Panel on the Nonprofit Sector

Convened by INDEPENDENT SECTOR

Strengthening **Transparency** **Governance** **Accountability** of Charitable Organizations

a final report to

Congress and the Nonprofit Sector

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PANEL ON THE NONPROFIT SECTOR

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Preface

This report is the culmination of a remarkable collaboration. Since October 2004, when it was convened at the encouragement of the Chairman and Ranking Member of the Senate Finance Committee, the Panel on the Nonprofit Sector has brought together thousands of people involved with charities and foundations—staff, board members, volunteers, and donors, along with government officials—for a thorough examination of the sector's governance, transparency, and ethical standards. The participation of people from organizations of widely varying sizes and programs has reflected both the charitable community's long-standing commitment to accountability and the increased attention to these issues stimulated by congressional concerns. The focus on ethical conduct already has produced substantial changes, as organizations have examined and revised their existing policies and standards.

While the Panel has invited input from diverse representatives of the nonprofit sector, it has made a special effort to listen to the views of the broader public. In addition to holding hearings in 15 locales and inviting comments on its website, the Panel discussed its recommendation with a committee of distinguished advisors from outside the sector. And Panel members have paid heed to the issues raised by those in the media who effectively serve as citizens' "fourth branch."

Accountability is crucial to our sector. Charitable organizations are an indispensable part of American society, offering relief from disasters, nurturing our spiritual and creative aspirations, caring for vulnerable people, protecting our natural and cultural heritage, and finding solutions to medical and scientific challenges. But they can fulfill these missions only by maintaining the trust of the public. Meeting the ethical standards that will justify this trust requires a series of ongoing commitments: from each charity and foundation, which must set standards and implement practices that manifest its dedication to transparency and governance; from the charitable community as a whole, which must share recommended practices and educate its members; and from the government, which must strengthen the law and dedicate the resources necessary to enforce it.

We hope this report, which includes and expands the ideas contained in the Panel's March 1, 2005, Interim Report, will intensify this effort. It begins with an overview of the charitable community, including its achievements, scope, and existing programs to improve ethics and accountability. It then describes the Panel on the Nonprofit Sector, focusing on the collaborative process we have been using and the principles on which we have based our work. The heart of the report is its recommendations, which offer a comprehensive approach to improving transparency and governance. The recommendations provide approaches that maintain the crucial balance between legitimate oversight and protecting the independence that charitable organizations need to remain innovative and effective. The final section outlines the issues that the Panel will examine during the summer as it concludes its work.

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Executive Summary

The Panel on the Nonprofit Sector is dedicated to ensuring that Americans continue to benefit from the richly varied programs provided by the charitable community. Formed at the encouragement of the leaders of the Senate Finance Committee, the Panel has led to an unparalleled collaboration on how to strengthen the sector's accountability, transparency, and governance. The participants in this effort—thousands of people representing diverse organizations from every part of the country—recognize that to serve their missions effectively, they must demonstrate that they are ethical, responsible stewards of Americans' generosity.

The Panel developed eight overarching principles to guide its recommendations:

The Role of Charitable Organizations in American Life

1. A vibrant charitable community is vital for a strong America.
2. The charitable sector's effectiveness depends on its independence.

The Responsibilities of the Charitable Community

3. The charitable sector's success depends on its integrity and credibility.
4. Comprehensive and accurate information about the charitable sector must be available to the public.
5. A viable system of self-regulation and education is needed for the charitable sector.

The Need for Balanced Government Oversight

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

The recommendations of the Panel on the Nonprofit Sector are a carefully integrated package that calls for improvement within the sector, more effective oversight, and changes in the law. No single action can achieve the necessary results by itself. The recommendations underscore the importance of transparency, of providing the information that allows the public to make informed choices and government officials to root out problems. Most important, the recommended actions offer a guide to maintaining the essential balance between adequate oversight that keeps potential abusers from using the sector to benefit themselves and safeguarding the independence of organizations in facilitating the opportunity for them to contribute to the wellbeing of society.

Summary of Recommendations

The detailed discussions in the report note important exceptions for organizations of particular types and sizes and other conditions that must be considered in the implementation of these recommendations.*

1. **Federal and State Enforcement**—Effective oversight of the charitable sector requires vigorous enforcement of federal and state law. Congress should increase the resources allocated to the Internal Revenue Service for overall tax enforcement and oversight of charitable organizations, and it should create a federally funded program to help states establish or increase oversight and education

* Recommendations for changes in the law or regulations would primarily apply to organizations required to file a Form 990 or 990-PF, and thus smaller organizations or religious congregations would generally be exempt. The discussion contained in the report gives further details.

programs for charitable organizations. Congress should also eliminate statutory barriers that prevent the IRS from sharing information about investigations of possible wrongdoing with state charity officials. (page 24)

2. **Internal Revenue Service Reporting**—The annual information returns filed by charitable organizations (Forms 990, 990-EZ, and 990-PF) should be improved so they provide more accurate, complete, and timely information for federal and state regulators, managers of charitable organizations, and the public. Electronic filing will increase accuracy and compliance in completing the returns, and Congress and the IRS should remove the legal barriers to requiring electronic filing of the returns by all charitable organizations. Congress should impose penalties on preparers who willfully omit or misrepresent information on the returns. Congress also should direct the IRS to require the organization's highest ranking officer to sign and certify the Form 990, as well as institute a new, brief annual reporting requirement for organizations with less than $25,000 in annual revenues. The IRS should make a number of changes in the format and instructions for Form 990 series returns, and suspend the tax-exempt status of any charitable organization that fails to correct incomplete or inaccurate returns for two consecutive years. The board of a charitable organization, or an appropriate committee, should review its organization's Form 990 series return. (page 26)

3. **Periodic Review of Tax-Exempt Status**—Congress should *not* implement a new periodic review system to verify that a charitable organization continues to meet the qualifications for tax-exemption. The IRS should focus its resources on review and investigation of the current returns filed by charitable organizations. In addition, boards of directors are encouraged to undertake a full review of their organizations' governing documents and policies at least once every five years. (page 33)

4. **Financial Audits and Reviews**—Having financial statements prepared and audited in accordance with Generally Accepted Accounting Principles and auditing standards improves the quality of financial information available to governing boards, government officials, and the public. Congress should require charitable organizations with at least $1 million or more in annual revenues to conduct an audit and attach audited financial statements to their Form 990 series returns, and those with annual revenues between $250,000 and $1 million to have their financial statements reviewed by an independent public accountant. (page 35)

5. **Disclosure of Performance Data**—Every charitable organization should, as a recommended practice, provide more detailed information about its operations, including methods it uses to evaluate the outcomes of programs, to the public through its annual report, website, and other means. The Form 990 returns are not useful as a tool for reporting complex program evaluation information. Congress should not require charitable organizations to report more detailed statements of program evaluations or performance measures as part of their Form 990 series returns. (page 37)

6. **Donor-Advised Funds**—Laws and regulations governing donor-advised funds should be strengthened to ensure that donors or related parties do not receive inappropriate benefits from these funds. Congress should amend tax laws to define and regulate donor-advised funds, including requiring sponsoring charities to make minimum distributions of 5 percent of aggregate donor-advised fund assets and enforcing minimum fund activity requirements. Congress also should prohibit sponsoring charities from making payments to a private foundation or directly or indirectly to the fund's donors, advisors, or related parties. Further, tax deductions for contributions to donor-advised funds should be allowed *only if* the donor has a written agreement with the sponsoring charity clarifying these restrictions. Penalties should be imposed on donors, advisors, and managers who violate these prohibitions. More information about the assets held by and disbursements made from donor-advised funds will improve both enforcement and understanding of these funds, and each sponsoring charity should be required to disclose aggregate information about its donor-advised funds on its Form 990. Sponsoring charities are encouraged to provide further information about their donor-advised funds to help others learn more about how the funds are distributed. (page 39)

7. **Type III Supporting Organizations**—Type III supporting organizations add value to the charitable sector that cannot and should not be replaced by other types of organizations. To curb abuse in these organizations, Congress should establish minimum distribution requirements, prohibit payments to or for the benefit of donors or any related party, and institute rules to increase the voice of the supported organizations in the governance of the Type III organization. A Type III supporting organization should be prohibited from supporting more than five qualified entities or from supporting any organization that is controlled by the donor or a related party. It should be required to provide certain documents to, and confirm the agreement of, its supported organizations at the time it files for recognition as a 501(c)(3) organization and when it files its annual Form 990 returns. Every supporting organization should be required to indicate on its Form 990 whether it is operating as a Type I, II, or III supporting organization. (page 45)

8. **Abusive Tax Shelters**—Congress should make clear that all tax-exempt organizations, including those not currently required to file tax returns, are subject to the same requirements as taxable entities with regard to reporting their participation in potentially abusive "listed" and other "reportable" tax shelter transactions, and should impose penalties on organization managers for failure to report if they knew or had reason to know that the transaction was a reportable transaction. Congress should impose penalties on taxable participants and material advisors who fail to notify tax-exempt participants that they would be engaging in a reportable transaction, and should ensure that appropriate sanctions are imposed on tax-exempt entities that knowingly participate in abusive tax shelters. Education will be key to both compliance with and enforcement of tax laws governing these complex transactions, and the IRS should be required to provide the clear, up-to-date, readily accessible information that charitable organizations need to determine whether a transaction is potentially abusive and whether they are under an obligation to disclose participation in a transaction. (page 49)

9. a. **Non-Cash Contributions: Appreciated Property**—Congress should strengthen the rules for the appraisals taxpayers can use to substantiate deductions claimed for property donated to charitable organizations and increase penalties on (1) taxpayers who claim excessive deductions based on an overstated value for the donated property and (2) appraisers who knowingly provide overstated appraisals. The Forms 8282 and 8283, which are filed, respectively, by taxpayers who claim tax deductions for donated items valued at $5,000 or more and by charitable organizations that dispose of those items within two years of the donation, could be a useful enforcement trigger for the IRS, and Congress should require those forms to be filed electronically. (page 53)

   b. **Non-Cash Contributions: Conservation and Historic Façade Easements**—A conservation easement or historic façade easement donation requires ongoing enforcement of the terms of the easement agreement by the charitable organizations who accept such donations. Congress should increase penalties on taxpayers who claim excessive deductions for donations of conservation or historic façade easements and should only permit a deduction for an easement if it is made to a qualified charity or government entity under the terms of a written agreement that specifies the restrictions the easement imposes on future use of the property. A charitable organization that accepts easement donations should be required to provide more information on its annual Form 990 about the easements it holds and to certify that it has implemented reasonable procedures for monitoring compliance with the terms of its easement agreements. Congress should impose penalties on charities that fail to enforce conservation or historic façade easement agreements. (page 56)

   c. **Non-Cash Contributions: Clothing and Household Items**—Congress should not limit deductions for contributions of clothing or household items to an arbitrary ceiling without a clear basis for establishing the amount of the ceiling and an assessment of the impact of the change on the level of charitable contributions. To assist taxpayers in valuation, the IRS should establish a list of the value that taxpayers can claim for specific items of clothing and household goods, based on the sale price of such items identified by major thrift store operations or other similar assessments. (page 58)

10. **Board Compensation**—Compensation to board members of charitable organizations is discouraged. Charitable organizations that do provide compensation to board members should be required to disclose the amount of and reasons for the compensation, as well as the method used to determine its reasonableness. Congress should prohibit public charities from providing loans to board members (such loans are already illegal for private foundations). Congress should also increase penalties on board members of charitable organizations who receive or approve excessive compensation. (page 61)

11. **Executive Compensation**—Charitable organizations should be required to disclose more clearly the compensation paid to their chief executive officer and other "disqualified persons" and to the five highest compensated employees. Congress should require officers and other disqualified persons who receive compensation that the IRS alleges is excessive to demonstrate that their compensation is reasonable, and should increase penalties imposed on individuals who receive and managers who approve excessive compensation. Members of boards or other authorized bodies who followed the rebuttable presumption procedures in determining the reasonableness of compensation should not ordinarily be subject to penalties, even if the compensation is later found to be excessive, but penalties should be imposed on board members and managers who approved such compensation if they did not follow those procedures nor otherwise exercised reasonable care in approving the transaction. As a matter of good practice, the full board of charitable organizations should approve any change in the compensation of the CEO annually and in advance and review the organization's full staff compensation program periodically. (page 66)

12. **Travel Expenses**—Charitable organizations that pay for or reimburse travel expenses of board members, officers, employees, consultants, volunteers, or others traveling to conduct the business of the organization should establish and enforce policies that provide clear guidance on their travel rules, including the types of expenses that can be reimbursed and the documentation required to receive reimbursement. With the exception of de minimis expenses of those attending an activity of the organization (such as a meal function), charitable organizations should not pay for nor reimburse travel expenditures for a spouse, dependents, or others who are accompanying an individual conducting business for the organization unless the additional person is also conducting business for the organization. Charitable organizations should be required to disclose on their Form 990 series returns whether they have a travel policy. The IRS should provide information in the instructions to the Forms 990 about travel costs that are not permitted or that should be reported as taxable income. (page 73)

13. **Structure, Size, and Composition of Governing Boards**—To qualify for recognition as a 501(c)(3) tax-exempt organization, an organization should generally be required to have a minimum of three members on its governing board. Further, to qualify as a public charity (rather than a private foundation), at least one-third of the members of the organization's governing board should be independent: that is, individuals who have not received compensation or material benefits directly or indirectly from the organization in the previous 12 months, whose compensation is not determined by other board or staff members, and who is not related to someone who received such compensation from the organization. Every charitable organization should be required to disclose on its Form 990 series return which of its board members are independent. Individuals barred from service on corporate boards or convicted of crimes related to breaches of fiduciary duty should be prohibited from serving on the boards of charitable organizations. Federal tax laws or regulations should *not* set a maximum number of members for the governing boards of charitable organizations. Every charitable organization should, as a matter of recommended practice, review its board size periodically to determine the most appropriate size to ensure effective governance and to meet the organization's goals. All boards should establish strong and effective mechanisms to ensure that the board carries out its oversight functions and that board members are aware of their legal and ethical responsibilities in ensuring that the organization is governed properly. (page 75)

14. **Audit Committees**—Charitable organizations should include individuals with some financial literacy on their boards of directors in accordance with the laws of their state or as a matter of recommended 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, and if state law permits, it may form an audit committee comprised of non-staff advisors who are not board members. (page 79)

15. **Conflict of Interest and Misconduct**—As a matter of recommended practice, charitable organizations should adopt and enforce a conflict of interest policy consistent with its state laws and organizational needs. The IRS should require every charitable organization to disclose on its Form 990 series return whether it has such a policy. Charitable organizations should also adopt policies and procedures that encourage and protect individuals who come forward with credible information on illegal practices or violations of adopted policies of the organization. There should be a vigorous sector-wide effort to educate and encourage all charitable organizations, regardless of size, to adopt and enforce policies and procedures to address possible conflicts of interest and to facilitate reporting of suspected malfeasance and misconduct by organization managers. (page 81)

SECTION I

Introduction

Charitable organizations make a difference in every American's life. Sometimes people benefit without being aware of the reach of this country's unique nonprofit sector. Visitors can enjoy a great urban park and never realize that charitable organizations are major contributors to the gardens, playgrounds, paths, and programs. Parents of children receiving polio shots may not know that one charitable group led the campaign to develop and distribute the vaccine and another funded much of its development. And people may not remember that the air and water that surrounds them is far cleaner because of how nonprofits have worked with government to reduce pollution.

Most of the time, Americans do appreciate how charitable organizations are improving lives across the country and around the world. They know that private support helps universities prepare youth for lifelong contributions to society, and that victims of disasters are helped in profound ways by nimble and timely intervention from charitable relief agencies. Communities across America are grateful for the museum, theater, dance, and music programs that grace their lives and for the assistance community day care programs offer to the very young and very old.

What make these organizations distinctive are not just the indispensable services they provide, but also how they do their work. Charities and foundations are created and sustained by people who want to give their time and resources to solve problems and enrich their communities. Nearly half of all adults volunteer each year, and nine out of 10 households make charitable contributions.[1] Individual donations total more than $207 billion, which comes on top of the $41 billion[2] given each year by corporations and foundations created from private money. These contributions of time and money reflect the public's commitment to and appreciation of this distinctive feature of American life: people coming together through charitable organizations to improve the lives of others and meet needs that government and business do not.

The Panel on the Nonprofit Sector is dedicated to ensuring that Americans continue to benefit from the richly varied programs of the charitable community. Formed at the encouragement of the leaders of the Senate Finance Committee, the Panel has led to an unparalleled collaboration on how to strengthen the sector's accountability, transparency, and governance. The participants in this effort—thousands of people representing diverse organizations from every part of the country—recognize that to serve their missions effectively, they must demonstrate that they are ethical, responsible stewards of the public's generosity.

This report is a vital part of the charitable community's commitment to keeping the public trust. Developed with the input of nonprofit leaders, experts, and volunteers, it offers a comprehensive approach to strengthening accountability. Its recommendations are a carefully integrated package that calls for improvement within the sector, more effective oversight, and changes in the law. No single action can achieve the necessary results by itself.

These recommendations underscore the importance of transparency, of providing the information that allows the public to make informed choices and government officials to root out problems. Most important,

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[1] Independent Sector, *Giving and Volunteering in the United States* (2001).

[2] Giving USA Foundation/Center on Philanthropy at Indiana University, *Giving USA* (2005).

the recommended actions offer a guide to maintaining the essential balance between adequate oversight that keeps potential abusers from using the sector to benefit themselves and safeguarding the independence of organizations in facilitating the opportunity for them to contribute to the wellbeing of society.

The Scope of the Nonprofit Sector

America's charitable community produces its results because of the commitment and talent of the people who have dedicated their lives to helping others. Part of that service comes from volunteers, who collectively provide the equivalent of 9 million full-time staff members. The sector's programs also are supported by its 11.7 million paid employees, 9 percent of the entire national workforce and a number greater than the finance, insurance, and real estate industries combined.[3]

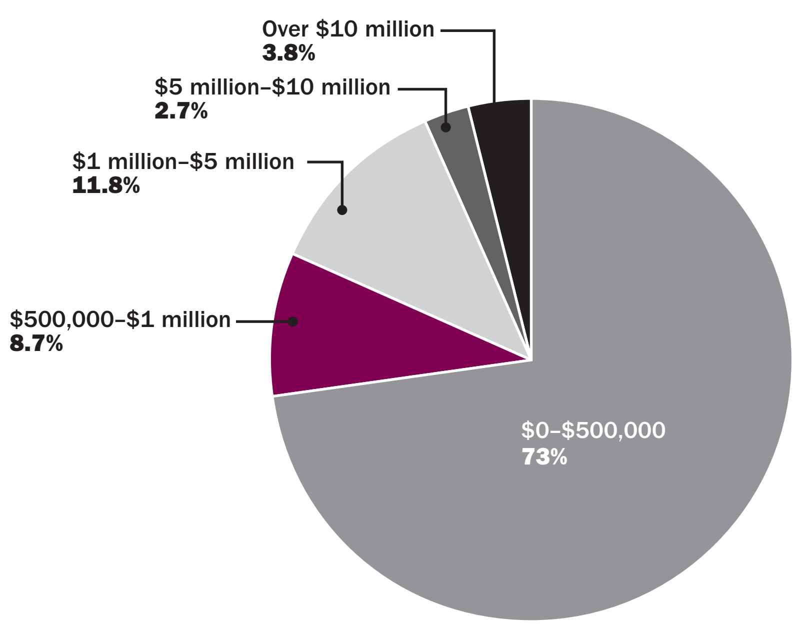
The organizations that these Americans work for continue a three-century tradition. In the colonial period, groups who found themselves in the minority—Scotsmen and women in Massachusetts, for example, or the Jewish community in South Carolina—created their own social service organizations. After the Revolutionary War, the number of churches, schools, and other charitable organizations grew so rapidly that after his 1831 tour of the United States, France's Alexis de Tocqueville identified voluntary "associations" as one of the features that distinguished American society from those in Europe. This growth accelerated through the century, leading to thousands of new organizations such as Hull House established by Jane Addams and the insurance cooperatives founded by new immigrants. The first part of the 20th century witnessed further expansion in the number and variety of charitable organizations, from private universities to community centers, from foundations to health care providers.

Nonprofits contribute to every community in America. Some programs started by nonprofits—including libraries, local schools, fire stations (many of which still use volunteers), and parks—have been expanded by government, enabling the broader community to enjoy their benefits. Philanthropic institutions have incubated new ideas that now seem commonplace, such as rocket science and the 9-1-1 emergency response system. Charitable organizations have also been the partners through which government effectively and efficiently delivers services such as early childhood education programs, health clinics, drug counseling, and after school programs.

This tradition of collaboration and innovation continues today, and the United States is now home to an estimated 1.3 million public charities, private

[3] Lester M. Salamon (editor), *The State of Nonprofit America* (Washington, D.C.: Brookings Institution Press, 2002)

Table 1. Breakdown of Charitable Organizations by Budget Size



Source: National Center for Charitable Statistics, Urban Institute (2003).

foundations, and religious congregations. Though the public is most familiar with larger groups, only 4 percent of all charitable organizations have annual budgets of more than $10 million. Most are small, with nearly three-quarters operating with budgets of less than $500,000.

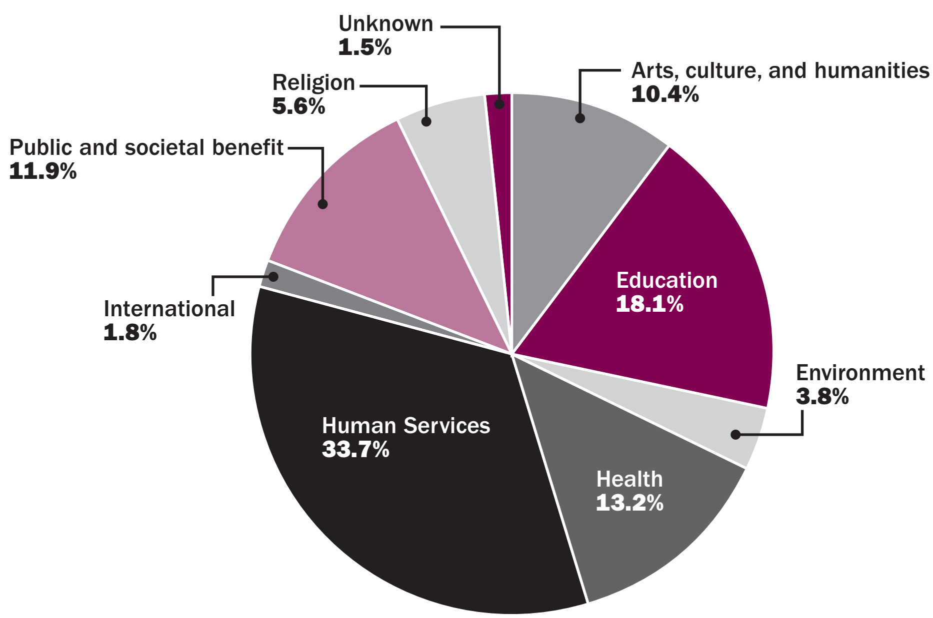
What is most impressive about America's charitable community is the variety of programs it offers. Its organizations fall into eight major categories:

- *Arts, culture, and humanities*, such as museums, symphonies and orchestras, and community theaters;
- *Education and research*, such as private colleges and universities, independent elementary and secondary schools, and noncommercial research institutions;
- *Environment and animals*, such as zoos, bird sanctuaries, wildlife organizations, and land protection groups;
- *Health services*, such as hospitals, public clinics, and nursing facilities;
- *Human services*, such as housing and shelter providers, organizers of sport and recreation programs, and youth programs;
- *International and foreign affairs*, such as overseas relief and development assistance organizations;
- *Public and societal benefit*, such as private and community foundations, civil rights organizations, and civic, social, and fraternal organizations; and
- *Religion*, such as houses of worship and their related auxiliary services.

Changing Education As We Know It: Jobs for the Future

Education is more critical today than ever before. Yet because of financial barriers or inadequate preparation for college, too few young people complete a postsecondary education. Jobs for the Future is pioneering a new concept of "early college" high schools: small, autonomous schools with programs designed for young people who might otherwise fail to advance to college. Students leave within four to five years of entering ninth grade with a high school diploma and an associate's degree or two years of college credit toward a bachelor's degree. In partnership with some of the world's leading foundations and education organizations[4], 25 "early college" high schools across the country have already opened their doors and 100 more plan to over the next seven years.

Table 2. Breakdown of Charitable Organizations by Mission*



Source: National Center for Charitable Statistics, Urban Institute (2003).

*Includes 501(c)(3) organizations with over $25,000 in annual revenues that file a Form 990 information return with the IRS. Many religious congregations, which are not required to file a Form 990, are excluded from this chart, and only those that have filed voluntarily are represented.

Building Arts and Economic Development: Mississippi Cultural Crossroads

A rural, economically poor area in southwestern Mississippi, Claiborne County seems an unlikely home for an award-winning arts program. But for more than 25 years, the nonprofit Mississippi Cultural Crossroads has been using quilting, theater, and other types of art to promote the educational, cultural, and economic development of the county's 12,000 residents. MCC brings together professional artists and community members, and it celebrates the achievements of skilled local artists, including making it possible for them to share and sell their work within and outside the community. These programs, many of which focus on children, also educate people of all races about African American heritage, particularly in the arts. One type of recognition for MCC's success came in 2000, when it received the Governor's Award for Excellence in the Arts and the Coming Up Taller Award from the President's Committee; another is the funding it has attracted from local, state, and federal governments, from private foundations, and individuals and businesses.

Though funding for individual organizations varies substantially, the majority of support for the sector as a whole comes from consumers of services and voluntary contributions: 38 percent from dues, fees, and other charges for goods and services, 17 percent from individual contributions, and an additional 3 percent from private foundations and corporate giving programs. Government grants and contracts provide 31 percent of the sector's revenues, and other sources, such as income from assets, supply the remaining 11 percent.

Government Regulation of Charitable Organizations

Despite the charitable community's enormous diversity, its organizations share one attribute: a commitment to advancing the common good. Congress and state legislatures have long recognized this special purpose by making charitable organizations tax-exempt, which enables them to dedicate their funds to fulfilling their missions. To encourage the American people to make contributions, federal and state governments have allowed taxpayers to deduct charitable contributions when calculating their income taxes.[5]

Charitable organizations receive their tax-exempt status under section 501(c)(3) of the Internal Revenue Code. A group interested in obtaining this designation must submit an application to the Internal Revenue Service that details its charitable purposes, its sources of funding, the members of its board of directors, its bylaws, and other information. (Religious congregations are an exception to these requirements: in keeping with constitutional protection separating church and state, religious congregations automatically receive 501(c)(3) status.) Organizations must file separate forms with their state or local government agencies to be exempt from local property and sales taxes.

There are two types of organizations under Section 501(c)(3): public charities and private foundations. Generally, a public charity must document that it receives at least one-third of its annual income from the public in the form of contributions and grants, whereas a private foundation derives its primary financial support from the contributions of an individual, family, or corporation. Foundations are subject to substantially more restrictive rules governing their operations, and their donors receive less favorable tax treatment for donations.

[4] Initiative funders and partners include The Bill & Melinda Gates Foundation, Carnegie Corporation of New York, The Ford Foundation, The W.K. Kellogg Foundation, Antioch University Seattle, City University of New York, Foundation for California Community Colleges, KnowledgeWorks Foundation, Middle College National Consortium, National Council of La Raza, Portland Community College, SECME, Inc., Utah Partnership Foundation, and the Woodrow Wilson National Fellowship Foundation.

[5] The Internal Revenue Code defines more than 25 categories of organizations that are exempt from federal income taxes, including private country clubs, business associations such as Chambers of Commerce or the National Association of Manufacturers, labor unions, fraternal organizations, and many others. Where other types of nonprofit organizations benefit the private, social, or economic interests of their members, charitable organizations must benefit the broad public interest and Congress has therefore provided, with very limited exceptions, that only those charities organized under section 501(c)(3) are eligible to receive tax-deductible contributions.

Several government agencies are charged with monitoring and regulating charitable organizations. At the federal level, the IRS's Division on Tax Exempt and Government Entities reviews applications for tax-exempt status, audits a sample of the information returns (the Forms 990) filed annually by nonprofits, and enforces the requirements imposed by the tax code on charitable organizations. The IRS is also authorized to assess fines and penalties and, as a last resort, to revoke tax-exempt status.

Most states have their own laws governing the creation, operation, and dissolution of charitable organizations. In most states, attorneys general bear the primary responsibility for enforcing these laws and investigating complaints of fraud or abuse of tax-exempt status. State charity regulators monitor adherence to charitable solicitation laws, investigate complaints of fraud or abuse of tax-exempt status, and maintain lists of registered nonprofit organizations.

Although this system of oversight has proven effective in identifying and deterring some individuals or organizations that violate the law, a serious shortage of resources has often made it difficult for government officials to identify and punish most violators. The number of charitable organizations has more than doubled since 1974, but the staff in the IRS exempt organizations division has increased by only 3 percent during this same period.

Ethical Concerns about the Nonprofit Sector

Starting in 2002, news outlets that had been following corporate scandals also began to examine the charitable sector. They have subsequently identified practices that are illegal or not in keeping with standards typical of the charitable sector. The leadership of the U.S. Senate Finance Committee expressed deep concern over such practices and began to take a closer look at charities and foundations. In June and July of 2004, the Committee conducted a hearing and a roundtable discussion on oversight and reform, and the staff released a discussion draft[6] of possible solutions. The Committee followed with additional hearings in April and June of 2005.

In testimony before the Committee, IRS Commissioner Mark Everson identified a number of issues:

- Misuse of charitable entities, such as donor-advised funds and Type III supporting organizations, so they benefit the donor rather than the receiving organization or the public;
- Abusive credit counseling organizations, many of which may have been set up not to assist debtors but to enrich the organizations' for-profit partners;
- Overstated charitable deductions by taxpayers, most often involving non-cash contributions;
- Widely varying methods for determining the compensation of executives; and
- Inconsistent and limited disclosure of governance practices.[7]

People Helping People: Faith in Action

Over the past decade, the Robert Wood Johnson Foundation's Faith in Action program has funded over 1,000 interfaith community coalitions, mobilizing volunteers from local congregations and communities to provide assistance with daily activities to people who are homebound because of long-term health problems, enabling them to maintain their independence. In a typical year, more than 34,000 Faith in Action volunteers from across the spectrum of religious faiths in America—Protestant, Catholic, Jewish, Muslim, Hindu and others—support more than 51,000 people in need.

Keeping the World Safe: Center for International Security and Cooperation

The Center for International Security and Cooperation at Stanford University is experimenting with ways to prevent, detect, and react to biological terrorism, with an emphasis on improvements in risk assessment, disease surveillance, communications, and response. The project brings experts in the life sciences together with counterparts in the field of public health, and is one of several initiatives to strengthen security around the globe funded by the John D. and Catherine T. MacArthur Foundation.

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6 Senate Finance Committee staff discussion draft, 108th Cong., *Tax-Exempt Governance Proposals* 7 (2004).

7 Mark W. Everson, Commissioner of Internal Revenue, testimony before the U.S. Senate Finance Committee, June 22, 2004, and April 5, 2005.

Making a Difference: The Conservation Fund
The Conservation Fund has worked with three of the nation's largest energy suppliers to offset the environmental impact of fossil fuel. In 2002, The Conservation Fund purchased 600 acres of non-productive land along the Red River, one of Louisiana's most degraded watersheds. Entergy Corporation planted more than 180,000 native trees to scrub the air of 275,000 tons of carbon dioxide over the next 70 years. As a result of this collaboration, the company is providing reliable, affordable, clean energy, and the nonprofit was able to restore important bottomland hardwood habitat for assorted wildlife. The land was later transferred to the U.S. Fish and Wildlife Service to create the Red River National Wildlife Refuge, and The Conservation Fund has since worked with American Electric Power Company and Chevron Corporation on similar projects.

Commissioner Everson pointed out that this list included only current violations of the law; the IRS is also concerned about areas where the law has not kept up with questionable practices.

Some of those who testified urged caution when considering new legislative options, particularly given the diverse way in which the charitable sector is organized. They noted that while a particular remedy may solve the targeted problem, it may also have an unintended adverse consequence for a great many other organizations. Moreover, legislation should not be so onerous as to stifle the generous inclination of Americans to give and to volunteer. Sector leaders pointed out that the charitable sector has a long tradition of self-regulation, and serious efforts ought to be made to strengthen such initiatives and to enforce existing law, in addition to proposing possible new legislative remedies. They urged lawmakers to recognize that one size does not fit all and that nearly three-quarters of charitable organizations have such limited resources that over regulation is likely to jeopardize their very existence.

The U.S. House Ways and Means Committee, under the leadership of Chairman Bill Thomas (R-CA), also began an examination of the charitable community in 2004. The Committee is examining the legal history of the tax-exempt sector; its size, scope, and impact on the economy; the need for congressional oversight; and what the IRS is doing to improve compliance with the law.

Taken together, the examinations underway by Congress, the IRS, and the sector itself constitute the most comprehensive review of the governance, regulations, and operations of the charitable community in three decades. Leaders of charities and foundations have viewed these developments as a clarion call to improve the operations of the sector and work with policymakers to strengthen oversight.

Efforts Within the Charitable Community to Improve Practice

The charitable community has long recognized that its organizations can deliver their services more effectively if they have strong systems of governance and accountability.[8] The sector's first major effort to strengthen its performance in this area began in 1918, when a coalition of nonprofits established the National Charities Information Bureau to help the public learn about the ethical and stewardship practices of organizations that raised money.

Current methods of self-regulation run along a continuum. On one end are systems of accreditation that delegate the authority to determine compliance of charitable organizations but still carry the force of law and sanctions for violations. At the other end are purely voluntary approaches in which organizations are encouraged, but not required, to follow a certain set of standards.

Several types of charities, including hospitals, institutions of higher education, and nursing homes, fit into the first category. Though the specific requirements vary by field of service and by state, the organizations in these fields must meet well-defined standards in order to receive insurance coverage, recognition of

[8] The Panel is in the process of studying the various systems of self-regulation and will offer recommendations on how to improve self-regulation in a supplemental report to Congress in the fall.

degrees conferred, access to government funding, and other benefits required for successful operation. Failure to meet these standards will result in substantial penalties, which even can include being prohibited from operating.

In the middle of the continuum are those organizations that have developed mandatory standards for their members. Land trusts, international relief and development organizations, some religious organizations, and fundraising professionals, among others, all are expected to meet standards laid out by an association within their field. A national organization with local affiliates may use a similar approach. In each of these situations, the organization or individual must comply with the standards in order to retain their membership or affiliation. While the failure to do so may not force an organization to close or an individual to leave the field, it can have severe repercussions: the loss of trust from members of the public who recognize the value of the membership, the inability to operate as an affiliate, and the decline of prestige within the peer group. This approach is likely to succeed where organizations are closely affiliated or belong to a homogeneous group where social sanctions have a strong impact.

On the voluntary end of the continuum are standards of conduct that an association encourages, but does not require, its members to meet. Sub-sectors using this approach include museums, foundations, and state associations of charitable organizations. The association or coalition typically provides guidance to its members on how to meet its standards or how to adapt them to a particular situation. Some organizations have no compliance procedure in place while others implement disciplinary action for violations by those organizations that subscribed to the standards. Though there is no direct sanction for not participating, those who do may benefit substantially from the positive awareness of the public, of peers, and of funders.

Two other initiatives within the charitable community encourage accountability. First are the so-called "watchdog" groups or those committed to increased transparency that provide information to the public about whether or not a charitable organization meets certain standards. A number of these groups set their own criteria and what areas of practice to concentrate on, and some may choose which organizations to evaluate, regardless of whether organizations want to be rated. Though these groups cannot impose sanctions directly, they can be influential if their ratings affect the giving decisions of the public. Some organizations within this group make no judgment about practices, but rather concentrate on ensuring that the public has access to information about the organizations.

Second, there are programs that improve ethics within the charitable community through training and education. Some of the organizations offering instruction focus exclusively on a discrete area, such as board governance or fundraising practices, while others have a broader mandate to assist with a range of issues. The use of these groups' resources is purely voluntary, but the demand from individuals and organizations for their services, often for a fee, indicates the value they provide at least to those who are aware of or able to afford their services.

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[9] encouraging it to assemble an independent group of leaders from the charitable sector to consider and recommend actions to strengthen governance, ethical conduct, and accountability within public charities and private foundations. The Senate Finance Committee leadership requested an interim report in February 2005 and a final report in the spring.

Composition of the Panel on the Nonprofit Sector

INDEPENDENT SECTOR responded on October 12, 2004, by announcing the creation of the Panel on the Nonprofit Sector. Its members are 24 distinguished leaders from public charities and private foundations from around the country. Collectively they reflect organizations both large and small; that work in a single community, across a state, or around the world; and that pursue the spectrum of causes that characterize the sector.

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

Collaborating to Improve Accountability: New Hampshire Officials and Charitable Organizations

Proud of their traditions of service and ethical conduct, leaders of New Hampshire's charitable organizations joined with state officials in 2004 to develop approaches to accountability that would maintain the public support that makes their work possible. This group developed recommendations and then tested them in six listening sessions with nonprofit leaders across the state. The resulting program, announced by the governor, attorney general, and the Excellence in Nonprofit Governance Committee at a press conference in February 2005, features workshops presented by the attorney general's office, a guidebook for board members describing their responsibilities, and tools and resources to help nonprofits understand how to carry out their missions as effectively as possible. At the center of the effort is the New Hampshire Nonprofit Checklist, which for the first time compiles in one place all legal requirements for the state's charitable organizations. Thirteen of the state's most prominent corporate, community, health conversion, and family foundations now only consider applicants who provide completed and signed checklists, and numerous other funders are considering adopting the same rule. Well underway are the development of "best practice" models for charitable organizations, and development of some form of accreditation or certification for agencies as they demonstrate mastery of these best practices.

The Panel's initial steps established the collaborative and inclusive approach that has characterized its work. To make sure it benefited from the expertise and viewpoints of those who have studied the sector as well as civic leaders outside of the sector, the Panel created two advisory groups. The members of the Expert Advisory Group, who come from academia, law, and nonprofit oversight, add extensive knowledge about the issues the Panel has considered. The members of the Citizens Advisory Group are 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.

The Panel also formed five Work Groups to examine key issues in governance and accountability. Volunteering their time and talent to serve on these groups are more than 100 experts on nonprofits, including academics, lawyers, accountants, former state oversight officials, and executives of public charities, foundations, and corporate giving programs. Drawn from an array of national, regional, and local organizations, they offer a range of perspectives that reflect the diverse needs and situations within the sector.

Each Work Group focused on a specific area:

- **Governance and Fiduciary Responsibilities**: composition, responsibilities, and compensation of boards of directors;
- **Government Oversight and Self-Regulation**: enforcement of existing laws and systems of self-regulation;
- **Legal Framework**: gaps in current laws and regulations governing charitable organizations;
- **Transparency and Financial Accountability**: improved reporting of financial and program information; and
- **Small Organizations**: impact of existing and proposed laws and reporting requirements on smaller charities and foundations.

The Panel has also drawn on the knowledge of dozens of other professionals. It invited a research project on models of self-regulation, accreditation, and standard-setting within the nonprofit sector, and it has convened two groups to study and recommend changes to the IRS Form 990 and 990-PF that would improve their value as a reliable and credible source of public information. Supporting all of this work was a staff under the leadership of the Panel's executive director and a legal team with expertise in nonprofit law. The Panel also consulted with technical advisors on the revision of the IRS Form 990 series, as well as with communications and research experts.

Funding for the Panel provides another indication of the breadth of support it has received from the charitable community. More than 90 organizations, including private foundations, community foundations, public charities, and corporate giving programs, have made financial commitments to support its work. The Panel also has benefited from invaluable pro-bono contributions by individuals throughout the sector and the community at large.

The Panel on the Nonprofit Sector Process

The Panel began its scope of work with the recommendations made in the Finance Committee staff discussion draft but also expanded its examination to related issues and considered a range of solutions. Its work was conducted in two primary phases, each leading to one of the reports the Senate Finance Committee leadership requested. It has also planned a third stage that will offer supplementary comments in the fall of 2005.

The Panel used a similar process during each of the phases. To help the Work Groups begin their discussions, the staff and legal team provided analyses of the key issues. Through a series of conference calls and the use of electronic listservs, the Work Groups analyzed

LIST OF FIELD HEARINGS AND THEIR CONVENERS

Atlanta
Co-Conveners: American Cancer Society; Boys and Girls Clubs; CARE; Community Foundation of Greater Atlanta; Georgia Center for Nonprofits; Southeastern Council of Foundations

Chicago
Co- Conveners: YMCA of the USA; Chicago Community Trust; Donors Forum of Chicago; United Way of Chicago; Chicago Chapter of the Association of Fundraising Professionals

Dallas
Co-Conveners: The American Heart Association; The Meadows Foundation

Denver
Co-Conveners: The Daniels Fund; The United Nations Foundation

Des Moines, Iowa
Co-Conveners: Greater Des Moines Community Foundation; Minnesota Council of Nonprofits; United Way of Central Iowa

Detroit
Co-Conveners: Michigan Nonprofit Association; Council of Michigan Foundations; W.K. Kellogg Foundation; Charles Stewart Mott Foundation

Duluth, Minnesota
Co-Conveners: Minnesota Council of Nonprofits; Minnesota Council on Foundations

Helena, Montana
Co-Conveners: Montana Nonprofit Association; Montana Community Foundation; Montana Society of CPAs; The Governor's Task Force on Endowments and Philanthropy

Minneapolis
Co-Conveners: Minnesota Council of Nonprofits; Minnesota Council on Foundations

New York
Co-Conveners: Alliance for Nonprofit Governance; The Ford Foundation; New School University; New York Community Trust; New York Regional Association of Grantmakers; Rockefeller Brothers Fund; The Surdna Foundation

Philadelphia
Co-Conveners: The Pennsylvania Association of Nonprofit Organizations; Nonprofit Center at LaSalle University; Delaware Valley Grantmakers; United Way of Southeastern Pennsylvania

San Diego
Co-Conveners: Council on Foundations; California Association of Nonprofits; INDEPENDENT SECTOR; San Diego Association of Nonprofits

San Francisco
Co-Conveners: The William and Flora Hewlett Foundation; CompassPoint Nonprofit Services; Northern California Grantmakers

Seattle
Co-Conveners: Nancy Bell Evans Center on Nonprofits & Philanthropy, University of Washington; Seattle University Center for Nonprofit and Social Enterprise Management; The Nonprofit Center; Northwest Nonprofit Resources; Nonprofit Network; Executive Alliance; Philanthropy Northwest; United Way of King County; Association of Fundraising Professionals Washington Chapter

Washington, DC
Co-Conveners: INDEPENDENT SECTOR; Council on Foundations; Center for Nonprofit Advancement; Nonprofit Roundtable of Greater Washington; Washington Regional Association of Grantmakers; Maryland Association of Nonprofit Organizations

Building International Communities and Strong Accountability: InterAction

InterAction, the largest alliance of U.S.-based international development and humanitarian organizations, has long been at the forefront of improving governance and accountability. It has for many years required its members to certify their compliance with its Private Voluntary Organization Standards that cover practices in financial management, fundraising, governance, and program performance. These standards, which strengthen public confidence in InterAction's members, have even become a model for comparable groups in other countries. Recently, its members have decided to make their process even more rigorous by launching two pilot projects. The first new program, known as "Self-Certification Plus," requires members to gather evidence that documents their compliance. In the second, five leading child-sponsorship agencies are using a private, independent accrediting agency to certify compliance of their sponsorship programs with the PVO Standards through a comprehensive audit of their headquarters and a random sampling of their field operations in other countries.

both the existing problems and possible solutions. The Expert Advisory Group conducted separate discussions on the same topics.

Though they shared many features, there were important differences between the first and second phases. The second phase included an in-person meeting for all the Work Groups, and a longer time period allowed more extensive discussion among the Panel, the Work Groups, and Expert Advisory Group on the issues.

The Panel encouraged feedback from the broader charitable community throughout both phases. It used its website to communicate about its work and to encourage comments and suggestions. During the period leading up to the Interim Report, it convened two national conference calls during which hundreds of participants—staff, volunteers, and board members—heard from Panel members and asked questions about the ongoing work.

Though both the website and phone calls demonstrated the sector's widespread interest in the Panel's work and, more broadly, in improving accountability and governance, the most vivid indication of the commitment to addressing these issues came from 15 field hearings the Panel held around the country between late March and May. While attendance varied according to the size of the city in which the hearing was held, virtually all of the meeting rooms were full and, in some cases, overflowing. In total, an estimated 2,500 people participated in the field hearings, and another 2,200 attended professional meetings during the same period that covered similar issues.

Each hearing was dedicated to giving community members the opportunity to share their thoughts and concerns about possible reforms. Despite widely varying locations and backgrounds of the speakers, seven points consistently came through in their comments:

- Most organizations operate ethically and responsibly;
- Recommendations must consider the limited resources available to small organizations;
- Steps to prevent abuses must not be so cumbersome that they undermine the ability of organizations to do their work;
- Religious groups should be held to the same standards of ethical conduct;
- The use of independent auditors and accountants is a powerful way to improve the operations of organizations of all sizes;
- Charitable organizations must, as they usually do, reject requests and proposals from potential donors or vendors that are illegal or unethical; and
- Nonprofit staff and board members are hungry for knowledge about methods of improving their operations and are willing to implement new policies immediately.

Towards the end of each phase, the ideas of Work Groups with feedback from the Expert Advisory Group were combined into a series of draft recommendations. The Panel posted these recommendations on its website and invited feedback from the nonprofit community during two comment periods; these responses were shared with the 24 Panel members. As it was developing its two reports, the Panel considered the draft recommendations along with the comments from the conference calls or the field hearings and the ideas of the Citizens Advisory Group.

The Panel presented its Interim Report to Senator Grassley and Senator Baucus on March 1, 2005, and then shared it with members of the Senate Finance Committee, members of the House Ways and Means Committee, and IRS and Administration officials, as well as the charitable community itself. The Interim Report was endorsed by nearly 300 organizations.[10]

In the report that follows, the Panel combines its recommendations from the Interim Report with its new recommendations to offer a comprehensive approach for strengthening governance, transparency, and accountability. While these recommendations have drawn upon the wisdom and expertise from many sources, they represent the collective views of the Panel.The Panel will offer supplementary comments on remaining issues (as described on page 83) in an addendum report in fall of 2005.

[10] A listing of endorsing organizations can be found on the Panel on the Nonprofit Sector's website, www.NonprofitPanel.org.

Communicating Transparency:
The David and Lucile Packard Foundation

The David and Lucile Packard Foundation is a 40-year-old family foundation that has long provided information about the impact of its grantees. As part of its commitment to transparency and effectiveness, it recently added extensive information on governance to its online presence. The foundation's website now offers grantseekers, media, and the public access to its bylaws, committee charters, code of conduct and statement of values, conflict of interest policy, and whistleblower policy. It also features the foundation's 990-PF for the previous five years and results from its two most recent surveys of grantees about the foundation's performance. An easily accessible place for public access to these policies, financial information and grantee perceptions, the website has helped educate the public about the foundation's operations, ensured greater accuracy in media reports, and saved staff time in responding to requests from reporters or other interested people.

SECTION II

Principles to Guide Improving the Accountability of Charitable Organizations

The Panel on the Nonprofit Sector's wide-ranging examination of how to strengthen the governance, accountability, and ethical standards of charitable organizations led to broader discussions about the essential qualities of the sector. The Panel developed the following principles in three key areas to guide its recommendations:

THE ROLE OF CHARITABLE ORGANIZATIONS IN AMERICAN LIFE

1. A Vibrant Charitable Community is Vital for a Strong America

America's voluntary spirit has shaped the history and character of our country since its inception. That great tradition of collaboration, generosity, and participation continues today in the form of public charities, private foundations, and religious congregations.

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 nonprofit sector provides the means for people to engage collectively and collaboratively in critical research, community-building, and advocacy efforts that strengthen democracy, advance freedom of expression, and add richness and diversity to community 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 charitable community remains a creative, vibrant, and unique feature of American life, with tens of thousands of organizations, large and small, working together to advance the public good rather than increase private gain. Any effort to address issues must take into account the sector's diversity and complexity and avoid the unintended consequence of stifling its ability to serve and innovate. 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 charitable organizations.

2. The Charitable Sector's Effectiveness Depends on its Independence

The power of the charitable community grows from its ability to bring together people who share a commitment to improving lives. They select the charitable community to make those changes because it offers the freedom to experiment with 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 around the world. America must continue to encourage such innovation and creativity by preserving the independence, within a broad range of public purposes the law defines as charitable, of charitable organizations to choose and pursue their mission as they deem best. Government appropriately sets the rules for the use of government funds by charitable organizations, but should resist intruding into policy and program matters best determined by the charitable organizations themselves.

THE RESPONSIBILITIES OF THE CHARITABLE COMMUNITY

3. The Charitable Sector's Success Depends on its Integrity and Credibility

Public trust is essential to a viable nonprofit sector. Because federal and state laws provide tax exemption and other privileges unavailable to for-profit entities, and because Americans contribute their resources and time to nonprofit organizations, government officials and the public have a right to expect these organizations to conduct themselves in an ethical manner. Strengthening this trust depends on the extent to which charities and foundations operate transparently, prevent fraud and the enrichment of insiders and other abuses, and serve the purposes for which they have been created. Board members have the primary responsibility, through their governance and oversight, to ensure these obligations are met.

4. Comprehensive and Accurate Information About the Charitable Sector Must be Available to the Public

To encourage participation and confidence in the nonprofit 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 and Education is Needed for the Charitable 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. The development and dissemination of these practices are an important component of the effort by the charitable sector to encourage all charitable 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 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 sub-sectors. 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 members to govern and CEOs to operate in a responsible, transparent, and accountable manner.

THE NEED FOR BALANCED GOVERNMENT OVERSIGHT

6. Government Should Ensure Effective Enforcement of the Law

Abuse of the privileges granted charitable 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 charitable 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 for those situations where the sector cannot reasonably be expected to deal with those who deliberately abuse the public trust and exploit nonprofit organizations for personal gain, and 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 consideration should be given to any actions that might deter 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, since each breach of the public trust 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 varying situations 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

1. FEDERAL AND STATE ENFORCEMENT

Introduction

Effective oversight of the charitable sector requires vigorous enforcement of the law at both the federal and state level. State attorneys general and other state charity officials have long held significant responsibility for establishing and enforcing regulations on the governance and management of charitable organizations and for overseeing solicitations of charitable contributions in their states. Federal officials as well as many state oversight officials also play a role in educating board and staff members of charitable organizations about legal responsibilities and requirements to the extent that resources will permit.

Statement of Problem

Funding for federal and state oversight of tax-exempt organizations has become increasingly inadequate as the size and complexity of the exempt sector has grown. Federal laws only permit the Internal Revenue Service to share relevant information with state revenue officers. The inability to share information about ongoing investigations with attorneys general and other state officials charged with overseeing charitable organizations increases the cost of oversight and enforcement and impedes the efforts of state officials to weed out wrongdoing efficiently and effectively.

Recommendations for Congressional 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. Congress should authorize funding to be provided to all states to establish or increase oversight and education of charitable organizations. Congress should authorize additional supplemental funding for states willing to provide matching dollars for further improvements in oversight and education. State matching funds should be new funding for regulation of charitable organizations that is not derived from fees imposed on charitable organizations. To qualify for matching funds, states should be required to adopt uniform state filing requirements and meet minimum standards for oversight and enforcement of regulations governing charitable organizations.
3. Congress should amend federal tax laws 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.

Recommendation for Charitable Organization Action

Charitable organizations should encourage state legislatures to incorporate federal tax standards for charitable organizations, including prohibitions on excess benefit transactions, into state law.

Background

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 charitable sector. The legislative history to the Tax Reform Act of 1969 indicates that the excise tax on the net investment income of private non-operating foundations was intended to fund the exempt organizations oversight function within the IRS. Those funds, to the disappointment of many, have never been designated for that purpose.

States currently have the authority to pursue federal tax violations if federal laws are incorporated into state law. Since 1975, 48 states and the District of Columbia have passed laws imposing the restrictions on private foundations in Chapter 42 of the Internal Revenue Code as a matter of state law.[1]

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[1] Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Cambridge, Massachusetts: Belknap Press of Harvard University Press, 2004), p. 267.

Rationale

The shortage of resources for oversight and enforcement extends beyond the charitable sector to many areas of tax enforcement. While the Panel believes 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—nearly $500 million in fiscal year 2002—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 continue to do so with impunity. The Panel would be strongly supportive of efforts by Congress to earmark funds derived from a variety of sources including excise taxes and penalties imposed on charitable organizations for improved oversight and education activities of the exempt organization division of the IRS.

The proposed new revenue sharing program must take into account that regulation of charities at the state level is quite diverse, and many states and territories do not currently regulate charitable activities and organizations beyond charitable solicitations. The program should be designed to encourage states that do not regulate, as well as states with insufficient state regulation, to adopt uniform state filing requirements for charitable organizations operating within the state. Each state should be required to have sufficient review and/or audit procedures and enforcement programs in place to ensure compliance with applicable laws and regulations. Education of charitable organizations about changes in federal and state laws and reporting requirements will be critical to increased compliance and should be incorporated into the new funding program requirements.

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.

If states incorporate federal tax standards into state law, enforcement of federal standards will likely increase and opportunity for collaboration between federal and state enforcement efforts will likely improve, resulting in 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.[2] 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.

[2] This approach offered in the Senate Finance Committee staff discussion draft, 108th Congress (June 2004)

2. INTERNAL REVENUE SERVICE REPORTING

Introduction

All private foundations and many public charities[1] are required to file an annual information return (Form 990, 990-EZ, or 990-PF) with the Internal Revenue Service that includes information about the organization's finances and operations. The 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. The IRS is currently undertaking a revision of the Form 990.

Statement of Problem

Too many of Forms 990 filed by charitable organizations provide inaccurate or incomplete information. Review of the Forms and enforcement of regulations governing charitable organizations are hampered by the high costs of processing paper returns. Delays in filing and processing the Forms further contribute to concerns about accessing up-to-date information. The list of organizations qualified to receive tax-deductible contributions under section 501(c)(3) provided by the IRS has outdated information for the many organizations that are not required to file annual information returns and may include organizations that have ceased operations or no longer qualify for tax-exemption.

Recommendations for Congressional Action

Congress should:

1. Authorize funding to enable the IRS to move forward with mandatory electronic filing of all Form 990 series returns as expeditiously as possible and to coordinate its electronic filing efforts with state filing requirements.
2. Amend federal tax laws to permit the IRS to require all charitable organizations to file their Form 990 series returns electronically, with appropriate accommodations to allow charitable organizations to comply with e-filing requirements in a timely, cost-effective manner.[2]
3. Direct the IRS to 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.
4. Amend federal tax laws to require 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 with basic contact and financial information. Congress should direct the IRS to make this form part of the Form 990 return series and to require that it be filed electronically. After an appropriate phase-in period, the IRS should be authorized to suspend the tax-exempt status of organizations that fail to file the required notification form for three consecutive years.
5. Amend federal tax laws to require charitable organizations 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.
6. Amend federal tax laws to extend present-law penalties imposed on income tax preparers[3] of personal and corporate tax returns for omission or misrepresentation of information, willful or reckless misrepresentation, or disregard of rules and regulations to preparers of Form 990 series returns.

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[1] 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 are excluded from this requirement.

[2] The Panel is studying with the intent to recommend further statutory changes that may be required to eliminate particular information requirements that increase the cost and difficulty of implementing electronic filing requirements for charitable organizations with substantial investment holdings. Regulations should also permit exceptions for smaller organizations that do not have easy or affordable access to the necessary computer hardware or software for electronic filing.

[3] IRC §6694.

Recommendations for Internal Revenue Service Action

1. The Internal Revenue Service should revise the Form 990 series returns to ensure accurate, complete, timely, consistent, and informative reporting.[4]
   a. Financial and program description summary information and the questions setting out what is expected should be clear and consistent throughout the Form 990 series returns.
   b. Information relevant only to particular types of organizations should be separated into distinct sections or schedules.
   c. Information about the organization's charitable purpose and key program achievements should be included on the first page of the Forms.
   d. Definitions of terms relating to relationships, transaction types, expense categories and other key operations should be clear and consistent throughout the Form 990 series returns.
2. The format and instructions for the Forms should be revised to provide clear information needed by state and federal regulators to enforce laws governing charitable organizations.
   a. A supporting organization should be required to indicate whether it is operating as a Type I, II, or III supporting organization. Type III supporting organizations should be required to attach documentation from the organizations they support verifying that the supported organization has agreed to be supported. In addition, such documentation should describe how the supporting organization has provided or will provide support that furthers the charitable purposes of the supported organization.
   b. An organization that owns donor-advised funds should be required to disclose the total number of funds it owns, the aggregate value of assets held in those funds at year end, and the aggregate contributions to and grants made from those funds during the year.
   c. Organizations that make financial awards and grants to organizations should be required to provide the name, city, and state of the grantee, the amount awarded, and the purpose of the grant.
   d. A separate schedule should be provided for organizations to report grants to individuals with the amount of the grant, the name of the grantee, and any relationship between the grantee and any person or corporation with an interest in the reporting organization. Current exceptions to reporting requirements for grants to individuals should remain in place.[5] This schedule should not be open to public inspection.[6]
3. The IRS should revise the Forms 990 and 990-PF to separate required disclosure of compensation paid by the charitable organization to its board members or trustees, its chief executive officer and all its officers, and the five highest compensated employees.[7] In addition, charitable organizations should be required to disclose compensation paid to employees who are related to a board member or officer of the organization if they are paid more than $50,000 in the tax year (indexed for inflation).
4. The IRS should revise the Forms 990 and 990-PF to require a charitable organization to disclose which of its board members are independent, according to the definition added to the tax laws by Congress.[8]

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[4] The Panel will be offering additional recommendations for improvement of the Form 990 series in the fall of 2005.

[5] The IRS does not currently require charitable organizations to name the individual recipient of grants to indigent families or individuals. Colleges, universities, and primary and secondary schools are not required to list the names of individuals who were provided scholarships or other financial assistance.

[6] Schedule B of the Form 990, which provides information on donors, is not open to public inspection for public charities to protect the privacy of donors. Similar protections should be in place to protect the privacy of individuals who receive grants from private foundations or public charities, while providing regulators the information needed to enforce private benefit restrictions.

[7] Specific recommendations for reporting compensation of board members are provided on page 61. Specific recommendations for reporting compensation of the chief executive officer and other key employees are provided on pages 66-72.

[8] Specific recommendations regarding the independence of board members are provided on pages 75-78.

5. The Form 990-PF should distinguish between expenditures related to charitable program-related activities, grantmaking activities, general administrative operations, and investments. Instructions to the 990-PF should provide clear definitions to facilitate consistent breakdown of grants, direct and indirect charitable program-related activities, and administrative costs, with guidelines for the allocation of these costs.
6. The IRS should require organizations that must have their financial statements audited to complete the Forms using the same accounting method used to prepare their audited financial statements.[9]
   a. The instructions for reporting of fundraising costs of public charities should incorporate the rules for allocation of joint costs set forth in AICPA SOP 98-2.[10]
   b. A parent organization with affiliates subject to its supervision and control and covered by the same group exemption should be given the option to file consolidated returns, provided that all other criteria for filing a group return are met.[11]
7. The IRS should amend the Forms 990 and 990-PF to require charitable organizations to indicate whether they have a conflict of interest policy and a travel policy. Instructions to the Forms should provide specific information regarding travel costs that are not permitted or that should be reported as taxable income (including reference to IRS Publication 463: *Travel, Entertainment, Gift and Car Expenses*).
8. The IRS should enforce existing financial penalties imposed on organizations or organization managers for failure to file complete or accurate returns, with appropriate provision for abatement of penalties if the errors and omissions are unintentional. When existing penalties do not result in compliance by the charity after two consecutive years or more, the IRS should suspend the tax-exempt status of any charitable organization.

Recommendation for Charitable Organization Action

The boards of charitable organizations, or an appropriate committee of the board, should, as a recommended practice, review the Form 990 or 990-PF filed by the organization annually.

Background

The Internal Revenue Service introduced "Modernized e-File" in February 2004, allowing organizations to file Form 990 returns electronically. As of early 2005, private foundations may file Form 990-PF returns electronically. Federal tax laws[12] authorize the IRS to prescribe regulations for determining which returns must be filed electronically, but the IRS may only require taxpayers that file at least 250 returns during the calendar year to file returns electronically. The IRS released regulations[13] on January 12, 2005, that will require all tax-exempt organizations with assets of $10 million or more and all private foundations and charitable trusts to file their annual information returns electronically by 2007 if they also file 250 tax returns or more during the calendar year.

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[9] Generally, audited financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP). Some organizations choose to use an accounting method other than GAAP, such as cash or modified cash basis, in their audited financial statements. Instructions should provide accommodation for particular schedules, such as the calculation of qualifying distributions for private foundations, to be prepared using the most appropriate accounting method, regardless of the method used to prepare the organization's audited financial statements.

[10] The American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund-Raising*, provides guidance for nonprofit organizations in accounting for fundraising activities that are conducted in combination with one or more other, mission-related activities.

[11] Affiliated organizations must also be exempt under the same 501(c) code.

[12] IRC § 6011(e).

[13] IRS Notice 2005-8.

IRS regulations permit any authorized officer of the organization[14] 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 showing 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[15], current preparer penalties imposed for filing false tax returns do not apply to the preparation of Form 990 information returns.

The IRS instructs charitable organizations to "generally use the same accounting method on the return as it regularly uses to keep its books and records."[16] The returns therefore may be prepared using a different accounting method than is used to prepare the organization's audited financial statements. The Generally Accepted Accounting Principles (GAAP) used to prepare most audited financial statements apply specific rules for the treatment of fundraising expenses and contributions received by and pledged to the organization that may differ from the cash records maintained by the organization.

Auditing rules generally require organizations that have many separate affiliates to prepare consolidated financial statements that eliminate duplicate financial information that can result from transactions between the parent organization and its affiliates. The IRS may permit, on request, affiliates of a public charity to file a single Form 990 as a group return, but the parent organization cannot be included in that return and must file a separate return.

For the past several years, the American Institute of Certified Public Accountants (AICPA), the National Association of State Charity Officials (NASCO), nonprofit research institutions, charitable organizations, and foundations have submitted recommendations to the IRS to improve the content, design, and format of the Forms 990 and 990-PF. The Form 1023, Application for Recognition of Exemption Under 501(c)(3) of the Internal Revenue Code, has been significantly revised by the IRS to segregate information that only applies to particular types of tax-exempt organizations, clarify questions asked of applicants, permit attachments where required, and provide a glossary of terms with clear definitions to assist organizations completing the application as well as readers of the Form after it becomes a public document.

Rationale

The annual information return a charitable organization files with the IRS 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. 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

[14] 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.

[15] 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.

[16] IRS 2004 Form 990 and 990-EZ Instructions, page 6.

also allows the IRS to reject and provide immediate feedback to organizations about incomplete returns and those with obvious inaccuracies.

However, before mandatory e-filing can be implemented, the IRS electronic filing system and Forms must be modified to allow for separate attachments. Software for electronic filing of the Forms must permit charitable organizations to import data prepared in other software packages to reduce the cost and possibility of errors that could be incurred if organizations were required to enter data separately. Accounting software providers should be encouraged to make the necessary changes to their programs as expeditiously as possible, and to make their software widely available.

The IRS 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 which 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.

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.

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.

Instituting an annual notification requirement for charitable organizations not currently required to file an information return because their gross revenues fall below the specified threshold will assist the IRS in providing more accurate information to the public about organizations eligible to receive tax-deductible contributions. It would also help to ensure that these organizations are notified of more detailed filing requirements should their annual revenues rise above the minimum filing threshold.

Because of the lack of current contact information for many of these organizations in the IRS databases and the need to inform such organizations of the new requirement and to facilitate their making the changes necessary for electronic filing, an appropriate phase-in period should be provided before automatic suspension is enforced. The annual notice should contain 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;
- The organization's mission statement;
- The organization's total revenues and expenditures for the year; and
- An indication of whether the organization has terminated operations.

A formal requirement to provide notification of termination to the IRS would provide greater clarification regarding organizations involved in dissolution or termination procedures. This will also improve the information the IRS provides to the public on charities that are eligible to receive tax-deductible contributions.

Automatic suspension of tax-exempt status is the most appropriate remedy for organizations that are not in compliance with reporting requirements. 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 were suspended, but unlike organizations whose tax-exempt status has been revoked, it would continue to be subject to the rules and reporting requirements of all charitable organizations. The IRS should be required to give prompt notice of the suspension to the organization and to the principal officer of the organization who signed its Form 1023 or its last information return, whichever is most recent.

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 education or guidance is available and enforcement is also increased. Extending penalties to professional tax preparers, however, could improve significantly compliance with Form 990 requirements because they prepare and certify the majority of these forms.

Revisions to the Forms 990 are needed to improve transparency of governance and management practices, ensure consistency in financial data, assist state and federal regulators in law enforcement, and improve the clarity, comparability, readability, and usability of information for donors and the public.[17]

In making revisions to the Forms, the IRS should consider the impact of changes on smaller charities and foundations so as not to impose undue burdens on them. Therefore it is essential that there be an appropriate balance among multiple goals: providing sufficient data to determine compliance with the applicable tax laws, informing donors and the general public, and at the same time being mindful of and responsive to organizations' administrative costs and burdens. The Forms and instructions must be presented clearly and in a manner that would permit smaller organizations to complete the Forms without the assistance of professional advisors, which may be unaffordable for these groups.

Some public charities and private foundations do not currently provide all of the information required by the IRS for reports on grants and awards they make to individuals and organizations. Separate schedules for reporting grants to organizations and grants to individuals that would apply to both the Form 990 and 990-PF should facilitate enforcement and compliance. The schedule listing grants to individuals, like the current Schedule B listing contributors to charitable organizations, should not be open to public inspection to protect the privacy of individuals.

Requiring organizations to prepare their information returns using the same accounting method used to prepare their audited financial statements, if they are required to have audited financial statements, will increase consistency between the two documents. However, the Generally Accepted Accounting Principles (GAAP) used in preparing most audited financial statements are increasingly diverging from the tax-law classification of certain transactions, and where this is the case, the charity should be required to follow the tax-law classification. For example, a transfer of an endowment from an operating charity to a community foundation is, as a matter of tax law, a gift to the community foundation. It is correctly reported as a gift, grant, or contribution on Form 990 and as an asset of the community foundation. For GAAP purposes, however, the same transaction is not reported as revenue, but merely as a change in assets (with a corresponding liability). The Panel is studying recommendations for further changes to uniform financial reporting principles and intends to provide further comments on this matter in the fall.

Reporting of foreign grants and transactions on a separate schedule is unnecessary and would be redundant and burdensome. Current federal laws already prohibit the diversion of funds to individuals or organizations listed as participating in or supporting terrorist activities, and there are severe consequences associated with providing support to such individuals or organizations.

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[17] The Panel has established two advisory groups to assist in making further specific recommendations for changes to the Form 990 and the Form 990-PF. These advisory groups will continue to develop more specific recommendations in the coming months.

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.

Other Considerations

The Panel discussed proposals to reduce the time period for extensions to file returns[18], 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 Forms 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." While the Panel recognizes the value of having current information available to interested parties, given the constraints charitable organizations face in meeting such goals, it does not recommend changing current policy regarding extensions.

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[18] Recommendation included in the Senate Finance Committee staff discussion draft, 108th Congress (June 2004).

3. PERIODIC REVIEW OF TAX-EXEMPT STATUS

Introduction

Organizations that have been granted tax-exempt status are required to file an annual information return with the Internal Revenue Service (Form 990, 990-EZ, or 990-PF) with information about the organization's finances, governance, operations, and programs.[1] An organization must disclose on its Form 990 or 990-PF whether it has made any significant changes to the activities it conducts to further its exempt purposes or its organizing and governing documents, and, if so, must describe the changes made and attach the pertinent documents.[2] The IRS has the authority to revoke or change an organization's tax-exempt status if an audit investigation proves that the organization no longer meets the requirements for its particular status.

Statement of Problem

The annual information returns filed by charitable organizations do not enable the public or government regulators to determine in a timely way whether an organization has substantially changed its mission or governance structure after it was granted tax-exemption by the IRS, and there is currently no mandated procedure for periodic review of a charitable organization's qualification for exemption.

Recommendation for Congressional Action

1. Congress should authorize additional resources to the IRS for overall tax enforcement and for improved oversight of charitable organizations. Such resources, if approved, should be focused on improving and reviewing the annual information returns filed by charitable organizations, as well as conducting audits and investigations into the activities of charitable organizations where warranted. Congress should not require charitable organizations to file an additional report every five years.[3]
2. Congress should direct the Secretary of the Treasury to require that applications for recognition as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code (Form 1023) be filed electronically.

Recommendations for Charitable Organization Action

The board of every charitable organization that is required to file a Form 990 or 990-PF should, as a recommended practice, undertake a full review of its organizational and governing instruments, key financial transactions, and compensation policies and practices at least once every five years.

Background

Organizations that are recognized by the IRS as tax-exempt under section 501(c)(3) of the tax code are eligible to receive tax-deductible contributions from the public.[4] To be recognized as a 501(c)(3) exempt organization, organizations (with certain exceptions[5]) must file a formal application (Form 1023) with the IRS, describing its current or planned financial and programmatic activities, organizational documents, and governance structure. After review of the application, the IRS may deny the application or grant the applicant tax-exempt status as a public charity or a private foundation. Once an organization has received a favorable

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[1] 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 are excluded from this requirement.

[2] Form 990, Part Vi, Lines 76 & 77.

[3] Recommendation included in Senate Finance Committee staff discussion draft, 108th Congress (June 2004), and in Joint Committee on Taxation Report to Congress (January 27th, 2005).

[4] The deductibility of contributions is subject to different rules depending on whether a 501(c)(3) organization is classified by the IRS as a public charity, private operating foundation, or private non-operating foundation.

[5] Houses of worship, specific related organizations, organizations (other than private foundations) whose annual gross receipts do not normally exceed $5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter, are not required to seek formal recognition of 501(c)(3) status.

tax-exempt determination from the IRS, it generally may continue to rely on the determination as long as "there are no substantial changes in the organization's character, purposes or methods of operation."[6]

The Form 1023, Application for Recognition of Exemption Under 501(c)(3) of the Internal Revenue Code, was significantly revised by the IRS in 2004 to segregate information that only applies to particular types of tax-exempt organizations, clarify questions asked of applicants, permit attachments where required, and provide a glossary of terms with clear definitions to assist organizations completing the application as well as readers of the Form after it becomes a public document.

Rationale

The Forms 990 and 990-PF should provide sufficient information to make initial judgments about whether the organization continues to operate for exempt purposes. The format and instructions for the Forms need significant revisions to facilitate more productive review by the public and by regulators, and if it is deemed helpful, certain parts of the Forms could be revised to require the reporting of multi-year data. Recommendations to require charitable organizations to file an additional report every five years would strain the resources of both the IRS and of charitable organizations required to complete the forms. Notwithstanding welcome efforts by the IRS Commissioner to increase enforcement personnel in the tax-exempt area, oversight and enforcement of charitable organizations have suffered from the limited resources available to the federal and state regulators.

The Form 1023 is an important document for potential donors, regulators and other interested parties to review in order to understand the intended purpose and structure of newly established public charities and to compare whether the organization continues to fulfill its original purposes after it has been in operation for a period of years. If the Form 1023 were filed electronically, it could be made available to the public more easily and cost-effectively through publicly available databases.

While a mandatory five-year review is not practical or cost-effective for government regulators, boards of charitable organizations should regularly review their governing instruments, financial policies and practices, and programmatic activities to ensure that the organization is devoting its resources appropriately to the fulfillment of its charitable purpose. Such reviews should be part of the ongoing work of a board of directors, and a special effort should be made at least once every five years to conduct a thorough review of key organizational documents, practices, and plans.

Particular attention should be paid to the organization's articles of incorporation, bylaws, and governing instruments to ensure that they reflect the organization's current practice; the organization's compensation policies and practices; and whether the organization's conflict of interest and compensation policies, as well as any relevant legal requirements, are being followed in any transactions with related parties.

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[6] Treasury Reg. § 1.50(a)-1(a)(2).

4. FINANCIAL AUDITS AND REVIEWS

Introduction

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 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 every organization that receives federal awards of $500,000 or more per year to perform an audit of its financial statements, as well as an audit of the programs for which funds were received.

Statement of Problem

Concerns have been raised about the quality of financial information on charitable organizations available to boards of directors, regulators, and the public. Some states require charitable organizations that meet specific financial criteria and that solicit funds from the public to have their financial statements audited, but there are no consistent requirements for financial audits.

Recommendations for Congressional Action

1. Congress should amend federal tax laws to require charitable organizations that are required to file a Form 990 or 990-PF and that have:
   a. $1 million[1] or more in total annual revenues to have an audit conducted of their financial statements and operations and to attach audited financial statements to the annual information return (Form 990 or 990-PF) filed with the Internal Revenue Service.
   b. At least $250,000 and under $1 million in total annual revenues to have financial statements reviewed by an independent public accountant.
2. Congress should direct the Secretary of the Treasury to specify in regulations that the audited statements should be made available to the public on the same basis as the annual information returns.

Background

There currently is no federal requirement for financial audits of charitable organizations (except under OMB Circular No. A-133 for those organizations that receive $500,000 or more in federal grants). A charitable organization is currently required to make its annual information returns 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.

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.[2] While national data was not available about specific audit costs, the Panel determined that the threshold of $1 million or more in total annual revenues would require most charitable organizations to spend less than

[1] Note: The change in thresholds from the recommendations in the Panel's Interim Report is a result of extensive consultation with organizations during the 15 field hearings and the request that the threshold be lower so as to encourage organizations to work with outside accountants and auditors.

[2] 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.

1 percent of their annual budget to obtain an audit.[3]

For smaller organizations with at least $250,000 and under $1 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. Many smaller organizations that have opted to work with an independent accountant have noted that the accountant provided invaluable assistance and guidance regarding the organization's financial records and have encouraged their counterparts to follow the same procedures.

This recommendation is limited to 501(c)(3) organizations that currently are 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.

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 statements should be made available for public inspection in the same manner as the Form 990 or 990-PF.

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.

The Panel notes that, in some cases, changing audit firms on a regular basis (every five years or more) can be beneficial and recommends that large organizations 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.[4]

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.[5] 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 will continue to examine these issues in the months ahead in order to make further recommendations to the Senate Finance Committee in a supplemental report.

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[3] The United Way of America has conducted an informal review 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. In 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.

[4] Recommendation included in Senate Finance Committee staff discussion draft (June 2004).

[5] 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."

5. DISCLOSURE OF PERFORMANCE DATA

Introduction

Charitable organizations are currently required to describe their four largest program services on the annual information returns they must file annually with the Internal Revenue Service.[1] Charitable organizations may also provide information about their goals and accomplishments in annual reports, other periodic reports, and their websites.

Statement of Problem

The annual information returns filed by charitable organizations generally do not provide sufficient information about the effectiveness of the organizations' programs to enable the public to make informed judgments about their charitable contributions. There are no commonly agreed upon procedures for ensuring that charitable organizations are evaluating the effectiveness of their charitable programs and services.

Recommendation

No Congressional action is recommended. Congress should *not* authorize the Internal Revenue Service to require charitable organizations to report more detailed statements of program evaluations or performance measures.

Recommendation for Charitable Organization Action

Every charitable organization should, as a recommended practice, provide detailed information about its programs, including methods it uses to evaluate the outcomes of programs, and other statements available to the public through its annual report, website, and other means.

Background

Instructions for the Form 990 and 990-EZ ask each filing organization to describe its "exempt purpose achievements in a clear and concise manner" for each of its four largest program services (as measured by total expenses incurred). The organization must enter the expenses, as well as grants and allocations, for each of these four largest programs, and combined information for all remaining programs. In a brief narrative about each program service, the organization may also show the amount of any donated services it received or utilized in carrying out the service.

Some types of charitable organizations, such as hospitals (and other health care providers) and educational institutions, are subject to accreditation programs that evaluate the quality of services. Others may be subject to evaluations of program service accomplishments required by public and private funding agencies or the federated giving programs in which they participate.

A variety of organizations—from external "watchdog" agencies to membership associations of nonprofit organizations in particular service or geographic areas—employ specific standards to assess the performance of charitable organizations. Generally, these standards focus on governance, fundraising activities, and financial operations, but many require that individual organizations have systems in place to establish goals for and to evaluate their own program performance.[2]

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[1] 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 are excluded from this requirement.

[2] The Panel will be offering recommendations in the fall 2005 supplemental report regarding the sector's various systems of self-regulation following a review of these systems.

5. DISCLOSURE OF PERFORMANCE DATA *continued*

Rationale

Because of the diversity of the sector and the subjective nature of performance measures, requiring more detailed statements of performance measures on the Forms would not provide meaningful information for the public or for regulators. It is very difficult to compare the accomplishments of one charity to another, even if they offer similar programs, without much more detailed information on the nature of the program services offered, the constituency served, the resources available to support the program, and both the short-term and long-range goals for the program, and type of program offered among other factors. Furthermore, annual performance indicators are not applicable to many types of programs, such as scientific or medical research and after-school programs where accomplishments may not be evident for a number of years.

The Forms 990 should make it possible for an organization to state that it continues to provide the services to the public upon which its charitable tax exemption was predicated. However, the Forms are not useful as a tool to communicate complex information about program goals, accomplishments, failures, and changes that have affected an organization's overall performance or the performance of a particular program. Each organization is therefore encouraged, as a recommended practice, to share more detailed information about its programs through an annual report or other appropriate document that is available to the public on the same basis as its Form 990. Organizations are also encouraged to post such information on their websites.

6. DONOR-ADVISED FUNDS

Introduction

Donor-advised funds have become an important means of stimulating charitable contributions from a broad range of donors who wish to make significant philanthropic gifts, either for immediate benefit to a charity or charities, or for long-term support of ongoing or emergent community needs. Donor-advised funds are particularly appealing to those donors who desire a philanthropic vehicle but who prefer not to assume the financial and administrative burdens required to establish a separate private foundation. Over the past several decades, the number of donor-advised funds has grown considerably. Last year alone, more than 7,000 new funds were created.[1]

Although there is currently no statutory definition of a donor-advised fund, there is substantial existing authority for regulating them. A donor-advised fund is generally understood to be a fund maintained by a public charity,[2] under which a donor (or an advisor designated by the donor) has the right to make recommendations about distributions. The asset belongs to the administering public charity, and it has a fiduciary obligation to ensure that donor-advised assets are used exclusively for charitable purposes.

Statement of Problem

Currently there is no statutory definition of a donor-advised fund, no comprehensive rules addressing the operation or potential abuse of such funds, and little information available regarding assets held in or distributed from donor-advised funds.

Because the donor retains the right to advise the charity regarding distributions of funds held in a donor-advised fund, policymakers have expressed concern that some donors will recommend distributions intended to benefit themselves and their families. Concerns have also been expressed that some assets contributed to donor-advised funds, for which the donors receive an income tax deduction, may not be distributed for charitable purposes within a reasonable amount of time (sometimes referred to as "asset parking"). Lawmakers are also concerned that donor-advised fund assets contributed by a private foundation, which counts such contribution toward satisfaction of the foundation's minimum payout requirement, may be distributed back to the private foundation ("round-tripping") and not used for intended charitable purposes.

Recommendations for Congressional Action

1. Congress should amend the federal tax laws to include new provisions defining and regulating donor-advised funds, including aggregate minimum distributions, minimum fund activity requirements and prohibiting private benefit transactions, and require the Secretary of the Treasury to issue implementing regulations. Statutory changes should not be effective until a reasonable period of time following the adoption of regulations.

Definition

a. The definition should identify clearly a "donor-advised fund" as a segregated fund or separately identified account owned and controlled by a sponsoring charity eligible to receive tax deductible charitable contributions[3] that holds contributions received from one or more donors who, either directly or through appointed

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[1] Leah Kerkman, Cassie J. Moore, and Brad Wolverton. "Growing Assets and Concerns: Proposed rules could hurt popularity of advised funds," *The Chronicle of Philanthropy* (April 28, 2005).

[2] 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.

[3] IRC § 170(c)

designees ("advisors"), have the privilege of advising the sponsoring charity regarding the distribution of any amounts held in the fund. The Secretary of the Treasury should be authorized to exclude specific types of funds from the term "donor-advised fund" by regulation.[4]

Aggregate Distribution Requirements

b. Each sponsoring charity should be required to make an aggregate minimum distribution (across all of its donor-advised funds) equivalent to 5 percent of the aggregate asset balance of all its donor-advised funds at the end of the previous year.[5] The Secretary of the Treasury should be authorized to create reasonable exceptions to the distribution requirement and alternative methods for performing the calculations. The Secretary shall define distributions that qualify for this purpose, including administrative expenses.

Fund Activity Requirements

c. Each sponsoring charity should be required to distribute to its own unrestricted account (or to one or more other qualified charities) 20 percent of the assets in any donor-advised fund for which, after reasonable notice or attempted notice to the donor and/or advisor, no distribution advice has been received and no distributions have been made for three consecutive years.
d. Each sponsoring charity should be required to terminate advisory privileges for a donor-advised fund for which, after reasonable notice or attempted notice to the donor and/or advisor, no distribution advice has been received and no distributions have been made (other than mandatory distributions as required above) for five consecutive years.

Private Benefit Prohibitions

e. Sponsoring charities should be prohibited from making grants, loans or other payments from donor-advised funds to any entity determined by the Internal Revenue Service to be a private non-operating foundation or to any fund or any organization in or outside the United States that is controlled by a donor-advised fund's donor or related party. Regulations should clarify that absent knowledge to the contrary, the charity may rely on donor certifications with respect to control.
f. Donors and advisors (or any related parties) should be prohibited from receiving any substantial benefit in return for or in connection with a grant recommendation. Grants, loans or other payments from donor-advised funds to or for the benefit of donors, advisors, or any related parties should be prohibited.

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[4] The types of funds that should be excluded by regulation should include but not be limited to, the following: (1) a fund for which all of the advisors are appointed by a governmental entity or a public charity (other than the sponsoring charity); (2) a fund created to benefit a single public charity or governmental entity, even if a donor or advisor or persons related to the donor or advisor may be part, although not a majority, of the committee that recommends distributions for specific charitable activities of the charity or entity (i.e., a designated fund at a community foundation); (3) a fund held for a specific charitable beneficiary or purpose that is supported by several unrelated donors, advised by a committee that may include one or more unrelated donors (but not controlled by any donor and related parties) (e.g., a field-of-interest fund); (4) any fund owned by a private foundation; and (5) any fund that is advised by committee that is not directly or indirectly controlled by the donor, advisor, or any related parties and on which the donor, advisor, or any related parties together comprise less than half the membership. The IRS should adopt appropriate rules defining what constitutes direct and indirect control.

[5] Exceptions to the proposed payout requirement should include, without limitation, a three-year exemption from the proposed payout requirement for charities that have held donor-advised funds for fewer than three years and an exception for charities that have historically exceeded the required minimum payout but do not meet the payout requirement in a single year. Regulations should also make clear that all distributions from the donor-advised funds to public charities, including distributions to the sponsoring charity for reasonable expenses incurred in administering the funds, should be included in calculating the aggregate minimum distribution.

g. Sponsoring charities should be prohibited from providing compensation or reimbursement of expenses, including fundraising expenses or expenses incurred in preparing recommendations for grants, from a donor-advised fund to its donors, advisors or any related parties.[6]
h. Sponsoring charities should be prohibited from making grants to individuals from donor-advised funds unless distribution recommendations for individual grantees are made by an advisory committee that is not directly or indirectly controlled by the donor or any related parties and on which the donor and any related parties together comprise less than half the membership.

2. Congress should amend the federal tax laws to impose sanctions sufficient to prevent violations of the proposed prohibitions.
   a. An excise tax should be imposed on the donor and/or advisor of a donor-advised fund if the donor, advisor, or any related party receives (1) a grant, loan, compensation or any payment or reimbursement of expenses from the donor-advised fund, or (2) any substantial benefit in exchange for or in connection with a donor-advised fund distribution recommendation. In addition, the donor and/or advisor should be required to repay the value of any benefit received. Regulations should specify the circumstances under which repayment should be directed to the sponsoring charity's unrestricted fund, to a charity that is not the sponsor, or to a charity that is not the original grantee.
   b. An excise tax should be imposed on managers of a sponsoring charity who knowingly and willfully approve the payment, whether by grant or otherwise, of compensation or reimbursement of expenses to a donor, advisor or a related party from the relevant donor-advised fund.
   c. To prevent duplicative penalties for the same act, these penalties, rather than section 4958, shall apply to transactions involving individuals who are disqualified persons with respect to the sponsoring charity.
   d. The Secretary of the Treasury should be authorized to suspend the exempt status of a sponsoring charity for multiple egregious or flagrant violations of the prohibitions recommended above.
3. Congress should amend the federal tax laws to allow a charitable deduction for a contribution to a donor-advised fund only if the donor has a written agreement with the sponsoring charity confirming that the sponsoring charity has exclusive legal control over the fund and that neither the donor, the advisor nor any related party may receive any substantial benefit in return for or in connection with a distribution recommendation.[7]
4. Congress should amend the federal tax laws to require sponsoring charities to obtain from the donor or advisor a certification for each recommended distribution stating that no substantial benefit will be received by the donor, the advisor, or any related party in exchange for or in connection with the recommended distribution.
5. Congress should amend the federal tax laws to require sponsoring charities to send to each recipient of a grant from its donor-advised funds a grantee acknowledgement indicating that acceptance of the grant signifies that no substantial benefit has been or will be provided to (1) the donor, advisor, or any party that is related to the donor or advisor (if the identity of the donor or advisor is known by the grantee charity) nor (2) any individual other than those in the charitable class of persons served by the grantee charity.

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[6] Exceptions to this rule should be defined in regulations for de minimis benefits such as food provided to members of an advisory committee that includes the donor or advisor.

[7] This provision should apply to all donor-advised funds established more than three months after the date of enactment of the requirement.

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should require each sponsoring charity to: disclose on its Form 990 the total number of donor-advised funds it owns, the aggregate value of assets held in those funds at the end of the sponsoring charity's fiscal year, and the aggregate contributions to and grants made from those funds during the year.

Recommendation for Charitable Organization Action

Charities are encouraged to provide further information to interested parties about the donor-advised funds they own, including the names of all funds, and should recognize that there is great interest in the community in donor-advised funds and how such funds are distributed.

Background

There is currently no statutory definition of a donor-advised fund and no specific regulation of the operation of such funds. As with its other assets, the sponsoring charity has a fiduciary obligation to ensure that donor-advised assets are used exclusively for charitable purposes. Sponsoring charities are subject to the same reporting requirements as any other public charity, but there are no legal requirements to provide separate reporting on funds held in or distributed from donor-advised funds.

Rationale

Definition: The term "donor-advised fund" should be defined statutorily as part of a set of targeted rules that address potential abuses of these funds while not 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 an understanding between the donor and the charity that the charity will consider non-binding advice from the donor (or an advisor) regarding distributions of the amount held in the fund.

The definition should explicitly exclude specific arrangements in which the donor's advisory rights are limited substantially. These exclusions should include funds for which a majority of the advisors are appointed by a public charity or by a governmental entity, as well as 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 Secretary of the Treasury should be authorized to clarify legitimate exceptions to the definition to avoid inappropriate application of the newly recommended rules and requirements.

Increased Disclosure: More information about the assets held by and disbursements made from donor-advised funds will improve both enforcement and understanding of these funds. Aggregate reporting is not expected to impose the costly administrative burden on sponsoring charities that would be involved in separate reporting on each donor-advised fund. While there could be benefits 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. Sponsoring charities should not be required to list the names of all of the individual donor-advised funds they own on the Form 990 because it would not provide sufficiently helpful information to grantees to justify the burden on the charity and the IRS of adding a voluminous schedule to the Form 990 filing.

Required Aggregate Distributions: A minimum aggregate distribution requirement is intended to hold sponsoring charities accountable for ensuring that donors do not "park" assets indefinitely in a donor-advised fund, but instead provide appropriate advice regarding the distribution of those assets to benefit charitable programs. An annual requirement that a sponsoring charity distribute 5 percent of the assets it holds in all of its donor-advised funds at the end of the prior year ordinarily should be easily met by most sponsoring charities, as the percentage distribution from sponsoring charities' donor-advised funds averaged approximately 15.8 percent in 2004.[8] Thus, there is no need to import the complex payout rules currently in place for private foundations into the donor-advised fund context.

However, this minimum aggregate distribution requirement could present difficulties in some situations. For example, an exemption from a distribution requirement would be reasonable for the first three years that a sponsoring charity holds some donor-advised funds in order to give the new donors an appropriate amount of time to recommend distributions. Additionally, the distribution requirement based on the prior year-end asset balance may be difficult to meet if the donor-advised fund assets experience significant, short-term fluctuations in value. In addition, a number of sponsoring charities hold donor-advised funds as endowment funds, subject to the Uniform Management of Institutional Funds Act (UMIFA) or other state law. For example, state law may restrict grants or other expenditures from such endowment funds where the value has fallen below historic principal, or the sponsoring charity's board may have adopted a spending policy rate that is below the minimum distribution requirement. In calculating the minimum aggregate distribution requirement, endowed funds should be excluded so that a disproportionate, higher payout requirement is not imposed on non-endowed funds.

Many sponsoring charities work with donors (including other charities) who wish to accumulate an endowment or a significant contribution over a number of years for a particular purpose. For example, a donor may wish to advise the sponsoring charity to purchase a fire truck for the local municipality or to endow a faculty position or scholarship fund at a university and would first need to accumulate sufficient assets. Thus, while the recommended legislation would establish a simple basis for calculating the minimum distribution requirement, such legislation should also direct the Secretary of the Treasury to define in regulations appropriate circumstances when a charity should be exempted from the minimum distribution requirement or permitted to calculate the required minimum distribution based on average asset holdings over a period of years.

Fund Activity Requirements: Sponsoring charities should be required to make reasonable efforts to contact donors and make distributions from the fund independently if the donor or advisor fails to recommend distributions for three consecutive years. Regulations should include appropriate exceptions for the funds that are intended to accumulate assets over a period of years, as described above, to meet a particular charitable purpose.

Private Benefit Prohibitions/Sanctions: Since intermediate sanctions rules often do not apply to a donor or advisor of a donor-advised fund, Congress should enact new prohibitions targeted specifically at the potential abuse of donor-advised funds by their donors or advisors. Sponsoring charities should not be permitted to make payments from a donor-advised fund to the fund's donor or advisor (or parties related to either). In addition, a donor, advisor, or a related party should not receive any substantial benefit in connection with grant recommendations made regarding donor-advised funds. The Panel recommends that the legislation and the legislative history of such a provision call for exceptions to this rule for de minimis benefits such as food provided to members of an advisory committee that includes the donor or advisor. Appropriate sanctions should be enacted to apply to donors or advisors who receive substantial benefits from or in connection with recommended distributions from donor-advised funds. In addition, managers of sponsoring charities who knowingly and willfully provide such benefits should also be subject to penalty. Any new penalties should have an exception for violations that were due to reasonable cause and not willful neglect.

Sponsoring charities should be prohibited from making grants to private non-operating foundations from assets held in donor-advised funds. While there may be

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[8] Leah Kerkman, Cassie J. Moore, and Brad Wolverton. "Growing Assets and Concerns" (April 28, 2005). Based on a survey of 88 organizations administering 80,000 funds.

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.

Sponsoring charities should not be permitted knowingly to make grants from a donor-advised 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 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, and thus Congress should not revise current law to permit donor-advised funds to satisfy a donor's legally binding pledge.

Written Agreement: Because donors may receive conflicting information about donor-advised funds and their rights and responsibilities with respect to such funds, the IRS should require sponsoring charities to have written agreements with every donor affirming that the charity holding the funds has exclusive legal control over the fund and specifying the legal prohibitions against providing any substantial benefit to the donor, the advisor, or any related party. This written agreement would put donors on notice that they are not allowed to receive substantial benefits in connection with grant recommendations and, to ensure that if such agreements are made, no deduction should be allowed for a contribution to a donor-advised fund that is not subject to such a written agreement.[9] Sponsoring charities are also encouraged to retain the right in their written agreements with donors to terminate advising privileges of a donor or advisor who has been assessed the proposed excise tax penalties on private benefit transactions.

Donor Certifications/Grantee Acknowledgements: Sponsoring charities should be required to help ensure that donors, advisors, and related parties do not receive any substantial benefit from donor-advised funds by obtaining certifications from donors and advisors that they will not receive any such benefit as a result of grants and expenditures they advise the charity to make, and requiring grantee charities to agree (as a condition of accepting the grant) that no such benefit has been provided.

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[9] In the case of a donor-advised fund with multiple donors, a written agreement should be signed by each donor with advising privileges or the donor(s) with the power to designate the advisor of the donor-advised fund.

7. TYPE III SUPPORTING ORGANIZATIONS

Introduction

Congress created supporting organizations in 1969 to confer public charity status on charities created to support one or more other public charities or governmental entities. Congress recognized that it is often beneficial and prudent for charities and their supporters to place certain assets or activities in a separate legal entity to insulate assets from liability or to facilitate separation of functions for programmatic, accounting, or other reasons.

There are three types of supporting organizations, based on the relationship the supported organizations have with the supporting organization. The supported organizations have influence but not control over a Type III supporting organization, making this structure uniquely suited to meet certain specific needs or desires of public charities, governmental entities, and donors.

Statement of Problem

The flexibility of Type III supporting organizations has also made them possible vehicles for abuse. A donor may inappropriately maintain de facto control over a Type III supporting organization and then cause it improperly to provide private benefits. In addition, although donors claim immediate deductions for contributions to Type III supporting organizations, some Type III organizations have been criticized for not making significant expenditures for charitable purposes for many years.

Recommendations for Congressional Action

Congress should direct the Secretary of the Treasury to:

1. Amend the regulations to ensure that contributions to Type III supporting organizations are used to benefit the supported organization(s), and not to benefit the donor, by:
   a. Requiring each Type III supporting organization to distribute annually to or for the benefit of its supported organization(s) an amount equivalent to 5 percent of its net assets, excluding assets used directly to support the charitable purposes of the supported organization(s).[1]
   b. Prohibiting grants, loans, compensation, and any other payments from a Type III supporting organization to or for the benefit of the donor or any related party.[2]
   c. Prohibiting Type III supporting organizations from supporting organizations that are controlled by the donor or a related party.[3]
   d. Requiring each Type III supporting organization to provide each of its supported organizations with a copy of its governing documents at the time it applies for exemption and whenever there are changes to such documents; a copy of its annual Form 990; and an annual report of its activities, including narrative, financial detail, and, specifically, a description of the support provided, how it was calculated or determined, and a projection of support to be provided in the subsequent year.
   e. Prohibiting Type III supporting organizations from supporting more than five qualified entities.
2. Amend the regulations to require that Type III supporting organizations formed as trusts must demonstrate a close and continuous relationship with the governing board or officers of the supported organi-

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[1] Operating expenses of a supporting organization should be considered as amounts distributed for the benefit of the supported organization.

[2] This restriction should not apply to donors that are themselves publicly supported charities.

[3] Legislative history should make clear that "control" is more than "substantial influence" as defined in §4958 so that a supporting organization may support a public charity on whose board the donor serves.

zations and that, as a result of such relationship, the supported organizations have a significant voice in the operation of the Type III organization.[4] The amended regulations should also specify how Type III supporting organizations with institutional trustees can demonstrate that the supported organizations have a significant voice in the Type III supporting organization.

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should:

1. Revise the Form 990 to require that every supporting organization indicate whether it is operating as a Type I, II, or III supporting organization.
2. Require every Type III supporting organization to attach to its initial exemption application[5] and its annual Form 990 a letter from each organization it supports. This letter must verify that the supported organization has agreed to be supported and describe how the supporting organization has provided or will provide support that furthers the charitable purposes of the supported organization.

Background

A supporting organization falls into one of three classifications, based on the degree of its involvement with the organizations it supports. A Type I supporting organization is controlled by the organization or organizations it supports; that is, a supported organization appoints a majority of the board members of the supporting organization. In a Type II supporting organization, a majority of the organization's board members also serve on the board of the supported organizations. In a Type III supporting organization, the supported organizations must have influence but not control over the supporting organization. Neither substantial contributors to a Type III supporting organization nor parties related to them may control the organization. Donors may choose all of the initial board members of a Type III supporting organization, but cannot retain the right to remove and reappoint board members. Furthermore, a Type III organization must demonstrate both that it is responsive to the needs of the supported organizations and that its support is an integral part of the work of at least one supported organization.

Under current regulations, a Type III supporting organization must, among other things, meet a "responsiveness test" in order to demonstrate that the supported organization has the requisite influence over it. There are currently two options for fulfilling the responsiveness test. The first option focuses on ensuring responsiveness to the supported organization by requiring a relationship between the governing bodies of the supporting and the supported organization. This option requires the supported organization to (1) appoint a board member of the supporting organization, (2) have one of its own board members holding a board seat or an important office in the supporting organization, or (3) have its board or officers maintain a "close and continuous relationship" with the board or officers of the supporting organization. In addition, because of the relationship between the governing bodies of the organizations, the supported organization must have a significant voice in the operation of the supporting organization.[6] The second option, available only to supporting organizations organized as trusts, relies on the fiduciary obligations in state trust law to ensure the responsiveness of the supporting organization. It is met

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[4] Treas. Reg. 509(a)-4(i)(2)(ii) currently describes how Type III supporting organizations that are not organized as trusts must have a close relationship with the supported organization that gives "officers, directors or trustees of the publicly supported organizations … a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization." This standard may need to be modified to accommodate Type III supporting organizations formed as trusts, particularly for organizations that have institutional trustees.

[5] IRS Form 1023, Application for Recognition of Tax-Exempt Status under Section 501(c)(3) of the Internal Revenue Code.

[6] Treas. Reg. §1.509(a)-4(i)(2)(ii)

by forming the supporting organization as a state law trust which can be enforced by the beneficiary under state law and naming the beneficiary organizations in the trust's governing document.[7]

Because supporting organizations are intended to have a close relationship with and thus some degree of accountability to one or more public charities, they are not subject to the more stringent rules applicable to private foundations, such as excise taxes on investment income, restrictions on transactions with disqualified persons, payout requirements, and restrictions on investments. Donations to supporting organizations are treated the same as donations to any other public charity.

Type III supporting organizations can be uniquely suited to address particular charitable purposes. For example:

1. 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.
2. 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.
3. Domestic "friends" organizations of foreign public charities, which generally cannot receive tax deductible donations themselves, are used to raise funds in the United States to support the foreign charity and are often organized as independently managed Type III supporting organizations so that they cannot be deemed mere conduits for the foreign organizations.
4. Donors wishing to support multiple charities with differing short- and long-term goals can appoint an independent board of the Type III supporting organization that can more effectively balance the charities' competing goals than a board made up of representatives of the charities.

Type III supporting organizations also have proved useful to some governmental entities in advancing their public purposes. For example, in a sale of a nonprofit hospital to a for-profit in which the parties agree to place the proceeds in a supporting organization to a community foundation, the state attorney general can require the 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 Type III supporting organization could pursue for the benefit of the governmental entity.

Many hospitals, educational institutions, and other public charities are structured as networks of service providers, commonly including Type III supporting organizations, 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.

Rationale

Type III supporting organizations add value to the charitable sector that cannot be replaced by other types of organizations. The Panel believes that it is both feasible and worthwhile to develop rules to curb abuse so that Type III supporting organizations can continue to serve valuable functions.

The 5 percent payout requirement will ensure, as is currently the case with private foundations, that Type III supporting organizations make significant charitable expenditures each year. Because donors to Type III organizations may not be subject to the intermediate sanctions provisions, a prohibition on certain transactions with donors and related parties with appropriate penalties for violations, similar to those suggested for donor-advised funds, could help deter abuses involving donors to Type III supporting organizations.

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[7] Treas. Reg. §1.509(a)-4(i)(2)(iii). Under this option, the beneficiary must have the right under state law to compel the organization to make a formal report of its assets, income, and expenses.

7. TYPE III SUPPORTING ORGANIZATIONS *continued*

The suggested modification of the responsiveness test would require actual operating relationships between the managers of supported organizations and those of Type III supporting organizations, regardless of whether the organization was formed as a corporation or a trust. Legal rights are not a practical substitute for actual representation on or a relationship with the governing body of the supporting organization.

Thus, requiring such a relationship would strengthen a supported organization's connection to its Type III supporting organization and help ensure that the supporting organization was responsive to the supported organization's needs.

If the recommendations are enacted, supported organizations will be in a position to exercise greater oversight of Type III organizations to prevent both insufficient charitable expenditures and improper benefits. Every Type III supporting organization will be required to obtain letters from each supported organization verifying its consent to be supported and detailing how it has been supported. Supporting organizations will also be required to provide governing documents, Forms 990 and annual reports to its supported organization(s). Limiting the number of supported organizations for each Type III supporting organization is intended to ensure that each supported organization has a sufficient interest in the supporting organization to provide active oversight of the supporting organization. However, because of the potential administrative burden involved in bringing all current Type III supporting organizations into compliance, this requirement should apply only to organizations created after the date of enactment.[8] Requiring all supported organizations to state their type on Form 990 will allow the IRS to focus its enforcement efforts on Type III supporting organizations.

[8] If increased reporting and enforcement efforts reveal significant problems in existing organizations with more than five supported organizations, this limitation could later be extended to existing organizations.

8. ABUSIVE TAX SHELTERS AND CHARITABLE ORGANIZATIONS

Introduction

Promising new and possibly generous revenue streams, some potential donors and financial advisors have convinced tax-exempt entities, including some charities, to help them participate in abusive tax shelters, which they may not realize are illegal.[1] Abusive tax shelters typically enable the investor to shield income from taxes in ways not intended by federal tax laws, and ultimately bring little benefit to the exempt organization. A number of transactions have been listed by the Internal Revenue Service as potentially abusive tax shelters.

Statement of Problem

Current tax laws, which require participants in potentially abusive transactions to disclose their involvement, do not make it clear whether exempt entities, particularly those not required to file tax returns, must disclose their participation in the same manner as taxable parties. Further, since involvement by a charitable organization in an abusive tax shelter does not result in an understatement of its tax liability, penalties are generally not imposed on exempt entities for knowingly participating in such transactions. IRS officials and lawmakers have expressed concern that a growing number of charities might be caught up unknowingly in these schemes.

Recommendations for Congressional Action

Congress should amend federal tax laws to:

1. Clarify the requirements for tax-exempt entities[2] to report participation in listed and other reportable transactions and to impose penalties for knowing failure to disclose such participation.
   a. Make clear that all tax-exempt organizations, including those not currently required to file tax returns, are subject to the same reporting requirements as taxable entities with regard to listed and other reportable transactions.
   b. Charities and other tax-exempt entities that participate in a listed or other reportable transaction and fail to disclose such participation should be subject to the same penalties as taxable entities if organization managers knew or had reason to know that the transaction was a reportable transaction.
2. Require taxable participants in and material advisors to a reportable transaction to notify in writing tax-exempt participants in advance that they would be engaging in a reportable transaction. The new law should impose severe penalties on taxable participants who fail to provide such notification prior to commencement of the transaction. Fulfillment of this notification requirement by any taxable participant or material advisor should be deemed to be fulfillment by all taxable participants in the transaction.
3. Ensure appropriate sanctions are imposed on charities and other tax-exempt entities that participate in abusive tax shelters.
   a. If a tax-exempt organization participates in an abusive tax shelter, an excise tax equal to 100 percent of the net income[3] received from the transaction should be imposed on the organization.
   b. If a tax-exempt organization participates in an abusive tax shelter that was a listed transaction, the organization managers knew that it was a listed transaction and the organization did not report its participation in the transaction as required, the organization's tax-exempt status should be revoked by the Secretary of the Treasury.
   c. Penalties should also be imposed on those persons within an exempt organization who are responsible for its participation in an abusive tax shelter.[4]

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[1] This report uses the term "abusive tax shelter" to refer to a transaction a significant purpose of which is federal income tax evasion or avoidance and with respect to which accuracy-related penalties have been imposed on at least one taxable participant under 6662A.

[2] This includes organizations exempt from taxation under Internal Revenue Code sections 501 and 401 and organizations whose income is excluded from taxation under Internal Revenue Code section 115.

[3] The net income from any transaction would be the income received for participation in the transaction less any unrelated business income tax paid on such income.

[4] Generally, penalties imposed on individuals responsible for the organization's participation in the transaction should be equal to 20 percent of the gross income received from the transaction up to a maximum of $20,000. If the individual(s) knew that the transaction was a reportable transaction and the transaction was not reported as required, the penalty should be equal to 30 percent of the gross income received by the charity up to a maximum of $30,000. If the individual(s) knew that the transaction was a listed transaction and the transaction was not reported as required, the maximum penalty should be increased to $50,000.

4. Require the IRS to provide clear, up-to-date, readily accessible information on listed and other reportable transactions to enable organizations and individuals to determine whether a transaction is potentially abusive and whether they are under an obligation to disclose participation in a transaction.

Recommendation for Charitable Organization Action

Charitable organizations, particularly coalitions, should work in partnership with the IRS and state oversight officials to educate charitable organizations about which transactions are potentially abusive and that these transactions may trigger additional reporting requirements and possibly pose risk to the organization.

Background

Many abusive tax shelters are designed to benefit a taxpayer either by manufacturing a loss or deduction on paper, even though the taxpayer has suffered no actual economic loss. Others shift taxable income to a "tax-neutral" person or entity that pays no tax on the income. Such "tax neutral" parties include non-U.S. citizens, companies with large net operating losses, American Indian tribes, pension plans, and other tax-exempt entities such as charities. The IRS has currently listed 31 transactions it believes to be abusive[5] (these are known as listed transactions).

The IRS has identified two listed transactions specifically identifying a charity as the tax-neutral party:

1. IRS Notice 2003-81 describes a transaction involving a donation to a charity of two offsetting foreign currency options, one in each of two different, but economically linked currencies. When the charity settles the two options, it receives a small amount of net income. Because of differences in tax treatment of publicly traded and privately written options, the taxpayer receives a charitable deduction without incurring an economic loss.
2. IRS Notice 2004-30 describes a transaction involving a donor's contribution to a charitable organization or other tax-exempt entity of a large block of non-voting stock in an S corporation stock, while the donor retains the relatively small number of voting shares of the S corporation. During the time the stock is owned by the exempt entity, it receives no cash from the S corporation, but a large portion of the S corporation's income is allocated to the exempt entity, which pays no tax on the income. The S corporation then buys the stock back for an amount far less than the phantom income allocated, but never paid, to the exempt entity. Finally, the S Corporation pays the retained income tax-free to the donor, the remaining owner of the stock. It should be noted, however, that charitable organizations are unlikely candidates as accommodation parties in this transaction because they are generally subject to unrelated business income tax (UBIT) on income earned by an S corporation. Thus, unless a charity had UBIT net operating losses, this scheme would not seem to work with a charity as the accommodation party.[6]

Over the past few years, Congress has enacted new rules to discourage and penalize participation in abusive tax shelters. These rules require taxpayers to disclose to the IRS their participation in potentially abusive transactions so that those transactions can be audited, and stiff penalties apply if a taxpayer fails to disclose with its annual tax return its participation in any of the six

[5] Listed and de-listed transactions are posted at www.irs.gov.

[6] This transaction does work, however, using an entity whose exemption is based on the fact that it performs essential state or local government functions (e.g., police pension funds) because such an entity, though not a charitable organization, can receive tax-deductible contributions and its income, including S corporation income, is excluded from taxation under IRC §115. Two of these organizations were found to have participated in 33 of the 58 transactions of this type marketed by KPMG (and a third organization of this type is also known to have accommodated an unknown number of these transactions). See Staff of the Permanent Subcommittee on Investigations, 109th Cong., *The Role of Professional Firms in the Tax Shelter Industry* 126–36 (Comm. Print 2005). *In Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005 (JCS-02-05), the Joint Committee on Taxation has proposed taxing S corporation income received by such entities.

categories of these "reportable transactions."[7] If, on audit, the IRS determines that the taxpayer used the abusive tax shelter to understate substantially its true tax liability, ordinary penalties for underpayment of tax apply, generally 20 percent of the amount of tax not paid. The penalty is increased to 30 percent of the amount not paid if the transaction was a reportable transaction that the taxpayer did not disclose as required.[8] In addition, the attorneys, accountants, and other professionals who provide assistance in the promotion or implementation of reportable transactions ("material advisors") also have reporting and list maintenance obligations and are subject to penalties for failure to comply with these obligations.[9]

Since the Forms 990 and 990-PF are made public, and thus could reveal participation in suspect transactions (regardless of any reporting obligation), charitable organizations that file such forms may be less desirable as tax-neutral parties than those whose returns are confidential or those who have no reporting obligation at all, such as organizations performing essential state or local government functions, including municipal workers' pension funds.[10]

Rationale

The current IRS approach of combating abusive tax shelters by requiring disclosure of participation in broad categories of suspect transactions, with follow-up audits of individual transactions to determine whether such transactions are in fact abusive, should apply equally to tax-exempt and taxable entities. Proposals to treat charities more harshly than other tax-exempt entities have no justification, particularly since there is no evidence of widespread charity participation in such transactions.[11]

The IRS and Joint Committee on Taxation have indicated that tax-exempt as well as taxable parties to listed and reportable transactions are subject to current reporting requirements and penalties for failure to disclose participation in such transactions. Because the current disclosure obligation is linked to a party's obligation to file a tax return, however, it is not clear whether the current disclosure requirements apply to all exempt entities, particularly those not required to file tax returns. Congress should amend federal tax laws to require all tax-exempt entities to report their participation in such transactions in the same manner as taxable participants. If an exempt organization fails to disclose properly its involvement in a reportable transaction that the organization managers knew or should have known[12] was a reportable transaction, the exempt organization should be subject to the same penalties as taxable entities: $200,000 for failure to report participation in a listed transaction and $50,000 for failure to report participation in any other type of reportable transaction.[13] Individual taxpayers are subject to the lower penalty of $100,000 for failure to report participation in a listed transaction and $10,000 for failure to report any other type of reportable transaction. Congress should consider whether it would be appropriate to impose these lower penalties on tax-exempt entities with total annual revenues below $250,000.

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[7] Treas. Reg. §1.6011-4 (reporting requirements) and IRC §6707A (penalties for failure to include reportable transaction information with return). "Reportable transactions" include "listed transactions" appearing on the IRS list (maintained on the IRS website) and substantially similar transactions, confidential transactions subject to certain nondisclosure requirements and limitations, transactions with contractual protections to insure the taxpayer from loss if the anticipated tax benefits are not obtained, certain loss transactions specified in the tax code, transactions with significant (over $10 million) book-tax differences, and tax credit-based transactions with brief holding periods. See Treas. Reg §1.6011-4(b).

[8] IRC §6662A.

[9] IRC §§6111, 6112, 6707 and 6708.

[10] IRC §115 and Treas. Reg.§1.6033-2(g)(v).

[11] In *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005 (JCS-02-05), the Joint Committee on Taxation suggests penalizing charitable organizations and their managers for participation in broad categories of transactions that are merely suspected of having the potential to be abusive transactions, when the taxable parties to such transactions would not be subject to any similar penalties for participation (and other tax-exempt entities would be subject to lesser penalties). The Joint Committee also suggests that new penalties, in addition to those currently imposed on taxable entities, be imposed on tax-exempt organizations that knowingly fail to report participation in listed or reportable transactions.

[12] For example, because of a disclosure by the taxable party or knowledge of the facts and circumstances that made the transaction reportable.

[13] IRC §6707A.

Because an abusive tax shelter primarily benefits the taxable parties to the transaction, Congress should require taxable parties and material advisors to reportable transactions to disclose in writing to any potential tax-exempt party that it is a reportable transaction, what type of reportable transaction it is (for example, whether it is a listed transaction), and that the transaction is subject to reporting requirements and potentially to penalties. Penalties should be imposed on taxable parties and material advisors who fail to advise exempt organizations of the reporting requirements and possible penalties.

If a taxable entity participates in an abusive tax shelter, it is likely to report and pay substantially less tax than it should. When challenged by the IRS, the taxable entity will have to pay the proper amount of tax still due, plus interest, and will also be subject to the ordinary penalty for not paying the proper amount of tax due.[14] These penalties, however, do not apply to tax-exempt entities. Thus, in order to remove the incentive to participate in such transactions, the tax code should be amended to impose an excise tax of 100 percent of any fee received by an exempt organization for its participation in an abusive tax shelter, net of any unrelated business income tax paid on the fee. However, penalties on the organization and responsible persons should be subject to abatement if participation was due to reasonable cause.

Abusive tax shelter transactions can be quite complex, requiring sophisticated legal or financial counsel to understand whether such a transaction has been "listed" by the IRS or otherwise is subject to current reporting requirements. Many charities have neither the internal expertise nor access to professional assistance needed to properly evaluate proposed transactions. It is imperative that the IRS and the charitable sector work together to help charities identify listed and other reportable transactions, understand their reporting obligations, and avoid becoming unwitting partners in abusive tax shelters. Such an effort will require resources to ensure that organizations have the opportunity to learn about these practices and how to avoid them.

[14] IRC §6662A.

9. NON-CASH CONTRIBUTIONS

A. APPRECIATED PROPERTY

Introduction

Non-cash contributions, including gifts of art, land, stock, securities, household goods, motor vehicles, clothing, among other items, are a significant source of support for many charitable organizations. Tax laws provide incentives for such contributions by permitting taxpayers to take an income tax deduction generally equivalent to the fair market value of property and other non-cash items donated to a qualified charity.[1] Specific rules apply to gifts of property that has appreciated in value since it was acquired by the taxpayer, while other conditions apply to gifts of conservation easements and gifts that have generally depreciated in value, such as motor vehicles, clothing, or household items.[2] Non-cash contributions accounted for roughly $34 billion, or 25 percent, of the amounts claimed for charitable contributions by taxpayers who itemized deductions on their federal income tax returns in 2003.

Statement of Problem

For gifts other than publicly traded securities, problems have arisen due to the lack of clear, objective standards for establishing the fair market value of the donated property. Taxpayers who claim a deduction for a single item or collection of items valued at $5,000 or more are required to have a qualified appraisal to justify their claim, but the standards and definitions for qualified appraisals are vague. As a result, the Internal Revenue Service has reported that some taxpayers have been over-estimating the value of donated property when calculating their income tax deductions.

The process of identifying, investigating, and litigating cases where taxpayers may have overstated the value of non-cash contributions, thereby reducing their tax liability, is very resource-intensive, and the cost may exceed the value that would be returned to the Treasury. Penalties for taxpayers who claim excessive values for donated items and appraisers who over- value such items may be too low to deter such actions.

Recommendations for Congressional Action

Congress should amend federal tax laws to:

1. Strengthen the definition of a qualified appraisal and a qualified appraiser for purposes of substantiating the value of deductions claimed for donated property as follows:
   a. Define a "qualified appraisal" as one prepared by a qualified appraiser in accordance with generally accepted appraisal standards and applicable Treasury regulations.
   b. Define a "qualified appraiser" as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary of the Treasury, pursuant to 31 U.S.C. 330(c) at any time during the previous three years; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.[3]
   c. Direct the Secretary of the Treasury to prescribe by regulation that a qualified appraisal for contributions of real estate claimed to have a value of more than $100,000 must be prepared by a state general certified real estate appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).
2. Expand penalties on taxpayers who claim a tax deduction for donated property to include a penalty of 10 percent of the amount of the tax not properly

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[1] For gifts of ordinary income property (property that would not have resulted in long-term capital gain if sold on the date of the contribution), tangible personal property that is used by the donee in a manner unrelated to the donee's exempt or governmental purpose, and property that is donated to or for the use of a non-operating private foundation, the taxpayer's deduction is limited to the fair market value of the donated property reduced by the amount of any gain above the taxpayer's basis.

[2] Issues related to gifts of partial interest in the contributed property as a conservation or historic façade easement and gifts of clothing and household items are discussed in 9b and 9c.

[3] Treas. Reg. 1.170A-13(c)(5)(iv).

paid if the claimed value of the donated property exceeds the correct value of the property by 50 percent or more.[4]

3. Impose new penalties on appraisers. First, a penalty (similar in operation to those currently imposed on and proposed for taxpayers)[5] should be imposed on an appraiser if the value of the property as stated in the appraisal exceeds the correct value of the property by 50 percent or more. The penalty should be 10 percent of the amount of the overvaluation, up to a maximum of $10,000 per appraisal (indexed for inflation). Second, a penalty (similar in operation to those currently imposed on tax return preparers)[6] should be imposed on an appraiser who knew (or reasonably should have known) that the value of the property as stated in the appraisal did not have a realistic possibility of being sustained. Appraisers would continue to be subject to the current penalty of $1,000 under §6701 (aiding and abetting an understatement of tax) and potential disbarment under 31 U.S.C. 330(c) if such penalty was imposed.
4. Mandate electronic filing of Forms 8282 and 8283 as soon as feasible, and require donors to complete information on the appraised value, including the name of the appraiser, before asking the charity to substantiate that it received the donation and indicate the condition of the property when it was received.

Background

Taxpayers who itemize deductions on their annual income tax returns are generally allowed to deduct the fair market value of property (including real estate, stocks and bonds, antiques, art objects, or interest in a business) donated to an organization exempt from taxation under Internal Revenue Code section 501(c)(3) or to a federal, state, or local governmental entity. The amount that taxpayers may deduct from their taxable income varies depending on the type of property contributed, the type of organization to which the property was contributed, and the taxpayer's income.

For certain types of property, including property owned by the donor for one year or less, tangible personal property that will not be used by the receiving charity for its exempt purposes, business inventory, works of art created by the donor, and property (other than publicly traded stock) contributed to a private non-operating foundation, the amount that can be deducted is limited to the lesser of the taxpayer's basis (generally cost) or fair market value. Special rules governing the amount that can be deducted also apply for contributions of conservation easements, intellectual property, vehicles[7], partial interests in property, scientific property used for research, computer technology and equipment to be used by the recipient charity for educational purposes, and inventory to be used by the recipient charity for the care of the ill, the needy, or infants. No deductions are permitted for contributions of services.

To claim deductions for all contributions of property, taxpayers are required to have a receipt from the charity with its name, the date and location of the contribution, and a description of the donated property. If it is impractical to obtain a receipt, the taxpayer must have other reliable records containing this information. No deduction is allowed for gifts of $250 or more unless the donor has a contemporaneous written acknowledgement from the recipient organization that describes and provides a good faith estimate of the value of any goods and services provided to the donor in exchange for the contribution. The amount of the taxpayer's deduction must be reduced by the amount of any benefit received in return for the contribution.

If the taxpayer claims deductions for contributions of property that total over $500, the taxpayer must file IRS Form 8283 with his or her tax return. If the deduction claimed for any single item exceeds $500, the taxpayer must have reliable written records that show when and how the item was acquired and the cost or other basis of the item. If the deduction claimed for any

[4] Congress might amend tax code §6662(e) to provide for a penalty equal to 10 percent of the amount of the underpayment of tax attributable to the substantial valuation misstatement.

[5] IRC §6662.

[6] IRC §6694.

[7] The American Jobs Creation Act of 2004 enacted in October 2004 limits the deductions taxpayers can claim for donations of motor vehicles. If the taxpayer claims a fair market value in excess of $500 and the vehicle is later sold by the charitable organization, the deduction is limited to the gross proceeds from the sale.

single item other than stock exceeds $5,000, the taxpayer must have the item appraised by a qualified appraiser and attach to his or her tax return a summary of the appraisal, a signed declaration of the appraiser, and a signed acknowledgement from the charitable organization that received the donation. An appraisal is also required for contributions of non-publicly traded stock if the deduction claimed exceeds $10,000. If either the claimed deduction is more than $500,000 or if the donor's total deduction for art is $20,000 or more, a copy of the qualified appraisal must also be filed with the donor's return. If a charity sells contributed property requiring an appraisal summary within two years of receipt of the property, the charity must file Form 8282 reporting that sale with the IRS.

A qualified appraisal is a written appraisal that: (1) relates to an appraisal made no earlier than 60 days before the contribution and no later than the due date (including extensions) of the return on which the deduction is first claimed; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes a description of the property, the contribution, the appraiser, and the appraisal methods and results; and (4) does not involve an appraisal fee based on a percentage of the appraised value of the property (other than certain fees paid to a generally recognized association that regulates appraisers).

A qualified appraiser is an individual who: (1) holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis; (2) is qualified to make appraisals of the type of property being valued; (3) is independent; and (4) understands that he or she may be subject to a civil tax penalty for an intentionally false or fraudulent overvaluation.

Rationale

The Panel supports the retention of current tax law standards that permit taxpayers to take a deduction for the fair market value of gifts of appreciated property, subject to restrictions on particular types of gifts. These standards have long provided strong incentives to taxpayers to make non-cash contributions to charity that have become a significant source of support for many charitable organizations, whether they use such contributions in the course of their exempt activities or re-sell the items to generate revenues to support their programs and services.

Many donors who have goods or property that have appreciated significantly in value would be unlikely to donate those items to charitable organizations, rather than simply retain the items for their own enjoyment or sell such items in the market, if their tax deduction were limited to the original cost or basis of those items. The after-tax cost of giving would rise significantly for donors who hold most of their assets in property or family businesses if deductions for contributions of such assets were limited to the taxpayer's basis in such property, producing a significant disincentive to contribute such assets to charitable organizations. When significant restrictions on non-cash gifts to charity incorporated into law in the 1986 Tax Reform Act led to a drop in giving, the restrictions were partially repealed by Congress in 1990 and fully repealed in 1993.

Strengthening appraiser and appraisal standards and imposing tougher penalties for improper valuations will help to improve the accuracy of values of deductions claimed by taxpayers for donated property. In addition to the more stringent definitions recommended for qualified appraisals and qualified appraisers, federal tax laws should retain the prohibition on using an interested or related party as a "qualified appraiser."

The Uniform Standards of Professional Appraisal Practice (USPAP) is recognized in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 as generally accepted appraisal standards required for use in federally related transactions. USPAP is also the required standard for most state appraiser certification boards and appraisal trade associations. Just as tax return preparers are subject to penalties if they willfully or recklessly disregard tax regulations to understate a taxpayer's liability, appraisers should be subject to penalties if they intentionally overstate the value of an item by 50 percent or more to assist a taxpayer in reducing tax liability.

The Forms 8283 filed by taxpayers and the Forms 8282 filed by charitable organizations if they sell or dispose of the property within two years of the donation are a potentially valuable source of information for the Internal Revenue Service. Mandatory electronic filing of these Forms would facilitate comparability of data and provide appropriate audit flags where there are significant discrepancies between the taxpayer's claimed value and amount received by charity.

B. CONSERVATION AND HISTORIC FAÇADE EASEMENTS

Introduction

A conservation or historic façade easement is a legal agreement between the owner of a building or land and a charitable organization or government agency that restricts permanently how the land can be used to serve specific conservation purposes. The easement may be designed to protect agricultural resources, forest, historic buildings or property, or open space. The owner gives up certain specific rights to the land, such as the right to build new structures on the land or make modifications to the appearance of a historic building and its surroundings, but retains ownership of the property, which can later be sold or left to heirs. The charitable organization or government agency that receives the donation of a conservation easement is thereafter responsible for monitoring and enforcing adherence to the terms of the easement by current and future owners of the property. The donation of an easement frequently lowers the value of the property because it restricts the development potential of the land or building. To qualify for a tax-deductible contribution, the donation must protect permanently specific conservation resources and meet other requirements set forth in federal tax laws.

Statement of Problem

Donations of conservation or historic façade easements present a number of problems for tax administrators. There is a lack of clear standards and qualifications for appraisers in establishing the difference in the value of the property before and after the easement restrictions are imposed, and such measures may be subject to highly speculative assumptions. The standards used by various governmental agencies to establish appropriate conservation purposes can vary substantially and are often so broad that the specific public benefit is not clear. The charitable organizations that accept partial interest contributions of land for conservation purposes are not regulated with regard to oversight of conservation easement donations, and there are no clear mechanisms for ensuring that the land continues to be used for the restricted conservation purposes on which the tax deduction was based.

Recommendations for Congressional Action

In addition to changes in qualified appraisal standards recommended for all gifts of appreciated property, Congress should amend federal tax laws to:

1. Enact into law the current regulatory requirement that deductions for conservation or historic façade easement donations be reduced by any financial or economic benefits the taxpayer receives as a result of the donation, including any increase in the value of other property owned by the taxpayer or any person related to the taxpayer.
2. Allow deductions for conservation or historic façade easement donations only if they are made to a qualified charity or government entity under the terms of a written agreement specifying the restrictions on the future use of the property once the donation is accepted. Congress should direct the Secretary of the Treasury to amend regulations to define a qualified charity as a publicly supported 501(c)(3) organization with a primary purpose of environmental protection or historic preservation and that has a commitment and the resources to manage and enforce the easement restrictions with appropriate procedures for certifying that a charity meets this definition.
3. Impose penalties on charities that fail to enforce conservation or historic façade easement agreements in proportion to the nature of the violation and the damage to the resources that were to be protected under the easement agreement. Authorize the Secretary of the Treasury to waive the penalty when a change in the conditions surrounding the property makes it impractical to enforce the easement restrictions.

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should require any charitable organization that accepts donations of conservation easements to:

1. Certify annually on its Form 990 that it has established and implemented reasonable written procedures for monitoring compliance with the terms of the conservation easements it holds and that it has adequate resources to enforce those restrictions.

2. File with its Form 990 a list of all donations of conservation easements it holds, setting forth the location of the property, the acreage, the purpose of the easement, the year the easement was donated, and whether there has been any modification in the easement.

Background

Conservation easements are contracts that are enforceable under state laws. A model Uniform Conservation Easement Act was adopted by the National Conference of Commissioners on Uniform State Laws in 1981, and 21 states and the District of Columbia have adopted laws regulating conservation easements based on this law. Twenty-seven other states have drafted and enacted their own conservation easement laws.[1]

Federal tax regulations encourage taxpayers to donate partial interest in property to ensure that such property will be used in perpetuity for the following conservation purposes:

1. Land that will be used on a substantial and regular basis by the public for recreation or education.
2. Land that serves as a significant natural habitat for an endangered or other protected class of fish, wildlife, plant community, or similar ecosystem.
3. Land that serves as "open space" (including farmland and forests) that is preserved for the scenic enjoyment of the general public pursuant to a specific federal, state, or local government conservation policy.
4. Land or a certified historic structure (including the façade of a certified historic structure) that is deemed to be "historically important" under the National Register of Historic Places Evaluation Criteria.

The taxpayer is permitted to take a tax deduction for such contributions that is generally equivalent to the difference between the fair market value of the property before and after the permanent restriction of the conservation or historic façade easement is put into effect. The amount of the deduction must be reduced by any financial or economic benefits the taxpayer receives as a result of the donation, including any increase in the value of other property owned by the taxpayer or any person related to the taxpayer. If the land may be put to a use that is inconsistent with the conservation purpose of the gift, no deduction is permitted.

Rationale

Tax deductions for contributions of full or partial interest in land provide significant incentives for taxpayers to preserve that land for the benefit of the public rather than sell all or part of the land for commercial or residential development. At the same time, it is essential that these tax benefits be accorded only for donations that serve valid conservation interests and are not granted to taxpayers who receive financial or economic benefits from the donation that are greater than the value of the donated property. The IRS has recently strengthened enforcement of laws governing deductions for contributions of conservation easements[2], and this effort should be encouraged. The Panel recommends a number of ways in which Congress should strengthen tax laws governing appraisals and appraisers to justify claims of deductions for contributions of appreciated property that should apply to conservation easements as well. In addition, the tax code should be amended to specifically delineate that any tax deduction claimed for a conservation easement as a result of a decrease in the value of the property must be reduced by any resulting increase in the value of other property owned by the taxpayer and individuals related to the taxpayer and strengthen penalties on taxpayers who violate the terms of a conservation easement donation.

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[1] Uniform Law Commissioners, National Conference of Commissioners on Uniform State Laws.

[2] Mark W. Everson, Commissioner of Internal Revenue, testimony before the U.S. Senate Finance Committee, June 22, 2004, and April 5, 2005.

Charitable organizations that receive donations of conservation easements must have sufficient expertise, systems, and resources to determine whether a particular donation will serve a valid conservation interest, to establish appropriate terms for permissible activities on the donated property, and to monitor adherence to the terms of the easement agreement. The cost of such enforcement may not necessarily be prohibitive given that current law allows the court to require costs incurred by a charity to enforce an agreement to be paid by the party violating the agreement. The Secretary of the Treasury must develop appropriate methods for ascertaining whether a charity is eligible to receive donations of conservation easements. Efforts are underway within the land trust and conservancy community to develop a strong system of standards of practice that would lead to accreditation of organizations qualified to receive and manage donations of conservation easements. The Panel will continue to examine proposals for requiring appropriate certifications from appraisers, donors, and charitable organizations involved in conservation easement agreements on the forms used by taxpayers to support tax deductions for conservation easement donations.

C. CLOTHING AND HOUSEHOLD ITEMS

Introduction

Contributions of clothing and household items are a vital source of support for many charitable organizations both in the faith and secular community, including those working with low-income and disabled individuals and families. Some contributions are used directly by the charitable organizations in their service programs or given to individuals in need. Others may be resold through thrift stores, while still others may be resold by the charity through charity auctions and similar activities with the proceeds devoted to support the program activities of the organization.

Statement of Problem

Contributions of clothing and household items present unique problems for taxpayers and tax administrators in determining the fair market value for tax deduction purposes. Clothing and household items are generally considered to be "loss property;" that is, the fair market value is substantially less than the original purchase price. These items are often of low value, and there are no uniform standards for taxpayers for establishing the value of such items, although some charitable organizations have attempted to guide donors with a standardized "value list" to assist them in determining the value of their donations.[1] Donations of clothing and household items may be particularly susceptible to overstatement of the fair market value because of the sentimental value a taxpayer may place on such items.

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[1] The average price range of items sold by Goodwill and Salvation Army is listed at www.goodwillpromo.org or www.taxwizzard.com/donated.html. Information is also provided at many donation collection sites.

Recommendation

No action by Congress is recommended.[2] Congress should *not* limit deductions for contributions of clothing or household items to an arbitrary ceiling without a clear basis for establishing the amount of the ceiling and an assessment of the impact of the change on the level of charitable contributions.

Recommendation for Internal Revenue Service Action

The Internal Revenue Service should establish a list of the value that taxpayers can claim for specific items of clothing and household goods, based on the sale price of such items identified by major thrift store operations or other similar assessments.

Background

To claim deductions for contributions of clothing or household items, taxpayers are required to have a receipt from the charity with its name, the date and location of the contribution, and a description of the donated property. If it is impractical to obtain a receipt, the taxpayer must have other reliable records containing this information. No deduction is allowed for gifts of $250 or more unless the donor has a contemporaneous written acknowledgement from the recipient organization that describes and provides a good faith estimate of the value of any goods and services provided to the donor in exchange for the contribution. The amount of the taxpayer's deduction must be reduced by the amount of any benefit received in return for the contribution.

If the taxpayer claims deductions for contributions of property that total over $500, the taxpayer must file IRS Form 8283 with his or her tax return. If the deduction claimed for any single item exceeds $500, the taxpayer must have reliable written records that show when and how the item was acquired and the cost or other basis of the item. If the deduction claimed for any single item other than stock exceeds $5,000, the taxpayer must have the item appraised by a qualified appraiser and attach to his or her tax return a summary of the appraisal, a signed declaration of the appraiser, and a signed acknowledgement from the charitable organization that received the donation. If a charity sells contributed property requiring an appraisal summary within two years of receipt of the property, the charity must file Form 8282 reporting that sale with the IRS.

Rationale

A maximum cap for annual aggregate deductions that falls within the average range of claims for non-cash contributions by taxpayers who itemize deductions might ease enforcement burdens. However, such a cap would likely to be a significant disincentive for taxpayers to make generous contributions of a number of items or high-end items rather than re-sell those items and retain the cash for their own use. Further, if individuals sell such items on the open market, there is no evidence that they will donate their proceeds to charity. While many of these items may be of relatively low economic value, some types of donations, such as computers, major appliances, high-quality furniture, and clothing may have a substantial re-sale value and are vital to the successful operation of thrift store operations, programs that assist homeless families and individuals transitioning to independent living arrangements, charity auctions, and other activities conducted by charitable organizations. An individual who is moving into a smaller home or a new geographic area has an incentive through the tax code to donate items to charity, rather than to move or sell the items, as do those who choose to update their wardrobes, or household furnishings.

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[2] As has been recommended by the Joint Committee on Taxation (January 27, 2005).

9. NON-CASH CONTRIBUTIONS *continued*

Tax rules should be simplified to provide clear standards for establishing appropriate valuation of these gifts and facilitate taxpayer compliance, while retaining incentives for taxpayers to donate substantial gifts of furniture and clothing. To assist taxpayers in establishing the fair market value of donated goods, the responsibility should fall to the IRS to provide a clear standard for determining such values based on the "value guides" currently offered by many charitable organizations. Charitable organizations that are the recipients of these donations are also encouraged to make such lists available on their websites.

Many charitable organizations that have relied on the proceeds of sales from donated motor vehicles have reported that donations have decreased by 40 to 45 percent since the tax laws were changed effective January 1, 2005, limiting deductions for such contributions to values under $500 or the amount of the proceeds from the sale of the vehicle.[3] Congress should evaluate the impact of those recent tax law changes and consider amending the law before imposing new restrictions on the deductibility of non-cash contributions to ensure that the loss to charitable programs and services does not exceed the tax savings that is generated for the Treasury.

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[3] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

10. BOARD COMPENSATION

Introduction

Millions of Americans serve each year on the boards of charitable organizations. Although some charitable organizations reimburse expenses related to board work, the vast majority of board members serve without compensation. In fact, board members of public charities often donate both time and funds to the organization, a practice that supports the sector's spirit of giving and volunteering.

A few charitable organizations, however, do compensate board members for their services. Charities and foundations are permitted under current law to pay reasonable compensation for services provided by board members. Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises (whether tax-exempt or taxable) under like circumstances.[1] Federal tax laws prohibit payment of excessive compensation, contracts, and transactions that provide excessive economic benefit to board members and other "disqualified persons."[2]

Statement of Problem

Media reports of substantial compensation provided to board members of some charitable organizations have raised questions about whether compensation of board members should be permitted and, if so, under what circumstances. The legal standards for imposing penalties for excessive compensation of board members and the amount of those penalties may not be sufficient to deter such compensation.

Recommendations for Congressional Action

Congress should amend the Internal Revenue Code to:

1. Impose penalties on board members and other managers of charitable organizations who approve of self-dealing or excess benefit transactions, including excessive compensation, not only if they knew that the transaction was improper but also if they "should have known" that it was improper—that is, if they failed to exercise reasonable care, such as following the "rebuttable presumption" procedures or other appropriate processes, in determining the reasonableness of compensation. Congress also should direct the Secretary of the Treasury to amend regulations to provide that if the appropriate authorized body has met the rebuttable presumption procedures for the transaction, an organization manager's participation in a transaction will ordinarily not be subject to penalty, even though the transaction is subsequently held to be a self-dealing or excess benefit transaction.
2. Increase penalties on foundation board members who are found to receive excessive compensation to 25 percent of the excess amount, and retain the current requirement to repay the excess amount to the organization.
3. Increase the amount of penalties on board members of charitable organizations who approve self-dealing or excess benefit transactions, including excessive compensation.
   a. The first-tier excise tax on foundation board members and other managers who approve excess compensation should be increased from 2.5 percent to 10 percent of the excess amount.
   b. The first-tier excise tax on foundation board members and other managers who approve self-dealing transactions not involving compensation should be increased from 2.5 percent to 5 percent of the amount of the transaction.
   c. The cap on first-tier penalties imposed on board members and other managers of charitable organizations, who approve of self-dealing or excess benefit transactions, including excess compensation, should be raised from $10,000 to $20,000.

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[1] Treas. Reg. § 53.4958-4(b)(1)(ii).

[2] For public charities, a disqualified person is someone who, at any time during the five-year period ending on the date of the transaction in question, was "in a position to exercise substantial influence over the affairs of the organization." Any member of a disqualified person's family as well as any entity in which one or more disqualified persons together own, directly or indirectly, more than a 35 percent interest is also considered a disqualified person. For private foundations, the definition of a disqualified person includes all of the above individuals as well as substantial donors, owners of more than 20 percent of a corporation, trust, or partnership that is a substantial contributor to the foundation, and the family members of any of these persons. Certain government officials are also considered disqualified persons. Treas. Reg. § 53.4958-3; Treas. Reg. § 53.4946-1.

d. The Secretary of the Treasury's authority to abate first-tier self-dealing taxes should be extended to include abatement of taxes imposed on foundation managers and disqualified persons whose participation in a self-dealing transaction was due to reasonable cause and not to willful neglect.[3]

4. Prohibit loans to board members.[4]

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should revise Forms 990 and 990-PF to require that charitable organizations clearly disclose the full amount of and reasons for compensation paid to any board member and indicate the method used to determine the reasonableness of compensation. The Forms should require organizations to:

1. Distinguish between compensation paid for board service (including amounts paid for service on committees or for taking on special assignments), compensation paid for performance of full- or part-time staff duties, and compensation for any other services provided as an independent contractor.
2. Indicate the estimated hours of service a compensated board member is expected to provide per year, the general duties of a compensated board member, and any special services provided by a compensated board member.
3. Separate compensation of corporate officers who do not serve as board members or trustees from information on board compensation.

Recommendations for Charitable Organization Action

1. The Panel generally discourages payment of compensation to board members by charitable organizations. In cases where compensation is deemed necessary due to the complexity of the responsibility, the time commitment involved in board service, and the skills required for the particular assignment, among other factors, charitable organizations should, as a recommended practice, review information on compensation provided by organizations comparable in size, grantmaking or program practices, geographic scope, location and with similar board responsibilities (for example, number of meetings, length of terms, and number of domestic or international site visits expected) to determine the reasonableness of any compensation provided to board members.
2. Charitable organizations should, as a recommended practice, make available to peer organizations on request relevant information that would assist in reviewing the reasonableness of board compensation policies.
3. Charitable organizations should, as a recommended practice, provide the city of residence of each board member, along with his or her full name, on their annual Form 990 or 990-PF.

Background

The Internal Revenue Code prohibits all charitable organizations from providing excessive compensation directly or through contracts and transactions that give excessive economic benefits to board members and other disqualified persons. Private foundations generally are prohibited from engaging in any financial transactions with disqualified persons, other than payment of reasonable compensation for services deemed necessary to the foundation's exempt purposes.[5]

For public charities, "intermediate sanctions" regulations encourage organizations to have compensation of officers approved in advance by members of an "authorized body" of the organization (such as the board or a board-appointed committee), none of whom have a conflict of interest with respect to the transaction.[6] If the authorized body approves the compensation based on appropriate data that helps determine comparability or fair market value and documents the basis for its determination at the time it makes its decision, the regulations confer a rebuttable presumption of the reason-

[3] 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 Internal Revenue Code sections 4941 through 4945 and 4958.

[4] Private foundations are already prohibited under self-dealing laws from making loans to board members.

[5] IRC §4941.

[6] Treas. Reg. § 53.4958-6(a)(1).

ableness of the compensation.[6] Board members of public charities who are charged by the IRS with receiving excessive compensation are generally not able to meet the conditions of the rebuttable presumption regulations because they have an inherent conflict of interest, and therefore must demonstrate that the compensation they receive is reasonable.

Federal regulations define comparable data needed to determine the reasonableness of compensation or other transactions with disqualified persons as (1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) the availability of similar services in the geographic area; (3) current compensation surveys compiled by independent firms; (4) actual written offers from similar organizations competing for the disqualified person; and, if the transaction involves the transfer of property, (5) independent appraisals of that property and (6) offers received as part of an open and competitive bidding process.[7]

A board member or other disqualified person of a public charity who is found to have received excessive compensation must repay the excess benefit to the charity, plus interest, and pay an initial tax of 25 percent of the excess benefit.[8] If a public charity provides benefits to a board member or other disqualified person and does not provide contemporaneous written substantiation that the benefit is intended as compensation for that individual (i.e., it reports the benefit as compensation on a Form W-2 or a Form 1099 or on its Form 990, it includes the benefit in a written employment contract or in the minutes of the meeting approving the compensation, or the individual reports the benefit as compensation on his or her income tax return), the value of the benefit will be treated automatically as an excess benefit.[9] If the individual fails to repay the excess benefit within a certain time period, the executive is subject to an additional tax of 200 percent of the excess benefit.[10]

A board member or other disqualified person of a private foundation who participates in a self-dealing transaction, including those involving excessive compensation, is subject to an initial tax of 5 percent of the compensation and a requirement to repay the compensation to the foundation.[11] For private foundations, in contrast to public charities, there is no contemporaneous written substantiation requirement. There is also no possibility of abatement of this initial tax even when the prohibited transaction was due to reasonable cause and was beneficial to the foundation. If the individual fails to repay the compensation within a certain time period, the individual is subject to an additional tax of 200 percent of the excess compensation.[12]

Board members and managers of charitable organizations who approve a transaction knowing it is a self-dealing transaction or provides an excess benefit are generally jointly and severally liable for a tax of 2.5 percent of the transaction amount for private foundations or 10 percent of the excess benefit for public charities, both capped at $10,000 per transaction, unless their participation is not willful and due to reasonable cause.[13] For private foundations, an exception to the general rule provides that if the transaction involves compensation, the penalty is 2.5 percent of the excess compensation.[14]

To impose penalties on public charity or private foundation board members or other managers, the IRS must prove that the manager's actions in accepting or approving an excess benefit or self-dealing transaction were conscious, voluntary, and intentional, and that the manager had actual knowledge of sufficient facts to determine that the transaction would be an excess benefit or self-dealing transaction, was aware that such a transaction would violate federal excess benefit or self-dealing transaction laws, and negligently failed to make reasonable attempts to determine whether the transac-

[6] Treas. Reg. § 53.4958-6.

[7] Treas. Reg. § 53.4958-6(c)(2)(i).

[8] IRC § 4958(a)(1), (f)(6); Treas. Reg. §§ 53.4958-1(a), 53.4958-7(c).

[9] Treas. Reg. § 53.4958-4(c)(3).

[10] IRC § 4958(b).

[11] IRC § 4941(a)(1), (e)(3); Treas. Reg. § 53.4941-1(b)(2)(i), (c)(6).

[12] IRC § 4941(b)(1).

[13] IRC § 4941(a),(c); IRC § 4958(a), (d).

[14] IRC §4941(e)(2).

tion was an excess benefit or self-dealing transaction.[15] A board member or other manager who relies on the advice of legal counsel (or, in the case of public charity managers, certain other professionals) is generally not held responsible for knowing that the transaction was improper.[16] In addition, a board member or other manager of a public charity is generally not held responsible for knowing that a transaction conferred an excess benefit if an appropriate authorized body has met the requirements of the rebuttable presumption procedures with respect to the transaction.[17]

Charitable organizations, with some exceptions[18], are required to report on their Form 990 or 990-PF the name, title, and average hours per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation, expense account, and other allowances paid to any board member. The instructions to the Forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).[19] Organizations are also required to include the preferred address of each board member.

Rationale

The Panel strongly encourages charitable organizations to support the long-standing tradition of asking boards of directors to serve on a voluntary basis. In the circumstances where organizations find it necessary to compensate board members due to the nature, time, or professional competencies involved in the work expected, there should be significant disclosure requirements to detail the amount of and reasons for such compensation, including the services provided and the responsibilities of board members. When compensation is provided to board members, it must be reasonable and necessary to support the performance of the charitable or philanthropic organization in its exempt function. Compensation paid to board members for services in the capacity of staff of the organization should be clearly differentiated from any compensation paid for board service.

Excessive compensation to board members should be penalized under current excess benefit or self-dealing rules. Board members of charitable organizations are responsible for ascertaining that any compensation they receive does not exceed to a significant degree the compensation provided for positions in comparable organizations with similar responsibilities and qualifications. Board members generally cannot avail themselves of the protections accorded by following rebuttable presumption procedures in establishing their own compensation because they would not meet the criteria for an independent authorizing body.

First-tier excise taxes and penalties imposed on managers and other individuals who improperly benefit from self-dealing or excess benefit transactions must be sufficient to create an effective deterrent. At the same time, provision must be made to abate penalty taxes for inadvertent self-dealing 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 symme-

[15] Treas. Reg. §§ 53.4941(a)-1(b)(3), 53.4958-1(d)(4)(i).

[16] Treas. Reg. §53.4941(a)-1(b)(6). Public charity managers may also rely on the professional advice of certified public accountants or accounting firms with relevant tax law expertise, as well as independent appraisers or compensation consultants who perform such valuation services on a regular basis, are qualified to make valuations of the particular type of property or services involved, and who provide certifications regarding those qualifications. Treas. Reg. § 4958-1(d)(4)(iii).

[17] Treas. Reg. §53.4958-1(d)(4)(iv).

[18] 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. Treas. Reg. §1.6033-2(g).

[19] Instructions for Form 990 and Form 990-EZ (2004), Part V, p.28

try 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 public charity managers and disqualified persons currently may be abated under section 4962.

The practice of providing loans to board members, while infrequent, has created both real and perceived problems for public charities. Under self-dealing laws, private foundations are already prohibited from making loans to board members. The Sarbanes-Oxley Act generally prohibits loans to any directors or executives of publicly owned companies, and many states expressly prohibit loans to directors and officers of nonprofit organizations. Although there may be circumstances in which it is determined to be necessary to offer loans to organization employees, it is not appropriate for charitable organizations to make loans to board members.

Greater transparency, including specific requirements for disclosing both the services provided and the responsibilities of board members, is an essential tool for identifying and adjusting the practices of those organizations that may be providing too much compensation. The Forms 990 and 990-PF should provide separate sections for reporting compensation of board officers and members and for compensation of staff and officers of the organization. Since boards of directors may meet on a monthly, quarterly, semi-annual, or other basis, it is often difficult for charitable organizations to meet the current requirement of the Forms 990 that they estimate the number of hours per week that their board members serve. Providing an annual estimate of the expected hours of service could offer a more realistic basis for evaluating the reasonableness of any compensation offered.

Most charitable organizations provide their own address as the preferred contact address of board members on their Form 990 or 990-PF. This policy enables the organization to be responsive to queries from interested parties. However given the importance of board members in setting the policies and overseeing the charitable resources of the organizations, the Panel recommends that organizations in addition provide the full legal names and city of residence for board members on the Forms in order to facilitate greater transparency and accuracy.

As the IRS moves forward with mandatory electronic filing of the Forms 990 and 990-PF, information about board compensation provided on the Forms will be more readily available. Electronic filing, when combined with the additional recommended disclosure requirements, should provide regulators, the public, and organization managers with clearer information to establish comparable compensation practices between organizations with similar programs and board responsibilities.

It is not advisable, either as a recommended practice or as a matter of law, to establish a maximum limit on compensation that can be paid to individual board members. Board compensation decisions should be made based on the facts and circumstances of each case. Setting an arbitrary limit could prohibit compensation that would be appropriate in some circumstances, and under different circumstances encourage higher compensation than is justified by implying that compensating board members is an expected practice rather than one that should be justified by the organization based on its unique needs.

NOTE: The Panel recognizes that many charitable organizations, particularly those that are organized as charitable trusts, may be governed by institutional trustees or be bound by specific terms for compensation of trustees by their founding documents. Such compensation is currently regulated primarily by state laws. The Panel will be studying possible legislative and regulatory remedies for addressing excessive compensation received by trustees under these circumstances.

11. EXECUTIVE COMPENSATION

Introduction

Charitable organizations are permitted under current law to pay reasonable compensation for services provided by board members, chief executive officers, and other staff. Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises (whether tax-exempt or taxable) under like circumstances.[1] Studies document that compensation for nonprofit workers and executives is on average substantially lower than their counterparts in the for-profit or government sectors.[2] In addition, as charitable organizations must compete with other organizations, including for-profit and government employers, to perform responsibly and effectively, many organizations find it necessary to provide compensation packages at levels that will attract and retain designated line staff and managers.

Statement of Problem

Media reports of seemingly excessive compensation for loans to executives of charitable organizations have caused concern among donors, state and federal regulators, and the public. Questions have been raised about whether current rules for determining what is "excessive" compensation are sufficiently clear and whether the penalties for violating those rules are severe enough to deter such payments.

Recommendations for Congressional Action

Congress should amend federal tax laws to:

1. Require executives and other "disqualified persons"[3] who are charged by the Internal Revenue Service with receiving excessive compensation to demonstrate that the compensation they receive is reasonable.
2. Impose penalties on board members and other managers of charitable organizations who approve of self-dealing or excess benefit transactions, including excessive compensation, not only if they knew that the transaction was improper but also if they "should have known" that it was improper—that is, if they failed to exercise reasonable care, such as following the "rebuttable presumption" procedures or other appropriate processes, in determining the reasonableness of compensation. Congress also should direct the Secretary of the Treasury to amend regulations to provide that if the appropriate authorized body has met the rebuttable presumption procedures with respect to the transaction, an organization manager's participation in a transaction will ordinarily not be subject to penalty, even though the transaction is subsequently held to be a self-dealing or excess benefit transaction.
3. Increase penalties on foundation executives and other disqualified persons who are found to receive excessive compensation to 25 percent of the excess amount, and retain the requirement to repay the excess amount to the organization.
4. Increase the amount of penalties on managers of charitable organizations who approve of self-dealing or excess benefit transactions, including excessive compensation.
   a. The first-tier on foundation managers who approve of self-dealing transactions involving excess compensation should be increased from 2.5 percent to 10 percent of the excess amount.
   b. The first-tier tax on foundation managers who approve of self-dealing transactions not involving compensation should be increased from 2.5 percent to 5 percent of the amount of the transaction.

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[1] Treas. Reg. § 53.4958-4(b)(1)(ii)

[2] Minnesota Council of Nonprofits, *Minnesota Nonprofit Economy Report* (2004), www.mncn.org; Congressional Budget Office, *Comparing the Pay of Federal and Nonprofit Executives: An Update* (July 2003), www.cbo.gov; Eric Twombly and Marie Gantz, Urban Institute, *Executive Compensation in the Nonprofit Sector: New Findings and Policy Implications* (2001), www.urban.org.

[3] For public charities, a disqualified person is someone who, at any time during the five-year period ending on the date of the transaction in question, was "in a position to exercise substantial influence over the affairs of the organization." Any member of a disqualified person's family as well as any entity in which one or more disqualified persons together own, directly or indirectly, more than a 35 percent interest is also considered a disqualified person. For private foundations, the definition of a disqualified person includes all of the above individuals as well as substantial donors, owners of more than 20 percent of a corporation, trust, or partnership that is a substantial contributor to the foundation, and the family members of any of these persons. Certain government officials are also considered disqualified persons. Treas. Reg. § 53.4958-3; Treas. Reg. § 53.4946-1.

c. The cap on first-tier penalties imposed on board members and other managers of charitable organizations who approve of self-dealing or excess benefit transactions, including excess compensation transactions, should be raised from $10,000 to $20,000

d. The Secretary of the Treasury's authority to abate first-tier self-dealing taxes should be extended to include abatement of taxes imposed on foundation managers and disqualified persons whose participation in a self-dealing transaction was due to reasonable cause and not to willful neglect.[4]

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should:

1. Revise the Forms 990 and 990-PF to require that a charitable organization disclose the full compensation paid to its chief executive officer and other officers.[5] Compensation reports on the Forms should clearly distinguish between base salary, benefits, bonuses, long-term incentive compensation, deferred compensation, and other financial arrangements or transactions treated as compensation (for example, interest-free loans or payment of a spouse's travel expenses) to the individual.[6]
2. Require charitable organizations to clearly disclose on the Forms 990 and 990-PF compensation paid to the five highest compensated employees and to all employees who are related to a board member or officer of the organization if they are paid more than $50,000 (including benefits)[7] in the tax year.
3. Require charitable organizations to disclose on the Forms 990 and 990-PF whether the organization followed the "rebuttable presumption" procedures in determining the reasonableness of compensation provided to the CEO.

Recommendations for Charitable Organizations Action

1. Charitable organizations should, as a matter of recommended practice, incorporate into their bylaws, articles, charter, or other appropriate governing documents a requirement that the full board must approve, annually and in advance, the compensation of the CEO unless there is a multi-year contract in force or there is no change in the compensation except for an inflation or cost-of-living adjustment.
2. If the board of directors chooses to use a compensation consultant to evaluate the compensation of the CEO, then, as a recommended practice, the consultant should be independent and should be hired by and report to the board or a designated board committee.
3. Governing boards or the compensation committee of the board should, as a matter of recommended practice, review the organization's staff compensation program periodically, including the salary ranges for particular positions and the benefits provided.

Background

The Internal Revenue Code prohibits payment of excessive compensation and other transactions that provide excessive economic benefit to executives and other disqualified persons.[8] Charitable organizations are also prohibited from providing excessive compensation or benefits to family members of individuals who have substantial influence over the organization's affairs.[9] Private foundations are generally prohibited from engaging in any financial transactions, other than payment of reasonable compensation for services deemed necessary to the foundation's exempt purposes, with their disqualified persons.[10]

For public charities, "intermediate sanctions" regulations encourage organizations to have executive compensation approved in advance by members of an "authorized body" of the organization (such as the

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[4] 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 Internal Revenue Code sections 4941 through 4945 and 4958.

[5] Officers include the president, chief executive officer, chief operating officer, treasurer, chief financial officer, and persons with different titles who perform the functions of those positions.

[6] The chart required by the U.S. Securities and Exchange Commission for reporting executive compensation on the proxy statements filed by publicly-traded corporations provides a good model for these reports. See Regulation S-K, 17 C.F.R. 229.402(b) (2004) detailing requirements for a "Summary Compensation Table".

[7] The $50,000 threshold should be indexed for inflation.

[8] IRC § 4941, § 4958.

[9] I.R.C. § 4941 and § 4946; § 4958(f).

[10] IRC § 4941.

board or a board-appointed committee), none of whom have a conflict of interest with respect to the transaction.[11] If the authorized body approves the compensation based on appropriate data that helps determine comparability or fair market value and documents the basis for its determination at the time it makes its decision, the regulations confer a rebuttable presumption of the reasonableness of the compensation.[12] These procedures are not required, and no penalties apply if an organization chooses not to follow them. The IRS may not draw any negative inferences simply because an organization chooses not to follow these procedures.[13]

Federal regulations define comparable data needed to determine the reasonableness of compensation or other transactions with disqualified persons as including (1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) the availability of similar services in the geographic area; (3) current compensation surveys compiled by independent firms; (4) actual written offers from similar organizations competing for the disqualified person; and, if the transaction involves the transfer of property, (5) independent appraisals of that property and (6) offers received as part of an open and competitive bidding process. Organizations with gross receipts (including contributions) of less than $1 million may rely on the compensation paid by three comparable organizations in the same or similar communities for similar services when approving compensation arrangements.[14]

A disqualified person of a public charity who is found to have received excessive compensation must repay the excess benefit to the charity, plus interest, and pay an initial tax of 25 percent of the excess benefit.[15] Abatement of this initial tax is available if the excess compensation was due to reasonable cause. If the approval process outlined above was followed in determining an executive's compensation, the compensation is presumed to be reasonable unless the IRS proves it to be excessive. If a public charity provides benefits to a disqualified person and does not provide contemporaneous written substantiation that the benefit is intended as compensation for that individual (i.e., it reports the benefit as compensation on a Form W-2 or a Form 1099 or on its Form 990, it includes the benefit in a written employment contract or in the minutes of the meeting approving the compensation, or the individual reports the benefit as compensation on his or her income tax return), the value of the benefit will be treated automatically as an "excess benefit."[16] If the disqualified person fails to repay the excess benefit within a certain time period, he or she is subject to an additional tax of 200 percent of the excess benefit.[17]

A disqualified person of a private foundation who receives excessive compensation is subject to an initial tax of 5 percent of the excess compensation and a requirement to repay the excess compensation to the foundation.[18] For private foundations, in contrast to public charities, there is no contemporaneous written substantiation requirement. There is also no possibility of abatement of this initial tax even when the prohibited transaction was due to reasonable cause and was beneficial to the foundation. If the executive fails to repay the excess compensation within a certain time period, the executive is subject to an additional tax of 200 percent of the excess compensation.[19]

Board members and other managers of charitable organizations who approve a transaction knowing it provides an excess benefit are generally jointly and severally liable for a tax of 2.5 percent of the transaction amount for private foundations or 10 percent of the excess benefit for public charities, both capped at $10,000 per transaction, unless their participation is not willful and due to reasonable cause.[20] For private foundations, an exception to the general rule provides that if the transaction involves compensation, the penalty is 2.5 percent of the excess compensation.[21]

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[11] Treas. Reg. § 53.4958-6(a)(1).

[12] Treas. Reg. § 53.4958-6.

[13] Treas. Reg. § 53.4958-6(e).

[14] Treas. Reg. § 53.4958-6(c)(2).

[15] IRC § 4958(a)(1), (f)(6); Treas. Reg. §§ 53.4958-1(a), 53.4958-7(c).

[16] Treas. Reg. § 53.4958-4(c)(3).

[17] IRC § 4958(b).

[18] IRC § 4941(a)(1), (e)(3); Treas. Reg. § 53.4941-1(b)(2)(i), (c)(6).

[19] IRC § 4941(b)(1).

[20] IRC § 4941; IRC 4958.

[21] IRC §4941(e)(2).

To impose penalties on public charity or private foundation managers, the IRS must prove that the organization manager's actions in accepting or approving an excess benefit or self-dealing transaction were conscious, voluntary, and intentional, and that the manager had actual knowledge of sufficient facts to determine that the transaction would be an excess benefit or self-dealing transaction, was aware that such a transaction would violate federal excess benefit or self-dealing transaction laws, and negligently failed to make reasonable attempts to determine whether the transaction was an excess benefit or self-dealing transaction.[22] A board member or other manager who relies on the advice of legal counsel (or, in the case of public charity managers, certain other professionals[23]) is generally not held responsible for knowing that the transaction was improper.[24] In addition, a board member or other manager of a public charity is generally not held responsible for knowing that a transaction conferred an excess benefit if an appropriate authorized body has met the requirements of the rebuttable presumption procedures with respect to the transaction.[25]

When a public charity signs a contract to hire a new chief executive officer, chief financial officer, or a chief operating officer with a fixed compensation amount or formula over single or multiple years, federal regulations do not require managers to evaluate whether compensation paid according to the terms of the contract is an excess benefit transaction if the individual was not a disqualified person with the organization at any time during the preceding five years.[26]

Charitable organizations, with some exceptions[27], are required to report on their Form 990 or 990-PF the name, title, and average hours per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation, expense account, and other allowances paid to any board member, officer, and key employee. The instructions to the Forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).[28] Organizations are also required to include the preferred address of each listed individual.

Rationale

The current market-based standard for determining reasonable compensation affirmed in federal tax laws provides charitable organizations the necessary flexibility to attract and retain qualified leadership. The Panel does not believe that Congress or the IRS should require charitable organizations to determine the compensation of key executives based only or primarily on comparable positions within the charitable sector. The Panel also does not believe that Congress or the IRS should limit the compensation of executives of charitable organizations to an arbitrary amount related to government employment contracts.

Charitable organizations increasingly find it necessary to compete with for-profit and government employers to attract and retain a range of qualified professionals. Charitable organizations are generally not in a position to offer all of the benefits available to corpo-

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[22] Treas. Reg. §§ 53.4941(a)-1(b)(3), 53.4958-1(d)(4)(i).

[23] Public charity managers may also rely on the professional advice of certified public accountants or accounting firms with relevant tax law expertise, and independent appraisers or compensation consultants who perform such valuation services on a regular basis, are qualified to make valuations of the particular type of property or services involved, and who provide certifications regarding those qualifications. Treas. Reg. § 4958-1(d)(4)(iii).

[24] Treas. Reg. §53.4941(a)-1(b)(6). Public charity managers may also rely on the professional advice of certified public accountants or accounting firms with relevant tax law expertise, and independent appraisers or compensation consultants who perform such valuation services on a regular basis, are qualified to make valuations of the particular type of property or services involved, and who provide certifications regarding those qualifications. Treas. Reg. § 4958-1(d)(4)(iii).

[25] Treas. Reg. §53.4958-1(d)(4)(iv).

[26] Treas. Reg. § 53.4958-3(a)(1).

[27] 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. IRC § 6033(a)(2).

[28] IRC § 132(e)

rate executives nor are they able to offer the job protections and benefits available to many government employees.[29] Governing boards should be free to make decisions about the appropriateness of using comparable positions from either government or the for-profit sector to develop a reasonable compensation package in order to attract appropriately qualified managers. Similarly, managers of charitable organizations should have the same option available to them. The Panel notes that there are a number of staff positions that are not possible to fill unless market rates are paid to staff with certain professional and technical qualifications.

Excessive compensation of and benefits to disqualified persons by charitable organizations should be penalized under current excess benefit and self-dealing rules, and the standards for imposition of penalties on both the individuals who receive excessive compensation or benefits and the managers who approve such transactions should be modified to provide a realistic possibility that appropriate penalties will be imposed.

Federal tax laws and regulations should continue to make clear that a board member who in good faith utilizes the approval procedure currently defined in the rebuttable presumption rules or who relies in good faith on the advice of counsel or other appropriate professional advisors generally should not be subject to penalties for approving a transaction even if it later is shown to be improper. These standards should apply uniformly to public charities and private foundations.

To provide boards with a strong incentive to exercise appropriate due diligence in approving executive compensation, penalties should be imposed on managers who "should have known" they were approving an improper transaction, as well as on managers who had actual knowledge that they were doing so. If charged with approving excessive compensation or another improper transaction, board members should continue to be protected from penalty if they can show that they followed the approval procedures outlined in the rebuttable presumption rules to determine the appropriateness of the compensation. Board members who rely upon information from a professional advisor before approving the transaction should similarly continue to be protected from penalty. However, ignorance resulting from a failure to exercise reasonable care should not be a defense.

Executives of charitable organizations bear some responsibility for ascertaining that the compensation they receive does not exceed to any significant degree the compensation provided for positions in comparable organizations with similar responsibilities, operating budgets, qualifications, and cost of living. The process used by the governing board or other authorized body to approve compensation should continue to be relevant in the overall determination of reasonableness, but should no longer shift the burden to the IRS of demonstrating that the compensation is excessive.

First-tier excise taxes imposed on managers and other individuals who improperly benefit from self-dealing or excess benefit transactions must be sufficient to create an effective deterrent. At the same time, provision must be made to abate penalty taxes for inadvertent self-dealing 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

[29] Executives at taxable companies may receive significant compensation in the form of stock or stock option grants and other non-cash compensation. For example, the 2003 Wall Street Journal/Mercer Human Resource Consulting CEO Compensation Survey (www.mercerhr.com), reported that long-term incentives, primarily stock options and restricted stock, represented over 60 percent of total chief executive compensation at large publicly traded U.S. companies in recent years. Government employees also often enjoy significant non-cash benefits. The U.S. Office of Personnel Management notes that federal government jobs generally come with substantial employer contributions to health insurance premiums, 10 paid holidays every year, 13 days of sick leave each year, from 13 to 26 paid vacation days depending on seniority, both a 401(k) type retirement plan and a defined benefit retirement plan, retiree health insurance benefits, and life insurance coverage options. Permanent employees of the federal government may also enjoy certain job protections, such as continuity and security under civil service regulations, receive significant training opportunities, and be eligible to transfer from one location to another without the loss of income or seniority. Office of Personnel Management, Pub. No, EI 61, *Working for the Federal Government—Benefits* (Feb. 14, 2005), www.usajobs.opm.gov.

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 public charity managers and disqualified persons currently may be abated under section 4962.

The practice of providing loans to executives, while infrequent, has created both real and perceived problems for charitable organizations. The Panel discourages charitable organizations from providing loans to staff members, but recognizes that there may be circumstances in which organizations find it necessary to make such loans, for example, to enable a new employee of a charity to purchase a residence near the offices of the charitable organization.[30] The terms of such loans should be clearly understood and approved by the board.

Greater transparency is an essential tool for identifying and adjusting the practices of those organizations that may be providing excessive compensation to disqualified persons. The Forms 990 and 990-PF should be revised to present the full compensation provided to board members, key employees[31], the five most highly compensated employees, and any other disqualified persons. The Forms should provide separate sections for reporting compensation of board officers and members and for compensation of staff and officers of the organization. Compensation information should be presented separately for each group in a chart similar to those required for proxy statements by publicly traded corporations governed by the U.S. Securities and Exchange Commission that lists different types of compensation separately for each individual. This format, accompanied by clear instructions, will become even more important as mandatory electronic filing requirements are implemented and the Forms 990 and 990-PF become a more timely resource for governing boards and regulators to locate comparable compensation data.

Some organizations whose budgets exceed the $1 million budget threshold for application of the full rebuttable presumption procedures still find it difficult to locate salary surveys or other data to establish comparable values for executive compensation within their geographic area or field of operation. Nonetheless, the rebuttable presumption procedures provide a model that will be useful for most organizations in determining the reasonableness of compensation paid to the chief executive officer. The Panel therefore believes it would be a useful reminder if charitable organizations were required to indicate on their Form 990 whether or not they followed these procedures in evaluating the CEO's compensation.

The Panel strongly encourages charitable organizations to adopt as part of their bylaws or governing documents a requirement that the board of directors must approve the compensation of the CEO annually and in advance of payment of the new compensation level. The board may choose to approve a multi-year contract with the CEO that provides for increases in compensation periodically or when the CEO meets specific performance measures, but the Panel encourages boards to

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30 California Corporate Code § 5236 prohibits charitable corporations from making loans of money or property to any director or officer other than financing for the purchase of the principal residence of an officer if the board deems it is necessary to secure or retain the services of that officer and the loan is secured by real property; payments of premiums on a life insurance policy on the life of a director or officer if repayment is secured by the proceeds of the policy and its cash surrender value; advances for expenses that would normally be reimbursed by the corporation; or other loans that are approved by the attorney general.

31 Key employees include the chief executive officer, chief operating officer, chief financial officer, and persons with the authority customary for such positions.

institute some regular basis for reviewing whether the terms of the contract have been met. If the board designates a separate committee to review the compensation and performance of the CEO, that committee should be required to report its findings and recommendations to the full board for approval.

The use of consultants to assist in determining the appropriate range of compensation within a given professional field of practice is still relatively new to the charitable sector. When governing boards use compensation consultants to help determine the appropriate salary for a CEO, the Panel recommends that the consultant be independent and report directly to the board or its compensation committee. Misrepresentations by compensation consultants that lead a board or its compensation committee to provide excessive compensation to the CEO should be reported to the appropriate state consumer protection authorities for prosecution.

While governing boards are responsible for hiring and establishing the compensation of the CEO, the Panel believes it is the responsibility of the CEO to hire other staff to carry out the work of the organization. In order to ensure that the CEO is serving the organization well, boards or a designated compensation committee should review the overall compensation program, including salary ranges and benefits provided for particular types of positions. Such a review will enable the board or its designated committee to assess whether the compensation program is fair and reasonable, and whether additional resources are needed to attract and retain staff.

12. TRAVEL EXPENSES

Introduction

Staff and board members of charitable organizations, like their counterparts in business and government, often need to travel to conduct their work effectively. For organizations that operate or fund programs around the world, travel costs may be a challenge particularly when commercial transportation is not available to targeted destinations. In other circumstances, such as in emergencies, travel costs may be higher than usual because of the difficulty of planning ahead. By law, expenses incurred by charitable organizations, such as transportation, lodging and meal costs, can be reimbursed as long as they are documented to establish that the expenses were incurred in connection with the individual's work for the organization, not his or her personal activities.

Statement of Problem

Media reports have provided examples of what appear to be excessive expenditures associated with travel for charitable organizations. While some of these practices may not have been illegal, they raise questions about whether such expenses are justifiable, leading some to consider proposing setting specific limits on the travel expenses of a charitable organization.

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should:

1. Require charitable organizations to disclose on their annual information returns (Forms 990 or 990-PF) whether or not they have a travel policy.
2. Provide specific information in the instructions to the Forms 990 and 990-PF regarding travel costs that are not permitted or that should be reported as taxable income (including reference to IRS Publication 463: *Travel, Entertainment, Gift and Car Expenses*).

Recommendations for Charitable Organization Action

1. Charitable organizations that pay for or reimburse travel expenses of board members, officers, employees, consultants, volunteers, or others traveling to conduct the business of the organization should establish and implement policies that provide clear guidance on their travel rules, including the types of expenses that can be reimbursed and the documentation required to receive reimbursement. Such policies should require that travel on behalf of the charitable organization is to be undertaken in a cost-effective manner. The travel policy should be provided to and adhered to by anyone traveling on behalf of the organization.
2. Charitable organizations should not pay for nor reimburse travel expenditures (not including de minimis expenses of those attending an activity such as a meal function of the organization) for spouses, dependents, or others who are accompanying individuals conducting business for the organization unless they, too, are conducting business for the organization.[1]

Background

Public charities and private foundations, like taxable organizations, are permitted to pay for or reimburse ordinary and necessary expenses incurred in carrying out their activities, including the costs of travel. Expenses for transportation, lodging, and meals must be documented to establish that they were incurred in connection with the work of the organization and not the personal activities of the individual. The law requires that these expenses not be "lavish or extravagant under the circumstances," though "lavish" and "extravagant" remain undefined in the tax code or in regulations.[2]

Special rules apply to many types of travel-related expenses and reimbursement methods, including per diem payments, car allowances, employer-provided vehicles, security expenses, and travel expenses of spouses or other family members.[3] Specific documentation requirements also apply for travel expenses; for example, proper receipts and an indication of the business purpose of the travel or expenditure must be provided.[4] Taxable organizations also have limitations on

[1] Current law requires that such payments of travel expenditures for spouses, family members, and others accompanying an individual traveling on behalf of the organization must be treated as taxable income to the individual who is traveling on behalf of the organization.

[2] IRC § 162(a)(2); Treas. Reg. §§ 1.162-2, 1.162-17.

[3] Treas. Reg. §§ 1.162-2, 1.132-5.

[4] IRC § 274(d); Treas. Reg. §§ 1.274-5, 1.274-5T.

deductions for meals, entertainment expenses, and some travel expenses.[5]

Travel expenses that are paid or reimbursed but that are not properly documented or are "lavish or extravagant" must be treated as additional taxable compensation to the individual benefiting from them. The law requires public charities intending to treat an expenditure as compensation to provide contemporaneous written substantiation by reporting the amounts on a Form W-2, a Form 1099, or a Form 990, or otherwise documenting such compensation in writing; otherwise, the compensation will be treated automatically as an "excess benefit."[6] Board members and executives of charitable organizations who approve or receive excessive travel benefits are subject to penalties under existing law.[7]

Rationale

Charitable organizations should establish and implement clear travel policies that will guide individuals who may incur travel expenditures while conducting the business of the organization and that will reflect the standards of the organization as to what it considers "reasonable" expenditures. Travel policies should include procedures for properly documenting expenses incurred and their organizational purpose.

While there are occasions on which travel may require the purchase of tickets and accommodations at the last moment and necessitate paying premium prices, as a matter of general practice travel policies should ensure that the business of the organization is carried out in a cost-effective and efficient manner. The same standards for reimbursement of travel expenditures should be applied to the organization's board members, officers, staff, consultants, volunteers, and others traveling on behalf of the organization. Decisions on travel expenditures should be based on how to best further the organization's charitable purposes, rather than on the title or position of the person traveling. As a general practice, charitable funds should not be used for premium[8] or first-class travel. However, boards should retain the flexibility to permit first-class or premium accommodations or travel when it is in the best interest of the organization. Such a policy should be consistently applied and transparent to board members and others associated with the organization. Many organizations have developed policies that allow for such travel if the flight is longer than six hours or if an overnight flight ("red-eye') enables the traveler to sleep during the flight and thereby save time and cost of an overnight stay.

An organization's travel policies should reflect the requirements and restrictions on travel expenditures imposed under current law. For example, policies should make clear that personal use of the organization's vehicles or accommodations is prohibited, unless the expenditure is treated as compensation. Public charities may permit individuals to reimburse the organization for the fair market value of the personal use of its property, though this option is not always available to private foundations because of restrictions on transactions with disqualified persons.

The Panel opposes limiting amounts paid by charitable organizations for travel, meals, and accommodations to the federal government rate or an alternative rate. Establishing arbitrary limits on the travel expenditures that can be reimbursed by a charitable organization would place an unreasonable barrier to many activities of the organization and would place an additional heavy burden on employees and volunteers serving the organization. Federal per diem rates can be a useful guide for charitable organizations, but there are many circumstances in which it is not possible or reasonable to reimburse at federal per diem rates while conducting the business of the organization. In addition, federal government employees are eligible for travel services and are able to secure special rates for travel and accommodations that are not currently available to charitable organizations.

The detailed guidance provided in IRS Publication 463: *Travel, Entertainment, Gift and Car Expenses* should serve as a guide for managers of charitable organizations in avoiding lavish, extravagant, or excessive expenditures. The IRS should reference this guidance in its instructions to the Forms 990. The instructions should also include specific information on when travel expenditures should be reported as compensation.

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5 IRC § 274 and the regulations there under.

6 IRC § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(c)(1).

7 IRC §§ 4941, 4958.

8 "Federal travel regulations define premium class travel as any class of accommodation above coach class, that is, first or business class." U.S. General Accounting Office, Travel Cards: Internal Control Weaknesses at DOD Led to Improper Use of First and Business Class Travel," October 2003 (GA)-04-88).

13. STRUCTURE, SIZE, COMPOSITION AND INDEPENDENCE OF GOVERNING BOARDS

Introduction

A knowledgeable, committed board of directors is the strongest protector of a charitable organization's accountability to the law, its donors, consumers of its products and services, and the public. Most people volunteer for boards because of a commitment to the mission of the organization and the value of the organization's work to society.

Statement of Problem

Failures by boards of directors in fulfilling their fiduciary responsibilities may arise when a board leaves governing responsibility to a small number of people, some of whom may have conflicts of interest that can mar their judgment. Other problems emerge when a board disperses responsibility among many people, thereby lessening the obligations of each and by default, increasing the authority of the chief executive officer. Many board members do not have the training or information necessary to understand adequately their fiduciary responsibilities or common practices for the boards of charitable organizations.

Recommendations for Congressional Action:

Congress should direct the Secretary of the Treasury to amend the regulations:

1. Regarding qualifications for recognition as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code to require a qualifying organization, with certain exclusions,[1] to have a minimum of three members on its governing board.
2. Regarding qualifications for recognition as a public charity (and exemption from private foundation status) under section 509(a) of the Internal Revenue Code to require that at least one-third of the members of a qualifying public charity's governing board be independent, with certain exclusions.[2] Independent board members should be defined as individuals (1) who have not been compensated by the organization within the past twelve months, including full-time and part-time compensation as an employee or as an independent contractor, except for reasonable compensation for board service; (2) whose own compensation, except for board service, is not determined by individuals who are compensated by the organization; (3) who do not receive, directly or indirectly, material financial benefits (i.e., service contracts, grants, or other payments) from the organization except as a member of the charitable class served by the organization; and (4) who are not related to (as a spouse, sibling, parent, or child) any individual described above.
3. To prohibit individuals barred from service on boards of publicly traded companies or convicted of crimes directly related to breaches of fiduciary duty in their service as an employee or board member of a charitable organization from serving on the board of a charitable organization for five years following their conviction or removal.

Recommendation for Internal Revenue Service Action

The Form 990 and 990-PF should be revised to require a charitable organization to disclose which of its board members are independent, according to the definition added to the tax laws by Congress.

Recommendations for Charitable Organization Action

1. Every charitable organization, as a matter of recommended practice, should review its board size periodically to determine the most appropriate size to ensure effective governance and to meet the organization's goals and objectives. All boards should establish strong and effective mechanisms to ensure that the board carries out its oversight functions and that board members are aware of their legal and ethical responsibilities in ensuring that the organization is governed properly.
2. A board of directors should ensure, as a matter of recommended practice, that the positions of chief executive officer, board chair, and board treasurer are

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[1] Excluded from this requirement would be houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS.

[2] Excluded from this requirement would be houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS.

held by separate individuals. If the board deems it is in the best interests of the charitable organization to have the CEO serve as the board chair, the board should appoint a lead director to handle issues that require a separation of responsibilities.

3. The charitable sector should undertake a vigorous effort to provide information and education to its organizations regarding the roles and responsibilities of board members and the factors that boards should consider in evaluating the appropriate size and structure needed to ensure the most effective and responsible governance.

Background

The duties and requirements for directors of charitable organizations are generally determined by the laws of the state in which the organization was founded or incorporated. Some states also have established requirements for boards of directors of organizations that conduct activities, particularly fundraising, within their states. The Revised Model Nonprofit Corporation Act, adopted in 1987 by the American Bar Association's Subcommittee on the Model Nonprofit Corporation Law of the Business Law Section, sets forth basic parameters for the structure and composition of boards. It requires that "a director shall discharge his or her duties as a director, including his or her duties as a member of a committee (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation."[3]

The Revised Act has been adopted in whole or in modified form by 23 states[4] for regulation of tax-exempt entities, including charitable organizations. The original Model Act (developed in 1952) has been adopted in whole or in modified form by six other states and the District of Columbia. The Model Nonprofit Corporation Act is generally enforced by the state attorney general, the secretary of state, or other state officials charged with oversight of charitable and exempt organizations. Where no specific nonprofit corporation rules have been established, the rules for business corporations generally apply to both taxable and tax-exempt entities.

The Model Act stipulates that boards of directors must have a minimum of three members. It sets no maximum number and provides for an organization to set and change the number of directors in its bylaws, so long as there are always at least three directors in place. In practice, some states require only one director for nonprofit corporations, while one state, New Hampshire, requires a minimum of five directors who are not related family members.

The Act also provides for boards of directors to create committees to assist in carrying out the organization's work, unless such committees are prohibited or limited by the organization's articles or bylaws. The Act prohibits board committees from taking particular actions, such as dissolution or sale of the corporation's assets, the election or removal of board members, and adoption or repeal of the corporation's articles or bylaws.[5] It further stipulates that the "creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct"[6] outlined in the Act.

The Act does not prescribe the qualifications of nonprofit board members, nor does it stipulate circumstances that would disqualify individuals from serving on boards. Directors may be removed through judicial proceedings or by a vote of the board if "a director has

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[3] Revised Model Nonprofit Corporation Act, section 8.30.

[4] The Act has been adopted in whole or with modifications in Alaska, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Indiana, Maine, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, Oregon, South Carolina, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming. The original Model Nonprofit Corporation Act developed in 1952 has been adopted as promulgated or modified by Alabama, the District of Columbia, New Jersey, North Dakota, Texas, Virginia, and Wisconsin.

[5] The Act states that committees may not authorize distributions; approve or recommend to members dissolution, merger or the sale, pledge or transfer of all or substantially all of the corporation's assets; elect, appoint, or remove directors or fill vacancies on the board or on any of its committees; or adopt, amend or repeal the articles or bylaws.

[6] Revised Model Nonprofit Corporation Act, section 8.25.

engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation … and removal is in the best interest of the corporation."[7] In judicial proceedings, a court may also stipulate that the director who is removed may be barred from serving on the board for a proscribed period of time.

The Sarbanes-Oxley Act of 2002 sets forth standards for the independence of members of board audit committees of publicly traded corporations; companies registered with the New York Stock Exchange must have a majority of directors who meet the Exchange's definition of "independence." Three states have legislative mandates for the independence of nonprofit boards of directors, although each state has its own definition of "independence."[8]

The Sarbanes-Oxley Act grants the U.S. Securities and Exchange Commission the authority to bar individuals from serving on the boards of publicly traded companies subject to the approval of a federal judge or an SEC administrative law judge. There is currently no prohibition on individuals barred by the SEC from serving on the boards of nonprofit corporations.

Rationale

To be recognized as an organization eligible to receive tax-deductible contributions from the public, an organization should have at least three members on its governing board to fulfill the board's fiduciary responsibilities. Three members allow for deliberation of governance matters and more diversity of thinking on such matters as possible conflicts of interest and self-dealing. This minimum requirement will be a change in law, as well as in practice, for many organizations. Some states allow organizations formed as a corporation (both for-profit and nonprofit) to have a single trustee, and some also permit the formation of a corporation sole.[9] The recommended change in the Internal Revenue Code would require appropriate exceptions for houses of worship and certain affiliated entities, as well as for existing organizations, such as organizations formed as a corporation sole or as trusts with fewer than three trustees, but legislation should clearly specify that organizations formed after a specific time period following enactment of the legislation would be required to have at least three directors.

Experts in nonprofit board governance are not of one mind as to the ideal maximum size of nonprofit boards. They note that size may depend upon such factors as the age of the organization, the nature and geographic scope of its mission and activities, and its funding needs. Some experts note that a larger board may be necessary to ensure the range of perspectives and expertise required for some organizations or to share in fundraising responsibilities. Others argue that effective governance is best achieved by a smaller board, which then demands more active participation from each board member. In the end, each charitable organization must determine the most appropriate size for its board and the appropriate number and responsibilities of board committees to ensure that the board is able to fulfill its fiduciary and other governance duties responsibly and effectively. It would be wise for the sector to make every effort to educate board members and man-

[7] Revised Model Nonprofit Corporation Act, section 8.10.

[8] Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Cambridge, Massachusetts: Belknap Press of Harvard University Press, 2004), pp. 160-161. New Hampshire requires that boards of directors must have at least five voting members "who are not of the same immediate family or related by blood or marriage." Maine and California require that no more than 49 percent of a nonprofit organization's board members be "interested persons." Both define interested persons as individuals compensated by the corporation for services (including full- or part-time employees, independent contractors, or otherwise), other than reasonable compensation provided to a director as a director and spouses or family members of any such compensated individual. Maine also includes any individual entitled to receive income (other than income received as a shareholder of a publicly traded company) from a business entity providing services to the nonprofit corporation.

[9] A corporation sole, created under state law, generally pertains to houses of worship and consists of one person only, and his or her successors in some particular station, such as the bishop or rector of a church. As a corporation sole, certain legal capacities and rights are granted in perpetuity to the individual by right of the particular station he or she holds.

agers about factors they should consider in determining the appropriate size and structure of their board of directors.

Both public charities and private foundations should be required to disclose which of their board members are independent, even though private foundations would *not* be required to have any independent members. Private foundations are subject to stringent self-dealing rules that do not apply to public charities because of the assumption that their boards would not be independent. Many donors to private foundations wish to involve family members on the boards of their foundations to ensure that the donor's philanthropic intentions and the family's philanthropic tradition will continue through future generations. Imposing a requirement that any members or a certain percentage of the members of a foundation's board must be independent could create a disincentive for families to make substantial, long-lasting gifts to the community by creating a private foundation. Such a requirement would also create a significant barrier for corporate foundations whose governing boards generally include officers and employees of the corporation that created and funds the foundation.

Because public charities are not subject to the same strict prohibitions on self-dealing transactions, it is important that at least one-third of their board members be free of the conflicts of interest that can arise when they have a personal interest in the financial transactions of the charity. Individuals who receive compensation for services or who receive material financial benefits from the charity, and their spouses or family members, would have such inherent conflicts of interest and would not be considered to be independent members. Individuals who receive services from the organization as part of the charitable class served by the organization should be considered independent unless they were otherwise compensated by the organization or related to an individual who receives compensation from the organization. The founders of a nonprofit corporation may initially turn to family members, business partners, even neighbors and friends to serve on the board of directors. Finding independent board members can be a particular problem in smaller communities and rural areas. Nonetheless, the effort to find independent members is important to the long-term success and accountability of the organization and should be a legal requirement for public charities that are eligible to receive tax-deductible contributions on the most favorable terms.

In developing legislation to meet this recommendation, the Secretary of the Treasury should be granted authority to develop appropriate exceptions to allow a greater number of employees or directors of a public charity to serve on the boards of subsidiaries or supporting organizations to that charity.

The fact that an individual has been barred from service on boards of publicly traded companies or convicted of a crime directly related to a breach of fiduciary duty in their service as an employee or board member with a charitable organization raises serious concerns about his or her perceived ability to fulfill the fiduciary responsibilities of a board member of a charitable organization. Charitable organizations should be prepared to ask and to remind current and prospective board members about this prohibition; however, the responsibility for resigning or declining board service should rest with the individual who has been prohibited from such service. Individuals who fail to inform the charity that they are ineligible to serve should be subject to a penalty equivalent to penalties imposed on tax preparers for omission or misrepresentation of information.

14. AUDIT COMMITTEES

Introduction

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 to assess the financial controls, policies, procedures, condition of the organization, and oversee the external auditor.

Statement of Problem

While it is the responsibility of the charitable organization board to ensure that the financial matters of the organization are in good order, many boards do not have sufficient expertise or the necessary degree of independence to conduct a thorough audit review.

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 recommended 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, and if state law permits, it may form an audit committee comprised of non-voting, non-staff advisors rather than board members.
2. There should be a sector-wide effort to educate charitable organizations about the importance of the auditing function.

Background

No federal law addresses the role of audit committees of charitable organizations. State laws governing nonprofit corporations generally permit, but do not require, governing boards to delegate their duties, to establish committees, and to rely on their reports.[2]

A California law passed in 2004 requires that the board of every charitable corporation required to register with the attorney general that receives annual gross revenues of $2 million must appoint an audit committee.[3] The board must appoint members of the audit committee, which may include non-board members. The committee members must be independent, meaning they cannot be members of the staff or receive any compensation from the corporation aside from compensation for services as a director and cannot have a material financial interest in any entity doing business with the corporation. If the corporation has a finance committee, it must be separate from the audit committee. The chair of the audit committee cannot be on the finance committee, and members of the finance committee must constitute less than one-half of the membership of the audit committee. Educational organizations, hospitals, and religious organizations are specifically exempted from application of the statute.[4]

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[1] See the Panel's recommendations on financial audits and reviews, page 35, of this report.

[2] Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Cambridge, Massachusetts: Belknap Press of Harvard University Press, 2004), page 431.

[3] California Government Code sec 12586(e)(2).

[4] *Id*.

Rationale

Oversight of the audit function is a critical responsibility of the board of directors, but boards must have the independence to assess the most cost-effective methods for ensuring that the organization's financial resources are managed responsibly and effectively. 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 the board 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.

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. Further, audit committees may be inappropriate for charitable organizations that are organized as trusts rather than as corporations. Therefore, *audit committees should not be defined or required by federal law*.

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

Many organizational leaders, both professional and volunteer, come to the charitable sector motivated by the mission of the organization and may not always have the requisite governance and financial knowledge. However, they may be very responsive to improving practices once they are made aware of the responsibilities expected of them. 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, assessing what the duties of the audit committee should be, and holding external auditors accountable for conducting thorough audits.

15. CONFLICT OF INTEREST AND MISCONDUCT

Introduction

Boards of directors have a responsibility to act in the best interests of the charitable organization they serve and must put their duty to the organization before their individual and private interests. Board members are expected to exercise sound judgment and care in overseeing the organization's business and resolving problems facing the organization. An important 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, as well as suspected cases of malfeasance or misconduct.

Statement of Problem

Some charitable organizations neither understand what a conflict of interest entails, nor have policies to help guide board members, staff, or volunteers in dealing with the apparent or actual conflicts that will inevitably arise. 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. Many within the charitable sector may not be aware of federal and state laws that address conflicts of interest and protect individuals who report suspected wrongdoing.

Recommendation for Internal Revenue Service Action

The Internal Revenue Service should revise the annual information returns filed by charitable organizations (Form 990, Form 990-EZ, Form 990-PF) to require all organizations to disclose whether they have a conflict of interest policy.

Recommendations for Charitable Organization Action

Every charitable organization, as a matter of recommended practice should:

1. Adopt and enforce a conflict of interest policy consistent with the laws of its state 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, facilitate disclosure of information that may help identify conflicts of interest, and specify procedures to be followed in managing conflicts of interest. Special attention should be paid to any transactions between board members and the organization.
2. 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 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.

There should be a vigorous sector-wide effort to educate and encourage all charitable organizations, regardless of size, to adopt and enforce policies and procedures to address possible conflicts of interest and to facilitate reporting of suspected malfeasance and misconduct by organization managers.

Background

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 he or she may have in a proposed transaction. Some such transactions are illegal, some are unethical, and others may be undertaken in the best interest of the charitable organization as long as certain clear procedures are followed.

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 the organization. All states mandate that directors and officers owe a duty of loyalty to the organization, and that 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.

Some state laws provide protections for employees who report misconduct under specific conditions. The Sarbanes-Oxley Act of 2002 prohibits employment-related retaliation by all entities—including charitable organizations—against whistleblowers who provide information on certain financial crimes delineated under federal law.

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 responsibility, 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.

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.*

SECTION IV

Work to be Completed by the Panel for a Supplemental Report

When the Panel on the Nonprofit Sector first convened last October, it recognized that the complexity and the number of issues that needed to be addressed might require more time for study and deliberation than the targeted deadline for this report. In its letter of response to Senators Grassley and Baucus on October 12, 2004, INDEPENDENT SECTOR noted that there likely would be a supplemental report to Congress in the fall of 2005 to address those issues that required more detailed consideration and so would not be ready for inclusion in the final report. In the coming months, the Panel will continue its examination of the issues listed below to provide further recommendations for actions that will strengthen good governance, ethical conduct, and effective practice in charitable organizations.

1. Financial Reporting and Transparency, including:

- **Improvements to the Forms 990 and 990-PF** so they facilitate more accurate reporting by charitable organizations and are more useful to regulators, donors, and the public;
- **Ways to achieve uniform financial standards** that will be widely used by charitable organizations of all sizes in areas such as the accounting of fundraising costs, of restricted funds, and of pledges for future contributions; and
- The definition of, standards for, appropriate levels of, and reporting of **administrative expenses** by both public charities and private foundations.

2. Possible Changes in the Legal Framework, including:

- The regulation and tax-exempt status of **credit counseling organizations**;
- Upgrading federal standards for **prudent investment** of funds by charitable organizations to correspond to changes in state laws;
- Expansion of **federal court equity powers** and the standing to sue members of governing boards of charitable organizations;
- Federal regulation of **nonprofit conversions** currently regulated by state laws;
- Rules and reporting requirements for charitable organizations that **operate or fund programs outside the United States**;

- Requirements for registration and financial reporting by public charities and their professional fundraisers by state and federal regulators to determine whether actions are needed, either by federal or state government or charitable organizations, to develop more uniform, cost-effective methods for **regulating charitable fundraising activities**; and
- State and federal regulation of **charitable trusts**, compensation of institutional trustees, and other issues unique to trusts and institutional trustees.

3. Accreditation and Standard-Setting, including:

- **Examination of accreditation and standard-setting systems and practices for charitable organizations**, including the characteristics that make an accreditation or standards system most effective and which standards or systems might work best for all or particular types of charitable organizations.

4. Improving Governance and Compliance, including:

- **Sample conflict of interest policies, travel policies, and other organizational policies** to identify and prevent wrongdoing and to improve management and governance practices; and
- **Educational programs and tools** to assist charitable organizations in strengthening governance and accountability and public understanding of the work of charitable organizations.

SECTION V

Summary of Recommendations for Congress, the Internal Revenue Service, and Charitable Organizations

The Panel on the Nonprofit Sector's recommendations are clustered together here according to actions to be taken by:

- Congress;
- the Internal Revenue Service; and
- charitable organizations.

Each of these recommendations is discussed in detail in Section III (pages 23-82) of this report. The detailed discussions note important exceptions for organizations of particular types and sizes, as well as other conditions that must be considered in implementation of these recommendations.

Recommendations for Congressional Action

To improve enforcement of current and proposed laws and regulations, Congress should:

- Increase the resources allocated to the IRS for oversight and enforcement of charitable organizations and also for overall tax enforcement.
- Authorize funding to be provided to all states to establish or increase oversight and education of charitable organizations. Congress should authorize additional supplemental funding for states willing to provide matching dollars for further improvements in oversight and education.
- Amend federal tax laws 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.

To improve the quality of information available to government regulators and the public, Congress should:

- Authorize funding to enable the IRS to move forward with mandatory electronic filing of all Form 990 series returns as expeditiously as possible and to coordinate its electronic filing efforts with state filing requirements.
- Amend federal tax laws to permit the IRS to require all charitable organizations to file their Form 990 series returns electronically, with appropriate accommodations to allow charitable organizations to comply with e-filing requirements in a timely, cost-effective manner.
- Direct the IRS to 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 of the organization, or, if it is a trust, by one of its trustees.
- Amend federal tax laws to require 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 with basic contact and financial information.
- Amend federal tax laws to require charitable organizations 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.
- Amend federal tax laws to extend 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 to preparers of Form 990 series returns.
- Direct the Secretary of the Treasury to require that Form 1023, the application for recognition as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code, be filed electronically.
- Amend federal tax laws to require charitable organizations with at least $1 million or more in total annual revenues to conduct an audit and attach audited financial statements to their Form 990 series returns, and to require organizations with annual revenues between $250,000 and $1 million to have financial statements reviewed by an independent public accountant.
- Direct the Secretary of the Treasury to specify in regulations that the audited statements should be made available to the public on the same basis as the annual information returns.

To strengthen the legal framework governing donor-advised funds and to prevent possible abuses, Congress should amend federal tax laws to:

- Define and regulate donor-advised funds, including aggregate minimum distributions, minimum fund activity requirements, and prohibition of private benefit transactions.
- Impose sufficient sanctions on donors, advisors, and related parties to prevent violations of the proposed prohibitions. Penalties should also be imposed on managers who knowingly approve of payments and transactions that violate the prohibitions if enacted.
- Allow a charitable deduction for a contribution to a donor-advised fund only if the donor has a written agreement with the sponsoring charity confirming that the sponsoring charity has exclusive legal control over the fund and that neither the donor, the advisor, nor any related party may receive any substantial benefit in return for or in connection with a distribution recommendation.
- Require sponsoring charities to obtain from the donor or advisor a certification for each recommended distribution stating that no substantial benefit will be received by the donor, the advisor, or any related party in exchange for or in connection with the recommended distribution.
- Require sponsoring charities to send to each recipient of a grant from its donor-advised funds a grantee acknowledgement indicating that acceptance of the grant signifies that no substantial benefit has been or will be provided to (1) the donor, advisor, or any party that is related to the donor or advisor (if the identity of the donor or advisor is known by the grantee charity) or (2) any individual other than those in the charitable class of persons served by the grantee charity.

To strengthen the legal framework governing Type III supporting organizations and prevent possible abuses, Congress should direct the Secretary of the Treasury to amend the regulations to ensure that contributions to Type III supporting organizations are used to benefit the supported organization(s), and not to benefit the donor by:

- Requiring each Type III supporting organization to distribute annually to or for the benefit of its supported organization(s) an amount equivalent to 5 percent of its net assets, excluding assets used directly to support the charitable purposes of the supported organization(s).
- Prohibiting grants, loans, compensation, and any other payments from a Type III supporting organization to, or for the benefit of, the donor or any related party.
- Prohibiting Type III supporting organizations from supporting organizations that are controlled by the donor or a related party.
- Requiring each Type III supporting organization to provide each of its supported organizations with a copy of its governing documents at the time it applies for exemption and whenever there are changes to such documents; a copy of its annual Form 990; and an annual report of its activities, including narrative, financial detail, and, specifically, a description of the support provided, how it was calculated or determined, and a projection of support to be provided in the subsequent year.
- Prohibiting Type III supporting organizations from supporting more than five qualified entities.
- Requiring that Type III supporting organizations formed as trusts must demonstrate a close and continuous relationship with the governing board or officers of the supported organizations and that, as a result of such relationship, the supported organizations have a significant voice in the operation of the Type III organization.

To prevent participation by charitable organizations and other tax-exempt entities in abusive tax shelters, Congress should:

- Clarify the requirements for tax-exempt entities to report participation in listed and other reportable transactions and impose penalties for knowing failure to disclose such participation.
- Require taxable participants in and material advisors to a reportable transaction to notify tax-exempt participants in writing in advance that they would be engaging in a reportable transaction. The new law should impose severe penalties on taxable participants who fail to provide such notification prior to commencement of the transaction.
- Ensure appropriate sanctions are imposed on charities and other tax-exempt entities that participate in abusive tax shelters.
- Require the IRS to provide clear, up-to-date, readily accessible information on listed and other reportable transactions to enable organizations and individuals to determine whether a transaction is potentially abusive and whether they are under an obligation to disclose participation in a transaction.

To address concerns that some taxpayers have overestimated the value of donated property when calculating tax deductions, Congress should:

- Strengthen the definition of a qualified appraisal and a qualified appraiser for purposes of substantiating the value of deductions claimed for donated property.
- Direct the Secretary of the Treasury to prescribe by regulation that a qualified appraisal for contributions of real estate claimed to have a value of more than $100,000 must be prepared by a state general certified real estate appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).
- Expand penalties on taxpayers who claim a tax deduction for donated property to include a penalty of 10 percent of the amount of the tax not properly paid if the claimed value of the donated property exceeds the correct value of the property by 50 percent or more.
- Impose new penalties on appraisers who knowingly overstate the value of property in appraisals used to substantiate tax deductions.
- Mandate electronic filing of Forms 8282 and 8283 as soon as feasible, and require donors to complete information on the appraised value, including the name of the appraiser, before asking the charity to substantiate that it received the donation and to indicate the condition of the property when it was received.

To address specific concerns regarding improper tax deductions for conservation or historic façade easement donations, Congress should:

- Enact into law the current regulatory requirement that deductions for conservation or historic façade easement donations be reduced by any financial or economic benefits the taxpayer receives as a result of the donation, including any increase in the value of other property owned by the taxpayer or by any person related to the taxpayer.
- Allow deductions for conservation or historic façade easement donations only if they are made to a qualified charity or government entity under the terms of a written agreement specifying the restrictions on the future use of the property once the donation is accepted.
- Direct the Secretary of the Treasury to amend regulations to define a qualified charity as a publicly supported 501(c)(3) organization with a primary purpose of environmental protection or historic preservation and with the commitment and resources to manage and enforce the easement restrictions.
- Impose penalties on charities that fail to enforce conservation or historic façade easement agreements in proportion to the nature of the violation and the damage to the resources that were to be protected under the easement agreement. Authorize the Secretary of the Treasury to waive the penalty when a change in the conditions surrounding the property makes it impractical to enforce the easement restrictions.

To address concerns regarding board members of charitable organizations who benefit from or approve excess benefit and self-dealing transactions, including excessive compensation transactions, Congress should:

- Impose penalties on board members and other managers of charitable organizations who approve self-dealing or excess benefit transactions, including excessive compensation, not only if they knew that the transaction was improper but also if they "should have known" that it was improper—that is, if they failed to exercise reasonable care, such as following the "rebuttable presumption" procedures or other appropriate processes, in determining the reasonableness of compensation.
- Direct the Secretary of the Treasury to amend regulations to provide that if the appropriate authorized body has met the "rebuttable presumption" procedures for the transaction, an organization manager's participation in a transaction will ordinarily not be subject to penalty, even though the transaction is subsequently held to be a self-dealing or excess benefit transaction.
- Increase penalties on foundation board members who are found to receive excessive compensation to 25 percent of the excess amount, and retain the current requirement to repay the excess amount to the organization.
- Increase penalties on board members of charitable organizations who approve self-dealing or excess benefit transactions, including excessive compensation.
- Prohibit loans to board members by public charities.[1]

To address concerns regarding excessive compensation and inappropriate benefits to officers and other disqualified persons of charitable organizations, Congress should:

- Require executives and other "disqualified persons" who are charged by the Internal Revenue Service with receiving excessive compensation to demonstrate that the compensation they receive is reasonable.
- Increase penalties on foundation executives and other disqualified persons who are found to receive excessive compensation to 25 percent of the excess amount, and retain the requirement to repay the excess amount to the organization.
- Increase penalties on managers of charitable organizations who approve of self-dealing or excess benefit transactions, including excessive compensation.

[1] Private foundations are already prohibited under self-dealing laws from making loans to board members.

To ensure that the boards of charitable organizations meet minimum standards necessary to fulfill their fiduciary responsibilities, Congress should:

- Direct the Secretary of the Treasury to amend the regulations regarding qualifications for recognition as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code to require a qualifying organization, with certain exclusions, to have a minimum of three members on its governing board.
- Direct the Secretary of the Treasury to amend the regulations regarding qualifications for recognition as a public charity (and exemption from private foundation status) under section 509(a) of the Internal Revenue Code to require that at least one-third of the members of a qualifying public charity's governing board be independent, with certain exclusions.
- Direct the Secretary of the Treasury to amend the regulations to prohibit individuals barred from service on boards of publicly traded companies or convicted of crimes directly related to breaches of fiduciary duty in their service as an employee or board member of a charitable organization from serving on the board of a charitable organization for five years following their conviction or removal.

The Panel recommends that Congress should not take action on the following proposals:[2]

- Congress should *not* require charitable organizations to file an additional report every five years.
- Congress should *not* authorize the Internal Revenue Service to require charitable organizations to report more detailed statements of program evaluations or performance measures.
- Congress should *not* limit deductions for contributions of clothing or household items to an arbitrary ceiling without a clear basis for establishing the amount of the ceiling and an assessment of the impact of the change on the level of charitable contributions.

Recommendations for Internal Revenue Service Action[3]

The IRS should revise the format and instructions for the Form 990 series returns to ensure accurate, complete, timely, consistent, and informative reporting, and to provide clear information needed by state and federal regulators to enforce laws governing charitable organizations. Specifically, the Forms should require that:

- All supporting organizations indicate whether they are operating as a Type I, II, or III supporting organization. In addition, each Type III supporting organization should be required to attach to its Form 990 and to its initial letter of application for exemption a letter from each organization it supports verifying that the organization has agreed to be supported.
- Organizations that hold donor-advised funds disclose the total number of donor-advised funds they own, the aggregate value of assets held in those funds at the end of the sponsoring charity's fiscal year, and the aggregate contributions to and grants made from those funds during the year.
- Organizations that hold conservation easements certify annually on their Forms 990 that the organization has established and implemented reasonable written procedures for monitoring compliance with the terms of the easements it holds and that it has adequate resources to enforce those restrictions. Organizations should file with their Forms 990 a list of all donations of conservation easements the organ-

[2] Ideas included in the Senate Finance Committee staff discussion draft, 108th Congress (June 2004), and/or the Joint Committee on Taxation report (January 27, 2005).

[3] Many recommendations included in the section on recommendations for congressional action pertain to giving additional authority or resources to the IRS to enable it to take further action.

ization hold, setting forth the location of the property, the acreage, the purpose of the easement, the year the easement was donated, and whether there has been any modification in the easement.

- Organizations that make grants or financial awards to other organizations provide the name, city, and state of the grantee, the amount awarded, and the purpose of the grant. Grants to individuals should be reported on a separate schedule with the amount of the grant, the name of the grantee, and any relationship between the grantee and any person or corporation with an interest in the reporting organization.
- Organizations that provide compensation to their board members disclose the full amount of and reasons for compensation paid to any board member and indicate the method used to determine the reasonableness of compensation.
- All organizations disclose which of their board members are independent, according to the definition added to the tax laws by Congress.
- All organizations disclose the full compensation paid to its chief executive officer and other officers. Compensation reports on the Forms 990 should clearly distinguish between base salary, benefits, bonuses, long-term incentive compensation, deferred compensation, and other financial arrangements or transactions treated as compensation (for example, interest-free loans or payment of a spouse's travel expenses) to the individual. Organizations should also be required to disclose whether the organization followed the "rebuttable presumption" procedures in determining the reasonableness of compensation provided to the CEO.
- All organizations disclose compensation paid to the five highest compensated employees and to all employees who are related to a board member or officer of the organization if they are paid more than $50,000 (including benefits) in the tax year.
- All organizations that must have their financial statements audited complete the Forms 990 using the same accounting method used to prepare their audited financial statements. The instructions for reporting of fundraising costs of public charities should incorporate the rules for allocation of joint costs set forth in American Institute of Certified Public Accounts (AICPA) SOP 98-2. A parent organization with affiliates subject to its supervision and control and covered by the same group exemption should be given the option to file consolidated returns, provided that all other criteria for filing a group return are met.
- All organizations indicate whether they have a conflict of interest policy and a travel policy. The instructions to the Forms 990 should provide specific information regarding travel costs that are not permitted or that should be reported as taxable income (including reference to IRS Publication 463: Travel, Entertainment, Gift and Car Expenses).

The IRS should further revise the Form 990-PF to distinguish between expenditures related to charitable program-related activities, grantmaking activities, general administrative operations, and investments.

To improve the quality and accuracy of filed returns, the IRS should enforce existing financial penalties imposed on organizations or organization managers for failure to file complete or accurate returns, with appropriate provision for abatement of penalties if the errors and omissions are unintentional.

To address concerns about excessive deductions based on improper valuations of donations of clothing and household items, the IRS should establish a list of the value that taxpayers can claim for specific items of clothing and household goods, based on the sale price of such items identified by major thrift store operations or other similar assessments.

Recommendations for Charitable Organization Action

Charitable organizations should encourage state legislatures to incorporate federal tax standards for charitable organizations, including prohibitions on excess benefit transactions, into state law.

The board of a charitable organization should, as recommended practice or in accordance with the laws of its state:

- Review the Form 990 or 990-PF filed by its organization annually.
- Undertake a full review of its organizational and governing instruments, key financial transactions, and compensation policies and practices at least once every five years.
- Include individuals with some financial literacy in its membership.
- Incorporate into the organization's bylaws, articles, charter, or other appropriate governing documents a requirement that the full board must approve, annually and in advance, the compensation of the CEO,

unless there is a multi-year contract in force or there is no change in the compensation except for an inflation or cost-of-living adjustment.
- Ensure, if it chooses to use a compensation consultant to evaluate the compensation of the CEO, that the consultant is independent and hired by and reports to the board or a designated board committee.
- Review, or have its compensation committee review, the organization's staff compensation program periodically, including the salary ranges for particular positions and the benefits provided.
- Review its size periodically to determine the most appropriate size to ensure effective governance and to meet the organization's goals and objectives.
- Ensure that the positions of chief executive officer, board chair, and board treasurer are held by separate individuals. If the board deems it is in the best interests of the charitable organization to have the CEO serve as the board chair, the board should appoint a lead director to handle issues that require a separation of responsibilities.

The Panel discourages payment of compensation to board members by charitable organizations. In cases where compensation is deemed necessary due to the complexity of board responsibility, the time commitment involved in board service, and the skills required for the particular assignment, among other factors, the board should review information on compensation provided by organizations comparable in size, grantmaking or program practices, geographic scope, location, and responsibilities (for example, number of meetings, length of terms, and number of domestic or international site visits expected) to determine the reasonableness of any compensation. Boards that do provide compensation should, as a recommended practice, make available to peer organizations on request relevant information that would assist in reviewing the reasonableness of board compensation policies.

Each charitable organization should, as a recommended practice:
- Provide detailed information about its operations, including methods used to evaluate the outcomes of programs, and other statements available to the public through its annual report, website, and other means.
- Provide the city of residence of each board member, along with his or her full name, on its annual Form 990 or 990-PF.
- Establish and implement policies that provide clear guidance on its travel rules, including the types of expenses that can be paid for or reimbursed and the documentation required.
- Prohibit payment or reimbursement of travel expenditures (not including de minimis expenses of those attending an activity such as a meal function of the organization) for spouses, dependents, or others who are accompanying individuals conducting business for the organization unless those individuals are also conducting business for the organization.
- Adopt and enforce a conflict of interest policy consistent with the laws of its state and tailored to its specific organizational needs and characteristics.
- Establish policies and procedures that encourage individuals to come forward with credible information on illegal practices or violations of adopted policies of the organization. The policy should specify that the organization will protect the individual who makes such a report from retaliation.

Charitable organizations that hold donor-advised funds should provide further information to interested parties about the donor-advised funds they own, including the names of all funds, and should recognize that there is great interest in the community in donor-advised funds and how such funds are distributed.

The charitable sector should undertake vigorous, sector-wide efforts to:
- Educate, in partnership with the IRS and state oversight officials, charitable organizations about financial transactions that are potentially abusive tax shelters and the additional reporting requirements and risks such transactions may pose.
- Provide information and education to organizations on the roles and responsibilities of board members and the factors that boards should consider in evaluating the appropriate size and structure needed to ensure the most effective, responsible governance.
- Educate charitable organizations about the importance of the auditing function.
- Educate and encourage all charitable organizations, regardless of size, to adopt and enforce policies and procedures to address possible conflicts of interest and to facilitate reporting of suspected malfeasance and misconduct by organization managers.

SECTION VI

Glossary of Terms

501(c)(3).
See Section 501(c)(3).

Annual Information Return.
See Form 990, Form 990-EZ, Form 990-PF.

Appraisal
An assessment of the value of any type of property (clothing, household goods, art, land) by an authorized person.

Asset Parking.
See Parking of Assets.

Audit.
See Financial Audit.

Charitable Organization
Any tax-exempt organization recognized under section 501(c)(3) of the Internal Revenue Code. In this report, charitable organization refers to both public charities and private foundations.

Community Foundation
A tax-exempt organization that generally holds a number of permanent funds created by many separate donors, all dedicated to the long-term charitable benefit of a specific community or region. A community foundation is generally recognized as a public charity, and is therefore not subject to the more stringent rules that apply to private foundations. Typically, a community foundation provides grants and other services to assist other charitable organizations in meeting local needs, and also offers services to help donors establish endowed funds for specific charitable purposes.

Compensation
All forms of cash and non-cash payments provided in exchange for services or products. In reporting compensation paid to a board member or employee, organizations are expected to include salary or wages, bonuses, severance payments, and deferred payments; retirement benefits, such as pensions or annuities; fringe benefits; and other financial arrangements or transactions treated as compensation (for example: personal vehicle, meals, housing, personal and family educational benefits, low-interest loans, payment of personal or spouse travel, entertainment, or other expenses, and personal use of the organization's property).

Note: The definitions in this section are intended to give the reader the general meaning of the terms as used in this report, and are not meant to take the place of legal analysis.

Conflict of Interest Policy

A conflict of interest arises when a board member or staff person's duty of loyalty to the charitable organization overlaps with a competing personal interest he or she may have in a proposed transaction. Some such transactions are illegal, some are unethical, and others may be undertaken in the best interest of the charitable organization as long as certain clear procedures are followed. A conflict of interest policy helps protect the organization by defining conflict of interest, identifying the classes of individuals within the organization covered by the policy, facilitating disclosure of information that may help identify conflicts of interest, and specifying procedures to be followed in managing conflicts of interest.

Conservation Easement

A legal agreement between the owner of a building or land and a charitable organization or government agency that permanently restricts how the property can be used for the purpose of serving specific conservation purposes, such as conservation of a significant natural habitat for an endangered or protected animal or plant community or protection of a certified historic structure or area that meets criteria set by the National Register of Historic Places. *See also* Partial Interest Donation.

Corporate Foundation

A private foundation that receives its primary funding from a profit-making business. The foundation is a separate, legal charitable organization even though it often maintains close ties with the founding company, and it must abide by the same rules and regulations as other private foundations. Also known as a company-sponsored foundation.

Disqualified Person

For public charities, a disqualified person is someone who, at any time during the five-year period ending on the date of the transaction in question, was "in a position to exercise substantial influence over the affairs of the organization." Any member of a disqualified person's family falls into this category, as does any entity in which one or more disqualified persons together own, directly or indirectly, more than a 35 percent interest. For private foundations, the definition of a disqualified person includes all of the above as well as substantial donors, owners of more than 20 percent of a corporation, trust, or partnership that is a substantial contributor to the foundation, and the family members of any of these persons. Certain government officials are also considered disqualified persons.

Donor-Advised Fund

Although there is currently no legal definition of a donor-advised fund, it is generally considered to be a fund created by an irrevocable gift to a charitable organization, in which the donor (or an advisor designated by the donor) has the right to provide non-binding recommendations to the charitable organization regarding distributions from the fund and, less commonly, the investment of its assets. The charitable organization that owns the fund (referred to in this report as the "sponsoring charity") has a fiduciary obligation to ensure that donor-advised assets are used exclusively for charitable purposes.

Due Diligence

The degree of prudence that a reasonable person is expected to exercise in reviewing a particular transaction or investment opportunity before deciding to act. *See also* Fiduciary Duty.

Excess Benefit Transaction

An economic benefit provided by a public charity to a disqualified person that is determined to be in excess of the value of the services or property received in exchange by the public charity. *See also* Disqualified Person, Intermediate Sanctions, Section 4958, Section 4941.

Excise Tax

A tax that applies to a specific type of income, activity, good, or service. For example, foundations are subject to an excise tax on net investment income.

Fair Market Value

The IRS defines fair market value as "the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts. If there is a restriction on the use of the property (such as a conservation easement), the fair market value price should reflect that restriction." (IRS Publication 561, *Determining the Value of Donated Property*)

Fiduciary Duty

The legal responsibility for investing money or acting wisely on behalf of another. Members of the governing board of a charitable organization have a fiduciary duty to act in the best interests of the organization.

Financial Accounting Standards Board (FASB)

A professional standards board created by accountants to establish standards of financial accounting—known as Generally Accepted Accounting Principles or GAAP—and reporting in the private sector, including charitable organizations. FASB provides the standards officially recognized by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. FASB operates under the auspices of the Financial Accounting Foundation, a public charity, and its work is primarily funded by mandatory fees paid by issuers of securities.

Financial Audit

A formal examination of an organization's financial records and practices by an independent, certified public accountant with the objective of assessing the accuracy and reliability of the organization's financial statements. An audit must follow standards set forth by the American Institute of Certified Public Accountants to be recognized as credible.

Financial Review

An examination of an organization's financial records and practices by an independent accountant with the objective of assessing whether the financial statements are plausible. A financial review does not involve the extensive testing and external validation procedures of an audit and generally provides less credibility than an audit. A review offers a lower-cost method of providing some assurance to board members and other managers of an organization that the financial systems and statements are in reasonable order.

First-Tier Tax

The initial excise tax imposed on disqualified persons who engage in self-dealing with, or who receive excess benefits from a charitable organization, and the board members and other managers who approve of such transactions.

Form 990 Series

Used in this report to refer to the three forms (Form 990, Form 990-EZ and Form 990-PF) filed annually with the IRS by charitable organizations. By law, a charitable organization must make its forms (with required schedules attached) publicly available.

Form 990

The IRS form that tax-exempt organizations (other than private foundations) that have annual revenues of $100,000 or more or total assets above $250,000 must file annually to report on their financial and program operations. Religious congregations and specific related institutions, specified government agencies, and other organizations identified by the IRS are exempt from this filing requirement.

Form 990-EZ

The IRS form that tax-exempt organizations (other than private foundations) which have annual revenues of $25,000 up to $100,000 or total assets between $100,000 and $250,000 must file annually to report on their financial and program operations. Religious congregations and specific related institutions, specified government agencies, and other organizations identified by the IRS are exempt from this filing requirement.

Form 990-PF

The IRS form that all private foundations are required to file annually to report on their financial and program operations.

Form 1023 Application for Recognition of Exemption Under Section 501(c)(3)

The IRS form filed by organizations to obtain recognition of exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code. Its filing is mandatory for all charitable organizations that want to be tax-exempt, except for religious congregations, certain organizations affiliated with religious congregations, and charitable organizations that have gross receipts in each taxable year of normally not more than $5,000.

Form 8282
The IRS form that charitable organizations must file if they sell or dispose of donated property valued at $5,000 or more (based on the value claimed by the donor on Form 8283) within two years of receiving the donation.

Form 8283
The IRS form that taxpayers must file with their annual tax return if they claim deductions for non-cash contributions with a total value of $500 or more. If the value of any single donated item or collection of items is valued at $5,000 or more, the taxpayer must have the Form signed by the appraiser who certified the value of the property and the charitable organization that received the donation.

Form 8868
The IRS form that a tax-exempt organization must file to obtain an extension of time for filing its annual information return. The organization must file the Form both to obtain an initial, automatic three-month extension of the filing deadline and to obtain an additional three-month extension that is available at the discretion of the IRS.

Generally Accepted Accounting Principles (GAAP)
The accounting principles set forth by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) that guide the work of accountants in reporting financial information and preparing audited financial statements for organizations.

Intermediate Sanctions
The name given to Section 4958 of the Internal Revenue Code that allows the IRS to impose penalties on the individuals who benefit from or approve an excess benefit transaction, rather than penalizing the organization. Prior to the passage of this law in 1996, the IRS's only penalty for such transactions was to revoke the tax-exempt status of the organization, thus these "intermediate sanctions" offer penalties that stop short of this severe sanction on the organization. Intermediate sanctions rules apply to all 501(c)(3) organizations (except private foundations) and to organizations exempt from taxes under section 501(c)(4) of the Internal Revenue Code. *See also* Excess Benefit Transactions, Rebuttable Presumption.

Joint Committee on Taxation (JCT)
A committee consisting of five members of the U.S. Senate Committee on Finance and five members of the U.S. House Committee on Ways and Means and that employs a technical staff to assist Congress with federal tax matters. Its duties include investigating the effects of taxes, exploring methods for simplification of taxes, making reports to Congress on the results of such studies, and providing revenue estimates for all tax legislation considered by either the House or Senate.

Nonprofit Organization.
See Tax-Exempt Organization.

Non-Operating Foundation
A private foundation that furthers its charitable purposes primarily by making grants to support charitable programs conducted by other organizations. *See also* Operating Foundation.

Office of Management and Budget (OMB) Circular A-133
The instructions provided by the Office of Management and Budget (OMB) regarding audits of states, local governments, and nonprofit organizations that receive federal funding. Under OMB Circular A-133, nonprofit organizations that receive $500,000 or more in federal grants per year must have their financial statements audited.

Operating Foundation
A private foundation that uses the bulk of its income to provide charitable services or to run charitable programs of its own, as opposed to making grants to other organizations. *See also* Non-Operating Foundation, Private Foundation, Public Charity.

Parking of Assets
Parking occurs when an individual contributes assets to a donor-advised fund, thereby receiving an income tax deduction, but those funds are not distributed for charitable purposes within a reasonable amount of time. Also known as "asset parking."

Partial Interest Donation
A contribution where the donor does not give up the full rights of ownership to a property or business, but donates certain rights to the property to a charitable organization. For example, partial rights could include the right to build on the property, to restrict access to the property, or to use certain natural resources on or from the property.
See also Conservation Easement.

Payout

The minimum amount that private foundations are required to expend for charitable purposes, including grants to outside organizations, operations of charitable programs, and reasonable and necessary administrative expenses. In general, the annual payout from a private foundation must be at least 5 percent of the average market value of its total assets.

Premium Travel

According to federal regulations, premium travel is any class of accommodation above coach or economy class, such as first or business class. Airline companies do not all use the same term to describe non-economy class of travel.

Private Foundation

A charitable organization under IRS Section 501(c)(3), typically established by a single individual, family, or company, that receives more than two-thirds of its support from its founders or from investment income earned by an endowment. Private foundations are subject to substantially more restrictive rules than public charities governing their operations, and their donors receive less favorable tax treatment for contributions. If a public charity fails to meet its "public support test" of receiving at least one-third of its income from the public in the form of contributions and grants, it is generally reclassified as a private foundation. *See also* Public Charity.

Public Charity

A charitable organization, recognized under IRS Section 501(c)(3), that receives at least one-third of its support from a broad segment of the general public.

Rebuttable Presumption

A rule under intermediate sanctions law that delineates procedures a public charity must follow in order for the IRS to presume that the compensation the charity provided to a disqualified person(s) in return for services or property is reasonable. The IRS may "rebut" this presumption by presenting evidence showing the compensation was excessive. The rules call for compensation to be approved in advance by the board (or other authorized committee) and further specifies that the members must not have a conflict of interest with respect to the transaction. The board must use information such as salary surveys, appraisals, or other appropriate data to help determine comparability or fair market value of the compensation, and it must also document the basis for its decision. *See also* Disqualified Person.

Responsiveness Test

This "test" sets forth certain requirements that a Type III supporting organization must meet to establish that it has a close, ongoing relationship with the organizations it supports.

Round-Tripping

A practice whereby a public charity distributes assets of a donor-advised fund that were contributed by a private foundation back to the private foundation, thereby circumventing the purposes of the payout requirement imposed on private foundations. *See also* Payout.

Sarbanes-Oxley Act of 2002

Signed into law in July 2002 in response to financial mismanagement by some corporations, the Sarbanes-Oxley Act imposes new obligations and penalties on corporate officers and directors of publicly traded companies and mandates increased disclosure by corporations to the Securities and Exchange Commission. For example, publicly traded companies must have an independent audit committee and CEOs must certify financial statements. Penalties for non-compliance include imprisonment and fines. Two specific provisions apply to all entities (including nonprofits): prohibitions on destruction of litigation-related documents and on retaliation against whistleblowers who identify specific types of financial wrongdoing.

Self-Dealing

Any financial transaction between a private foundation and its disqualified persons, other than reasonable compensation for services. Such self-dealing transactions, even those that provide a below-market rate benefit to a disqualified person, are prohibited under Section 4941 of the Internal Revenue Code. *See also* Disqualified Persons, Excess Benefit Transaction.

Section 170
The section of the Internal Revenue Code that sets forth the rules taxpayers must follow to claim tax deductions for contributions to charitable organizations.

Section 4941
The section of the Internal Revenue Code prohibiting self-dealing transactions for private foundations and imposing excise taxes on disqualified persons who participate in and managers who approve such transactions. *See also* Disqualified Persons, Self-Dealing.

Section 4958
The section of the Internal Revenue Code prohibiting excess benefit transactions by public charities and imposing excise taxes on disqualified persons who participate in and managers who approve such transactions. *See also* Disqualified Persons, Excess Benefit Transaction, Intermediate Sanctions.

Section 4962
The section of the Internal Revenue Code that permits the IRS to abate penalties on charitable organizations and their managers who engaged in certain illegal activity if the actions were due to reasonable cause (not willful neglect) and if they corrected the problem within a certain time period. This section does not permit the IRS to abate penalties imposed on private foundations and their managers for self-dealing transactions (under section 4941a of the Internal Revenue Code).

Section 501(c)(3)
The section of the Internal Revenue Code that defines tax-exempt organizations eligible to receive tax-deductible contributions. To qualify, an organization must be operated exclusively for charitable, religious, educational, scientific, or literary purpose, to name a few examples. 501(c)(3) charities are further defined as public charities or private foundations. *See also* Private Foundation, Public Charity.

Section 509(a)
The section of the Internal Revenue Code that defines the rules for determining that an organization is a public charity (as opposed to a private foundation) and thereby eligible to receive tax-deductible contributions on more favorable terms.

Sponsoring Charity
The charitable organization that owns a donor-advised fund.

Substantial Contributor
A donor who contributes more than $5,000 to a private foundation and whose gift is also more than 2 percent of the total contributions received by the private foundation in that year is considered a substantial contributor, and is thus deemed a disqualified person. *See also* Disqualified Person.

Supporting Organization
A public charity that is organized and operated to support other specified public charities, and is therefore not required to demonstrate that it receives at least one-third of its support from a number of unrelated donors (as do most other public charities). There are three categories of supporting organizations: Type I, Type II, and Type III. Each of these organizations must meet a specific legal test designed to ensure that the organization(s) being supported has some influence over the actions of the supporting organization. *See also* Type I, Type II, and Type III Supporting Organization.

Tax-Exempt Organizations
Organizations that meet an approved tax-exempt purpose and thus do not have to pay federal and/or state income taxes, except with respect to income earned by a trade or business that is unrelated to the purpose for which the organization was granted tax-exemption. The Internal Revenue Code defines more than 25 categories of organizations that are exempt from federal income taxes, including charities, business associations, labor unions, fraternal organizations, and many others. Whereas other types of nonprofit organizations benefit the private, social, or economic interests of their members, charitable organizations must benefit the broad public interest and Congress has therefore provided, with very limited exceptions, that only those charities organized under section 501(c)(3) are eligible to receive tax-deductible contributions. *See also* Charitable Organization, Private Foundation, Public Charity.

Type I Supporting Organization
A public charity organized and operated exclusively for the benefit of one or more other public charities and that is controlled by the public charity or charities it supports, usually through the appointment of a majority of the directors or trustees of the supporting organization.

Type II Supporting Organization
A public charity organized and operated exclusively for the benefit of one or more other public charities of which the majority of directors or trustees also serve as directors, trustees, or officers of the supported organization.

Type III Supporting Organization
A public charity organized and operated exclusively for the benefit of one or more other public charities, which has a close relationship with one or more of the supported organizations through an overlapping officer, director, or trustee (or a close and continuous working relationship between its officers, directors, or trustees and those of one or more of the supported organizations), and which provides sufficient support to one or more of the supported organizations to ensure their attentiveness to the supporting organization's activities.

Uniform Management of Institutional Funds Act (UMIFA)
Model legislation put forward in 1972 by the National Conference of Commissioners on Uniform State Laws to govern the management and expenditure of investment assets held by charitable organizations. UMIFA has been adopted in some form by most states and the District of Columbia. Generally, UMIFA is not applicable to charitable trusts.

Uniform Standards of Professional Appraisal Practice (USPAP)
The generally accepted standards for professional appraisal practice in North America. USPAP contains standards for all types of appraisal services, including real estate, personal property, business, and mass appraisal. USPAP is recognized in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 as the generally accepted appraisal standards required for use in federally related transactions. USPAP is also the required standard for most state appraiser certification boards and appraisal trade associations.

U.S. Securities and Exchange Commission
An agency of the federal government with the primary mission of protecting investors and maintaining the integrity of the securities markets, including overseeing key participants in the securities world, promoting disclosure of important information, enforcing the securities laws, and protecting investors who interact with these various organizations and individuals.

Whistleblower Protection Policy
A policy to encourage staff and volunteers to come forward with credible information on illegal practices or violations of adopted policies of the organization. The policy specifies that the organization will protect the individual from retaliation. It also identifies those staff or board members or outside parties to whom such information can be reported. The Sarbanes-Oxley Act requires all entities—including nonprofit organizations—to protect whistleblowers identifying certain types of financial misconduct against retaliation.

SECTION VII

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,

Chuck Grassley

Charles E. Grassley
Chairman

Max Baucus

Max Baucus
Ranking Member

INDEPENDENT SECTOR

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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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