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IRS Commissioner Testimony: Charitable Giving Problems and Best Practices

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Written Statement of Mark W. Everson, Commissioner of Internal Revenue, before the Committee on Finance, U.S. Senate: Hearing on Charitable Giving Problems and Best Practices

Thank you, Mr. Chairman, Senator Baucus, and distinguished members of this Committee, for the opportunity to explain the role of the Internal Revenue Service (IRS) in a number of issues relating to tax-exempt organizations. We can be proud of the vast majority of exempt organizations that are fully and effectively carrying out their important missions. I must emphasize that my remarks, which by necessity will focus on problems we have observed, should not be interpreted as an indictment of the tax-exempt sector. The vast majority of tax-exempt entities carry out their valuable role in full compliance with the letter and spirit of the laws.

As you know the Administration strongly supports efforts to encourage and support donations to our Nation's charities. The Administration's FY 2005 Budget includes a number of tax relief proposals designed to stimulate charitable giving. However, I share your concern that some entities are using their status to achieve ends that Congress clearly did not intend when it conferred the privilege of tax-exemption.

Before I begin, let me give you a few statistics on the population I am here to discuss. When the subject of tax-exempt organizations arises, we commonly think of charities. This is understandable, given the prominent and valuable role of charitable organizations. But the tax-exempt sector is far broader. The approximately 3,000,000 tax-exempt entities include almost 1,000,000 section 501(c)(3) charities and almost 1,000,000 employee plans. The other million entities include state and local governmental entities, Indian tribal governments, and other tax-exempt organizations such as labor unions and business leagues. This sector is a vital part of our nation's economy that employs about one in every four workers in the U.S. In addition, nearly one-fifth of the total U.S. securities market is held by employee plans alone.

As I will discuss, there are abuses of charities that principally rely on the tax advantages conferred by the deductibility of contributions to those organizations. Other abuses involve not only charities, but other exempt organizations that allow themselves to further purposes other than those for which tax-exemption is authorized. When abusive tax avoidance transactions are involved, the facilitators of those abuses include not only

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charities and other exempt organizations, but also employee retirement plans, state and local governments, and Indian tribal governments. While the abuse in this sector may still be isolated, I share your view that we must quickly and effectively act now. If these abuses are left unchecked, I believe there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised.

I am committed to combating abuse in this area. We recently released our IRS Strategic Plan for 2005-2009. Along with improving service and modernizing our computer systems, one of our strategic goals is to enhance enforcement of the tax law.

The President has asked for an IRS fiscal year 2005 budget of $10.674 billion, a $490 million (4.8%) increase over the FY 2004 appropriation. Most of this increase, $300 million, will be used to restore and reinvigorate our enforcement presence. If funded, we expect to increase our spending in the examination area with respect to tax-exempt and government entities by 17% in 2005. This funding is crucial, particularly with respect to charities. Historically, IRS functions regulating tax-exempt entities have not been well funded due to the lack of revenue they generated. This view is misdirected in light of the size and importance of the sector. With staffing in this area flat at best and with the number of charities increasing annually, our audit coverage has fallen to historically low levels, compromising our ability to maintain an effective enforcement presence in the exempt organizations community.

One of our four specific objectives is to deter abuse within tax-exempt and governmental entities, and misuse of these entities by third parties for tax avoidance or other unintended purposes. I will align my remarks today with this strategic objective. First, I will talk about IRS deterrence of abuses within tax-exempt and governmental entities. Second, I will discuss IRS deterrence of the misuse of these entities by third parties for tax avoidance or other unintended purposes. For the most part, I will focus my remarks on charities, but the abuse of tax-exempt organizations transcends charities. I believe it is important to give the Committee a comprehensive overview of the problems we face in this area.

I would like to start by highlighting the Administration's legislative proposals to address abusive tax avoidance transactions generally, including those that may involve tax-exempt organizations, and legislative proposals to address specific abuses involving tax-exempt organizations. The Administration's FY 2005 Budget contains a number of legislative proposals, originally announced by the Treasury Department in March 2002 to combat abusive transactions. These proposals include statutory changes that would create better, coordinated disclosure of abusive transactions by taxpayers and promoters, and would back these improved disclosure rules with meaningful penalties. Other proposals would increase promoter penalties, increase accuracy-related penalties for certain undisclosed abusive transactions, target egregious behavior, curtail frivolous submissions, and reinforce the disclosure rules for off-shore accounts that may be used in some abusive transactions. Under this Committee's leadership, these proposals are closer to enactment. In March 2002, The Treasury Department also announced a number of administrative actions to combat abusive transactions, and virtually all of

these actions have been completed. I will describe other administrative actions the IRS is taking to combat abuses in the tax-exempt area.

In addition, although the Administration is committed to encouraging gifts to charity, it also wants to ensure that taxpayers are accurately valuing property they donate to charity. As described below, the Administration's Budget includes proposals to address the problem of overvaluation of certain gifts of property to charity.

DETERRENCE OF ABUSES WITHIN TAX-EXEMPT ORGANIZATIONS AND GOVERNMENT ENTITIES

The Need for Enhanced Governance

In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a corporation, its executives, its accountants and auditors, and its legal counsel. Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. We at the IRS also have seen an apparent increase in the use of tax-exempt organizations as parties to abusive transactions. All these reflect potential issues of ethics, internal oversight, and conflicts of interest.

Specific Examples of Failures in Governance and the IRS Response

Credit Counseling Organizations

Over the past several years, we have seen an increase in applications for tax-exempt status from credit counseling organizations that are substantially different from their predecessors. The new breed appears to be more focused on marketing debt management plans than providing educational or charitable services, and they operate with a relatively high fee structure. Governance failures have been endemic, including conflicts of interest in service contracts. In one case we have seen a large number of individuals and business entities involved in a scheme to sell a fraudulent business plan to create credit counseling organizations as fronts for profit-making businesses. As a result, we have embarked on an unprecedented effort in this area.

We are focusing our audit resources on those organizations with the highest risk of noncompliance with tax law. We have selected 50 tax-exempt credit counseling organizations for examination; the majority of these examinations are currently underway. The balance will be assigned to agents by the end of this fiscal year. This summer, we will have 50% of the total revenues of those credit counseling organizations that file information returns under active examination. To date, we have initiated and will be pursuing the use of proposed revocations of exemption of credit counseling organizations in appropriate circumstances. We also plan to seek injunctions and penalties against both individuals and companies for promoting fraudulent tax schemes.

We also are focusing on slowing the proliferation of new credit counseling organizations that may not be serving charitable purposes. As with all tax-exempt organizations, our goal is to ensure that every credit counseling organization that applies for exemption meets all applicable standards before we recognize exemption.

Change is taking place, and the industry is starting to move in the right direction. However, what has happened thus far is only the beginning. There still is much to be done. We remain very concerned that the potent combination of exemption from income tax and from consumer protection laws is encouraging those who are motivated by profit rather than charity to seek tax exemption. To address that concern, we are continuing our broad-based approach that includes an enhanced examination program, stricter scrutiny in our application process, partnering efforts with the state attorneys general and the Federal Trade Commission (FTC), as well as warnings to consumers about our concerns. We will use all tools available to ensure that these organizations act lawfully, including revoking tax-exempt status where warranted.

Compensation Issues

The issues of governance and executive compensation are closely intertwined. We are concerned that the governing boards of tax-exempt organizations are not, in all cases, exercising sufficient diligence as they set compensation for the leadership of the organizations. There have been numerous recent reports of executives of both private foundations and public charities who are receiving unreasonably large compensation packages.

Neither a public charity nor a private foundation can provide more than reasonable compensation. Reasonable compensation is determined with respect to the market value of the services performed and depends upon the circumstances of the case. In general, reasonable compensation is measured with reference to the amount that would ordinarily be paid for comparable services by comparable enterprises under comparable circumstances.

Section 501(c)(3) provides that the assets of an organization cannot inure to the benefit of private shareholders or individuals. If an organization pays or distributes assets to insiders in excess of the fair market value of the services rendered, the organization can lose its tax exempt status. Moreover, insiders of public charities and of private foundations are subject to excise taxes on any overpayments they receive. Although an overpayment to an insider of a public charity could result in a revocation of tax-exempt status, section 4958 of the Internal Revenue Code (Code) provides an intermediate sanction that ameliorates that result in many cases. Under section 4958, an excise tax can be imposed on the insider who received the overpayment and on certain managers who knowingly approved the overpayment.

The payment of excessive compensation to an insider of a private foundation likewise may give rise to excise taxes under section 4941 of the Code on both the insider and on certain managers who knowingly approved the overpayment. In addition, the foundation itself and its managers may be subject to tax on any overpayment under section 4945 of the Code. Although the private foundation rules permit the payment of reasonable and

necessary compensation to foundation insiders, most other transactions between a private foundation and its insiders are prohibited outright, without regard to subjective factors such as the reasonableness of the amounts, fair market value of property involved, or whether the transaction benefits or harms the foundation.

IRS Tax Exempt Compensation Initiative: This summer, we are launching a comprehensive enforcement project to explore the seemingly high compensation paid to individuals associated with some exempt organizations. This is an aggressive program that will include both traditional examinations and correspondence compliance checks. The purpose of the project is to enhance compliance by learning what practices organizations use to set compensation; learning how organizations report compensation to the IRS and the public; and creating positive tension for organizations as they decide on compensation arrangements. These organizations need to know that their decisions will be reviewed by regulatory authorities. This project also will have educational components.

We will be contacting hundreds of organizations. During the first stage, we will be looking at public charities of various sizes and private foundations. We will be asking these organizations for detailed information and supporting documents on their compensation practices and procedures, and specifically how they set and report compensation for specific executives. Organizations also will be asked for details concerning the independence of the governing body that approved the compensation and details of the duties and responsibilities of these managers with respect to the organization. Other stages will follow, and will include looking at various kinds of insider transactions, such as loans or sales to executives and officers. We also will be looking at organizations that failed to, or did not fully complete, compensation information on Form 990.

This information will help inform the IRS about current practices of self-governance, both best practices and compliance gaps, and will help us focus our examination program to address specific problem areas.

Private foundation market segment initiative: In the early 1980s, the IRS conducted an examination study of private foundations and concluded that there was a high level of compliance by these organizations. This led to lower audit coverage of private foundations, even compared to the decline in overall audit rates. That information is now dated. In addition, we are seeing a steady growth in what had been a fairly stable sector, now estimated as close to 100,000 entities. As a result, we have not only increased our coverage, we have developed a market segment initiative to learn about compliance issues raised by private foundations. Market segment initiatives are analogous to the National Research Program (NRP) in that they concentrate on a particular unique portion of the tax-exempt community to gauge its compliance with the tax laws. This project will study different categories of private foundations in several phases and ultimately will involve approximately 400 examinations. The goal is to measure compliance levels and ascertain whether anecdotal information, both good and bad, reflects foundation behavior generally. Depending upon what we find, we expect the results to allow us to develop improved enforcement mechanisms, a more focused educational effort, and improvements to Form 990-PF, the annual information return

filed by private foundations. This market segment initiative will commence by November 2004.

Terrorist Financing and Charities

Obviously, a key concern is the financing of terrorism through the use of charities. Although that topic is beyond the scope of this hearing, we note that on March 4, 2004, we sent you a letter laying out our FY2005 initiative targeted toward this problem. We look forward to working with the Committee on this issue of national import.

Enhancing Governance--The Need for Better Coordination with the States and with Other Federal Agencies

I believe that the various enforcement agencies, including the IRS, can achieve better enforcement results by partnering and coordinating our efforts. For example, we issued a joint consumer alert with the Federal Trade Commission (FTC) and the National Association of State Charity Officers (NASCO) on credit counseling abuses. Our ability to share information is governed by section 6103, and the flow of information to us in these relationships necessarily exceeds what we can offer in exchange. Nevertheless, we are taking the steps necessary to ensure that we are able to work effectively with the states and other federal agencies to the extent permitted by statute.

Coordination with States

As Messrs. Josephson and Pacella will tell us, the states play an important role in the regulation of charities and private foundations. While the IRS's role is the administration of federal tax law, state law covers most other aspects of an exempt organization's existence, including issues involving contracting, fundraising, use of trust corpus, and consumer protection. State enforcement often can yield important information for federal tax administration.

To give an example, a number of states are actively looking at private foundations under state nonprofit corporation and charitable trust laws. The IRS has asked to monitor information arising from those efforts. What we learn may allow us to better focus our own enforcement efforts, and help identify areas where increased information sharing with the states is appropriate.

In fact, we have been working with NASCO to improve our coordination with the states not only with respect to private foundations, but with respect to public charities as well. Although we are limited by section 6103 in what we can provide to the states, there are some exceptions. Recently, we revised and streamlined our procedures for forwarding to state attorneys general and other authorized state officials copies of denial letters we have issued to applicants for charity status, and revocation letters we have issued to existing charities.

In addition, we have told NASCO we can provide better feedback on organizations they refer to us for examination. We have offered meetings to discuss areas of mutual interest and determine what kinds of information it would be useful for the IRS and

states to share. We hope to schedule an annual IRS/NASCO strategic planning meeting to allow state officials input into our annual exempt organizations work plan. Finally, we have proposed piloting project teams in key compliance areas that include NASCO members.

To facilitate continued cooperation with the states, the Treasury Department believes Congress should authorize the IRS in appropriate circumstances to share returns and return information about tax-exempt organizations with state charity officials to the extent necessary to administer state laws governing the administration of charitable assets and the solicitation of charitable contributions, or to facilitate the resolution of issues relating to the organization's federal tax-exempt status. The Treasury Department believes any legislation that permits disclosure of additional information should be based on a balancing of the interests of state charity officials and concerns regarding taxpayer privacy and the impact on federal tax administration. In addition, such disclosure should be subject to the same confidentiality, recordkeeping, and safeguard provisions that apply to information shared by the IRS and with state tax officials. The Treasury Department believes the approach taken in the CARE Act as passed by the Senate addresses many of these concerns.

Coordination with Other Federal Agencies

We work with other federal agencies in a number of areas. For example we continue to engage in information sharing with the FTC to learn more about the credit counseling industry, including joint meetings with the FTC with representatives from industries that provide business services to credit counseling organizations. We have established an expedited process through which FTC attorneys may request approved Form 1023 application files. Similarly, the FTC has established an expedited process through which we may obtain information we need for enforcement. We expect to continue this mutually beneficial relationship and find other ways to leverage our scarce resources.

Enhancing Governance--The Need for More Outreach

As I discussed above, stronger governance procedures are needed for exempt organizations. The sanctions for serious lapses in governance are clear. There is the possibility of revocation of exemption, along with the various excise taxes against individuals that I mentioned before. But sanctions are a last resort. We need to publicize practices that will help and encourage these organizations and their officers to prevent abuses in the first place.

To help tax-exempt organizations, we are developing a plain-language brochure to set forth certain practices we believe will be useful in promoting good governance, ethics, and internal oversight. This brochure will be available this fall.

The publication will explore practices that are not necessarily required by law but that may elevate the standards, conduct, and workings of exempt organizations. Although the IRS does not have authority to require organizations to follow specific practices, organizations without effective governance controls are more likely to have compliance problems. The publication is intended to provide exempt organizations, and in particular

public charities, with a list of practices that will help guard against abuses involving, among other things, inappropriate financial transactions and operations. Among the topics we expect to cover are standards of integrity; the role, selection and duties of the governing board; conflict of interest policies; record-keeping; checks and balances that help prevent abuses; and fundraising practices, to name a few.

We also are developing forms changes to focus more specifically on governance questions. We have asked for and received comments from the public on whether the annual information return for exempt organizations (Form 990) should require disclosure of whether the organization has a conflict of interest policy or an independent audit committee, and whether additional disclosure should be required concerning certain financial transactions or insider relationships.[1] Our Form 990 revision team is working on a comprehensive overhaul of the form to provide better compliance information about these organizations to the IRS, the states, and the public.

In addition, we are revising Form 1023, *Application for Recognition of Exemption*, to provide new focus on governance issues, both in terms of questions that explore compensation setting practices and arrangements, and on conflict of interest questions. We are expanding the form instructions to include a sample conflict of interest policy, and other materials to help filers better understand good governance practices. We expect the revised Form 1023 to be available by the end of the calendar year.

DETERRENCE OF THIRD PARTY MISUSE OF TAX-EXEMPT AND GOVERNMENT ENTITIES

I am turning now from abuses involving failures of governance of certain tax-exempt entities to abuses of tax-exempt entities by third parties. Unquestionably, there is overlap. There is often complicity between the exempt entity and the third party abuser, and thus governance issues arise in these cases as well. What distinguishes this category of abuses is that the third party is seeking to exploit the entity's tax-exempt status.

Abuse Involving Tax-exempt Accommodation Parties

I cannot overstate the seriousness of the involvement tax-exempt and government entities as accommodation parties to abusive transactions. We use the term "accommodation party" to describe the tax-exempt entity's involvement in a transaction that does not necessarily affect the entity's primary function, but is designed to provide tax benefits to a third party that is a taxable entity. This role served by tax-exempt entities has become increasingly significant as abusive transactions have evolved. Many of the earliest abusive transactions hinged on the use of partnerships and subchapter S corporations to facilitate transactions and thwart detection through the use of multiple entities and complex structures. As the IRS has responded and placed increased emphasis on the examination of those types of entities, we have seen an increased use of various tax-exempt entities--including charities private and government

[1] Announcement 2002-87, 2002-2 C.B. 624.

pension plans, Indian tribal governments, and municipal governments--to achieve equally abusive results.

Almost half of the transactions we have identified to date as "listed transactions" (i.e., tax avoidance transactions) under the return disclosure regulations may rely to some degree on the use of a tax-exempt party. In fact, five of the eight transactions we have listed in FY 2004 use a tax-exempt party. Although in many of the transactions the entity involved could be a foreign entity not subject to U.S. tax, in other cases the entity could be a tax-exempt organization. The S corporation transaction described below is an example of an abusive transaction that may involve a domestic tax-exempt organization.

We believe this is an area of major concern for your Committee. When taxpayers use artificial means to avoid their share of the tax burden, they not only shift the burden to all taxpayers, but also undermine the public's confidence in the integrity of our system. Further, for many tax-exempt entities, most notably charities, tax-exemption, the charitable contribution deduction, and other tax benefits constitute an indirect subsidy of activities Congress has determined are beneficial to society. However, when those entities engage in transactions that offer tax benefits not intended by Congress to third parties, there is a cost to society without a corresponding increase in social benefits.

The schemes are many. Here I will detail two examples of recently listed transactions that illustrate the abuse of the tax system and the challenges we face in dealing with the transactions. The first example is a transaction in which taxpayers donate offsetting foreign currency option contracts to a charitable organization to trigger a loss deduction while avoiding taxation on corresponding gain. The second example involves the purported transfer of S corporation nonvoting stock by a taxpayer to a tax-exempt entity in an attempt to shield income from taxation while allowing the taxpayer to retain the economic benefits of ownership.

Offsetting Foreign Currency Option Contracts

This marketed promotion exploits the Code's rules for recognizing gain or loss on foreign currency contracts. The taxpayer holds offsetting positions in contracts on a currency traded on a regulated futures exchange (these contracts are subject to section 1256 of the Code), and contracts on a currency that is not traded on a regulated futures exchange (these contracts are not subject to section 1256). Straddle positions are taken so that all gains are offset by losses.

Section 1256 of the Code requires a taxpayer to recognize the inherent gain or loss at the time of any assignment of a currency contract traded on a regulated futures exchange. However, assignments of contracts on currencies that are not traded on a regulated futures exchange are not subject to section 1256.

Before the close of the calendar year, a participating taxpayer assigns the offsetting section 1256 contracts and non-section 1256 contracts to a recognized public charity. Although this generates a small charitable deduction for the donor, the main feature is that the donor can recognize the loss on the section 1256 contracts without recognizing

the corresponding gain on the non-section 1256 contracts. Rather, the charity, which is not subject to tax, recognizes this gain on the non-section 1256 contracts.

We have identified dozens of entities, both taxable and tax-exempt, that are involved in this type of transaction. Examinations are underway. Because we identified and began enforcement action on this issue early, we are still gathering data on the dollar impact of these transactions and we believe the revenue loss may have been minimized by early detection. However, preliminary data suggests the impact may exceed one million dollars per transaction. We listed this transaction in Notice 2003-81, 2003-51 I.R.B. 1223, which requires disclosure by participants.

The S Corporation Transaction

This abusive transaction is designed to shift income from the individual shareholder of an S corporation to an unrelated tax-exempt accommodation party that is either a municipal pension plan or a charitable organization with an unrelated business income tax net operating loss. Participants purport to donate S corporation nonvoting stock to the tax-exempt accommodation party while effectively retaining the economic benefits associated with ownership, either through stock options or repurchase rights. The purported donations generally represent 90% of the number of outstanding shares of S corporation stock. The transfer of the S corporation shares thus is designed to shift the pass-through of 90% of the S corporation taxable income from the original shareholders to the accommodation party, for purposes of deferring or avoiding taxes. The original S corporation shareholders retain voting control of the S corporation and thus retain control over the timing of corporate distributions (i.e., although the pass-through of taxable income occurs while the accommodation party holds the S corporation shares, the distribution of the underlying profit is controlled by the original S corporation shareholders). Not surprisingly, during the period that the accommodation party holds close to 90% of the outstanding shares, the S corporation distributes little or none of its profit. After a period of time, the original shareholders either cause the S corporation to repurchase the accommodation party’s nonvoting stock at an artificially low value, or else the original shareholders themselves dilute the value of the shares held by the accommodation party to a small amount by exercising warrants to purchase additional shares of nonvoting stock vastly in excess of the number of shares held by the accommodation party. In either event, the original S corporation shareholders attempt to enjoy a lengthy tax holiday while retaining control and substantially all the economic value of the S corporation, including the retained profit.

We have identified dozens of S Corporation Transactions involving the reallocation of hundreds of millions of dollars from shareholders to tax-exempt accommodation parties. Examinations are underway. We listed this transaction in Notice 2004-30, 2004-17 I.R.B. 828.

Problems the IRS Faces in Addressing This Area

Disclosure

Disclosure is an important way for the IRS to identify participants in abusive transactions. However, our disclosure scheme, which originally was developed to address the taxable sector, does not yet fit all tax-exempt participants because the method of reporting does not fit all tax-exempt entities well. For example, an organization must attach Form 8886 to its annual tax return for each year that the organization participates in a listed transaction. For this purpose, “tax return” includes information returns, so tax-exempt entities that file information returns are covered by the regulations. However, entities that are not required to file any return are not covered. This excepted category includes churches, small exempt organizations, state and local governments, state and local government retirement plans, and Indian tribal governments. Thus, these entities are not covered by the section 6011 disclosure net.

Lack of Sanction

Another difficulty in addressing accommodation parties is that IRS has no sanctions comparable to those that can be imposed on promoters or investors. Currently, there is no sanction for a taxpayer’s failure to disclose a reportable transaction under section 6011 of the Code. The Administration has proposed in its FY 2005 Budget legislation that would impose meaningful penalties on all taxpayers that fail to disclose reportable transactions, including listed transactions, on their returns. As noted above, however, not all tax-exempt entities are required to file a federal tax return.

In addition, the accuracy-related penalties imposed by the Code are not sufficient to deter a tax-exempt accommodation party, which neither invests in the transaction nor has taxable income to understate. Finally, IRS’ compliance sanctions for exempt organizations do not fit these situations. Participation in the transaction as an accommodation party rarely will affect the tax status of a charity, qualified plan, or other tax-exempt entity. In the offsetting foreign currency options transaction, for example, the accommodating charity receives some net value. Its receipt of the asset has not changed the organization’s purposes or activities, nor has the receipt of the asset caused the organization to engage in an excess benefit transaction. The abuse is that the transaction is structured to generate a tax benefit for the donor that far exceeds not only the amount authorized by the Code for charitable contributions, but also the net benefit received by the charitable organization.

IRS Response to Accommodation Party Strategies

Accommodation parties in S Corporation Transactions designated as participants. On April 26, 2004, we took an important step about the involvement of tax-exempt entities as accommodation parties in abusive tax transactions. In Notice 2004-30, we designated the S Corporation Transaction as a listed transaction and for the first time exercised our authority under the return disclosure regulations to designate specifically the tax-exempt accommodation party as a “participant” for purposes of those regulations. As a participant, the accommodation party must comply with the disclosure

requirements. Thus, if required to file a return, the tax-exempt accommodation party must attach a Form 8886 to its return for the taxable year it received the donation from the S corporation, the taxable year of the reacquisition, and all intervening years.

All filers will be required to identify accommodation parties involved. At the same time we issued Notice 2004-30, we also announced[2] that we would revise Form 8886 to require all filers to identify the names of all parties to a listed transaction, including the names of tax exempt parties that facilitate the transaction. We have just released the revised Form 8886. Thus, a tax-exempt accommodation party to a listed transaction that is not itself required to file Form 8886 will be identified through the Forms 8886 filed by the other parties to the transaction. Although this information could be obtained through the examination process, requiring this information on the Forms 8886 that are filed will give us a better picture early of the tax-exempt entities that are facilitating the abusive transactions.

Previously listed transactions will be reviewed. We are reviewing transactions we have previously designated as "listed transactions" to determine whether we should treat tax-exempt accommodation parties in those transactions as "participants."

Future listed transactions. We will consider in all future listed transactions whether any tax-exempt accommodation parties should be designated as a participant.

There may be other actions necessary, in a regulatory context or otherwise. We look forward to working with your staff in this important area.

Misuse of Tax-Exempt Entities by Donors and Investors

We are facing a number of other current issues where donors or others are using or attempting to use tax-exempt organizations for private purposes, including sheltering assets for deferred personal use or claiming accelerated or inflated deductions. I will briefly discuss certain classes of cases in which we have found abusive behavior. It is important to note that although certain types of organizations are being used inappropriately in particular instances, the abuses are not typical of these types of organizations, taken as a whole.

Section 509(a)(3) supporting organizations

A supporting organization is a public charity that in carrying out its charitable purpose supports another exempt organization, in almost all cases another public charity. The phrase can cover a wide variety of organizations: endowment funds for universities; subordinate entities that provide essential services for hospital systems; and many others. The classification as a supporting organization is important because it is one method by which a charity can avoid classification as a private foundation. Because of the required relationship between the supporting organization and its supported organization, the supporting organization is classified as a public charity, even though the supporting organization may be funded by a smaller number of persons. Private

[2] Press release IR 2004-44.

foundations are subject to many more restrictions and to the above-referenced regime of excise taxes on certain behaviors.

Let me emphasize here that we believe the vast majority of supporting organizations are entirely legitimate and upstanding charities. However, some tax planners see the supporting organization primarily as a means by which an organization's creator can effectively operate what would ordinarily be a private foundation under the less restrictive rules applicable to public charities. Self-dealing and certain other transactions with substantial contributors to these organizations would be prohibited in the private foundation context.

However, some of the abuses and promotions we have seen clearly are not consistent with tax-exempt status. For example, in one promotion we have uncovered there is, almost immediately after a purported charitable donation to a supporting organization, an unsecured loan of all or a significant portion of the funds back to the donor and creator. A key part of this transaction is the effort by the promoter to ensure a lack of oversight of the supporting organization by the public charity it purports to support. While too technical to outline in this testimony, we are seeing several strategies that frustrate the ability of the supported public charity to oversee its supporting organization, clearing the way for abuses.

We have several promoters under investigation in this area and are examining dozens of organizations. More examinations are likely and we expect to be examining numerous individual returns shortly.

Corporations Sole

First, let me say that corporation sole statutes are a historical artifact intended to allow church officers, such as bishops or parsons of a church, to be incorporated for the purpose of insuring the continuation of ownership of property dedicated to the benefit of a legitimate religious organization.

However, we have become aware that some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under the pretext of being a "bishop" of a religious organization or society. The idea promoted is that this entitles the individual to exemption from federal income taxes as an organization described in section 501(c)(3). Individuals are told that their income will not be reportable or taxable, that their assets cannot be reached by current or future creditors.

These promotions have no legitimacy, and we are taking vigorous action to stop them. We are conducting dozens of promoter investigations of corporate sole promoters. To deter potential customers from being lured into the scheme, we published Rev. Rul. 2004-27, 2004-12 I.R.B. 625, which clearly explains that a taxpayer cannot avoid income tax by establishing a corporation sole.

Donor Advised Funds

A donor advised fund is a separately identified account maintained and operated by a section 501(c)(3) organization. These accounts have become very popular in recent years. Each account is funded with contributions made by a donor or a group of donors. For the payment to qualify as a completed gift, the charity must have legal control over the donated funds. While the donor, or individuals selected by the donor, may advise on the distribution of funds from the account and the investment of assets in the account, the charity must be free to accept or reject the donor's recommendations. For example, a donor may contribute $1,000,000 to a donor advised fund and claim the whole amount as a charitable deduction for the year in which the contribution is made. In future years the donor may advise the fund as to desired distributions to qualified beneficiaries (e.g., other charities). In operation these funds allow considerable input from the donor but are not classified as private foundations. Again, in a legitimate donor advised fund, the charity must have legal control over the donated funds and must have the right to disregard the donor's advice.

We have seen abuses in this area, both in examinations and in applications for exemption from new organizations. A case in which the IRS denied exemption is pending in the Court of Federal Claims. In addition, we are aware that some promoters encourage clients to donate funds and then use those funds to pay personal expenses, which might include school expenses for the donor's children, payments for the donor's own "volunteer work", and loans back to the donor. We have over 100 individuals under audit in connection with such cases.

Certain Employee Stock Ownership Plans (ESOPs)

Some ESOPs have been created for no purpose other than to circumvent statutory restrictions. For example, we discovered an abuse through our determination letter process that led to our publication of Rev. Rul. 2003-6, in which we stopped a strategy to market ESOPs on the basis that they would be eligible for the grandfathered (rather than the 2001) effective date of section 409(p). Rev. Rul. 2003-6 outlined a promotion where a person set up a series of ESOPs in advance of an effective date hoping to sell the plans later as part of the promotion.

In-Kind Donations to Charities—the Problem of Overvaluation and Other Issues

With respect to gifts of both tangible and intangible property, we have seen overvaluation by some taxpayers to inflate the charitable contribution deduction at public expense. Valuation issues can be especially difficult. The Administration's FY 2005 Budget includes several proposals to address the problem of overvaluation of donated property. But there can be other problems as well.

Intellectual Property

A key issue in intellectual property donations, as in all other property donations, is whether the property has been appropriately valued. In the case of patent and other intellectual property donations in particular, we have concerns about overvaluation,

whether consideration has been received in return, and whether only a partial interest of property is being transferred. To address valuation concerns, the Administration's FY2005 Budget includes a proposal to limit the taxpayer's initial deduction for contributions of certain intellectual property to the lesser of the taxpayer's basis in the property or the fair market value of the property. Under the proposal, the taxpayer would be permitted to deduct certain additional amounts based on the amount of revenue, if any, actually received by the charity from the donated property. The Administration's Budget also includes a proposal to require all taxpayers (including C corporations) to obtain a qualified appraisal of property (other than inventory property and publicly traded securities) if the deduction claimed exceeds $5000, and to attach a copy of the appraisal to the taxpayer's return if the deduction claimed exceeds $500,000.

In addition to these legislative proposals, we have issued Notice 2004-7, 2004-3 I.R.B. 310, which is aimed at donors, promoters, and appraisers. The Notice reminds taxpayers that transfers of property are not deductible:

- If the transfer is of a partial interest in property.
- To the extent that consideration is received for the transfer.
- If the transfer is inadequately substantiated.
- To the extent the property is overvalued.

The Notice reminds taxpayers that the fair market value of a patent must take into account whether the patented technology has been made obsolete by other technology; any restrictions on the donee's use of, or ability to transfer the patented technology; and the length of time remaining before the patent's expiration.

Conservation Easements

Conservation easements placed on land or buildings have become a significant part of environmental and historic preservation movements. Some charities exist primarily to receive and hold land and easements in perpetuity to prevent development.

Although easements represent a valued part of philanthropy, let me briefly summarize some of the issues we have seen. As stated, gifts of partial interests in property are ordinarily not deductible. An easement, of course, is only a partial interest. However, section 170(f)(3) provides an exception to the partial interest rule for qualified conservation contributions such as conservation easements.

We have seen several abuses in this area. There have been cases where the easement being donated is overvalued. There are also cases in which the donor, or the donor's successor in interest, takes an action inconsistent with the easement without adverse consequences. The conservation easement rules place the charity in a watchdog role over the easements it possesses. If the charity fails to monitor these properties (another failure in governance), the potential exists for inconsistent use by the landowner of the property upon which the original deduction was premised. In other cases, taxpayers are claiming large deductions when they are not entitled to any deduction at all (e.g., when

taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements).

We have developed guidance to remind donors and charities the legal requirements for a conservation easement contribution. We expect that this guidance, examination in this area, and the forms changes and one of the compliance initiatives described below, will improve compliance in the area of easements donations.

Vehicle Donations

For a taxpayer, donating a car to a charity has definite appeal. One can help a charitable cause, dispose of the car, and take advantage of tax provisions that are designed to support the generosity of Americans. Deductions are limited to the fair market value of the property.

In its recent study[3], the GAO estimated that about 4,300 charities have vehicle donation programs. In its review of returns for tax year 2000, the GAO estimated that about 733,000 taxpayers claimed deductions for donated vehicles they valued at $500 or more. Highly troubling is GAO's analysis of 54 specific donations, where it appears that the charity actually received less than 10% of the value claimed on the donor's return in more than half the cases, and actually lost money on some vehicles. While this study is important information for potential vehicle donors, it does not necessarily indicate that the charity is doing anything wrong. Most car donations result in small gains for the charity. From the charity's point of view, often a small gain is better than no gain. The GAO states that its sample of specific donations was too small to allow generalization to all vehicle donations. But we cannot ignore the clear implications of the study. The Administration's FY2005 Budget includes a proposal to curtail the problem of inflated deductions being claimed for donated vehicles by allowing a deduction only if the taxpayer obtains a qualified appraisal of the vehicle.

IRS enforcement efforts with respect to donated vehicles: We are educating donors and charities on what constitutes a well-run donation program. In December 2001, we alerted the public to a series of nine steps that individuals should take when donating their vehicles to ensure that a gift is to a recognized and reputable charity, and that the appropriate deduction is taken for the make, model, and condition of the vehicle[4]. We have just released two plain language brochures regarding car donation programs, one for the benefit of the vehicle donors; the other for the benefit of charities. We will be partnering with the states to distribute the brochures to the fundraising community, as the states regulate fundraising activity.

On the compliance side, we have two programs. In the first, the IRS is focusing specifically on individuals who have taken deductions for vehicle donations. We are conducting approximately 200 correspondence examinations of vehicle donors to learn how donors are valuing their donated vehicles. In the second, the IRS is matching taxpayers' Forms 8283, which substantiate large deductions for donations of various

[3] Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight (GAO-04-73, November 2003).
[4] IR-2001-112, December 3, 2001.

kinds of property, against Forms 8282. We believe non-cash donations of property other than vehicles may be an equal or larger problem. Based upon what we learn from these programs, we will decide what further compliance actions may be necessary.

We are also looking at how to improve our forms for reporting non-cash contributions. Taxpayers list their non-cash gifts of over $500 on Form 8283. The IRS and Treasury are studying ways to improve the form to facilitate compliance with and enforcement of the substantiation requirements.

CONCLUSION

In summary, let me assure you that this Administration understands just how important the exempt sector is to our nation and how important it is that we act against outliers before they do any further damage to the tax system and to the confidence of our citizens. That is why we have made this one of our four enforcement initiatives and have asked for additional funds to ensure that we are able to do what needs to be done. We are confident that if we focus both on the governance issues and the misuse of entities by others we will be able to address these problems effectively. Let me also say that the Administration commends this Committee for your recognition of the problems and your effort to get at the causes of and solutions for these abuses.

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