if a waiver certificate is not filed. This will preclude any possible misunderstandings between the Government and a charitable organization which did not file the waiver, still made social security payments, and ultimately became subject to the provisions of Public Law 94-563. It will also preclude the possibility of a future conflict between an organization's employees and the Social Security Administration over the payment of benefits.

IRS is taking action to assure the proper identification of charitable organizations which are already on the business master file by comparing names on the exempt organization master file and Social Security Administration records to the business master file. This approach should detect all charitable organizations which are presently not identified as such on the business master file and do not have a waiver certificate on file.

However, the action taken by IRS to date has not addressed the basic cause of inaccurate identification of charitable organizations on the business master file--

judgmental decisions. We believe that the organizations should be identified as charitable on the business master file at the time they officially receive their exempt status from IRS rather than when they apply for an identification number. This would permit the identification to be based on fact rather than judgment. Although an organization generally has 15 months from the time it is created to apply for tax-exempt status, 1/ we do not believe this will cause many refundable payments. It is possible that many organizations will apply for exemption immediately; the ones that do not, since they are just beginning operations, are likely to have small payrolls, if they have any payroll at all. If payments are made, they can be detected and refunded as soon as the organizations' exempt status is determined.

Prior to the law change, if an employee chose to withdraw voluntarily from the social security program--when given the opportunity to do so by the employer--it was his or her decision alone. However, if an organization unilaterally withdrew it would have had a serious effect on the organization's personnel. While some employees may have worked long enough before leaving the program to qualify for benefits, termination of coverage was rarely in the best interests of the younger employees who had not had the opportunity to gain an adequate level of protection. However, we did not believe that the Government had any choice but to notify appropriate organizations of their options under the previous law--one of which was the right to refund. It was because of administrative inadequacies in IRS that the problem went undetected.

Correctly identifying charitable organizations on the business master file will resolve the difficulties now encountered in detecting unnecessary unemployment tax payments. Once a charitable organization is identified as such, any subsequent payments which are unnecessary will result in immediate abatement and refund.

RECOMMENDATIONS

To assure that IRS properly identifies charitable organizations and their employment tax filing requirements we recommend that the Commissioner of IRS:

1/If an organization applies for exempt status within 15 months, the exemption will be recognized retroactively to the date it was organized. Otherwise, exemption will be recognized only for the period after the application is received by IRS.

- Continue the matching programs to assure that charitable organizations are properly identified on the business master file and that their waiver status is properly recorded.
- Revise IRS procedures so that a charitable organization is identified on the business master file at the time the organization officially receives its exempt status rather than at the time it applies for an employer identification number.

It follows that IRS should rebate to appropriate organizations, with interest, unnecessary unemployment tax payments for a period up to 3 years in which such taxes were paid, with such period to end with the date of detection by IRS of the improper payments.

AGENCY COMMENTS AND OUR EVALUATION

The Commissioner of Internal Revenue stated in a November 13, 1976, letter that action will be taken on each of our recommendations. (See app. II.) Specifically he agreed to:

- Continue IRS efforts to purify the business master file so that charitable organizations and their waiver status can be identified. During the next 6 months the organizations affected by Public Law 94-563--those organizations making social security payments without a waiver certificate on file--will be identified and their status properly recorded. During the following 6 months all other charitable organizations will be identified and properly classified.
- Implement two procedures early in 1977 which will identify charitable organizations on the business master file at the time they receive tax-exempt status. Upon receipt of a charitable organization's application for tax exemption, IRS will notify the organization of the waiver requirements applicable to social security taxes should its request for exempt status be granted. When the tax-exempt status is officially approved or denied, IRS will again advise the organization of its social security and Federal unemployment tax responsibilities. Information regarding the organization's filing status will be made part of the business master file at the time the final determination of an organization's tax-exempt status is made.

--Notify and make refund arrangements as appropriate to all charitable organizations which have made unnecessary Federal unemployment tax payments for the preceding 3-year period.

We believe that if IRS takes the above actions the problems cited in this report will be resolved.

The Department of Health, Education, and Welfare had no substantive comments on this report. (See app. III.)

STATISTICAL PROJECTIONS OFREFUNDABLE FEDERAL EMPLOYMENT TAX PAYMENTS

To obtain statistically reliable data on the extent to which charitable organizations were making refundable social security and Federal unemployment tax payments on a national basis, IRS randomly selected 1,000 of the approximately 242,000 active organizations on its exempt organization master file as of June 1975. ^{1/} Transaction data on these organizations was then drawn from the business master file to determine (1) if they were properly identified as charitable and (2) if refundable employment taxes were being paid by them.

Sample results showed that 814, or 81 percent, were making no employment tax payments in calendar year 1975. Of the remainder, 108, or 11 percent, had filed a waiver certificate; 6, or six-tenths of 1 percent, were making social security payments without a waiver certificate on file but were identified as charitable on the IRS business master file; 59, or 6 percent, were not identified on the IRS business master file as being charitable organizations and were making payments without having filed the necessary waiver certificate; and 10 organizations were identified by IRS as having filed a waiver certificate, but no record of such filing was available at the Social Security Administration. The remaining three were classified as State or local government entities on the business master file.

Included in the 108 organizations which had a waiver certificate were 14 organizations which were not identified as charitable on IRS' business master file and were not identified as having filed a waiver certificate when in fact, documentation corroborating that one had been filed is on record with the Social Security Administration.

With respect to unnecessary Federal unemployment tax payments, we found that 31 charitable organizations which were making social security payments had also made unemployment tax payments at some time during the period 1972 through 1975, for which no refund had been received.

^{1/}Our sample was based on June 1975 numerical counts since no report on the number of charitable organizations was prepared by IRS from July through December 1975. However, in January 1976 there were 248,000 such organizations on record, and by July 1976 the number had increased to 257,000.

APPENDIX I

APPENDIX I

On the basis of this data, we have made the following statistical projections at a 95-percent confidence level.

	<u>Number of payers</u>		<u>Employment tax payments</u>	
	<u>Mean</u>	<u>Sampling error</u>	<u>Mean</u>	<u>Sampling error</u>
			<u>(millions)</u>	
<u>Refundable social security tax payments</u>				
Charitable organizations making social security payments--no waiver certificate or associated documentation on record with IRS or the Social Security Administration	14,278	+3,534	\$151.6	+\$66.9
Charitable organizations recorded by IRS as having filed a waiver certificate but with no record of such filing with the Social Security Administration (note a)	2,178	+1,417	92.0	+89.3
Combined total of charitable organizations which have not filed a waiver certificate but are making social security payments (Note: means are addible whereas sampling errors are not.)	16,456	+3,777	243.6	+125.2
Charitable organizations which, according to social security records, had filed waivers but were not identified as having filed on the IRS business master file	3,388	+1,763	No estimate needed because waiver information was on file with Social Security Administration	
<u>Unnecessary unemployment tax payments</u>				
Charitable organizations which made unnecessary unemployment tax payments and had either not received a refund or had received only a partial refund	10,165	+3,009	5.2	+2.4

a/Excludes one charitable organization making large payments which, if incorporated, would have increased the numerical mean to 2,420 + 1,493 and the dollar mean to \$355 million + \$441.6 million.

Internal Revenue Service**Department of the Treasury**

Commissioner

Washington, DC 20224

NOV 13 1976

▷ Mr. Victor L. Lowe
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

. Dear Mr. Lowe:

We have reviewed your draft report to the Joint Committee on Internal Revenue Taxation entitled, "Millions in Social Security and Federal Unemployment Tax Payments by Charitable Organizations Subject to Refund".

The report suggests that we develop procedures to inform organizations when they are not liable for FICA/FUTA taxes. We agree that equitable administration of the tax laws requires notification to taxpayers when they pay taxes for which they are not liable. We strive to accomplish that. For example, a computer notice is generated to service center personnel when a Form 941/940 return posts to an account and there is an indication that the taxpayer organization is not liable for FICA/FUTA taxes. If service center research fails to resolve the issue, a letter is sent to the taxpayer requesting that the organization either file a Form SS-15 (to waive the exemption from the tax) or submit a claim for refund.

Our comments follow regarding specific recommendations contained in the report.

Recommendation No. 1 - Continue the current matching programs to assure that charitable organizations are properly identified on the business master file and that their waiver status is properly recorded.

We are continuing Business Master File (BMF) purification efforts to identify IRC 501(c)(3) organizations. This is accomplished by matching the BMF with the Exempt Organization Master File (EOMF) and the SS-15a tape file from the Social Security Administration (SSA). The matching of files will identify entities carried on the BMF as exempt organizations which are not listed on the EOMF. It will also identify organizations that have filed waivers of exemption but are

Mr. Victor L. Lowe
Director, General Government Division

not listed or are incorrectly carried on the EMF. In addition, we will identify the exempt organizations that have filed Forms 941 (with FICA tax amounts) but for which there are no records of a Form SS-15 waiver of exemption.

The recent passage of PL 94-563 (Ottinger Bill) has impacted our clean-up to the extent that our efforts will be to first purify those organizations affected by the law. This effort will be completed within the next 6 months. We will maintain a record of these organizations for future deletion from our clean-up files. The residue will then be purified over the following 6 months to accomplish the complete clean-up effort.

Recommendation No. 2 - Notify charitable organizations identified as having made unnecessary social security tax payments of the requirement to file a waiver if they want social security coverage, and of their right to obtain refunds for such payments made during the last three years.

This recommendation has been obsoleted by PL 94-563. If a charitable organization has paid FICA taxes for three consecutive quarters, they have been deemed to have constructively filed an SS-15 and are no longer entitled to a refund.

In addition, 501(c)(3) organizations who have already received a refund and have paid FICA taxes for three consecutive quarters have 180 days to file an SS-15 for the period(s) of the refund and any subsequent quarters. During these 180 days the employers have the right to ask the employees to pay their share of the FICA tax. If the employer does not submit an SS-15, then on the 181st day, the employer is liable for his share of FICA as well as the employee's share of the FICA.

We are now in the process of identifying those organizations who have received a refund and will be mailing notices to them by the first of the year. The notice will advise them of the requirements of the law and what is necessary to resolve their account. Additionally over the next 6 months, we will also identify those organizations who have not received a refund and notify them of their responsibilities as required by PL 94-563.

[See GAO note 1, p. 26.]

Mr. Victor L. Lowe
Director, General Government Division

Recommendation No. 3 - Rebate to appropriate organizations, with interest, all unnecessary unemployment tax (FUTA) payments for a period up to three years, with such period to end with the date of detection by IRS of the improper payments.

Our present procedures verify the filing of the FUTA returns against our master file records for liability to file. In those instances where the organization improperly files because of exempt status we so notify the organization and arrange for appropriate refund including any accrued interest.

Upon completion of our clean-up action of the master file we will notify any such remaining exempt organizations and arrange for refunds as appropriate.

Recommendation No. 4 - Revise IRS procedures so that the identification of charitable organizations on the business master file is made at the time the organization officially receives its exempt status rather than at the time an organization applies for an employer identification number.

In addition to our regular procedures and the purification efforts described above, we will implement two additional precautionary procedures beginning early in 1977. Upon receipt of an application for exemption from tax, we will notify the sender of the waiver requirements applicable to FICA taxes should an exemption be granted. When the application is approved or denied, we will again advise the organization of its FICA and FUTA responsibilities (depending upon whether it is or is not exempt). Information regarding the organization's filing status will be made part of the business master file at the same time.

Recommendation No. 5 - IRS should be charged with the responsibility of making refunds to employers and employees of their respective shares of taxes paid. It is also recommended that IRS match these employees against Service records.

The general rule with respect to refunds (IRC 6402) requires that they be made to the person (in this case, the IRC 501(c)(3) organization) making the overpayment. Thus, legislative action would be required to revise Section 6402. The pertinent regulations (31.6402(a)-2(a)) elaborate on the general rule and require the organization to obtain from all affected employees appropriate statements regarding the overpayment being claimed by the organization.

[See GAO note 1, p. 26.]

Mr. Victor L. Lowe
Director, General Government Division

It is only after these actions are taken that an individual claim for refund may be filed when the employee is not given his or her share of the FICA tax paid (see Regulations 31.6402(a)-2(b)). The individual claims must be accompanied by supporting statements. Again, substantial changes would be required in the regulations to effect this recommendation.

Aside from the legislative and regulatory changes required, we believe that implementation of this recommendation would significantly add to the administrative burden. For example, we would have to require for each individual the name, address, SSN, identification of amount due from the employer, and certification from each employee that the amount had been received and would not be claimed as a credit on an individual income tax return. After this information was received, separate certifications of overpayments would have to be prepared, separate allowable interest computations made, and finally, separate refund checks issued (with related postage and handling costs).

For these reasons, we believe the existing rules governing refunds are adequate. However, if an employee believes an exempt organization has received a refund of FICA taxes but has not returned the employee's share, he or she may refer the matter to the Service. We will check our records, contact the organization (if necessary) and advise the employee of our findings.

[See GAO note 2, p. 26.]

With kind regards,

Sincerely,

A handwritten signature in dark ink, appearing to read "Duke A. ...". The signature is written in a cursive style.

Commissioner

- GAO note 1: Recommendations 2 and 5 were negated with the signing of Public Law 94-563 and were deleted from the body of the final report. They have been retained in this appendix as a matter of public record.
- GAO note 2: IKS comment deleted because it was not directly pertinent to our findings, conclusions, or recommendations.



DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20201

NOV 10 1976

Mr. Gregory J. Ahart
Director, Human Resources Division
United States General Accounting
Office
Washington, D.C. 20548

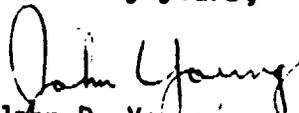
Dear Mr. Ahart:

The Secretary asked that I respond to your request for our comments on your draft report, "Millions in Social Security and Federal Unemployment Tax Payments by Charitable Organizations Subject to Refund."

Responsible officials have reviewed this report and discussed a number of changes with your staff to clarify or correct various statements. Since your staff agreed to incorporate these changes in the final version of the report, we have no further comments.

We appreciate the opportunity to comment on this draft report before its publication.

Sincerely yours,


John D. Young
Assistant Secretary, Comptroller

PRINCIPAL DEPARTMENT OF THE TREASURYOFFICIALS RESPONSIBLEFOR ADMINISTERING ACTIVITIESDISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF THE TREASURY:		
William E. Simon	Apr. 1974	Present
George P. Shultz	June 1972	Apr. 1974
COMMISSIONER OF INTERNAL REVENUE:		
Donald C. Alexander	May 1973	Present
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
ASSISTANT COMMISSIONER (ACCOUNTS, COLLECTION AND TAXPAYER SERVICE):		
James I. Owens	July 1976	Present
Robert H. Terry	Aug. 1973	July 1976
Dean J. Barron	July 1971	Aug. 1973