Senate Committee on Finance
July 22, 2004

Charity Oversight and Reform Roundtable

Written Comments and

Statement for the Record

of the

Association of Fundraising Professionals (AFP)
1101 King Street # 700
Alexandria, VA 22314
703-519-8456; 800-666-3863
www.afpnet.org

July 21, 2004

Senate Committee on Finance
Attn: Editorial and Document Section
Rm. 203 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Comments Regarding Discussion Draft released by Senate Finance Committee Staff in the Area of Reforms and Best Practices in Tax-Exempt Organizations

On behalf of the Association of Fundraising Professionals (AFP), I am pleased to respond to the Senate Finance Committee's staff discussion draft of proposals for reforms and best practices in the area of tax-exempt organizations. As an organization that represents individuals responsible for generating philanthropic funds, AFP has first-hand knowledge and understanding of charitable giving and related governance processes. We hope our thoughts and perspective will prove helpful to the Finance Committee as it continues its examination of issues related to best practices and oversight of the nonprofit sector.

Organizational Background

For nearly forty-five years, AFP has provided guidance and standards to those engaged in the fundraising process. AFP's considerable expertise in the legislative field is based upon the combined experience of our 26,000 members across North America and around the world. We have 169 chapters located in almost every state and metropolitan area, as well as in Canada and Mexico. AFP also maintains strategic alliances with similar organizations in Europe and East Asia. Our members raise funds for a wide variety of charities, from large, multinational institutions to local grassroots organizations on every conceivable issue – education, healthcare, religion, and the environment, to name just a few.

AFP members are required annually to sign our Code of Ethical Principles and Standards of Professional Practice, which were first developed in 1964. The AFP Code of Ethics is widely recognized in sector as the leading guide to best practices in fundraising. The Code is unique in the field since it is one of only a handful of standards which are formally *enforced*. AFP's strong ethics enforcement procedures are intended to emphasize to our members and to the sector the importance of self-governance. Violation of the Code can result in the revocation of credentials and expulsion of members who engage in prohibited behavior.

AFP instituted a credentialing process in 1981 – the CFRE, Certified Fund Raising Executive designation--to aid in identifying for the giving public fundraisers who possess the demonstrated knowledge and skills necessary to perform their duties in an effective, conscientious, ethical, and professional manner. This was followed in 1990 by the ACFRE, for advanced fundraisers.

This background is cited to emphasize the importance that AFP and its members place on ethical fundraising. Much of our work is spent educating and training members in ethical fundraising practices and working with federal and state regulators to improve regulation and to identify wrongdoers who don't belong in the charitable sector.

Since its founding, AFP has championed donor rights. AFP was the driving force behind the creation of the *Donor Bill of Rights* and provides information to potential donors about how to select, evaluate, and give wisely to charities. A copy of the *Donor Bill of Rights* is attached. Similarly, AFP supported the Treasury Regulations developed by the Internal Revenue Service (IRS) to implement the "intermediate sanctions" of the Internal Revenue Code.

Overview

As AFP has noted in previous submissions, our organization remains committed to working with the Finance Committee (and Congress), the Internal Revenue Service, Federal Trade Commission, and other interested agencies to ensure the best possible operation of the tax-exempt system. However, there is no evidence of widespread abuses in the sector. To the contrary, most charities are legitimate organizations that abide by the law and focus their efforts on accomplishing their mission and providing needed services.

All nonprofit corporations are chartered by state governments and subject to state authority. This power, combined with the power of the IRS, already provides significant protection for donors and members of the general public. In almost all cases, the current laws are sufficient; the problems lie in enforcement. And if additional laws are needed, they should be fashioned to target wrongdoers without burdening legitimate charities.

While the staff draft discussion document includes several good ideas, it also contains some proposals that would result in severely increased administrative burdens that will not be offset by greater benefits for the donor community. As a result, the major effect of these proposals may be to unnecessarily undermine the ability of many charities to pursue their mission and purpose.

Specific Comments

Five-year review of tax-exempt status by the IRS (Section A-1)

This proposal would prove onerous for both tax-exempt organizations and the IRS. More importantly, it is unclear what specific benefit the proposal would provide, since the IRS is not required to review all organizations or even issue new determination letters. Given the large number of annual submissions this requirement would engender, it is difficult to see how the already-understaffed IRS could effectively review even a small percentage of these documents. It is no secret that applications for recognition of exempt status (Forms 1023 and 1024) now often languish unread at the IRS for four to six months and, even after that, the applications are often approved with only a cursory review. Perhaps more important, the proposal appears to impose what is actually a tax on the "tax-exempt" sector. The "processing" or "filing" fee suggested by the proposal is unwarranted and untenable.

This proposal establishes a theme which is maintained throughout much of the discussion draft. The discussion draft seems to suggest in several areas that what is appropriate for private sector corporations may be suitable for nonprofit entities. For profit companies generally can recoup the cost of government-imposed expenses from consumers. By contrast, many donors do not want to see their charitable gifts being used for administrative expenses except to the degree absolutely necessary. Simply put, the federal and state governments should be working to minimize the expenses which they impose on the nonprofit sector.

Donor advised fund reforms (Section A-2)

Donor advised funds are a relatively new giving mechanism that tend to take dollars out of the charitable stream of resources and leave them in the hands of a financial services institution. AFP applauds the Committee for taking cognizance of this development. Donor advised funds can have a negative effect on the relationship between charities and donors because they tend to limit their interaction. Since donors are supposed to relinquish control of the funds, charities often end up working with the institution and not the donors. Donor-charity interaction is one of the keys to a healthy nonprofit sector – *volunteers* become donors, who in turn become advocates of the charity's mission, who become committee chairs, who move on to be board members dedicated to the needs of the charity's stakeholders.

While there may be nothing wrong with this for profit corporate intervention in the charitable giving process, AFP believes there is room for significant improvements in the laws governing donor advised funds. AFP will not address the matter in these comments, but we are concerned about the compensation arrangements for donor advised fund brokers who both acquire and manage the gifts to such funds. Further, although we don't comment on every provision listed in the discussion draft related to donor advised funds, we are pleased to see a proposal that would permit grants from donor advised funds to satisfy a donor's charitable pledge. In addition, we feel equally strongly that private foundations should not be allowed to circumvent the annual minimum distribution rules by "parking grants" to donor advised funds (see discussion draft, Section C-3).

Insider and Disqualified Person Reforms (Section B)

AFP was a staunch supporter of the intermediate sanctions provisions adopted by the Internal Revenue Service in the 1990s. As charities rely on public trust and confidence to raise funds and manage their operations, it is critical that appropriate laws and regulations are fashioned to prevent insider dealings and other conflict of interest or private inurement transactions.

We note for the Committee that AFP and other organizations have mechanisms in place to address many of these issues. As previously mentioned, to our knowledge, AFP has the oldest and the only enforced code of ethics in the charitable sector. Members are required to sign our Code of Ethical Principles and Standards of Professional Practice (Attachment B) and can be expelled or censured for violations. Our Code prohibits many of the types of arrangements that the proposals in Section B address.

Therefore, we would strongly encourage the Finance Committee to look more closely at AFP as a self-governing membership organization, especially as it considers the issue of certification (which we address later in these comments). The very role of associations is to promulgate standards for specific sectors and professions (in AFP's case, fundraising). Many of the behaviors that the Committee seeks to delineate may be more effectively addressed by organizations in the sector.

Encourage additional grant-making by private foundations (Section C-2)

AFP generally supports initiatives to encourage more dollars to enter the charitable stream, particularly after they are removed from the taxable resources of the government. Providing incentives for foundations to pay out more than 12 percent of their non-charitable use assets return for grants is an appropriate suggestion that deserves serious consideration.

Provide states the authority to pursue federal actions (section D-2)

AFP has long supported initiatives that would allow greater coordination between the federal government and the states in enforcing tax laws and targeting abuses. However, it is not at all clear that granting states the authority to pursue federal tax law violations is advisable. There is little reason to think that state authorities that are not designed to enforce federal tax law will succeed where the IRS, the federal agency that is so designed, has failed. Moreover, each state already has adequate authority to prosecute state tax and other violations.

Improve Quality and Scope of Forms 990 and Financial Statements (Section E)

As the Finance Committee considers reform of Form 990, AFP notes that the IRS is currently undertaking its own review of the document and its requirements. As a result, before making changes it may be useful to await the release of the IRS's proposed modifications to Form 990. We would also note that the Form 990 was not designed to be an accountability document, but a reporting document. As the debate on accountability has grown, we have seen many proposals that would seek to enhance the Form 990's purpose and add additional sections. We have serious concerns that the Form 990 cannot be "all things to all people."

As we have noted in previous comments to the IRS, the form is not very user-friendly and the public will continue to have difficulty using it for accountability and comparison purposes, especially if the Form is enhanced and enlarged. We strongly believe in public accountability, but the Form 990 is not the right place to determine accountability and other "best practices" issues. The Form 990 should be made more focused as a reporting instrument which helps the Service investigate nonprofit organizations as tax-exempt entities. This form should be used to help identify organizations which are improperly claiming charitable status rather than a catch-all for analyzing the overall performance of a nonprofit.

Require signature by Chief Executive Officer (Section E-1)

In the private sector, senior executives of a corporation are compensated for the many demands which the market, shareholders, and the government place on them. In the nonprofit arena, compensation for senior employees is limited by organizational resources and the law. In many grassroots charities, the executive director is a volunteer who receives no compensation. Making nonprofit "executives" liable for organizational "processes and procedures" may dissuade candidates from taking jobs at exempt organizations. It is appropriate to require accountability of chief executive officers; it is inappropriate to impose liability where there is no culpability or negligence. AFP urges additional discussion of this topic.

Penalties for failure to file complete and accurate 990 (Section E-2)

AFP is concerned that the penalties included in this provision will have an unfair impact on smaller organizations. The monetary fines could dramatically hurt a smaller charity to the point of having to close its doors, while a larger one will be able to pay the penalties with relative ease. Given the IRS's current lack of resources, we are also concerned about the uneven and inconsistent enforcement that may occur.

Finally, we are not convinced that the penalties in this provision will do much to encourage enforcement or dissuade fraudulent organizations. Most of the problems related to Form 990 stem from ignorance or miseducation about how to complete the form. We believe that many illegitimate or fraudulent organizations seeking to avoid detection already file faultless Form 990s—a regulator's nightmare. Thus, the provision will tend to penalize law-abiding charities rather than fraudulent bad actors. Furthermore, additional problems are needlessly created by sending all penalties to the very branch of the IRS responsible for enforcing the law. If more funds are required by the Exempt Organizations branch of the IRS, let Congress appropriate such funds directly and openly.

Penalty for failure to file timely 990 (Section E-3)

For many of the same reasons listed in the above paragraph, we are concerned about the impact of this proposal, especially for smaller charities. Accountants often increase their fees around tax filing season, leading many charities to delay filing in order to save on fees and spend more of their funds on programs and services.

Electronic filing (Section E-4)

AFP supports electronic filing and other initiatives that the IRS has undertaken to make filing required documents and information more streamlined. However, we are concerned that if electronic filing was made mandatory, smaller charities might not have the appropriate technical resources to fulfill that mandate.

Disclosure (Sections E6-9)

AFP strongly supports disclosure of charitable activities, but fears that some of the proposals in the discussion draft could impose burdens and costs that outweigh the intended benefits. In particular, AFP believes that a $250,000 threshold for audits and other disclosure requirements is far too low, and notes that California and several other states are enacting legislation to raise this threshold to $2 million and higher. (It bears noting that at current audit rates, usually $25,000 or more, 10% of an organization's $250,000 in revenues could be required to meet this obligation.) Furthermore, some of the disclosure requirements appear unnecessarily and unproductively intrusive (such as disclosure of performance goals), and could lead to dissemination of proprietary information.

In the wake of the Sarbanes-Oxley Act of 2002, nonprofit organizations have taken steps to implement changes with respect to governance. Specifically, many organizations have replicated the audit committee feature of Sarbanes-Oxley--to the extent feasible--by creating board committees whose function it is to ensure that appropriate financial controls are in place and that reliable accounting and auditing are conducted. In addition, increasing numbers of states are implementing audit requirements. Additional federal audit requirements are not likely to provide greater protection for donors or the public and they could waste state resources. Once again, charities are not money-making corporations and the requirements imposed on the private sector must be carefully analyzed to determine their potential impact on the nonprofit sector.

Public Availability of Documents (Section F)

Current federal and state laws provide for extensive public disclosure of corporate information. AFP supports the concept of public disclosure in the charitable sector, but questions the benefit of the additional disclosure requirements proposed in the discussion draft. In particular, we are concerned with the new approach to disclosure via a website. Current law requires charities to disclose certain documents when asked. Charities have the option of complying by placing these documents online. But requiring all charities with websites to publish all such information online—if the charity maintains a website--creates a technical and administrative burden with which some charities, especially smaller entities, may not be able to comply. Indeed, many legal advisors might counsel their nonprofit clients with a website to eliminate their online presence rather than risk violation of federal disclosure requirements.

Encourage Strong Governance and Best Practices for Exempt Organizations (Section G)

Some of the proposals to improve governance, especially those with respect to boards are already required by states. These proposals seem to represent an unnecessary federalization of traditionally state activity. Furthermore, while we support some areas of the proposals on board duties, other areas are of serious concern. For example, requiring board members to utilize their "special skills or expertise" would limit willingness to serve on boards, especially since board members would be federally liable for breach of these duties. Smaller charities are certain to suffer the most, as sophisticated would-be board members either refuse to serve or condition their service upon the purchase of expensive "errors and omissions" insurance. Giving the IRS authority to remove board members usurps the power of the states and violates the principles of corporate self-governance.

AFP is also concerned about the limitations on board composition. We have seen no evidence that a board composed of more than 15 members is not effective, efficient or somehow inherently inappropriate. Restrictions on direct or indirect compensation represent an unjustified shotgun approach when there are instances where compensation may be appropriate (reimbursements for travel and other necessary expenses). Finally, while we understand what the Committee is attempting to reach in creating the definition of an independent member, this approach opens a huge can of worms. Would a long-time volunteer and donor be considered "free of any relationship with the corporation or its management that may impair or appear to impair the director's ability?"

Accreditation (Section G-5)

Accreditation in the charitable arena, especially given the wide diversity of the sector, is a very ambitious task for the federal government to undertake, fund and/or sponsor. AFP believes that this is an area that needs considerable additional discussion and refinement since accreditation can take many forms. As we noted earlier in our comments, existing some professional and trade groups such as AFP are already in the business of setting standards, and we strongly recommend

that the Finance Committee analyze existing programs and codes in place. (Although the Committee references specific states where "accreditation…is already taking place," AFP is not aware of any formal state sanctioned "accreditation" programs anywhere in the U.S.) AFP has extensive experience and expertise with respect to accreditation and even licensure policies and would be pleased to assist in this area.

However, while basing charitable status on an organization's accreditation may be a suitable long-term goal, in the interim this will be impossible. The sector contains nearly one million charities alone, ranging from small grassroots organizations to multi-national institutions. Simply developing an accreditation process with standards that can adequately and fairly encompass all of these types of organizations will be difficult enough. Then will come the Herculean task of having every charity go through the accreditation process. From this perspective, the $10 million proposed to authorize IRS accreditation services is hopelessly inadequate.

Establish prudent investor rules (Section G-6)

AFP supports development of a federal standard on prudent investor rules, but only if this federal standard preempts rather than supplements state rules.

Funding of Exempt Organizations and for State Enforcement and Education (Section H)

We support the proposal to reinstate the authorization for appropriation of up to $200 million of revenue from the tax on the net investment income of private foundations. We would, however, oppose any filing fee on organizations that file the Form 990 (or 990-EZ, or 990-PF). Additionally, while we have no arguments against funding state enforcement, we would encourage full funding of the IRS before providing additional funds to the states.

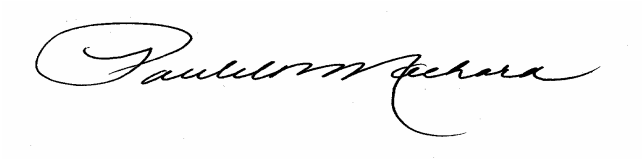
Valuation (Section I-4)

AFP appreciates the work of the Finance Committee in the area of valuation. While we do not pretend to have all of the answers in this area, we do have concerns with the process of "baseball arbitration." Because an arbitrator would be forced to choose one side's valuation (based on its own, probably favorable calculations), it is most likely that under "baseball arbitration," the figure decided upon will always be wrong. While this system might be suitable for the game of baseball, we believe tax policy should be based on valuations which are as accurate as possible. More study is needed in this area, and AFP would be happy to participate. We do believe, however, that both the public perception of charities and the charities themselves will be benefited by removing charities as much as possible from involvement with the valuation process.

Conclusion

AFP appreciates the opportunity to comment on the Finance Committee's staff discussion draft of proposals for reforms and best practices in the area of tax-exempt organizations. We respectfully offer our assistance to the Finance Committee as it proceeds with further consideration of these and similar proposals.

Sincerely,



Paulette Maehara, CFRE, CAE
President & CEO