Panel on the Nonprofit Sector

Convened by Independent Sector

Interim Report

presented to the Senate Finance Committee

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PANEL ON THE NONPROFIT SECTOR

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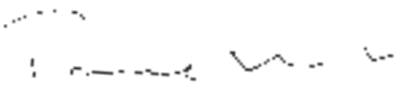
Preface

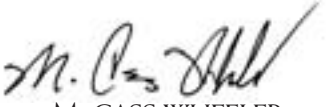
Nonprofit organizations are an indispensable part of American society. The country's network of nearly 1.3 million charitable and philanthropic organizations offers relief in times of disaster, nurtures our spiritual and creative aspirations, cares for vulnerable people, and finds solutions to medical, scientific and environmental challenges. Charitable organizations occupy a central place in every community, drawing upon the talents and generosity of and providing service to an enormously diverse group of people.

The Panel on the Nonprofit Sector is dedicated to ensuring that charities and foundations remain a vital and responsive force in America and around the globe. Convened at the encouragement of the U.S. Senate Finance Committee in October 2004, the Panel seeks to help the nonprofit sector meet the highest ethical standards in governance, fundraising and overall operations. Participating in the Panel's work are more than 175 experts and leaders drawn from across the country and reflecting a wide spectrum of experience in the sector. The Panel also has sought input from hundreds of other interested nonprofit organizations to inform its work. These efforts highlight two of the defining characteristics of the nonprofit community: its willingness to take initiative to make improvements, and its commitment to collaboration.

The following report sets forth the Panel's initial recommendations for strengthening the accountability of charities and foundations. The report begins by describing the composition, reach and accomplishments of the sector, background that is essential to understanding the Panel's recommendations and reasoning, and by explaining the process by which the Panel drew upon the expertise of practitioners and scholars throughout the nonprofit community. It then lays out the overarching principles that guided the Panel's analysis. The main section of the report provides recommendations for specific rules and practices intended to strengthen the sector today and in the years to come. The report concludes with a summary of the areas of study that will be the basis for the second phase of the Panel's deliberations.



PAUL BREST
President
William and Flora Hewlett Foundation



M. CASS WHEELER
Chief Executive Officer
American Heart Association

Co-Conveners, Panel on the Nonprofit Sector

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Executive Summary

PRINCIPLES TO GUIDE IMPROVING THE ACCOUNTABILITY AND GOVERNANCE OF CHARITABLE ORGANIZATIONS

In developing its recommendations, the Panel on the Nonprofit Sector's work was guided by the following eight overarching principles:

1. A Vibrant Nonprofit Sector Is Essential for a Vital America.
2. The Nonprofit Sector's Effectiveness Depends on its Independence.
3. The Nonprofit Sector's Success Depends on its Integrity and Credibility.
4. Comprehensive and Accurate Information about the Nonprofit Sector Must Be Available to the Public.
5. A Viable System of Self-Regulation Is Needed for the Nonprofit Sector.
6. Government Should Ensure Effective Enforcement of the Law.
7. Government Regulation Should Deter Abuse Without Discouraging Legitimate Charitable Activities.
8. Demonstrations of Compliance with High Standards of Ethical Conduct Should Be Commensurate with the Size, Scale and Resources of the Organization.

RECOMMENDATIONS

This interim report includes recommendations to improve governance and oversight of the charitable sector that call for action by the sector, by individual charitable organizations, by the Internal Revenue Service, and by Congress. The following recommendations have been abbreviated to facilitate quick review; the full recommendations corresponding to the recommendation numbers below are provided in Section III of this report.

Recommendations to Improve Transparency of Charitable Organizations

1. To ensure that the annual information returns (Form 990, 990-EZ, or 990-PF) filed by charitable organizations with the IRS provide accurate, timely information about the organization's finances, governance, operations and programs, the IRS should:
   a. Require that the returns be signed, under penalties of perjury, by the chief executive officer, the chief financial officer, or the highest ranking officer of the charitable organization, or, if the organization is a trust, by a trustee of the organization.
   b. Fully enforce existing financial penalties imposed on organizations or organization managers for failure to file complete and/or accurate returns.
   c. *Suspend* the tax-exempt status of any charitable organization that fails to comply with filing requirements for two or more consecutive years after appropriate notice from the IRS.
   d. Extend the penalties imposed on preparers of personal and corporate tax returns for omission or misrepresentation of information, or disregard of rules and regulations, to preparers of Form 990 series returns.
   e. Move forward expeditiously with mandatory electronic filing of all Form 990 series returns, including modifications to allow for separate attachments and accommodations needed by smaller organizations to facilitate compliance.
   f. Coordinate federal e-filing efforts with state e-filing requirements.
   g. Require that the application for recognition as a tax-exempt organization under Section 501(c)(3) be filed electronically.
2. To improve the accuracy and completeness of financial information on charitable organizations, Congress should require all charitable organizations that must file a Form 990 or 990-PF to:
   a. Have an audit conducted of their financial statements and operations if they have $2 million or more in total annual revenues, or have financial statements reviewed by an independent public accountant if they have at least $500,000 and under $2 million in total annual revenues.
   b. Attach legally required audited financial statements to their Form 990 or 990-PF.
3. To improve the accuracy of lists identifying organizations qualifying for tax-deductible contributions, Congress should require charitable organizations to:
   a. File an annual notice with the IRS if they are excused from filing an annual information return because their annual gross receipts fall below $25,000. Failure to file this notice for three consecutive years should result in automatic suspension of tax-exempt status, following an appropriate phase-in period.
   b. Notify the IRS if and when they cease operations and to file a final Form 990 series return within a specified period after termination.

Recommendations to Enhance Governance in Charitable Organizations

To improve governance practices, every charitable organization should:

4. Adopt and enforce, as a matter of best practice, a conflict of interest policy tailored to its specific needs and its state laws.*
5. Include individuals with some financial literacy on its board of directors consistent with state laws or as a matter of good practice; and consider establishing a separate audit committee of the board if the organization has its financial statements independently audited.
6. Establish policies and procedures that (1) encourage individuals to come forward with credible information on illegal practices or violations of adopted policies of the organization, and (2) protect individuals who make such reports from retaliation.*

The charitable sector should implement vigorous sector-wide efforts to educate and encourage all charitable organizations to implement these recommendations.

The IRS should require all charitable organizations to disclose whether they have a conflict of interest policy on their annual information return.

Recommendations to Strengthen Government Oversight of Charitable Organizations

7. Donor-advised funds are funds owned, controlled and administered by a public charity where the donor retains the right to make recommendations regarding the distribution or investment of those funds. Donor-advised funds are an important means of stimulating charitable contributions from donors who wish to contribute to current needs or build endowments for long-term needs. To ensure that donor-advised assets are used exclusively and appropriately to advance charitable purposes, Congress should:
   a. Define the term "donor-advised funds" in law.**
   b. Prohibit public charities from making grants to private non-operating foundations from assets held in donor-advised funds.
   c. Enact minimum activity rules requiring public charities holding donor-advised funds to (1) contact the donors/advisors of funds that have been inactive for a period of years to request advice and (2) make distributions or revoke advisory privileges if there has been no activity in an individual donor-advised fund account for a specified period.
   d. Prohibit public charities from knowingly using assets held in a donor-advised fund to (1) reimburse donors/advisors or related parties for expenses incurred by them in an advisory capacity for the selection of grantees; (2) compensate donors/advisors or related parties for services rendered, if all or substantially all of such compensation is paid from the relevant donor-advised fund; or (3) make grants to the donor/advisor or related parties.

* The Panel plans to provide model policies in its final report.

**The Panel plans to provide specific recommendations on these issues in its final report.

e. Require public charities that own and administer donor-advised funds to include on forms used to recommend potential grantees a donor certification that the grant will not provide any substantial benefit to, or relieve any obligation of, the donor, the advisor or any related party.
f. Prohibit public charities that own and administer a donor-advised fund from knowingly making grants from that fund to satisfy a legally binding charitable pledge of the donor/advisor.

8. The appropriate valuation and disposition of non-cash contributions deserves close examination in the context of *all* public charities. New legal safeguards against abuse by charities or taxpayers may be required, but any changes to federal law should not discourage individuals or corporations from making valuable non-cash contributions to charity nor force charities to dispose of donated property in a manner that would diminish its financial value to the charity.**
9. Penalties and anti-abuse rules should be modified carefully to deter inappropriate actions without unjustly punishing individuals for inadvertent violations. Congress should:
   a. Increase first-tier excise taxes imposed on foundation managers and disqualified persons who knowingly participate in self-dealing transactions.**
   b. Modify the standard for imposition of penalties on organization managers to provide a realistic possibility that such penalties will be imposed on managers when appropriate.**
10. Congress should enact targeted anti-abuse rules, accompanied by appropriate penalties, to eliminate the inappropriate use of Type III supporting organizations while maintaining the availability of such organizations for legitimate charitable purposes.**
11. Congress should develop appropriate anti-abuse provisions, with sufficient penalties, to deter charitable organizations from participating in listed tax shelter transactions.**

To improve enforcement of charitable regulations at the state and federal level, Congress should:

12. Encourage states to incorporate federal tax standards for charitable organizations into state law.
13. Increase the resources allocated to the IRS for oversight and enforcement of charitable organizations and also for overall tax enforcement.
14. Allow state attorneys general and other state officials charged by law with overseeing charitable organizations the same access to IRS information currently available by law to state revenue officers, under the same terms and restrictions.

Next Steps

A large part of the Panel on the Nonprofit Sector's work lies ahead. Additional concerns related to strengthening the governance, ethics and accountability of charitable organizations will be addressed in the Panel's final report to be released in the spring. A detailed list of issues the Panel plans to address in its second phase of work appears in Section IV of this interim report.

Introduction

America's philanthropic and charitable organizations play a distinctive role in American society and around the globe.[1] These approximately 1.3 million public charities, private foundations and religious congregations commit their resources and efforts to enriching life in communities worldwide. The nonprofit sector encompasses organizations involved in virtually every aspect of human endeavor. Whether dedicated to the advancement of knowledge and creative expression, the support of free speech, or the protection of vulnerable people, nonprofit organizations fulfill their missions with the help of millions of volunteers and professionals.

Among the great accomplishments of this sector:

- The 9-1-1 emergency response system was developed with the support of the Robert Wood Johnson Foundation. Today, an effort is underway to create the 2-1-1 information network led by the United Way of America that will connect people with health and human service programs in their communities.
- The Global HIV Vaccine Enterprise brings together some of the world's leading scientists and nonprofit organizations to expedite the creation of an HIV vaccine. Created by the Bill and Melinda Gates Foundation, this initiative has stimulated new collaborative research and funding from the private and public sectors.
- Prevention is at the heart of the work of Youth & Shelter Services, Inc. in Ames, Iowa, which targets teenagers and families at risk. For thirty years, YSS has focused on programs to prevent and reduce tobacco use, chemical dependency, teen pregnancy, juvenile crime, and emotional disorders.
- Nonprofit medical and mental health facilities in Montana and Wyoming have come together to create the Eastern Montana Telemedicine Network, which links patients and physicians from rural areas to specialized services that otherwise are hundreds of miles away. Through interactive video conferencing, patients receive real-time health services, counseling, and education. Today there are more than 200 such networks nationwide.

[1]The scope of this report is intended to address public charities, private foundations and religious congregations—those nonprofit organizations that fall under IRS section 501(c)(3).

- The banning of the harmful pesticide DDT has helped revive the declining populations of bald eagles, ospreys, peregrine falcons, and other endangered birds. Efforts to prohibit its use were supported by nonprofits such as Environmental Defense and spurred the birth of modern environmental law.
- In the last two decades, more than 36 million students have learned how to confront prejudice and bigotry through the Anti-Defamation League's "A World of Difference" classroom training program.

DIMENSIONS OF THE NONPROFIT SECTOR

The number of public charities and private foundations in America has nearly doubled over the last twenty years. Designated by the Internal Revenue Service as section 501(c)(3) organizations, they currently employ approximately 11.5 million people. The sector is predominately composed of small organizations, with 64 percent of all 501(c)(3) nonprofits operating with budgets of under $500,000 per year. Only 6 percent of nonprofit organizations have annual budgets larger than $10 million, though this group accounts for a considerably larger portion of the sector's overall activity. The American people contribute approximately $201 billion annually directly to charitable institutions, and the country's 65,000 private foundations and corporate giving programs provide an additional $40 billion toward charitable endeavors. A number of nonprofits also serve as the instruments through which government discharges some of its obligations, and are partially funded through public dollars.

To encourage widespread philanthropic giving and enable nonprofits to fulfill their missions, federal and state governments have provided the incentive of tax deductions to encourage donors to increase their gifts and have exempted nonprofits from paying most taxes. This special status is based on the expectation that the activities of nonprofit organizations serve the common good and are not conducted for private gain.

THE PANEL ON THE NONPROFIT SECTOR

Factors that Led to the Creation of the Panel on the Nonprofit Sector

The vast majority of charitable organizations[2] conduct their work in an ethical, responsible and legal manner. As in the commercial and public sectors, a small number of individuals and organizations have abused the public trust placed in them by engaging in unlawful or unethical conduct. Particularly after the corporate governance scandals that marked 2002, the national media has reported on allegations of questionable conduct by trustees and executives of public charities and private foundations. In some instances, the alleged abuses were clear violations of the law. In other cases, questions were raised about whether the practices at issue met the high ethical standards expected of the charitable sector.

While recognizing that only a small number of charitable organizations engaged

[2] Throughout this report, the term "charitable organizations" is used to refer to public charities, private foundations and religious congregations, unless otherwise specified.

in such conduct, leaders of the U.S. Senate Finance Committee and state legislators across the country asserted that further legislative and regulatory action might be necessary if illegal and excessive practices continued. Their concern resulted in a hearing convened by the Senate Finance Committee in June 2004, which was followed in July by a Committee staff-led roundtable at which sector leaders responded to a Senate Finance Committee staff discussion draft[3] of possible remedies to the problems that had emerged. Many national and local organizations had long shared the concerns of the Senate Finance Committee leadership that unethical actions of even a few bad actors had the potential to undermine the good work of the entire sector. As a result, the nonprofit community recognized the need to come together to find ways to better address these issues.

Convening of the Panel on the Nonprofit Sector

On September 22, 2004, the chairman of the Senate Finance Committee, Senator Charles Grassley (R-IA), and the ranking member, Senator Max Baucus (D-MT), sent a letter to INDEPENDENT SECTOR[4] encouraging it to assemble an independent group of leaders from the nonprofit charitable sector to consider and recommend actions to strengthen governance, ethical conduct, and accountability within public charities and private foundations. In response, on October 12, 2004, INDEPENDENT SECTOR announced the Panel on the Nonprofit Sector, naming 24 distinguished leaders from public charities and private foundations as its members.

Panel members represent large and small nonprofit organizations, community foundations and membership associations, organizations that operate worldwide or in a single state. The missions of these organizations encompass a broad spectrum of causes, all of which promote the public good.

Report Timetable

The Senate Finance Committee leadership requested an interim report from the Panel by February 2005 and a final report by the spring of 2005. Anticipating that there may be additional concerns requiring further consideration following the final report, the members of the Panel plan to continue to meet through the fall of 2005 and may offer additional comments.

Panel Work Groups

In order to benefit from the immense expertise within the sector, the Panel convened five Work Groups to address many of the issues identified by lawmakers:

- Governance and Fiduciary Responsibilities;
- Government Oversight and Self-Regulation;
- Legal Framework;
- Transparency and Financial Accountability; and
- Small Organizations.

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[3] *See* Senate Finance Committee staff discussion draft, 108th Cong. (2004).

[4] INDEPENDENT SECTOR is a nonprofit, nonpartisan coalition of approximately 500 national public charities, private foundations, and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state across the nation.

In total, the five Work Groups include over 100 professionals and other experts from the nonprofit sector who have agreed to volunteer their time and talent to support the Panel's work. Work Group members are leaders drawn from a diverse array of national, regional and local organizations. They include noted academics and practioners, state oversight officials and executives of public charities, foundations and corporate giving programs.

Panel Advisory Groups

As part of an effort to compile and utilize the knowledge and perspectives of as many individuals as possible, the Panel on the Nonprofit Sector created two Advisory Groups. The Expert Advisory Group is drawn from the ranks of academia, law and nonprofit oversight, and brings particular expertise to the issues being considered by the Panel. The Citizens Advisory Group is comprised of leaders of America's business, educational, media, political, cultural and religious institutions who provide a broad perspective on how these issues affect the public at large.

Panel Research

So that it can make informed recommendations during the forthcoming phase of its work, the Panel is initiating a series of research projects. These studies will analyze:

- Models of self-regulation, accreditation and standard-setting within the nonprofit sector and other relevant areas.
- Internal Revenue Service Forms 990 and 990-PF, in order to identify recommendations for improving the value of these forms as a credible source of public information on charities and foundations.
- How targeted Americans perceive the nonprofit sector and their views of the sector's meaning and impact on their lives.

Staff Support and Funding

The work of the Panel on the Nonprofit Sector in this initial phase has been supported by staff under the leadership of the Panel's executive director[5] and a team from a law firm that specializes in the law of exempt organizations.[6] The Panel staff is also working closely with other consultants and experts.

Already, more than 80 organizations, including private foundations, community foundations, public charities, and corporate giving programs, have made financial commitments to support the work of the Panel. These contributions reflect the sector's widespread commitment to supporting the work of the Panel by ensuring it has the funds necessary to achieve the goals set forth by the Senate Finance Committee leadership. The Panel also has benefited from invaluable pro-bono contributions of time and expertise by individuals throughout the sector and the community at large.

About the Process

To advance the Panel's work, its staff and legal team analyzed the issues raised in the Senate Finance Committee staff discussion draft on governance, fiscal management and

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[5] The Panel's executive director is Diana Aviv, president and CEO, INDEPENDENT SECTOR, Washington, D.C.

[6] Leading the legal team from Caplin & Drysdale, Chartered is Robert Boisture, member and group leader of the firm's exempt organizations practice.

ethical practice within the nonprofit sector. Upon receipt of the resulting materials, the Work Groups developed recommendations for inclusion in the Panel's interim report through a series of conference calls and the use of listservs. The Expert Advisory Group reviewed the analysis and conclusions of the Work Groups and added its own recommendations.

Given the unparalleled assembly of talented individuals working on this project, there was the desire by some to expand the agenda to address an even broader range of issues of concern to the sector. Though many issues were thought to be worthy of consideration at some future date, they were not included as part of these initial deliberations in the interest of meeting the timetable set forth by the Senate Finance Committee leadership.

As part of its effort to ensure that its processes were open, inclusive, transparent, and strengthened by the experience of many groups around the country, the Panel posted the draft recommendations of the Work Groups and Expert Advisory Group on its website at www.NonprofitPanel.org and encouraged nonprofit organizations to comment on them. In addition, the Panel convened two national conference calls to discuss both the draft recommendations and the process through which they were developed, and to invite further input from all those interested in the Panel's work. The Panel also benefited from the broad experience of the members of the Citizens Advisory Group.

Principles to Guide Improving the Accountability and Governance of Charitable Organizations

The following principles have guided the recommendations of the Panel on the Nonprofit Sector:

1. A VIBRANT NONPROFIT SECTOR IS ESSENTIAL FOR A VITAL AMERICA

America's voluntary spirit has shaped the history and character of our country since its inception. The 19th century French visitor and scholar Alexis de Tocqueville noted that, from their colonial days, Americans have come together voluntarily to improve the common good. He remarked that this was a distinctive quality of American life, to which there was no parallel in any European society. That great tradition of collaboration, generosity and participation continues today in the form of nonprofit public charities and private foundations.

Our country's expansive network of charitable organizations enriches America's communities by providing vital services in such fields as health, education, social assistance, community development and the arts. The voluntary nonprofit sector provides the means for Americans to engage collectively and collaboratively in critical research, community-building and advocacy efforts that strengthen American democracy, advance freedom of expression, and add richness and diversity to American life. U.S. nonprofit organizations assist victims of disasters, provide educational and economic opportunities, alleviate poverty and suffering at home and abroad, and foster worldwide appreciation for democratic values of justice and individual liberty.

Today, the nonprofit sector remains a creative, vibrant and unique feature of

American life, with thousands of organizations, both large and small, working together to create a better world. Unlike its commercial for-profit counterpart, the public good, rather than personal gain, is at the core of its activities. Any effort to address issues within the nonprofit sector must take into account the sector's diversity and complexity and avoid the unintended consequence of stifling its vitality. Further, any policy changes must be aimed at strengthening the great American traditions of giving to, volunteering in, and serving as leaders, directors and trustees of our charitable organizations.

2. THE NONPROFIT SECTOR'S EFFECTIVENESS DEPENDS ON ITS INDEPENDENCE

At the heart of the nonprofit sector is its power to bring people together who are committed to solving problems and enhancing the public good. Among the nonprofit sector's great strengths is its ability to pilot new ideas, to respond to needs without delay, to hold government accountable, and to encourage all efforts, both large and small, that will improve the quality of life for people across the country and abroad. Our country must continue to encourage such independent innovation and creativity by allowing charitable organizations the freedom, within a broad range of public purposes viewed by the law as charitable, to define and pursue their mission as they deem best. Government appropriately sets the rules for the use of government funds by nonprofits, but should resist inappropriate intrusion into policy and program matters best determined by the charitable organizations themselves.

3. THE NONPROFIT SECTOR'S SUCCESS DEPENDS ON ITS INTEGRITY AND CREDIBILITY

Public trust is essential to a viable nonprofit sector. The sector's value to society depends on the extent to which its organizations use their assets exclusively and effectively to advance public purposes. Federal and state laws recognize the value of nonprofit organizations by providing tax exemption and other privileges unavailable to for-profit entities. Americans contribute their resources and time to nonprofit organizations and work through these organizations to serve the common good. Donors, volunteers, consumers of services, and public officials have a right to expect nonprofit organizations to conduct themselves in a manner that will earn and sustain the public trust. To retain and strengthen this trust, nonprofit organizations have an obligation to operate in an open and transparent manner, prevent fraud and the enrichment of insiders and other abuses, and serve the purposes for which they have been created. Board members should ensure these obligations are being met through proper governance and oversight.

4. COMPREHENSIVE AND ACCURATE INFORMATION ABOUT THE NONPROFIT SECTOR MUST BE AVAILABLE TO THE PUBLIC

To enable and support the public's participation in the nonprofit sector and assure ongoing confidence in the sector, the public must have access to accurate, clear, timely, and adequate information about the programs, activities and finances of all charitable organizations. Government regulation should promote such transparency while providing sufficient flexibility to accommodate the wide range of resources and capabilities of nonprofit organizations, particularly of small organizations.

5. A VIABLE SYSTEM OF SELF-REGULATION IS NEEDED FOR THE NONPROFIT SECTOR

The vast majority of charitable organizations are committed to ethical conduct and responsible governance and are willing to conform to commonly accepted standards of practice. Such practices are an important component of the effort by the charitable sector to encourage all nonprofit organizations to embrace the highest possible standards of conduct. Whether it be peer review and feedback, coupled with transparency in practice or more complex systems of accreditation, such initiatives, if actively embraced by the sector, are likely to bring about positive change.

Although self-regulation is unlikely to work with those who deliberately and cavalierly violate standards of ethical practice and are immune to peer pressure, the charitable sector nonetheless must be actively involved in identifying and promoting best practices and strongly encouraging compliance within relevant subsectors. The sector must offer educational programs that reach the entire sector, especially the board members and professional leaders who may not otherwise be aware of the expectations and requirements imposed on them. Both the sector and government should provide the resources necessary to disseminate best practices and to develop and sustain ongoing education efforts to help board trustees to govern and CEOs to operate in a responsible, transparent and accountable manner.

6. GOVERNMENT SHOULD ENSURE EFFECTIVE ENFORCEMENT OF THE LAW

Abuse of the privileges granted nonprofit organizations, while perpetrated by a small number of individuals and organizations, threatens the work of the entire sector and may diminish the generosity of donors. Accordingly, government should authorize and appropriate sufficient resources to facilitate full implementation of the law designed to prevent such abuses. There also should be greater coordination between federal and state oversight officials in order to make best use of limited resources and avoid duplication of work. In addition, government should support sound educational and technical assistance programs to ensure that all nonprofit organizations are familiar with the law and appropriate standards of practice.

7. GOVERNMENT REGULATION SHOULD DETER ABUSE WITHOUT DISCOURAGING LEGITIMATE CHARITABLE ACTIVITIES

Regulation is necessary to address instances in which the sector cannot reasonably be expected to deal with those who deliberately abuse the public trust and exploit nonprofit organizations for personal gain. New regulation may be needed where current legal standards have proven inadequate. However, regulation that is not responsive to the diversity of the nonprofit sector has the potential to increase the administrative and financial obligations of compliance to a level that will force some organizations to curtail or even cease their legitimate charitable activities. Particular care should be given to any actions that might deter new donors or discourage responsible volunteers from serving on boards.

8. DEMONSTRATIONS OF COMPLIANCE WITH HIGH STANDARDS OF ETHICAL CONDUCT SHOULD BE COMMENSURATE WITH THE SIZE, SCALE AND RESOURCES OF THE ORGANIZATION

All organizations should be expected to operate ethically and serve as worthy stewards of the public and private resources entrusted to them. Fraud or abuse cannot be condoned in any organization for any reason. A breach of the public trust by any organization, large or small, damages the reputation of the entire sector. At the same time, it may not be possible or desirable for small organizations, given their limited human, technical and financial resources, to demonstrate their ethical and accountable operation by complying with some of the more complex legal requirements appropriate for larger charitable organizations. Lawmakers must consider the range of organizations to which regulations may apply, and must refrain from adopting regulations where the costs of demonstrating compliance outweigh the benefits gained.

SECTION III

Recommendations of the Panel on the Nonprofit Sector

Maintaining public trust in the nonprofit sector requires a balance of vigorous government enforcement, and effective governance of charitable organizations through a viable system of management and governance standards and proactive educational programs that are part of a self regulatory system. The recommendations offered in this interim report include some recommendations for actions by the charitable sector and by charitable organizations and their boards of directors, recommendations for action by the Internal Revenue Service, and recommendations for legislative action to improve governance and oversight of the sector.

These recommendations, while drawing upon the wisdom and expertise of hundreds of organizations and individuals, are those of the Panel on the Nonprofit Sector. Organizations associated with this process as well as others will be encouraged to endorse the recommendations once they have been shared with the Senate Finance Committee.

Recommendations to Improve Transparency in Charitable Organizations

1. INTERNAL REVENUE SERVICE INFORMATION RETURNS

Issue

Organizations exempt from federal income tax are required to file an annual information return (Form 990, 990-EZ, or 990-PF) with the Internal Revenue Service.[1] For charitable organizations,[2] this annual information return serves as the primary document providing information about the organization's finances, governance, operations and programs for federal regulators, the public, and many state charity officials.

Current IRS regulations permit any authorized officer of the organization[3] to sign Form 990 returns certifying, under penalty of perjury, that the return and accompanying schedules and statements are true, correct and complete. Exempt organizations may receive an automatic three-month extension to file their Form 990 returns by filing a request on Form 8868, and the IRS has the discretion to grant an additional three-month extension upon a showing of reasonable cause.

The IRS may impose penalties for failure to file a required return or to include required information on Form 990 series returns. These penalties may reach up to $10,000 or 5 percent of gross receipts per return for organizations with annual receipts of $1 million or less, and $50,000 per return for organizations with over $1 million in annual gross receipts. Although the majority of Form 990 series returns are prepared by professional tax personnel who certify the form under penalty of perjury,[4] current preparer penalties imposed for filing false tax returns do not apply to the preparation of Form 990 information returns.

As a result, too many Form 990 series returns provide inaccurate or incomplete information. Current information often is not available to the public and government officials because of delays in filing and processing the returns. Enforcement is hampered by the high costs of processing paper returns.

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[1] Excluded from this requirement are organizations other than private foundations with annual gross receipts of $25,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities and other organizations relieved of this requirement by authority of the IRS.

[2] Throughout this report, the term "charitable organizations" is used to refer to public charities, private foundations and religious congregations, unless otherwise specified.

[3] For a corporation or association, this officer may be the president, vice president, treasurer, assistant treasurer, chief accounting officer or other corporate or association officer, such as a tax officer. A receiver, trustee, or assignee must sign any return he or she files for a corporation or association. For a trust, the authorized trustee must sign.

[4] Surveys conducted by the IRS and National Center for Charitable Statistics indicate that approximately 80 percent of all Forms 990 are prepared by professional tax personnel.

Recommendation for Charitable Organization Action[5]

Charitable organizations should encourage their boards or an appropriate board committee to review the Form 990 or 990-PF. Board members should be familiar with their organization's Form 990 or 990-PF return as it is a central public document about the organization. Depending on the knowledge and expertise of its members, a board may choose to delegate this responsibility to an appropriate committee of the board. This recommendation should be adopted as a "best practice" by all charitable organizations.

Recommendations for Internal Revenue Service Action

1. The IRS should require that the Form 990 series returns be signed, under penalties of perjury, by the chief executive officer, the chief financial officer, or the highest ranking officer, or, if the organization is a trust, by a trustee of the organization. Requiring one of the highest ranking officers in an organization to sign the Form 990 or 990-PF and attest to the accuracy and completeness of its contents will strengthen the effort and oversight organizations devote to the preparation and filing of these returns. It also will ensure that the senior executive officers of charitable organizations are cognizant of and take responsibility for the representations made in their Forms 990 to the public and regulatory officials about their charitable operations.
2. Existing financial penalties imposed on organizations or organization managers for failure to file complete and/or accurate returns could provide a sufficient deterrent to non-compliance and should be fully enforced by the IRS. However, increasing financial penalties could present a hardship for charitable organizations, particularly where there are unintentional errors and omissions, and would not necessarily improve compliance unless enforcement is also increased. The Panel therefore does not support the proposal in the June 2004 Senate Finance Committee staff discussion draft to increase existing penalties for failure to file complete and accurate Forms 990.
3. When existing penalties for failure to file a required return after appropriate notice from the IRS do not result in compliance by the charity after two consecutive years or more, the IRS should be authorized to *suspend* the tax-exempt status of any charitable organization. *Suspension* of the tax-exempt status of organizations that fail to file for two consecutive years would mean that such organizations could not receive tax-deductible contributions and their income would not be exempt from taxation until they make appropriate correction and restitution. The IRS should immediately develop procedures for

[5] Recommendations for charitable organizations are intended to encourage voluntary charitable sector action and do not require government action.

timely notification of suspension of exemption. The Panel does not support *revocation* of the tax-exempt status as a cost-effective and appropriate penalty.

4. Present-law penalties imposed on income tax preparers of personal and corporate tax returns for omission or misrepresentation of information, willful or reckless misrepresentation, or disregard of rules and regulations should be extended to preparers of Form 990 series returns. Extending penalties to professional tax preparers will improve compliance with Form 990 requirements significantly because they prepare and certify the majority of these forms.
5. The IRS should move forward with mandatory electronic filing of all Form 990 series returns as expeditiously as possible. However, before mandatory e-filing can be implemented, the IRS electronic filing system and forms must be modified to allow for separate attachments. The IRS also should be directed to make appropriate changes to the Forms 990 and 990-PF to allow charitable organizations to comply with e-filing requirements in a timely, cost-effective manner and to make appropriate accommodations for organizations with limited annual receipts and assets to comply. Some statutory changes may be required to eliminate particular information requirements that increase the cost and difficulty of implementing electronic filing for large organizations without serving a clear enforcement purpose and to provide appropriate accommodation for smaller organizations that do not have easy or affordable access to the necessary computer hardware or software for electronic filing.

   Electronic filing by all charitable organizations likely will increase compliance with Form 990 requirements significantly and provide the public with more timely access to information on the nonprofit sector. Electronic filing software provides organizations with immediate checks on incomplete and potentially inaccurate information before they file returns, and e-filing also allows the IRS to reject and provide immediate feedback to organizations about incomplete returns and returns with obvious inaccuracies.
6. Federal e-filing efforts should be coordinated with state filing requirements. By coordinating e-filing efforts with state charity officials, the IRS could expand its enforcement capacity, encourage more uniform and timely reporting, and simplify the task of organizations that are required to file in multiple states.
7. The IRS should require that the Form 1023, the application for recognition as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code, be filed electronically. The Form 1023 is an important document for potential donors and regulators to review in order to understand the intended purpose and structure of newly established public charities. If the Form 1023 were filed electronically, it could be made available to the public more easily and cost-effectively through publicly available databases.

Other Considerations

The Panel discussed proposals to reduce the time period for extensions to file returns, which is currently set at three months for the first extension and an additional three months for a second extension. Charitable organizations may require additional time to obtain the necessary information from third parties to file a complete and accurate return. Generally, charitable organizations do not file their Form 990 or 990-PF returns until they have audited financial statements and they may encounter significant delays in having audits completed, particularly in areas of the country where there are a limited number of accountants with expertise in nonprofit accounting rules. Given the financial challenges that so many charitable organizations face on a daily basis, some organizations find that it is more cost effective to have returns prepared during the accounting "off season." *The Panel will be studying other proposals to increase the timeliness of filing Form 990 series returns to include further recommendations in its final report.*

There is a need for revision and reform of the Form 990 series returns to ensure accurate, complete, timely, consistent and informative reporting. *The Panel intends to offer recommendations for revising the form and substance of Form 990 series returns in its final report.*

2. FINANCIAL AUDITS AND REVIEWS

Issue

Concerns have been raised about the quality of financial information on charitable organizations available to boards of directors, regulators and the public. Having financial statements prepared and audited in accordance with generally accepted accounting principles and auditing standards improves the quality of financial information available. A number of states require charitable organizations that meet certain financial criteria and/or that solicit contributions from the public to prepare audited financial statements. Under the Office of Management and Budget Circular No. A-133, the federal government currently requires non-federal organizations that receive federal awards of $500,000 or more per year to perform an audit of the federal funds received and expended and the programs for which the funds were received. There is currently no other federal requirement for financial audits of charitable organizations.

Recommendations for Legislative Action

1. Charitable organizations that are required to file a Form 990 or 990-PF and that have $2 million or more in total annual revenues should be required by law to have an audit conducted of their financial statements and operations. Charitable organizations that are required to file a Form 990 or 990-PF and that have at least $500,000 and under $2 million in total annual revenues should be required by law to have financial statements reviewed by an independent public accountant.
2. All charitable organizations that are required by law to have audited financial statements should also be required to attach their financial statements to the annual information return (Form 990 or 990-PF) filed with the Internal Revenue Service. The statements should be made available for public inspection in the same manner as the Form 990 or 990-PF.

Rationale

Financial audits can be a substantial expense for many charitable organizations, depending on the size, scale and complexity of the organization's operations. Thresholds for various state requirements for audited financial statements by charitable organizations were reviewed, as were requirements of some accreditation agencies for audits or reviews of participating organizations based on specific financial criteria.[6] While national data was not available about specific audit costs, the Panel determined that the threshold of $2 million or more in total annual

[6] For example, the Evangelical Council for Financial Accountability requires all participating agencies to obtain an annual audit performed by an independent certified public accounting firm in accordance with generally accepted auditing standards (GAAS) with financial statements prepared in accordance with generally accepted accounting principles (GAAP). Organizations with less than $500,000 in annual revenues may periodically obtain a compilation and review of financial statements in lieu of an audit.

revenues would require most charitable organizations to spend less than 1 percent of their annual budget to obtain an audit.[7]

For smaller organizations with at least $500,000 and under $2 million in total annual revenues, a financial statement review by an independent accountant offers a less expensive option while still providing the board, regulators and the public with some assurance of the accuracy of the organization's financial records.

This recommendation is limited to 501(c)(3) organizations that are currently required to file an annual information return with the IRS, thereby excluding houses of worship and their affiliated organizations, governmental units and their affiliates, and other specific organizations.

Charitable organizations are currently required to make their annual information returns (the Form 990 series) available to the public for a period of three years at the organization's principal and regional or district offices during regular business hours; and by mail upon personal or written request, or by posting on the organization's own website or on the Internet. Requiring organizations to make their audited financial statements available on the same basis will provide the public with additional, reliable information by which to monitor such organizations.

The Panel recognizes that there may be some discrepancies between information in the audited financial statements and information provided on the Form 990 returns, particularly for organizations that have consolidated financial statements but must file independent information returns for each of the related entities covered in the consolidated statements. Provisions must be made for organizations to explain discrepancies and, where appropriate, to file both the consolidated statements for the parent organization and appendices detailing financial information for the related entity.

[7] The United Way of America is conducting a study of member audit costs that will be shared with the Panel. Preliminary data indicates that the average audit cost for agencies in United Way's Metro Area II (smaller urban areas) where annual revenues range from $4 million to $9 million were $15,795 or 0.26 percent of the annual revenue. For agencies in Metro Area III, where annual revenues range from $2 to $3.8 million, the average audit cost was $10,440 or 0.37 percent of the annual revenues. The smallest agencies, Metro Area VII, whose annual revenues are below $500,000, the average audit cost was $3,475 or 0.93 percent of the annual revenues.

Other Considerations

The Panel noted that in some cases, changing audit firms on a regular basis (every five years or more) can be beneficial and recommends that large organizations, as a best practice, consider rotation of audit firms or partners as appropriate. However, the availability of auditors with the appropriate expertise can be quite limited based on where the organization is located and the size and complexity of its operations. The cost of audits and the willingness of some auditors to perform all or part of the audit on a pro bono basis can also determine the practicality of rotating audit firms or partners. Therefore, the Panel does not believe it would be appropriate for the federal government to require the rotation of auditors for charitable organizations.

The Panel discussed concerns raised by a number of scholars and accounting practitioners that some standards established by the Financial Accounting Standards Board (FASB) may be inappropriate for charitable organizations.[8] The Panel also examined the need for greater definition and understanding of the standards and requirements for auditors regarding reportable events discovered in the course of a financial audit or review. *The Panel intends to examine these issues more closely in the months ahead in order to make more informed recommendations in its final report to the Senate Finance Committee.*

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[8] For example, Robert N. Anthony, professor emeritus at Harvard University, has been sharply critical of the SFAS No. 116 and No. 117 issued by FASB in the mid-1990s and stated that "SFAS No. 117 challenges the accountant to find a sensible way of preparing an operating statement for nonprofit organizations that have contributed endowment, plant, or museum objects. The statement mixes operating transactions with nonoperating transactions and leads to what many believe to be a useless bottom line."

3. ANNUAL NOTIFICATION REQUIREMENT FOR ORGANIZATIONS NOT FILING INFORMATION RETURNS

Issue

The Internal Revenue Service publishes a list of organizations eligible to receive tax-deductible contributions to assist taxpayers in making charitable giving decisions. However, this list (Publication 78) includes outdated contact information for many organizations and may include many organizations that have ceased operations or become inactive without notifying the IRS. The IRS currently has no mechanism for updating information for organizations that do not file an annual Form 990 series return because their annual receipts fall below the specified amount (generally, under $25,000) or because they meet other criteria for houses of worship and their affiliated organizations, governmental units and their affiliates, and other specific organizations. Consequently, taxpayers cannot rely on the IRS list for accurate information.

Recommendations

1. Legislation should be enacted requiring all organizations recognized under section 501(c)(3) of the Internal Revenue Code that are currently excused from filing an annual information return because their annual gross receipts fall below the specified amount (currently below $25,000) to file an annual notice with the IRS containing the following items:
   - The organization's name and any name under which such organization operates or does business;
   - The organization's mailing address, telephone number, and Internet website address (if applicable);
   - The organization's taxpayer identification number;
   - The name and address of a principal officer of the organization;
   - A statement of the organization's mission;
   - The organization's total revenues and expenditures for the year; and
   - An indication of whether the organization has terminated operations.

   This notification form should be incorporated in the Form 990 series and should be required to be made available to the public on the same basis as other Form 990 series returns. Further, the IRS should be directed to make this notice available for electronic filing and should require e-filing of this notice as soon as possible.
2. Charitable organizations should be required to notify the IRS if and when they cease operations and to file a final Form 990 series return within a specified period after termination.
3. The IRS should be required to *suspend* the tax-exempt status of organizations that fail to file the required notification form for three consecutive years. Because of the lack of current contact information for many of these organizations in the IRS databases, the Panel recommends that an *appropriate phase-in period* be provided before automatic suspension is enforced.

Rationale

This notification requirement would assist the IRS in providing for public use more accurate information on the charitable organizations that are exempt from federal income taxes and are eligible to receive tax-deductible contributions. It would also help to ensure that all organizations granted charitable tax-exempt status by the IRS can be notified of more detailed filing requirements should their annual gross receipts rise above the minimum filing thresholds.

Currently, organizations that are terminating operations are asked to send a letter to the Exempt Organization Customer Account Services at the IRS and, if they file an annual return (Form 990, 990-EZ or 990-PF), to check a "Final Return" box on the first page of the return. A formal requirement to provide notification of termination to the IRS would provide greater clarification regarding organizations involved in dissolution or termination procedures. This, coupled with the new annual notification requirement, should enable the IRS and the public to have more timely, accurate information on charities that are eligible to receive tax-deductible contributions.

The Panel believes that automatic suspension of tax-exempt status is a cost-effective remedy for both the IRS and organizations that are not in compliance. The IRS should be required to give prompt notice of the suspension. The organization's income would not be exempt from taxation and the organization would not be eligible to receive tax-deductible contributions if its status was suspended, but the status can be reinstated with relatively little impact and cost to the IRS when the error or offense is corrected.[9]

Other Considerations

The Panel discussed whether this notification form should include additional information, such as the names of the organization's board of directors, the source of the organization's funds, and disclosure of whether the organization currently engages in a limited number of governance and accountability best practices (based on questions included on the new Form 1023 Application for Recognition of Exemption) through a checklist-style series of yes/no questions. After careful consideration, the Panel determined that such additional information would unduly complicate and increase the cost of establishing and enforcing the new notification requirement and therefore did not include this in its recommendation.

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9 In its January 26, 2005, report, "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-02-05), the Joint Committee on Taxation of the U.S. Congress calls for a similar annual notification requirement and suggests that an organization's tax-exempt status should be automatically revoked if the organization fails to provide the required annual notice for three consecutive years. The Panel believes that automatic revocation introduces unnecessary cost burdens for the IRS and the organization and suggests that the same results can be achieved more cost-effectively through automatic suspension of tax-exempt status.

Recommendations to Enhance Governance of Charitable Organizations

4. CONFLICT OF INTEREST POLICY DISCLOSURE

Issue

There are instances in which board members and staff of charitable organizations have personal, business or other interests in transactions that the charitable organization undertakes. A conflict of interest arises in such situations when the board member or staff person's duty of loyalty to the charitable organization comes into conflict with the competing interest they may have in the proposed transaction. Some such transactions are illegal, some are unethical, and some may be undertaken in the best interest of the charitable organization as long as certain clear procedures are followed. A fundamental step in preventing abuse in and protecting the reputation of charitable organizations is the identification and appropriate management of apparent and actual conflicts of interest. Many charitable organizations neither understand what a conflict of interest entails, nor have policies to help guide board members, staff and volunteers in dealing with the apparent or actual conflicts that will inevitably arise.

A conflict of interest policy can help to ensure that a charitable organization, and its officers and directors, comply with federal and state legal obligations. Violations of section 4941 of the Internal Revenue Code (self-dealing transactions for private foundations) and section 4958 (excess benefit transactions for public charities) are triggered by transactions involving individuals who may have a conflict of interest with respect to the organization, as defined by the Code. All states mandate that directors and officers owe a duty of loyalty to the organization, and improperly benefiting from a transaction involving a conflict of interest more than likely involves a violation of the duty of loyalty. Some state statutes specifically penalize participation in transactions involving conflicts of interests unless the organization follows certain prescribed procedures.

Recommendations for Charitable Organization Action

1. Every charitable organization, as a matter of best practice, should adopt and enforce a conflict of interest policy consistent with the laws of the state in which it is located and tailored to its specific organizational needs and characteristics. This policy should define conflict of interest, identify the classes of individuals within the organization covered by the policy, specify procedures to be followed in managing conflicts of interest and facilitate disclosure of information that may lead to conflicts of interest. Special attention should be paid to any transactions between board members and the organization.
2. There should be a vigorous sector-wide effort to encourage all charitable organizations, regardless of size, to adopt and enforce conflict of interest policies.

4. CONFLICT OF INTEREST POLICY DISCLOSURE continued

Recommendation for Internal Revenue Service Action

The Form 990 series (Form 990, Form 990-EZ, Form 990-PF) should be revised by the IRS to require all charitable organizations to disclose whether they have a conflict of interest policy. Beyond this new disclosure requirement, however, no new legal requirements are warranted. Because of the variability both in state laws and among charitable organizations, adoption and enforcement of conflict of interest policies should be a matter of recommended practice for the sector. *The Panel expects to develop model conflict of interest policy provisions to assist charitable organizations in crafting policies tailored to their specific organizational needs.*

Rationale

Establishing and enforcing a conflict of interest policy is an important part of safeguarding charitable organizations against engaging in unethical or illegal practices. A requirement to report annually whether or not an organization has adopted such a policy will remind organizations that have not yet done so that this is an important step to take and will likely result in more organizations adopting and enforcing such policies. The Panel notes with approval that the IRS has already added a question to the new Form 1023 asking organizations whether they have adopted a conflict of interest policy.

The Panel also notes that if an organization has a conflict of interest policy requiring signatures by board members and staff, and signed forms are missing, an outside auditor is required to report that fact in connection with its audit. This constitutes yet another means to ensure compliance with conflict of interest policies.

5. AUDIT COMMITTEES

Issue

One of the primary duties of the board of directors of a charitable organization is to ensure that all financial matters of the organization are conducted legally, ethically and in accordance with proper accounting rules. Depending on the size and scale of the organization, the board of directors may choose or be required by law[1] to have the organization's financial statements audited or reviewed by an independent auditor. In overseeing the audit process, the full board of directors must have sufficient objectivity in assessing the financial controls, policies, procedures, and condition of the organization, and adequate oversight of the external auditor.

At issue is whether boards of directors should be required by law to establish a separate audit committee to review management's performance and the performance of external auditors hired to conduct audits, reviews and compilations.

Recommendation

Audit committees should not be defined or required by federal law. Oversight of the audit function is a critical responsibility of the board of directors, but boards of directors must have the independence to assess the most cost-effective methods for ensuring that the organization's financial resources are managed responsibly and effectively. Organizations with small boards of directors and limited organizational structures may not choose to delegate the audit oversight responsibility to a separate committee. This decision should be determined by the board of the organization and not be mandated by law. Further, audit committees may be inappropriate for charitable organizations that are organized as trusts rather than as corporations.

Recommendations for Charitable Organization Action

1. Charitable organizations should include individuals with some financial literacy on their board of directors in accordance with the laws of their state or as a matter of good practice. Every charitable organization that has its financial statements independently audited, whether legally required or not, should consider establishing a separate audit committee of the board. If the board does not have sufficient financial literacy, it may form an audit committee comprised of non-voting, non-staff advisors rather than board members if state law permits.
2. There should be a sector-wide effort to educate charitable organizations about the importance of the auditing function. Since so many organizational leaders, both professional and volunteer, come to the charitable sector motivated by the mission of the organization, they may not always

[1] See Issue #2, Financial Audits and Reviews, p. 23-25 of this report.

have the requisite knowledge regarding governance and finance. However, they may be very responsive to improving practices once they are made aware of the process.

Other Considerations

Audit committees can help the board have greater assurance that audited financial statements are accurate and comprehensive by reducing possible conflicts of interest between outside auditors and the paid staff of the organization. It is important that the board or its audit committee, if it chooses or is required by state law to establish such a committee, include individuals with financial expertise. The board or its audit committee should not include paid staff of the organization in the audit review process.

The Panel discussed the board's responsibilities for overseeing the audit process and duties it should either perform itself or delegate to an audit committee. These include:

- Retaining and terminating the engagement of the independent auditor;
- Reviewing the terms of the auditor's engagement at least every five years;
- Overseeing the performance of the independent audit;
- Conferring with the auditor to ensure that the affairs of the organization are in order;
- Recommending approval of the annual audit report to the full board;
- Overseeing policies and procedures for encouraging whistleblowers to report questionable accounting or auditing matters of the organization;
- Approving any non-audit services performed by the auditing firm;
- Reviewing adoption and implementation of internal financial controls through the audit process; and
- Monitoring the organization's response to potentially illegal or unethical practices within the organization, including but not limited to fraudulent accounting.

Education and technical assistance should be available to boards of directors to assist them in overseeing the audit process and deciding whether to establish audit committees, assess what the duties of the audit committee should be and hold external auditors accountable for conducting thorough audits. *The Panel expects to make further recommendations on mechanisms for providing and funding such assistance and educational efforts in its final report.*

6. REPORTING OF SUSPECTED MISCONDUCT OR MALFEASANCE

Issue

Employees and others affiliated with charitable organizations may be reluctant to come forward with information about suspected wrong-doing or questionable practices for fear of retaliation by their employers. Some state laws provide protections for employees who report misconduct under specific conditions. The Sarbanes-Oxley Act of 2002 prohibits employment-related retaliation (including by nonprofits) against whistleblowers who provide information on certain financial crimes delineated under federal law. Many within the charitable sector may not be aware that the whistleblower provision of the Sarbanes-Oxley Act applies to nonprofits as well.

Recommendation

Existing legal provisions protect individuals working in charitable organizations from retaliation for engaging in whistleblowing activities, and violation of these provisions will subject organizations and responsible individuals to civil and criminal sanctions. Because of the great diversity of organizational structure, governance, and capacity within the charitable sector, as well as the variability in state laws, whistleblower policies and procedures will be more effective if they are tailored to the needs of individual organizations. Therefore, no additional legislative action is required.

Recommendations for Charitable Organization Action

1. All charitable organizations should establish policies and procedures that encourage individuals to come forward with credible information on illegal practices or violations of adopted policies of the organization. These policies and procedures should specify the individual or individuals within the organization (both board and staff) or outside parties to whom such information can be reported, and should include at least one way to report such information that will protect the anonymity of the individual providing the information. The policy also should specify that the organization will protect the individual who makes such a report from retaliation.
2. To facilitate the establishment of these policies and procedures, a sector-wide education initiative should be undertaken to inform charitable organizations about establishing such policies and procedures. This initiative should develop model policies as well as notification and reporting procedures for use by charitable organizations. *The Panel will review policies that have been implemented successfully by charitable organizations to provide recommendations in its final report.*

Recommendations to Strengthen Government Oversight of Charitable Organizations

7. DONOR-ADVISED FUNDS

Issue

Over the past century, donor-advised funds have evolved as an important means of stimulating charitable contributions from a broad range of donors. Community foundations pioneered the development of donor-advised funds and such vehicles remain a vital means for donors to make philanthropic contributions today and to build endowments for long-term community needs. More recently, other types of charitable organizations—including educational institutions, cultural organizations, federations and a new class of national charities that receive and distribute donor-advised funds—have begun to make more extensive use of donor-advised funds.

There currently is no statutory definition of a donor-advised fund. However, a donor-advised fund is generally understood to be a fund maintained by a public charity,[1] typically as a separately identified fund or account, though in some cases as a separate trust. The donor-advised fund is owned, controlled, and administered by the public charity, subject to an agreement under which the donor (or an advisor designated by the donor) has the right to make recommendations with respect to distributions and/or investments. As with its other assets, the administering public charity has a fiduciary obligation to ensure that donor-advised assets are used exclusively for charitable purposes.

For many donors, donor-advised funds are an attractive alternative to creating a private foundation. Because they are donations to a public charity, contributions to a donor-advised fund may qualify for more favorable charitable deduction treatment than contributions to a private foundation. Because they are assets of a public charity, donor-advised funds are not subject to the self-dealing, payout, and taxable expenditure rules applicable to private foundations. Finally, because the public charity owns and administers the fund, the donor is freed of the administrative burden of creating and maintaining a private foundation and also benefits from the philanthropic and substantive expertise of the public charity.

Most charities with donor-advised funds exercise the highest levels of fiduciary responsibility to ensure that donor-advised assets are used exclusively and appropriately to advance charitable purposes. However, donor-advised funds can be subject to a range of potential abuses if the administering public charity fails to exercise its fiduciary responsibility. Specific concerns include the following:

- Current reporting obligations for charities owning donor-advised funds are inadequate to allow the IRS, the media and the general public to determine the extent of assets held in donor-advised funds and how those assets are employed in furtherance of the charity's exempt purposes.

[1] Although there is no known prohibition on private foundations administering donor-advised funds, virtually all donor-advised funds are and historically have been administered by public charities. Therefore, this description does not address the donor-advised funds, if any, that may be administered by private foundations.

- Assets contributed to donor-advised funds, for which the donors receive a current income tax deduction, potentially may not be used for charitable purposes within a reasonable amount of time if the assets are "parked" in the donor-advised fund. There are also concerns that some charities may permit assets contributed by a private foundation, which counts such distribution toward satisfaction of the foundation's minimum payout requirement, to be distributed back to the private foundation ("round-tripping").
- Some donors try to manipulate donor-advised fund grants to obtain substantial private benefits, such as payment of tuition or the purchase of tickets to charity events.
- Some public charities may approve the use of donor-advised assets to reimburse donors/advisors for travel costs and other expenses purportedly related to the investigation of potential grantees.

Recommendations for Internal Revenue Service Action

Public charities, in addition to identifying themselves as owners of donor-advised funds on the Form 990,[2] should be required to disclose on their Form 990 aggregate financial information about donor-advised funds they hold. While there could be benefit to charities and the public from the disclosure of greater information about donor-advised funds, such as the names of advisors to the funds, such disclosure would compromise donor anonymity (where anonymity is desired) and deter some donors from giving. *The Panel will make recommendations on the specific types of information that should be reported by public charities in its final report.*

Recommendations for Legislative Action

1. The term "donor-advised fund" should be statutorily defined to provide a basis for targeted rules addressing potential abuses of donor-advised funds, without discouraging use of such funds by donors. The definition should make clear that a donor-advised fund is a separately identified fund or account consisting of assets owned by a public charity with respect to which there is an understanding between the donor and the charity that the charity will consider non-binding advice from the donor (or an advisor) regarding investments or distributions of the amount held in the fund. The definition explicitly should exclude specific arrangements in which advisory rights are substantially more limited than in the typical donor-advised fund, such as funds for which a majority of the advisors are appointed by a public charity or by a governmental entity and funds designated at the time of the gift to support a specific charitable purpose when specified conditions regarding the selection of fund advisors and/or grantees are met. *The Panel is considering several definitions of "donor-advised fund" put forth*

[2] *See* IRS Form 990, Schedule A, Part III, Question 4a (2004).

by various experts and intends to make specific recommendations in its final report regarding the contours of a definition, including the types of funds that should be excluded from the definition and the appropriate section of the Internal Revenue Code for such a definition to appear.

2. Public charities should be prohibited from making grants to private non-operating foundations from assets held in donor-advised funds. While there may be some situations in which grants from assets held in donor-advised funds to private non-operating foundations are desirable, attempts to draft or enforce a more targeted rule allowing these few instances while prohibiting other such distributions would be extremely difficult, if not impossible.
3. Public charities holding donor-advised funds should be subject to minimum activity rules to ensure that funds are not permitted to remain in inactive donor-advised fund accounts indefinitely. These minimum activity rules should require charitable organizations (a) to contact the donors/advisors of funds that have been inactive for a period of years to request advice and (b) to make distributions or revoke advisory privileges if there has been no activity in an individual donor-advised fund account for a specified time period. This recommendation addresses concerns about "parking" of assets over extended periods while preserving the ability of donors to use donor-advised funds legitimately to accrue assets for a specific intended charitable purpose, such as creating a field-of-interest fund, scholarship fund or an endowed faculty chair at a university. *The Panel intends to make further recommendations for these minimum activity rules with specific time periods in its final report.*
4. Public charities should be prohibited from knowingly using assets held in a donor-advised fund to:
   (a) Reimburse donors/advisors or related parties for expenses incurred by them in an advisory capacity for the selection of grantees;
   (b) Compensate the donor/advisor or related parties for services rendered, if all or substantially all of such compensation is paid from the relevant donor-advised fund; and
   (c) Make grants to the donor/advisor or related parties.
   This narrowly targeted prohibition on certain uses of donor-advised fund assets is an easily administrable standard that would prevent identified abuses.[3]
5. Public charities that own and administer donor-advised funds should be required to include on forms used to recommend potential grantees a donor certification that the grant will not provide any substantial benefit to, or relieve any obliga-

[3] *See* Senate Finance Committee staff discussion draft, 108th Cong. (2004) (second and tenth recommendation relating to donor-advised funds).

tion of, the donor, the advisor or any related party.

6. Public charities that own and administer a donor-advised fund should not be permitted knowingly to make grants from that fund to satisfy a legally binding charitable pledge of the donor/advisor. Assets of donor-advised funds belong to the charity that owns and administers the funds and allowing donors to make binding pledges on those assets would violate the prohibition on use of charitable assets for private benefit. The proposal in the Senate Finance Committee staff discussion draft to permit donor-advised funds to satisfy a donor's legally binding pledge would ease administration of donor-advised funds; however, the Panel believes that it is important to adhere strictly to the principle that assets in donor-advised funds may not be used in ways that confer substantial benefits on donor/advisors.

Other Considerations

The Panel is studying proposals requiring that donor-advised fund grantees acknowledge to the grantor public charity that the donor-advised grant will not result in any substantial benefit to the recommending donor/advisor.[4] Such proposals must balance the benefit of the grantee's verification that no benefit has been provided to the donor/advisor with the anticipated administrative burdens of carrying out a grantee acknowledgement requirement and the need to respect the value of maintaining donor anonymity.

The Panel discussed how minimum payout requirements could be implemented for donor-advised funds and determined that subjecting assets held in donor-advised funds to the complex rules that govern distributions by private foundations would require public charities holding those assets to incur significant administrative costs without producing a corresponding public benefit, since most donor-advised fund programs pay out substantially more than 5 percent. The Panel therefore opposes establishing a minimum payout requirement for donor-advised funds.

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4 *See, e.g., id.* at 2 (third recommendation relating to donor-advised funds).

8. RULES FOR VALUATION OF PROPERTY CONTRIBUTIONS

Issue

In its discussion draft, Senate Finance Committee staff recommended that contributions to donor-advised funds of assets other than cash or publicly traded securities be required to be sold within one year of the contribution (or that donor-advised funds be allowed to receive only contributions of cash or publicly traded securities).

The Senate Finance Committee staff discussion draft also proposed that a mandatory "baseball arbitration" (where the arbitrator must choose one side's valuation) procedure be instituted to assist in resolving federal tax valuation disputes regarding the value of property contributed to a charity (other than cash or publicly traded securities).

Recommendation

The appropriate valuation and disposition of non-cash contributions should be addressed in the context of all public charities, rather than developed for specific types of assets or funds that are held by charities. *The Panel has instituted procedures to study these complex issues over the coming months in order to provide specific recommendations in its final report to the Senate Finance Committee.*

Note: The Panel has deep reservations concerning the Joint Committee on Taxation recommendation in its January 27, 2005, report on "Options to Improve Tax Compliance and Reform Tax Expenditures" to limit deductions for contributions of property (other than publicly traded securities) to the donor's basis in the property or, if less, the fair market value of the property. The effect of this proposal could be to eliminate a significant source of contributions for charities.

Rationale

Federal law should provide adequate safeguards against abuse by charities or taxpayers in all areas, including valuation and disposition of non-cash contributions. At the same time, it is important to ensure that any changes to federal law do not unnecessarily discourage individuals or corporations from making valuable non-cash contributions to charity or force charities to dispose of donated property in a manner that would diminish its financial value to the charity. The Joint Committee on Taxation's argument that gifts of property other than publicly traded securities require significant diversion of resources from the mission of a charitable organization does not comport with sector experience and does not take into account the capacity of many charities like community foundations and institutions with major endowments to make effective use of gifts of real estate, closely held stock, limited partnership interests, and other securities in meeting their long-term financial goals to further their charitable missions, nor the importance to museums and other cultural organizations of donations of art and artifacts. The Joint Committee on Taxation raises a number of other possible approaches to valuation concerns related to donated property ranging from strengthening present-law appraiser and appraisal rules to eliminating, in whole or in part, the charitable contribution deduction for property. *This is an area that deserves significant study and deliberation for the Panel to reach a meaningful recommendation for the Senate Finance Committee's consideration.*

9. PENALTY TAXES ON SELF-DEALING AND OTHER VIOLATIONS

Issue

Foundation managers and disqualified persons are currently subject to first-tier excise taxes when they engage in self-dealing transactions.[5] These excise taxes may be too low to deter the prohibited actions effectively. Although the Internal Revenue Code gives the Secretary the authority to abate first-tier excise taxes levied against foundation managers whose participation in other types of transactions was due to reasonable cause and not willful neglect,[6] this authority does not currently extend to abatement of first-tier excise taxes imposed on disqualified persons or foundation managers involved in self-dealing transactions. The lack of protections for disqualified persons and managers inadvertently participating in self-dealing transactions where the foundation was not harmed and the individuals involved received no "excess benefit" (and thus would not have been subject to an excise tax at all if the organization involved had been a public charity) can lead to harsh and unjust results.

The Internal Revenue Service can also impose excise taxes on foundation managers who knowingly participate in jeopardizing investments and taxable expenditures and on managers of public charities who knowingly participate in excess benefit transactions,[7] but these taxes rarely have been imposed. Treasury regulations currently stipulate a number of conditions for establishing whether a foundation or organization manager acted knowingly when he or she participated in an excess benefit transaction or other prohibited activity. This has created an extremely high burden of proof on the Secretary before taxes can be imposed.

Recommendations for Legislative Action

1. First-tier excise taxes imposed on foundation managers and disqualified persons who knowingly participate in self-dealing transactions should be increased. *The Panel is currently studying various proposals regarding the taxes that should be imposed and expects to make a definitive recommendation in its final report.*

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[5] Section 4941 of the Internal Revenue Code. Penalties may be imposed on a manager if such manager participated in the self-dealing transaction knowing that it was such a transaction, unless such participation was not willful and was due to reasonable cause. Penalties may be imposed on a disqualified person who participates in a self-dealing transaction regardless of whether he or she knows that it is such a transaction. First-tier excise taxes are currently equal to 2.5 percent and 5 percent of the amount of the transaction for managers and disqualified persons, respectively.

[6] Section 4962 of the Internal Revenue Code.

[7] Section 4941 of the Internal Revenue Code concerns self-dealing transactions: section 4944 concerns jeopardizing investments, and section 4945 concerns taxable expenditures. Section 4958 of the Code prohibits public charities from engaging in excess benefit transactions. An organization manager is statutorily defined for each of the provisions and is generally someone who is, or who has powers or responsibilities similar to, an officer, director or trustee of the organization or, in the case of a private foundation, any employee who has responsibility or authority over the decision in question.

2. The Secretary's authority to abate first-tier taxes on managers participating in self-dealing transactions should be extended to include abatement of taxes imposed on foundation managers and disqualified persons who have participated in a self-dealing transaction. Standards for abatement should be clarified, and the language of the abatement provision in Internal Revenue Code section 4962 should be revised to more closely coordinate with the language of the penalty provisions in sections 4941 through 4945 and 4958. *The Panel expects to make specific recommendations on this matter in its final report.*
3. The standard for imposition of first-tier excise taxes on organization managers should be modified to provide a realistic possibility that such penalty taxes will be imposed on managers who fail to meet their fiduciary duties in approving or failing to oppose a prohibited transaction. This standard must be tailored so as not to unnecessarily deter qualified individuals from serving as managers of charitable organizations for fear that penalty taxes would be imposed unfairly. *The Panel is studying proposals to modify the standard and expects to make a recommendation in its final report.*

Rationale

First-tier excise taxes and penalties imposed on managers and other individuals who improperly benefit from self-dealing or excess benefit transactions and other wrongdoing must be sufficient to create an effective deterrent. At the same time, provision must be made to abate penalty taxes for inadvertent violations where the individual did not receive an "excess benefit" and the foundation was not harmed. For example, a well-meaning board member may allow a foundation to rent space in a building he or she owns for less-than-market-value rent, not realizing that this would violate self-dealing rules. Extending abatement authority would also promote greater symmetry in the penalties imposed on disqualified persons and managers of private foundations (under section 4941) and of public charities (under section 4958), as penalties on charity managers and disqualified persons currently may be abated under section 4962.

Standards for imposition of penalties must provide sufficient latitude for the Secretary to impose penalties on managers who have participated in prohibited transactions, while preserving protections essential to the ability of organizations to recruit qualified individuals to serve on boards. *Proposals to alter the current standard require careful study and analysis before the Panel is able to make specific recommendations to the Senate Finance Committee.*

10. TYPE III SUPPORTING ORGANIZATIONS

Issue

A Type III supporting organization is a public charity that is organized and operated exclusively for the benefit of one or more other public charities. Supporting organizations allow a public charity to use separate entities to insulate assets from liability or to separate certain functions (such as investing or fundraising), without becoming subject to the more stringent rules covering private foundations relating to insider transactions, required distributions, business holdings, investments, and expenditures. Like other types of supporting organizations, there must be a close and continuous relationship between the Type III supporting organization and the supported organization, but the supported organization does not have legal control over the Type III supporting organization. Substantial contributors to a Type III supporting organization and their family members are prohibited from controlling the supporting organization.

Type III supporting organization rules allow for independent ownership and management of assets exclusively dedicated to the benefit of the supported charities, thus permitting the supported charities, donors, and government entities to address specific needs and circumstances such as those described in the examples provided later in this discussion.

The flexibility currently allowed in the use of Type III supporting organizations makes them uniquely suited to meet the needs of public charities, governmental entities, and donors in a variety of circumstances, but has also made these organizations targets for abuse. Some donors inappropriately maintain de facto control over assets contributed to Type III supporting organizations, using the Type III organization as the functional equivalent of a private foundation without effective oversight by the public charity that is the nominal "supported organization."

Recommendation

Targeted anti-abuse rules, accompanied by appropriate penalties, should be enacted to eliminate the inappropriate use of Type III supporting organizations while maintaining the availability of such organizations for legitimate charitable purposes. Because of the important role Type III supporting organizations may play in a wide range of legitimate charitable situations, at this time the Panel does not support proposals to eliminate Type III supporting organizations entirely. *The Panel will include specific recommendations regarding anti-abuse rules in its final report.*

Rationale

Careful study is required to develop measures that will prevent and punish abuses, while continuing to allow the proper use of Type III supporting organizations to further the charitable purposes of the supported

charity. The Panel has identified the following examples where Type III supporting organizations are uniquely suited to address charitable purposes:

- Type III supporting organizations that support public colleges and universities are able to hold and manage technology assets independently so that they are not subject to control and potential appropriation by state governments for other, unrelated state programs.
- Donors wishing to ensure that gifted assets remain dedicated to a particular charitable program or purpose and are not used for other activities the supported charity may pursue or, in the case of unique collectibles, to ensure gifted assets will be kept and exhibited in the community, not sold to support other activities of the charity, can achieve that goal by contributing the assets to an independently managed Type III supporting organization.
- Domestic "friends" organizations of foreign public charities that are used to raise funds in the United States to support the foreign charity are often organized as independently managed Type III supporting organizations so that they cannot be deemed mere conduits for the foreign organizations.
- Type III supporting organizations are often used where multiple charities with differing short- and long-term goals are to be supported because Type III organizations' independent management can effectively balance the charities' competing goals.
- Type III supporting organizations also have proved useful to governmental entities in advancing their public purposes. For example, in a nonprofit hospital conversion in which the parties agreed to place the sale proceeds in a supporting organization to a community foundation, the state attorney general insisted on use of a Type III supporting organization so that the new entity would have a strong separate identity from the community foundation. In other cases, state or federal law may prohibit government-controlled entities from engaging in activities that an independent support organization could do for the benefit of the governmental entity.
- Many hospitals, educational institutions and other public charities are structured as networks of service providers as opposed to single entities. Often the 501(c)(3) parent organization that directs and provides administrative services to subsidiary operating entities can qualify as a public charity only as a Type III supporting organization because it controls the supported organizations rather than being controlled by or under common control with them.

11. TAX SHELTERS

Issue

Some charitable organizations, as well as other tax neutral persons and entities, have been involved as accommodation parties in abusive tax avoidance transactions (i.e., tax shelters). The Senate Finance Committee staff discussion draft has proposed that charitable organizations that the Internal Revenue Service determines have accommodated "listed tax shelter transactions or reported transactions (with a significant purpose of tax avoidance)" without receiving an "affirmation that the transaction is not a listed or reported transaction" under existing federal tax law would have their section 170 status revoked for a year and be subject to a 100 percent tax on all accommodation fees or other direct benefits received. "Listed transactions" are those which the IRS has determined to be tax avoidance transactions and identified as such by notice or other published guidance.[8] "Reportable transactions" include "listed transactions" as well as other types of transactions that must be disclosed to the IRS even though there has been no determination that such other transactions are abusive.[9]

Recommendation

Appropriate anti-abuse provisions must be developed and should be sufficient to deter charitable organizations from participating in a listed transaction. The IRS recently has released final regulations under Circular 230, which sets forth best practices for tax advisors as well as standards for covered opinions and other written advice. *The Panel is studying the Circular 230 regulations, relevant code provisions and regulations, as amended by the American Jobs Creation Act of 2004, as well as proposals from the Senate Finance Committee staff discussion draft and the Joint Committee on Taxation, to make a specific recommendation regarding such provisions in its final report.*

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[8] *See* Treas. Reg. Section 1.6011-4(c).

[9] *See* Treas. Reg. Section 1.6011-4(b). It is assumed that the term "reported transactions" in the Senate Finance Committee staff discussion draft refers to "reportable transactions."

Rationale

The Panel is deeply troubled by the participation of some charitable organizations in abusive tax avoidance transactions but notes that such activity is a complex problem whose reach extends beyond charitable organizations. Even as remedies are considered for participation in abusive tax avoidance transactions, the charitable sector must do more to educate managers and directors about tax shelter transactions in order to prevent charities from becoming unwitting participants in abusive schemes.

The Panel believes that appropriate penalties must be imposed on managers and organizations that knowingly participate in abusive transactions but believes that revocation of the organization's section 170 status, as proposed in the Senate Finance Committee staff discussion draft, may be the incorrect penalty depending on the size and scale of the offense. This penalty would deprive an organization that depends on public contributions of a major portion of its funding for a year, an amount that could far exceed financial penalties imposed on other types of accommodation parties. In addition this penalty may have little effect on an organization that does not rely on public contributions.

The Panel notes that the Joint Committee on Taxation has proposed a penalty tax of 100 percent of an organization's income attributable to participation in the prohibited transaction, along with penalties to be imposed on organizations for failure to disclose required information on a prohibited transaction and penalties on organization managers who approve such a transaction, knowing or having reason to know that the transaction is a prohibited tax shelter transaction. *The Panel is currently studying this proposal along with other relevant code provisions and regulations before making a more specific recommendation.*

12. STATE ENFORCEMENT OF FEDERAL LAWS

Issue

The Senate Finance Committee staff discussion draft includes a proposal to give states the authority to pursue, with the approval of the Internal Revenue Service, federal tax violations by exempt organizations. However, states can incorporate federal law into state law. For example, since 1978, 48 states and the District of Columbia have had laws imposing the restrictions on private foundations in Chapter 42 of the Internal Revenue Code as a matter of state law. While state authorities generally have the ability under state law to pursue actions against charitable organizations and their managers, they do not have the ability to enforce federal tax law.

Recommendation for Legislative Action

States should be encouraged to incorporate federal tax standards for charitable organizations, such as section 4958 (prohibiting excess benefit transactions), into state law.

Rationale

If states incorporate federal tax standards into state law, enforcement of federal standards will likely increase, opportunity for collaboration between federal and state enforcement efforts will increase, and charitable organizations will face more uniform federal and state standards. The Panel believes this approach is preferable to granting the states authority to enforce federal tax laws with the approval of the IRS, as was recommended by the staff discussion draft of the Senate Finance Committee, because incorporating federal tax standards into state law grants greater flexibility to the states while at the same time not burdening the already stretched IRS with another task. *The Panel will consider which specific federal tax standards would be most appropriate for adoption at the state level for possible inclusion in its final report.*

13. FUNDING FOR FEDERAL AND STATE ENFORCEMENT

Issue

Funding for oversight of tax-exempt organizations has become increasingly inadequate as the size and complexity of the exempt sector has grown. Over the past 20 years, funding for Internal Revenue Service oversight of exempt organizations has remained essentially constant while the sector has nearly doubled in size and become even more complex. Funding of oversight at the state level varies substantially among states, but all lack sufficient resources to provide adequate oversight of the rapidly growing charitable sector. Congress initially recommended that revenues from an excise tax imposed since 1969 on the net investment income of private non-operating foundations should be used to fund the exempt organizations function within the IRS. Those funds have never been designated for that function. The beneficial impact of legislative and regulatory changes recommended by the Panel as well as the efficacy of current law will be diminished if additional resources are not provided for education, oversight and enforcement.

Recommendations for Legislative Action

1. Congress should increase the resources allocated to the IRS for oversight and enforcement of charitable organizations and also for overall tax enforcement.
2. The Panel would be strongly supportive of efforts by Congress to earmark funds derived from penalties, fees and excise taxes imposed on charitable organizations for improved oversight and education activities of the Exempt Organization Division of the IRS.

Rationale

The shortage of resources for oversight and enforcement extends beyond the charitable sector to many areas of tax enforcement. While the Panel feels it is critical to increase the resources allocated to exempt organization oversight, any such increase should not be at the expense of other vital areas of tax enforcement.

Revenues collected annually from the excise tax on private foundations now greatly exceed the current budget of the IRS Exempt Organizations Division. The Panel recognizes the fiscal challenges facing Congress today, but believes that, without adequate resources for oversight and enforcement, those who willfully violate the law will be able to continue to do so with impunity.

14. INFORMATION SHARING BETWEEN FEDERAL AND STATE OFFICIALS

Issue

While current law allows the Internal Revenue Service to share relevant information with state revenue officers, it does not permit such information sharing with state attorneys general and other state officials charged with overseeing charitable organizations. The inability to share information about ongoing investigations increases the cost of oversight and enforcement and impedes the efforts of state officials to weed out wrongdoing efficiently and effectively.

Recommendation for Legislative Action

Congress should pass legislation to allow state attorneys general and any other state officials charged by law with overseeing charitable organizations the same access to IRS information currently available by law to state revenue officers, under the same terms and restrictions.

Rationale

The Panel believes that the responsible sharing of relevant information between federal and state officials will enable these officials to perform their duties more effectively. It also will assist charitable organizations by reducing the burden they often face in responding to duplicative federal and state inquiries for information.

The Panel has some concern about the potential for improper disclosure of shared information by state officials but assumes that there will be sufficient protection if current legal safeguards against such disclosure by state revenue officers are applied to state officials charged with oversight of charitable organizations.

15. PUBLIC DISCLOSURE OF INTERNAL REVENUE SERVICE DETERMINATIONS

Issue

Effective enforcement of the laws and regulations governing tax-exempt organizations depends, in large measure, on the fair and efficient resolution of disputes between the Internal Revenue Service and charitable entities. When the IRS and an organization settle a dispute, the final determination of tax liability is set forth in a closing agreement. Currently, the IRS may not disclose closing agreements as well as related audit results to the public without the consent of the organization. The Senate Finance Committee staff discussion draft has proposed requiring that closing agreements and other audit results be disclosed to the public without redaction, except that an exempt organization's identity could be deleted if the audit were initiated pursuant to information volunteered by the organization.

Panel Note

The Panel was unable to reach a consensus on whether the IRS should be required publicly to disclose without redaction closing agreements between the IRS and a charitable organization and related audit results.

On the one hand, public disclosure of closing agreements can help to educate the public and nonprofit community on how the tax laws are being interpreted and applied. It is important to know whether and how those who have been found to have abused charitable assets are penalized, and it is equally important to know how the IRS interprets various circumstances in enforcing tax laws governing charitable organizations. Such information serves as an educational tool as well as a deterrent to others, and allows the public to know of the improper behavior of the particular organization.

On the other hand, public disclosure could significantly deter resolution of disputes between the IRS and charitable organizations and result in the unnecessary expenditure of resources on litigating disputes that would otherwise have been settled. In the interest of resolving disputes efficiently and expeditiously, charitable organizations often accept a confidential closing agreement containing recitations that do not accurately reflect the organization's view of the matter. Requiring the public disclosure of all closing agreements might result in the organization determining that it must pursue a different course of action that could well result in protracted negotiations on the closing agreements and unnecessary litigation.

SECTION IV

Issues the Panel Will Consider for Its Final Report

The preceding report is the first phase of the Panel on the Nonprofit Sector's work. Throughout the spring, the Panel and its associated groups will continue their examination of how to improve the governance and accountability of America's charitable organizations. The Senate Finance Committee staff discussion draft issued in June 2004 will continue to serve as the primary framework for the Panel's deliberations. At the end of this second phase, which will include further consultation with the nonprofit community at large, the Panel will issue a final report. The Panel may continue its work during the summer and offer additional comments in the fall.

ISSUES REFERRED FROM THE INTERIM REPORT

The issues that will be considered during this second phase fall into two main categories. The first involves topics that the Panel has already begun to examine but that require further study to produce informed recommendations. These issues include:

1. Appropriate phase-in of requirements that charitable organizations file annual returns electronically.
2. Model policies and guidance on developing conflict of interest policies, policies for reporting suspected misconduct or malfeasance, and codes of ethics.
3. Appropriate definition of and minimum activity rules for donor-advised funds, and proposals to require donor-advised fund grantees to acknowledge or certify that the grant will not provide any substantial benefit to the recommending donor/advisor.
4. Targeted anti-abuse rules, accompanied by appropriate penalties, for Type III supporting organizations.
5. Appropriate rules and accompanying penalties to prevent the participation of charitable organizations as accommodation parties in abusive tax shelters.
6. Amending excess benefits and self-dealing regulations to increase the amount of first-tier excise taxes that should be imposed, to establish standards for abating penalty taxes when warranted, and to modify the standard for imposition of penalties.
7. Specific federal tax standards that would be most appropriate for adoption at the state level.

ADDITIONAL ISSUES FOR EXAMINATION

The Panel and its Work Groups will also be studying for its final report many other issues raised in the Senate Finance Committee staff discussion draft that were not part of the first phase of its work. As it considers each topic, the Panel will be giving special consideration to the needs and concerns of small organizations. These topics are in four major areas:

Transparency

1. **Revisions to Forms 990 and 990-PF and Accompanying Instructions**
   The Panel will examine recommendations to revise and restructure the Forms 990 and 990-PF to facilitate more accurate reporting by charitable organizations and to improve the utility of the forms for regulators, donors and the public.
2. **Uniform Financial Standards for Accounting and Financial Reporting by Charitable Organizations**
   The Panel will examine proposals to address inconsistencies in reporting between audited financial statements and Form 990 series returns through the establishment of uniform standards in areas such as accounting of fundraising costs, restricted funds, and pledges for future contributions. The Panel will also consider which agencies are most suitable for promulgating accounting and financial reporting standards appropriate for charitable organizations.
3. **Periodic Review of Tax-Exempt Status**
   Both the Senate Finance Committee staff discussion draft and the Joint Committee on Taxation's January 27, 2005, report

include proposals to require organizations, other than houses of worship, exempt from taxation under section 501(c)(3) and eligible to receive tax-deductible contributions, to file every five years sufficient information to determine whether the organization continues to be organized and operated exclusively for exempt purposes. The Panel will examine the types of information that would be necessary to make this determination, the cost to charitable organizations of complying with these proposals and the cost of enforcing these proposals, in order to make recommendations in its final report regarding the efficacy of such proposals and, if needed, appropriate alternatives to meet the intended goal.

4. **Disclosure of Performance Data**
   The Senate Finance Committee staff discussion draft includes a proposal to require organizations with more than $250,000 in gross receipts to include with their Form 990 a detailed description of annual performance goals and measurements for meeting those goals. The Panel will consider various proposals for how this might be accomplished, the value it might bring to donors and to charities, and the cost of enforcing such a requirement for both the government and charitable organizations to make recommendations in its final report.
5. **Facilitating Public Access to Data on Public Charities and Foundations**
   Currently, some annual information returns filed by public charities are available online, free of charge, at GuideStar, and both GuideStar and The Foundation Center provide free access to the most recent Forms 990-PF filed by private foundations. Both of these services currently depend on private charitable support to provide free public access. Both of these services, as well as the National Center for Charitable Statistics, also provide searchable databases on a fee-basis. GuideStar is engaged in another project, NASCONet, in cooperation with the National Center for Charitable Statistics and the National Association of State Charities Officials (NASCO), to create an online database that will permit greater sharing of information between state and federal regulators and the public. The Panel will examine various proposals for joint public-private ventures to facilitate public access to a broader range of data on public charities and private foundations.

Governance

1. **Structure, Size and Composition of Boards of Directors**
   The Senate Finance Committee staff discussion draft includes proposals to restrict the size of a charitable organization's governing board, require that no more than one member of a charitable organization's board be directly or indirectly compensated by the organization, and prohibit compensated members from serving as the board's chair or treasurer. The Panel will examine proposals regarding the appropriate size and structure of boards of directors of charitable organizations and will make recommendations as to which standards, if any, should be required

as a condition of charitable organizations' tax-exempt status or encouraged as a matter of good practice.

2. **Standards for "Independence" of Board Members and Other Criteria for Board Membership**
   The Senate Finance Committee staff discussion draft raises questions as to whether boards of directors or audit committees should be required to include "independent" members, and whether rulings by the U.S. Securities and Exchange Commission prohibiting certain individuals from serving on the boards of publicly traded companies should also be applied to charitable organizations. Two states currently require boards of charitable organizations to include independent members. The Panel will examine definitions for what constitutes an "independent" board member, including statutory definitions in the two states that require boards of charitable organizations to include independent members, and will make recommendations as to which definitions and conditions for board membership, if any, should be mandated by federal law or encouraged as a matter of good practice.
3. **Board Compensation**
   While most board members of charitable organizations serve without compensation, it may be necessary for an organization to compensate board members if significant work is expected from them or if such compensation is relevant to the board member's ability to serve. Trustees frequently receive compensation for administering a trust, as well as reimbursement of expenses related to that work. The Panel will consider proposals in the Senate Finance Committee staff discussion draft to prohibit compensation to trustees of a non-operating private foundation or limit such compensation to a statutorily prescribed de minimis amount and will make recommendations regarding which restrictions on board compensation, if any, should be mandated by federal law or encouraged as a matter of good practice.
4. **Executive Staff Compensation**
   Boards of directors are responsible for hiring and overseeing the chief staff officer of the organization, including approval of the compensation of that officer. Boards also are generally involved in approving the overall staff compensation program. The Senate Finance Committee staff discussion draft includes proposals to require boards of directors to approve compensation for all management positions annually and in advance unless there is no change in compensation other than an inflation adjustment. The staff discussion draft also includes a proposal that any compensation consultant to the charitable organization must be hired by and report to the board, and must be independent, and that "compensation arrangements must be explained and justified and publicly disclosed (with such explanation) in a manner that can be understood by an individual with a basic business background." The Panel will examine these proposals and other expert advice to make recommendations in its final report.

5. **Travel Expense Policies**
   Some are concerned that "excessive" travel costs—including what have been described as lavish hotels and first-class or private airplane travel—may be disguised benefits to organization insiders. The Senate Finance Committee staff discussion draft proposals would limit amounts paid by charities for travel, meals and accommodations to the federal government rate or an alternative nonprofit rate, with penalties imposed on both the charity and individual if the set rates are exceeded. The Panel will examine which restrictions on travel expenses, if any, should be mandated by federal law and whether guidelines for appropriate travel expenses could be promulgated by the sector as good practice.
6. **Changes to Rules Regulating Excess Benefit and Self-Dealing Transactions with Disqualified Persons and Related Penalties**
   Transactions between charitable organizations and "disqualified persons" may inappropriately benefit the disqualified person at the expense of the charitable organization, but they can also be a source of low-cost or free resources that the organization can use to further its charitable mission. Transactions between private foundations and disqualified persons are prohibited, whereas in public charities such transactions are prohibited only when they result in "excess benefits" to the disqualified person. The Panel will consider and make recommendations regarding proposals in the Senate Finance Committee staff discussion draft to expand the definition of disqualified persons and extend the ban on self-dealing transactions (except for reasonable compensation) for private foundations to public charities.
7. **Defining and Controlling Administrative Expenses**
   Some believe that administrative expenses at some charitable organizations are too high, and that those amounts may indicate private benefit or inurement and that insufficient assets are being used for the intended charitable purposes. The Senate Finance Committee staff discussion draft contained proposals for private foundations that would: (a) clarify the definition of "administrative expenses;" (b) require additional supporting documentation if a private foundation's administrative expenses are over 10 percent; and (c) disallow administrative expenses over 35 percent for purposes of the payout requirement. The Panel will examine this proposal in the context of both private foundations and public charities.

Accreditation and Standard-Setting

1. **Criteria for Accreditation and Other Standard-Setting Systems**
   The Senate Finance Committee staff discussion draft proposed an authorization of $10 million to the Internal Revenue Service for a charity accreditation program that would be administered by the IRS as well as by other organizations contracting with the IRS. Preference for federal funding would be given to organizations that are accredited by IRS-designated entities that establish best practices for tax-exempt organizations. The Senate Finance Committee staff dis-

cussion draft further recommends that the IRS, in consultation with the Office of Personnel Management, establish appropriate accreditation and governance requirements for charities participating in the Combined Federal Campaign. The Panel will review findings from a study of self-regulatory, certification, and accreditation systems in place among charities and other fields in the United States and will make specific recommendations in its final report for accreditation and standard-setting programs for the sector, whether the IRS or other agencies should be designated to promulgate and administer standards for the sector. Additionally the Panel will recommend what role the sector might play in the area of accreditation and standard-setting.

2. **Appropriate Mechanisms for Education, Training and Technical Assistance in Self-Regulatory Systems**
   The Senate Finance Committee staff discussion draft proposed that federal funding be provided to state and national exempt organizations to educate other charitable organizations about good practices, to assist those organizations, particularly small ones, in meeting proper standards and accreditation requirements, and to inform the public of charitable organizations that meet accreditation standards. There are many programs and organizations that provide education, training and technical assistance to help nonprofit boards and staff managers comply with voluntary standards for good practices as well as legal requirements. In addition, the IRS Exempt Organization Division has expanded the educational tools available on the IRS website to assist charities and foundations in complying with current regulations. The Panel will examine the scope of these current systems to identify effective models, problems in implementation, and needs for expansion of these programs, and make recommendations regarding the Senate Finance Committee staff proposal.

Government Oversight

1. **Valuation of Non-Cash Contributions**
   Taxpayers who itemize deductions on their federal income tax returns generally are allowed to deduct the fair market value of property donated to a nonprofit exempt under section 501(c)(3). Concerns have been raised that some taxpayers are inflating the fair market value of donations and that identification and resolution of valuation disputes are difficult and resource intensive for the IRS. The Panel will consider proposals made in the Senate Finance Committee staff discussion draft and in the January 27, 2005, report of the Joint Committee on Taxation as to appropriate safeguards against abuse by charities or taxpayers in the area of valuation and disposition of non-cash contributions that would not unnecessarily discourage the public or corporations from making non-cash contributions to charity. The Panel will consider the following proposals:
   - Establishment of a "baseball arbitration" process (where the arbitrator must choose one side's valuation) to resolve differences between donors and the IRS regarding the accurate valuation of non-cash contributions for tax purposes;

- Limiting deductions for contributions of clothing and household items to an aggregate maximum amount of $500 per year;
- Limiting deductions for other non-cash contributions to the taxpayer's basis in the property or, if less, the fair market value of the property;
- Strengthening present-law appraiser and appraisal rules; and
- Eliminating, in whole or in part, the charitable contribution deduction for property.

2. **Disposition of Non-Cash Contributions**
   Concerns have also been raised in the Senate Finance Committee staff discussion draft and the Joint Committee on Taxation report that a charitable organization may encounter significant difficulties in disposing of non-cash contributions and that, particularly in the case of donor-advised funds, the charity may hold such assets beyond a reasonable timeframe rather than using those resources to further its charitable mission. The Panel will make recommendations as to any appropriate legal mandates regarding the disposition of donated property by charitable organizations that would maintain the integrity of the tax deduction without forcing charitable organizations to dispose of donated property in a manner that would diminish its financial value to the charity.
3. **Regulation of International Grantmaking and Charitable Activities**
   The Senate Finance Committee and the Treasury Department have proposed various alternatives to prevent the diversion of charitable resources to organizations and individuals that foster or participate in terrorist activities. The Panel will examine proposals developed by other working groups of funders and charities involved in international activities to make recommendations in its final report.
4. **Consumer Credit Counseling Organizations**
   Critics have alleged that many credit counseling organizations' activities do not further the traditional purposes that justified tax exemption for such organizations—public education or relief of poverty—and numerous allegations of private benefit and private inurement have been levied against such organizations. In addition, deceptive advertising and fraudulent business practices in the credit counseling industry are a concern. The Senate Finance Committee staff discussion draft and the Joint Committee on Taxation report include proposals for numerous additional requirements for exemption for these organizations. The Panel will examine these proposals in light of their ramifications for other charitable tax-exempt organizations to make recommendations in its final report.
5. **Prudent Investing Rules**
   There have been significant changes in recent years in the regulation of nonprofit investment activity under state law. Internal Revenue Code section 4944 imposes a prudent investor standard of care on private foundations, but that section has not been updated to reflect the changes in state law. The Senate Finance Committee staff discussion draft included a proposal to create a federal prudent investor rule, to be based on state laws,

that would regulate the investment activities of both private foundations and public charities. The Panel will make recommendations on whether such a federal rule should be enacted, how it might best be enforced, and what rules for disclosure of investment holdings would be required of charitable organizations.

6. **Regulation of Nonprofit Conversions**
   There is concern that nonprofit conversions, currently regulated by state laws and not necessarily involving IRS knowledge, provide opportunities for abuse. The Senate Finance Committee staff discussion draft includes proposals to develop federal nonprofit conversion rules. The Joint Committee on Taxation has also proposed new federal regulations for nonprofit conversions. The Panel will study these proposals to make recommendations in its final report.
7. **Regulation of Charitable Solicitations**
   As of 2003, 39 states were actively regulating charitable solicitations, including requirements for registration and financial reporting by charities that solicit contributions from the public as well as by professional fundraisers and solicitors. The multiplicity and diversity of filing requirements and exemptions place a substantial burden on charities that solicit in more than one state, and boards of directors are often unclear as to their responsibilities in this area. The Panel will examine various proposals and efforts by the National Association of State Charity Officials (NASCO), state regulators, and experts in nonprofit governance to make recommendations for boards of directors and for possible legislative action.
8. **Expansion of Federal Court Equity Powers and Standing to Sue**
   State courts currently have powers to impose fines and issue injunctions against boards of directors of charitable organizations to stop the boards from taking actions that may be deemed harmful to the organization or place its assets in jeopardy. The Senate Finance Committee staff discussion draft proposes expanding the powers of the U.S. Tax Court so it can enforce the fiduciary duties of boards and take action against charitable organizations and individual board members for dereliction of fiduciary duties. These proposals would permit any director or trustee to bring a private action against a charity, allow any member of the public to bring a complaint regarding a charity to the IRS for review and adjudication, and permit the IRS to seek the removal of any director or board member by the Tax Court. The Panel will review these recommendations in light of current state and federal provisions to protect the assets of and to remedy any detriment to charitable organizations resulting from violations of substantive rules. In its final report, the Panel will also weigh the benefits of expanding the standing rules against the potential costs of diverting those with fiduciary responsibility and depleting charitable assets in defense of frivolous complaints.

Note: There may be additional areas that the Panel deems necessary to study and offer recommendations.

SECTION V

Appendix

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

September 22, 2004

Ms. Diana Aviv
President and CEO
Independent Sector
1200 18th St. NW, Suite 200
Washington, D.C. 20036

Dear Ms. Aviv:

The Senate Finance Committee is deeply concerned about transactions with and within charitable organizations that are inappropriately exploiting charities' tax-exempt status and that may be wrongly enriching individuals and corporations. We are considering a number of comprehensive reforms to protect charities from bad actors and strengthen their accountability to donors.

We are mindful that this is a large and diverse sector and our intensions are to encourage good practice, sound governance and responsible work that leads to the improvement of the common good. We are aware and applaud the many efforts around the country by nonprofit sector organizations to consider how best to encourage good practice and conversely root out the bad actors.

The discussions at the Senate Finance committee roundtable on July 22nd convened by our staff provided an opportunity for the airing of some such initiatives and also gave us input regarding legislation that will be forthcoming thereafter. We are gratified by the strong degree of support for enacting legislation that will facilitate the collection of more useful information, in a format that allows for greater consistency and transparency through electronic filing. These are among a number of issues for which there appears to be immediate support that are important to put in place without delay. We recognize also that for some in the sector there is concern about the broader issues relating to governance and practice and to achieve similar support will take time and careful analysis to construct appropriate legislative remedies and enable good self-regulation.

Toward that end we encourage you to convene an independent national panel on the non-profit sector to consider and recommend actions that will strengthen good governance, ethical conduct and effective practice of public charities and private foundations. We encourage you to work with those committed to reform and not let a potential minority prevent substantive improvements by requiring unanimity on proposals. There is great value in your bringing together an independent group of leaders with broad experience whose wisdom might inform this process. While we cannot be bound by your panel's work, we would welcome the recommendations that will be

forthcoming from such a panel to assist our legislative efforts to improve oversight and governance of charitable organizations, as well as to stimulate or initiate efforts within the charitable community to identify and enforce standards of best practices in the areas of though not limited to governance, transparency, financial accountability, conflicts of interest, fundraising practices, and grant making practices.

Given the urgency of the situation, we encourage you to move forward expeditiously to convene such a body, and share your recommendations as you develop them, particularly as they relate to legislative action. We would appreciate the panel providing a report of its initial findings and recommendations to the Finance Committee by February 2005 and a final report in the spring of 2005.

Thank you for your time and assistance. We ask for a response within 30 days.

Cordially yours,

Charles E. Grassley
Chairman

Max Baucus
Ranking Member

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October 12, 2004

Senator Charles E. Grassley, Chairman
Senator Max Baucus, Ranking Member
U.S. Senate Committee on Finance
Washington, DC 20810-6200

Dear Senator Grassley and Senator Baucus,

Thank you for your letter of September 22, 2004, encouraging INDEPENDENT SECTOR to convene an independent panel on the non-profit sector to consider and recommend actions that will strengthen good governance, ethical conduct and effective practice of public charities and private foundations.

We appreciate your thoughtful comments about the diversity of this important sector and the many good efforts around the country to consider how best to encourage good practice and address the wrongful actions of those who are exploiting charities' tax-exempt status and abusing the public trust. We applaud your desire to engage in serious analysis and deliberation to construct appropriate legislative remedies and enable good self-regulation.

To that end, we are proceeding with convening the independent national panel on the non-profit sector that you have called for and plan to engage a broad spectrum of leaders from charities and foundations of all sizes, as well as technical, legal, and financial experts to assist the panel in its work. As you have requested, the panel will provide an initial report of its findings and recommendations to the Finance Committee in February 2005, and a final report in the spring of 2005. We expect the work of the Panel to continue through the fall and will probably update our recommendations to you at that time.

I have attached a list of the outstanding individuals who have agreed to serve on the panel. We will provide other updates to your staff as we proceed with this important effort.

Thank you for your interest and support for the work of this vital sector. We look forward to working with you in the months ahead.

Sincerely,

Diana Aviv

Diana Aviv
President and CEO

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Convened by INDEPENDENT SECTOR

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