

DEPARTMENT OF EDUCATION

34 CFR Parts 75, 76, and 81

RIN 1880-AA56

General Education Provisions Act—
Enforcement: Equitable Offsets

AGENCY: Department of Education.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Secretary proposes to amend Part 81 of Title 34 of the Code of Federal Regulations, containing regulations regarding enforcement under the General Education Provisions Act (GEPA). The amendment would include regulations clarifying the circumstances under which equitable offset is taken into account in determining harm to an identifiable Federal interest under section 453(a)(1) of the GEPA. The proposed regulations would enhance grantee flexibility and reduce burden by contributing to the early resolution of audit disputes and the avoidance of protracted litigation.

The proposed regulations in this notice do not apply to programs under the Higher Education Act of 1965 or the Impact Aid statutes (Pub. L. 81-874, Pub. L. 81-815, and Title VIII of the Elementary and Secondary Education Act of 1965 (ESEA) as amended by Pub. L. 103-382).

DATES: Comments must be received on or before August 4, 1995.

ADDRESSEES: All comments concerning these proposed regulations should be addressed to Ted Sky, Senior Counsel, U.S. Department of Education, 600 Independence Avenue SW., Washington, DC 20202-2121.

FOR FURTHER INFORMATION CONTACT: Ted Sky. Telephone: (202) 401-6000. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1-800-877-8339 between 8 a.m. and 8 p.m., Eastern time, Monday through Friday.

SUPPLEMENTARY INFORMATION:**I. Recognition of Offset Costs**

Section 453(a)(1) of the GEPA, 20 U.S.C. 1234b(a)(1), provides that a recipient determined to have made an unallowable expenditure, or to have otherwise failed to discharge its responsibility to account properly for funds, shall be required to return funds in an amount that is proportionate to the extent of the harm its violation caused to an identifiable Federal interest associated with the program under which the recipient received the award.

The proposed regulations (in § 81.32 (c) and (d)) would state the

circumstances under which the Secretary or an authorized Department official, in determining the extent of harm to an identifiable Federal interest caused by a violation, may take into account costs that the recipient could have charged to the Federal grant or cooperative agreement in question but in fact did not. These costs are "offset costs." Issues pertaining to those so-called offset costs have arisen in connection with administrative litigation before the Office of Administrative Law Judges (OALJ).

The Secretary believes that regulatory guidance regarding these issues would be helpful to the field, would enhance grantee flexibility, would increase the possibilities for early resolution of disputes, and would reduce the need for protracted litigation arising from expenditure disallowance and other audit claims under Department programs, while maintaining proper accountability. The Secretary solicits additional public comments and suggestions as to how this balance may best be achieved.

Equitable offset is not a new concept initially proposed in these regulations. The concept has evolved over time, through case-by-case adjudication, both in decisions of the Secretary and the courts, arising from disputes under programs administered by the Secretary. The proposed regulations are consistent with this precedent.

If finally adopted, it is anticipated that the provisions of proposed § 81.32 (c) and (d) would apply to existing cases before the OALJ, but without regard to § 81.32(c)(5) (relating to early identification of offset costs).

The proposed regulations are based upon the conclusion that the recognition of offset costs, under appropriate circumstances and subject to appropriate limitations, is consistent with section 453(a)(1) of the GEPA. The proposed regulations would provide for the recognition of offset costs under the following circumstances:

- The offset costs must meet all the requirements of the grant or cooperative agreement, including any applicable recordkeeping requirements;
- The recipient must demonstrate that the offset costs could have been charged to the grant or cooperative agreement during the same Federal fiscal year as the original violation;
- The charging of offset costs to the grant or cooperative agreement must not result in other violations of applicable requirements, such as maintenance of effort, matching or non-supplanting requirements;

- The practices and policies that resulted in the original violation must have been corrected and must not be likely to recur;
- The original violation must not have been intentional or willful.

Under the proposed rule, the Secretary would have the burden of initially establishing a prima facie case that a violation was willful or intentional so as to preclude an offset. It is not anticipated that these cases will be frequent. However, on occasion, circumstances may suggest the existence of this situation. For example, where a recipient continues to incur costs or carry out program activities that the Department has advised the recipient are beyond the purview of the grant, the issue of whether a violation was willful or intentional might be presented.

Federal financial assistance under a program subject to a statutory non-supplanting requirement must supplement and be additional to any State assistance for the project in question. A recipient of assistance under this type of program generally must use all Federal funds awarded for project purposes, irrespective of the use of State or local funds.¹ To permit a recipient to offset disallowed costs under the federally funded project with State or local-funded costs would normally be contrary to the non-supplanting requirement and would result in the diminution of the project to the detriment of the beneficiaries to be served and contrary to the purposes of the program.

In the case of a program with a non-supplanting requirement, therefore, a recipient has a particularly heavy burden in showing that use of State or local funds as offset costs is consistent with the requirement. The Department has identified a limited number of situations in which this burden could be met.

(1) *State administrative expenses.* Where a disallowance involves State administrative expenditures, and the recipient proposes to offset other State administrative expenditures that could have been charged to the grant but were not, the non-supplanting requirement should not present a bar to the offset. Presumably the State administrative expenditures would not have been made in the absence of the program.

¹ One exception to this principle is the non-supplanting requirement in section 614 of the Individuals with Disabilities Education Act which requires a local educational agency to supplement what it has expended on special education in the past. This approach is more similar to a maintenance of effort requirement than it is to the non-supplanting requirements in other statutes. (See 34 CFR 300.230.)

(2) *Other cases where the offset expenditures would not have been incurred in the absence of the Federal program.* In exceptional circumstances a recipient may be able to establish that the State or local expenditures sought to be used as an offset would not have been incurred in the absence of the program and thus do not give rise to a question under the non-supplanting requirement. For example, the recipient might be able to show that a particular cost was so related to the Federal grant that it would not have been incurred in the absence of that grant.

(3) *Statutorily excluded funds.* Under the statute governing the program in question, there may be categories of expenditures that may be specifically excluded from the reach of the non-supplanting requirement. For example, under section 1120A(b)(1)(B) of the Title I (ESEA) statute, 20 U.S.C. 6322(b)(1)(B), certain State and local funds may be excluded for purposes of determining compliance with the Title I non-supplanting requirement. These funds would be available for offset purposes, despite the non-supplanting requirement, assuming that other requirements of the proposed rule would be met.

In proposing these rules, the Secretary does not intend to encourage recipients to incur unallowable costs or engage in activities that will give rise to accountability issues. On the contrary, the Secretary believes that the proposed regulations will enable the Department to more readily focus time on those areas where the most serious accountability problems occur.

II. Early Identification of Issue

The proposed regulations provide that, if the recipient is apprised of the violation in a draft audit report or other written communication issued prior to the final audit report, the offset costs must be presented to the auditor within a 60-day period. This provision is designed to ensure that offset claims are raised sufficiently early in the audit process to permit the auditor to verify the claimed offset costs and make recommendations regarding those costs, within the overall context of the auditor's responsibility, prior to the issuance of the final audit report. Even if an oral rather than a written communication regarding the violation is made during the audit process, recipients are encouraged to present offset cost claims to the auditor so that these matters may be taken into account in the audit report in an orderly fashion.

If the recipient is first apprised of the violation in the final audit report, the offset costs must, under the proposed

regulations, be presented to the authorized Department official within a 60-day period after the issuance of the final audit report. If the recipient is first apprised of the violation after the issuance of the final audit report, then the 60-day period runs from this first written notice. In either event, offset cost "claims" must be presented in the form of facts verified by an independent auditor.

Early notice of these issues is intended to encourage and contribute to early resolution of disallowance cases (through alternative means of dispute resolution or otherwise) and reduction of litigation expense for recipients as well as for the Department.

The early notice provision in § 81.32(c)(5) is also designed to avoid introduction of offset cost issues late in the audit appeal process. The introduction of offset cost issues at the litigation stage in prior and currently pending cases before the OALJ has caused administrative problems, requiring more audit work long after the original audit is over, thus delaying resolution of these cases. However, as indicated above, these advance notice requirements would not apply to pending cases.

In addition to adding the proposed provisions to 34 CFR Part 81, a cross-reference is proposed to be added to Subpart G of 34 CFR Part 75 and Subpart H of 34 CFR Part 76.

Executive Order 12866

These proposed regulations have been reviewed in accordance with Executive Order 12866. Under the terms of the order the Secretary has assessed the potential costs and benefits of this regulatory action.

The potential costs associated with the proposed regulations are those resulting from statutory requirements and those determined by the Secretary to be necessary for administering this program effectively and efficiently as discussed in those sections of the preamble that relate to specific sections of the regulations. Burdens specifically associated with information collection requirements, if any, are identified and explained elsewhere in this preamble.

Regulatory Flexibility Act Certification

The Secretary certifies that these proposed regulations would not have a significant economic impact on a substantial number of small entities. States and State agencies are not considered to be small entities under the Regulatory Flexibility Act. Small local educational agencies could be affected by these regulations. However, these proposed regulations are intended

to implement statutory provisions and are designed to provide greater flexibility and reduce litigation in the administration of the programs in question. They should not have a significant economic impact on any small entities affected.

Paperwork Reduction Act of 1980

These proposed regulations have been examined under the Paperwork Reduction Act of 1980 and have been found to contain no information collection requirements.

Invitation to Comment

Interested persons are invited to submit comments and recommendations regarding these proposed regulations.

All comments submitted in response to these proposed regulations will be available for public inspection, during and after the comment period, in Room 5400, 600 Independence Avenue SW., Washington, DC, between the hours of 8:30 a.m. and 4:00 p.m., Monday through Friday of each week except Federal holidays.

To assist the Department in complying with the specific requirements of the Executive Order and the Paperwork Reduction Act of 1980 and their overall requirement of reducing regulatory burden, the Secretary invites comment on whether there may be further opportunities to reduce any regulatory burdens found in these proposed regulations.

List of Subjects

34 CFR Part 75

Education Department, Grant programs—education, Grant administration, Incorporation by reference.

34 CFR Part 76

Education Department, Grant programs—education, Grant administration, Intergovernmental relations, State-administered programs.

34 CFR Part 81

Enforcement, General Education Provisions Act, Offset costs.

Dated: March 16, 1995.

Richard W. Riley,

Secretary of Education.

(Catalog of Federal Domestic Assistance Number does not apply)

The Secretary proposes to amend Parts 75, 76, and 81 of Title 34 of the Code of Federal Regulations as follows:

PART 81—GENERAL EDUCATION PROVISIONS ACT—ENFORCEMENT

1. The authority citation for Part 81 continues to read as follows:

Authority: 20 U.S.C. 1221e-3, 1234-1234i, 3474, unless otherwise noted.

2. Section 81.32 is amended by revising the heading and by adding new paragraphs (c), (d) and (e) to read as follows:

§ 81.32 Proportionality; equitable offset.

* * * * *

(c) In determining the extent to which a violation that is not intentional or willful caused harm to an identifiable Federal interest, the Secretary or an authorized Department official, as appropriate, may take into account costs that could have been charged to the Federal grant or cooperative agreement but in fact were not (offset costs), only if the recipient has demonstrated that—

(1) The offset costs would have met all the requirements of the grant or cooperative agreement, including any applicable recordkeeping requirements;

(2) The offset costs could have been charged to the grant or cooperative agreement during the same Federal fiscal year as the original violation;

(3) The charging of offset costs to the grant or cooperative agreement would not result in other violations of applicable requirements, such as maintenance of effort, matching, or non-supplanting;

(4) The practices and policies that resulted in the original violation have been corrected and are not likely to recur; and

(5) (i) If the recipient was apprised of the violation in a draft audit report or other written communication from the cognizant auditor that was issued prior to the final audit report—

(A) The offset costs were presented to the auditor within 60 days after the issuance of the draft audit report or other written communication; and

(B) The auditor verified that the costs met the conditions in paragraph (c) of this section;

(ii) If the recipient was first apprised in writing of the violation in the final audit report or the costs were timely presented to but not verified by the auditor, the offset costs were presented to the authorized Department official, in the form of facts demonstrating compliance with this paragraph and verified by an independent auditor, within 60 days of the issuance of the final audit report; or

(iii) If the recipient was first apprised of the violation in writing after the issuance of the final audit report, the offset costs were presented to the authorized Department official, in the form of facts demonstrating compliance with this paragraph and verified by an independent auditor, within 60 days of the first written notice of the violation;

(d) In making a verification under paragraph (c)(5) of this section, the independent auditor may be the auditor that initially conducted the audit and may base the verification on the original audit as long as the offset costs were examined as part of that audit and were not disallowed.

(e) For the purposes of § 81.32(c)(1), in the case of a discretionary program under which awards are made by the Secretary, “grant” or “cooperative agreement” means the grant or cooperative agreement awarded to the recipient.

3. Section 81.40 is amended by redesignating paragraphs (d) and (e) as (e) and (f), respectively, and by adding a new paragraph (d) to read as follows:

§ 81.40 Burden of proof.

* * * * *

(d) An offset cost should be taken into account in accordance with § 81.32 (c) and (d), except that the Secretary has the burden of initially establishing a prima facie case that a violation was willful or intentional so as to preclude an offset.

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4. The Appendix to Part 81 is amended by adding new Examples 14, 15, 16, 17, and 18 to read as follows:

Appendix to Part 81—Illustrations of Proportionality

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Equitable Offset Allowed

(14) Administrative costs of a State educational agency (SEA) are disallowed by the auditor under a program subject to a non-supplanting requirement because the SEA did not maintain adequate time distribution records for employees charged to the grant. The SEA demonstrates that other employees, whose salaries are paid for out of State funds, performed administrative functions allowable under the Federal grant during the relevant fiscal period. Adequate records, including any necessary time distribution records, were maintained for these employees. Charging these costs to the grant would not violate other requirements. The non-supplanting requirement does not bar the offset because it is presumed that the State funds would not have been spent in the absence of the program. The SEA presents a corrective action plan to ensure that future recordkeeping violations will not arise. There is no evidence that the SEA intentionally failed to keep the required records. The Secretary recognizes the offset costs under the principles stated in § 81.32 (c) and (d) and reduces the required

recovery by the amount of the offset costs.

Equitable Offset Not Allowed—Violation of Program Requirement

(15) Under the Title I program, a LEA provides remedial reading services to children residing in ineligible attendance areas. The LEA proposes to offset the disallowed costs with funds expended for eligible Title I children under a State compensatory education program similar to Title I but not excluded from the operation of the non-supplanting requirement in Title I under section 1120A(b) of the Title I statute. Even though the costs of the State program would otherwise have been allowable under Title I, an offset is not allowed because the use of the State funds would violate the non-supplanting requirement.

Equitable Offset Not Allowed

(16) Under a Federal vocational education program with a maintenance of effort requirement, the SEA fails to maintain required time distribution records for employees working on more than one program. The State proposes to use as offset costs the salaries of other employees, charged to State funds, who worked exclusively on the Federal program. If all those costs are not included as State expenditures, however, the SEA would not have sufficient State expenditures to satisfy the maintenance of effort requirement under the Federal program. An offset is not allowed, because the charging of the offset costs to the Federal grant would have resulted in another violation of an applicable program requirement (maintenance of effort).

Equitable Offset Partially Allowed

(17) In this example the State needs some but not all of its proposed offset costs to satisfy the matching requirement applicable to the program. The State may use the remaining offset costs (i.e., those not needed to meet the matching requirement) to reduce its liability. For example, under a program with a 1:1 matching requirement (\$1 of State funds must be spent for every \$1 of Federal funds), the State has spent \$100,000 of Federal funds and \$100,000 of State funds. However, the auditors have determined that \$20,000 of the Federal funds were not supported by required time distribution records. The State could not fully extinguish its liability through an offset, because the State would not meet the matching requirement. (If \$20,000 of State funds were used as an offset, the State would have left only \$80,000 of allowable matching costs which would not

support Federal expenditures of \$100,000 under the 1:1 match requirement.)

Nevertheless, the State liability could be partially reduced by an offset. The amount of the partial offset is computed by combining the *allowable* Federal and State expenditures (\$80,000 Federal plus \$100,000 State = \$180,000), and computing the allowable Federal expenditure that would be supported by the required State match. The allowable Federal expenditure would be \$90,000 (\$180,000×50%) which would be supported under the 1:1 match by \$90,000 of State expenditures. Rather than repaying the full amount of the Federal disallowance (\$20,000), the State would be required to repay \$10,000 (the difference between the amount actually charged to the Federal grant (\$100,000) and the allowable Federal expenditure considering the allowable State matching costs

(\$90,000)). The State therefore is credited with a partial offset of \$10,000.

*Equitable Offset Not Allowed—
Intentional or Willful Violation*

(18) Under the Title I program, the State seeks written advice from the Secretary regarding the allowability of certain expenditures. The Secretary informs the State that the expenditures are unallowable under the Title I statute. Nevertheless, the State proceeds to spend its Title I funds in this manner. An offset is not allowed, even though other expenditures could have been properly charged to the Title I program, because the Secretary determines that the State's violation is intentional and willful.

**PART 75—DIRECT GRANT
PROGRAMS**

5. The authority citation for Part 75 continues to read as follows:

Authority: 20 U.S.C. 1221e-3 and 3474, unless otherwise noted.

6. Part 75 is amended by adding the following cross-reference to the existing cross-reference in Subpart G immediately following the heading: "See 34 CFR 81.32, Proportionality; equitable offset."

**PART 76—STATE-ADMINISTERED
PROGRAMS**

7. The authority citation for Part 76 continues to read as follows:

Authority: 20 U.S.C. 1221e-3, 3474, and 6511(a), unless otherwise noted.

8. Part 76 is amended by adding the following cross-reference immediately following the heading for Subpart H: "Cross-Reference. See 34 CFR 81.32, Proportionality; equitable offset."

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