S. HRG. 109–207

CHARITIES AND CHARITABLE GIVING: PROPOSALS FOR REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 5, 2005

Printed for the use of the Committee on Finance

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CHARITIES AND CHARITABLE GIVING: PROPOSALS FOR REFORM

TUESDAY, APRIL 5, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Snowe, Thomas, Santorum, Bunning, Rockefeller, Jeffords, Lincoln, Wyden, and Schumer.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thanks to everybody for coming.

This hearing is on two very important subjects. The first is strengthening the role of charities in this country. The second is closing the tax gap that relates to charities and to charitable gifts.

Last week, the commissioner of the Internal Revenue Service came out with the preliminary findings on the tax gap. The news is not good. We continue to have a tax gap of well over $300 billion a year. That is the difference between the amount of tax voluntarily paid and the amount of tax that should be paid.

Like a loaf of bread, the tax gap is made up of many slices. There is not one specific problem or issue that makes up the whole. If we are going to close the tax gap, then we are going to have to do so one slice at a time.

In one particular area, we become familiar with the problem of individuals taking big tax deductions based on estimates, often pie-in-the-sky estimates, for gifts of closely held stock, in addition to the real and tangible property that is given to charity.

What we see too often is the charity receiving a very small amount of support, at best, from this kind of gift. At the same time the taxpayer gets a tremendous benefit from the tax deduction.

I have here a Spring Bok from South Africa. [Laughter.] Unfortunately, some people think that its name is really a "free buck." The Spring Bok is known for its ability to leap when startled. I was surely startled myself when we learned of this new tax scam.

The story in this morning's *Washington Post* makes me think that many people think that the "tax" in taxidermy is meant to allow them to write off safaris to Africa as tax deductions if they give away the stuffed animal.

This type of scam gives new meaning to the term "tax gaming." I expect the Internal Revenue Service to be very active in big game hunting when it comes to this particular type of tax shelter.

So, Mr. Commissioner, I would suggest the next head that needs to be mounted—figuratively, of course—is the appraisers who have been promoting this sort of scam. This taxidermy problem is just one example of what we are seeing too often when it comes to certain tax deductions for gifts to charities. Similar problems with valuation exist throughout the tax code. Finding solutions is part of slicing away at the tax gap.

Now, the second aspect of today's hearing is strengthening the charitable sector. From the earliest days of European settlements, charity has been central to our national character.

In his sermon to the Puritans sailing to the Massachusetts Bay Colony, John Winthrop said that they would be "creating a city upon a hill for all to see." The Reverend Winthrop said that "to succeed in a new land, the Puritans needed to be a model of Christian charity."

The years between then and now have proven the importance and the value of the ethic of giving. Today's tax code recognizes the importance of charities and helping those in need. It provides tax-exempt status to charitable organizations and tax deductions for charitable giving.

Congress, the administration, and the charitable sector itself are all obliged to make certain that these tax preferences are used as intended. Congress has not taken on serious review of tax-exempt organizations since 1969, and that is the year that man first walked on the moon.

Today, I am submitting for the committee record a letter from our good IRS commissioner Mark Everson. Mr. Everson's letter to Senator Baucus and me makes it clear that a lot has changed since 1969.

Congress must revisit the laws in this area to make sure that it is charity that benefits from the laws rather than the private interests.

Last year, the Finance Committee had a hearing and a roundtable discussion on this subject. We considered a staff discussion paper. Since then, we received the Joint Committee on Taxation's thoughtful proposal in this area, and the IRS commissioner's detailed observations.

We have also engaged the charity sector, which is providing recommendations and reactions to the nonprofit panel. It is my hope that, in the near future, the Finance Committee can move legislative reforms that will strengthen charitable governance and address this part of the tax gap.

Those revenues can offset the costs of what we know as the CARE Act, which has been under the able leadership and advocacy of Senator Santorum. I am confident we can consider a mark that will take meaningful steps to address this part of the tax gap, help see that charities act in the interest of their charitable purpose, and, finally, engage in charitable giving. Today's hearing gives committee members an opportunity to explore these matters in detail.

In the absence of Senator Baucus, who was necessarily delayed, I call upon Senator Rockefeller for a statement for the Minority.

[The letter from Commissioner Everson appears in the appendix.]

OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER IV, A U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Thank you, Mr. Chairman. I am very pleased that you have called this meeting. Just from listening to your statement, as an average citizen, I would guess about 50 percent of foundations were cheating and 50 percent were doing good work.

I find that most unfortunate, because there is no mention made, or reference made, except for the second part of the discussion, how to strengthen—and a good deal of John Winthrop—to make foundations stronger.

I know, from very personal experience, that foundations and charities do a tremendous amount of good work. I hope that our panelists, if they so feel, will reflect on that.

In a time when maybe one of the great scams of all time is the enormous tax cuts which have been given to people without anything at all required in return, and now the effort to make them permanent, forever, while we struggle with Social Security, Medicaid, and Medicare—that is kind of an interesting thing, too.

I also assume that when the chairman spoke about $300 billion of shortfall, that he was not just referring to foundations, but he was referring to the number of people in other groups that do not pay taxes. It was not clear from his statement.

The CHAIRMAN. But you are right. It includes everything.

Senator ROCKEFELLER. Yes.

I have a lot of experience with foundations, a lot with my own family. I have worked a lot with foundations. I am on a lot of foundation boards now that have to do with my State of West Virginia, having to do with research on Alzheimer's, having to do with economic development, having to do with a whole lot of different areas of the State that need help that do not get, and will get much less, help from the Federal Government in the coming years.

I find a lot of these organizations to be absolutely excellent and to be doing things that others are not, and making possibilities for people that the government will not, or chooses not to do.

For example, the Bennendom Foundation is an enormously powerful and wonderful foundation in West Virginia. They do untold good. They are based in Pittsburgh, but, happily, Michael Bennendom was born in West Virginia and the greater part of that money goes to West Virginia. Most of the private and public colleges and universities in West Virginia could not operate without the Bennendom Foundation and what they have done in the past.

The Greater Kennaw Valley Foundation, the Eastern West Virginia Community Foundation, the Nature Conservancy in West Virginia all are doing excellent work in my home State.

In the past couple of years, we have seen reports of some indefensible abuses of the nonprofit sector for personal enrichment. I take these problems very, very seriously. I would also like to take them in perspective.

I want to fix those problems, but I want to fix those problems in a way which does not discourage foundations from continuing to operate or individuals' instincts, which are needed now more than ever, both for public service in a non-financial way, and for public service in a financial way for those who can afford to do that.

I am concerned that Congress may inhibit charities' abilities to fulfill their missions if we impose unreasonable—I think we have to impose some very reasonable—strictures on hiring, compensation, administrative expenses, or reporting. For example, we must take into consideration the vast differences between organizations, some of which provide direct services and will naturally have higher administrative costs.

I also want to be careful not to discourage charitable gifts from individual citizens. Indeed, this Congress has approved legislation to try to encourage charitable giving, and I assume did so for a reason, and I do not think we should move unreasonably in the opposite direction now.

Many of the proposals that the committee is considering will dramatically improve the transparency of nonprofit organizations. I happen to think that this is a very good way that we can guard against abuse and fraud at foundations and charities, where they exist, by requiring nonprofit entities to file more complete information with the Internal Revenue Service and by making more of this information available to the public. The government also, and the media also, and the donor community can provide valuable scrutiny to ensure that organizations are truly fulfilling their charitable missions according to all the laws.

I am very pleased that the representatives of nonprofit organizations with whom I have met have encouraged Congress to improve disclosure requirements for the nonprofit community. I believe that we can work together to do something reasonable and proper in this respect.

As we have seen in the recent case of the Nature Conservancy, when questionable behavior is brought to light, organizations can act aggressively, and do act aggressively, to reform and protect against abuses. In fact, I will go further.

The government standard now in place at the Nature Conservancy is considered the gold standard for nonprofit governance, and I applaud them for their recent actions. They went through a bad patch, but they did what they needed to do and they have come out very well.

Concerning one of the most important consequences of greater disclosure is the opportunity for the IRS to directly review whether organizations' actions are consistent with their missions.

I am interested in strengthening the enforcement abilities of the IRS to make sure that it can provide effective oversight, and I will have questions with respect to the people that you have to do that.

I am looking forward to today's witnesses about how Congress can help eliminate fraud and abuse conducted under the guise of charity, where that exists. We must prevent nonprofit organizations from benefitting from abusive tax shelters. We also ought to make certain that wealthy individuals are not able to game the system by taking charitable deductions for schemes that provide little or no real public benefit.

I believe, in closing, Mr. Chairman, that we can take what I would call prudent steps—I have always found that a comforting phrase—to eliminate unethical practices in the nonprofit sector, and we need to be reasonable, forceful, and accurate about those prudent steps.

Then we will really be doing a favor to many, many high-quality ethical organizations—they want this—that do so much good every day, not just in my State, but all across the world. So, I look forward to this committee's striking the right balance, and I thank the Chairman.

The CHAIRMAN. Thank you.

Our first panel is going to provide us with an overview of the problems and possible——

Senator SANTORUM. Mr. Chairman?

The CHAIRMAN. Senator?

Senator SANTORUM. Would it be appropriate if I just make a couple of brief comments?

The CHAIRMAN. Senator Santorum.

OPENING STATEMENT OF HON. RICK SANTORUM, A U.S. SENATOR FROM PENNSYLVANIA

Senator SANTORUM. Thank you. I will ask that my full statement be made a part of the record.

The CHAIRMAN. I suppose it is legitimate, since you are the sponsor of the CARE Act, and because of your leadership in this area. Proceed.

Senator SANTORUM. Well, I thank you, Mr. Chairman. I am a sponsor of the CARE Act, and I feel very, very strongly about the role of nonprofits in our communities across America, and obviously introduced the CARE Act because I would like to see more resources go to these very organizations which are out there meeting educational, human services, and other needs to those who are less fortunate in our society.

As I have spoken with the Chairman in the past, I have some very serious concerns about some of the initiatives that are being put forward by the committee. I just want to make mention of a few that I have very serious concerns about.

The reason I have concerns is not because the committee has not shown that there are some problems out in the nonprofit world. There are problems everywhere. The question is, has there been adequate enforcement? I think that is really what we should be focusing on.

I wrote a letter to Secretary Snow recently and asked him whether these problems, many of which have been raised in previous hearings and the newspapers, could be handled simply through increased enforcement.

His response to me was, it is too soon to tell. That does not sound like a ringing endorsement for moving forward on a broad array of new proposals to potentially hamper the ability of nonprofits to be able to meet their charitable missions.

So I think we really do need to look at enforcement. I got a letter recently from an organization that looked at the 94 instances of "abuse" that were cited in the June 22, 2004 hearing.

[The letter and other supporting materials appear in the appendix on p. 279.]

I am told that all but two, actually, are illegal under current law, of these abuses that have been cited. So, is there a need for additional legislation here when what seems like the overwhelming problem is inadequacy of enforcement by the IRS in this area?

Again, I am willing to sit down and look. I think there are many in the nonprofit community and those who are concerned about this who would like the opportunity to have some input. I just wanted to put my marker down here that I do have some concerns.

I have concerns about taxation of fraternal organizations and what that would mean to their ability to be able to do the good works that they do. A lot of them are in my State and do a lot of wonderful things for the community.

There are some concerns out there, and I appreciate the Chairman's leadership in bringing some of those concerns to light. I can tell you from the standpoint of having worked with a lot of nonprofits in my career here in the U.S. Senate, those nonprofits who are out there doing the good work want this cleaned up too, because it hurts them. It hurts their ability to go out and fund-raise. It hurts their ability to go out and meet their mission.

So, they want the bad actors cleaned out just as bad as, I think, members of this committee would like to see it done. We want to do so without hampering their ability to meet their charitable mission. I think that is what the Senator from West Virginia just said, and I will look forward to working with him, as well as the Chairman, in making sure we have a nice, balanced approach here.

Thank you, Mr. Chairman.

The CHAIRMAN. Yes. I think if you get a chance to study the Commissioner's letter, you will find out that it is not just enforcement, but it is also the need of some change in legislation.

[The prepared statement of Senator Santorum appears in the appendix.]

The CHAIRMAN. Now to our panel.

We have Commissioner Everson. I particularly want to thank you, Commissioner, because you and your staff have sent this very thorough letter to Senator Baucus and me regarding these problems. I commend you for this letter and commend it to everybody who is interested in this issue. I would say, without question, it is one of the most thoughtful and thought-provoking letters that I have received from an agency of the Federal Government.

We also have Mr. George Yin, Staff Director for the Joint Committee on Taxation. His organization, earlier this year, responded to a request of Senator Baucus and me for proposals in dealing with the tax gap.

His report and findings will be part of a more detailed hearing focusing on that tax gap coming up April 15. However, today we are asking Mr. Yin to comment on the extensive recommendations made on improving tax compliance in the areas of charity and charitable giving.

Then we have Mr. Leon Panetta, who has distinguished himself as a member of Congress and as a member of the previous administration, and now is connected with the Panetta Institute in California, and also is associated with various nonprofit panels.

Finally, we have the attorney general of the State of Minnesota, Mike Hatch. It is important that the Finance Committee, as we consider reforms, bear in mind the roles that States traditionally have played in attending to charities carrying out their mission, and also take this opportunity to learn from the States.

Unfortunately, there are only a handful of States that are active in the area of charities. But we are pleased, today, to have you, General Hatch, with us, because you have been a leader in this area, and particularly in the area of tax-exempt foundations.

Now, we are going to depart a little bit from our usual 5 minutes because Commissioner Everson and Mr. Yin both have been given 10 minutes because they have an extensive amount of material to cover. We have asked them to be very thorough.

Then we will have the traditional 5 minutes for oral statements. Everybody's written statement, regardless of how long, will be incorporated into the record.

So, Mr. Everson?

STATEMENT OF HON. MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. EVERSON. Mr. Chairman, distinguished members of the committee, I do not think I will use all that time, but certainly we can cover a lot of details in the questioning.

Thank you for inviting me here today. I am pleased to be a part of this panel, particularly with Mr. Panetta. He demonstrates to me that there is life after OMB, although I am not sure that there is life after OMB and the IRS. [Laughter.] So, we will see.

I commend you for bringing attention to the need for reform within the charitable sector. I share your admiration for the work undertaken by this sector and believe that the overwhelming majority of charitable organizations do their utmost to comply fully with the letter and spirit of the tax law.

But we are now at an important juncture. As I discussed with you last spring, and as I discuss at length in my written testimony, problems exist. Simply stated, there are increasing indications that the twin cancers of technical manipulation and outright abuse that we saw develop in the profit-making segments of the economy are now spreading to pockets—pockets, I would say, Senator Rockefeller—of the nonprofit sector.

The government recognizes the challenges in this area and is moving to address them. We welcome the Finance Committee's work and the work of the Joint Committee to determine what help the IRS might need as we augment our efforts in the tax-exempt arena.

Similarly, it is heartening to see leading members of the nonprofit community itself taking steps to address abuses. I congratulate the Panel on the Nonprofit Sector convened by the Independent Sector for delivering a constructive report calling for strengthening the accountability of charities and foundations.

I wish the accounting, legal, and business communities had been as enthusiastic about confronting abuses and the erosion of professional ethics when corporate governance problems and the proliferation of shoddy tax shelter promotions first became evident.

The extent of our concern is such that we have made determining abuse within tax-exempt and governmental entities, and the misuse of such entities by third parties for tax avoidance or other unintended purposes, one of our four service-wide enforcement priorities, and we are dedicating resources to this task.

Although the IRS budget for fiscal year 2005 increased by only one-half percent, we have boosted our budget for exempt organization examinations by over 20 percent.

The President's 2006 budget requests an additional $14.5 million to further step up our activities in the tax-exempt sector. Our focus areas include those about which the committee has publicly raised concerns: abusive tax avoidance transactions, supporting organizations, conservation easements, and the seemingly high level of compensation for officers and directors of charities and foundations, to name a few.

We are beginning to see results. For example, in the area of credit counseling, we are on record that too many of these organizations are operating for the benefit of insiders who are improperly in league with profit-making companies. We have responded aggressively and now have more than half the tax-exempt credit counseling industry, in terms of revenues, under examination.

We have either revoked or proposed the revocation of tax-exempt status for 20 percent of the industry, again, measured by revenues. We are moving in the right direction, but I know that we are by no means done and need to continue our work.

Before closing, I would like to raise three points for your consideration. First, while the nonprofit sector has grown and become more complex, there has been little change in the law.

An overall review of the rules is timely. In particular, we need to ask whether the IRS has the flexibility it needs to respond to compliance problems. We are too frequently forced to choose between inconsequential penalties, on the one hand, or the nuclear option, revocation of tax-exempt status, on the other. De minimis penalties may have little impact on the troublesome behavior, and revocation may not be in the public interest.

Second, we need to promote transparency through more electronic filing. The Interim Report of the Panel on the Nonprofit Sector supports mandated electronic filing for all 990 returns.

I must note, however, that at present the IRS does not have the authority to mandate electronic filing for organizations that file fewer than 250 returns annually. This severely reduces the number of exempt organizations that can be required to file electronically. The administration supports reducing the 250 return threshold. I hope that this is part of any reform discussion.

I also believe there should be a discussion of sharing enforcement information with other agencies, particularly State regulators. You need only look at our recent work with the States on abusive tax shelters to see how valuable an active partnership can be. I know this committee has previously supported information sharing in your CARE legislation. I hope that this is a topic in the coming review.

To put a finer point on information sharing, I return to credit counseling organizations. It seems unconscionable to me that the FTC and the State of Minnesota must do their important work in

this area without the full benefit of our audits and criminal investigations.

Moreover, as you listen to Mr. Johnson on the next panel, think how we could work with the State of Tennessee as they tackle abusive cases like the one he describes.

Mr. Chairman, I admire the energy you, the committee, and your staffs are bringing to this topic. If we do not act to assure the integrity of the nonprofit sector, there is a risk that Americans will lose faith in charitable organizations. If that happens, they will stop giving, and those who need will suffer.

Thank you.

The CHAIRMAN. Thank you, Mr. Everson.

[The prepared statement of Mr. Everson appears in the appendix.]

The CHAIRMAN. Now, Mr. Yin?

STATEMENT OF GEORGE K. YIN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Mr. YIN. Thank you very much, Mr. Chairman and members of the committee. It is a pleasure to testify today about the exempt organization proposals in the recent Joint Committee on Taxation's staff report on options to improve tax compliance and reform tax expenditures. As the Chairman indicated, the report was a response to a request of the Chairman and the Ranking Member.

As the Chairman asked, I will briefly highlight today the proposals dealing with charitable contributions, and then turn to those concerning the operation of exempt organizations.

In the case of charitable contributions, the report focuses on the most significant area of potential noncompliance, namely, the valuation of non-cash charitable gifts.

Under present law, taxpayers are entitled to deduct the fair market value of most charitable gifts of capital gain property to a public charity. When property value is uncertain, this rule presents compliance burdens for the taxpayer, noncompliance opportunities, and law enforcement difficulties.

As Commissioner Everson's written testimony indicates, challenging taxpayer valuations is a very resource-intensive task for the IRS. Even a preliminary determination that the amount of a deduction may be questionable requires an up-front commitment of resources. If a serious challenge is to be made, more resources are needed to secure alternate appraisals and opinions.

Adding to the problem is the fact that the interests of the donor and the donee are generally aligned, with each party therefore willing to give the donor's claimed value the benefit of the doubt.

The staff report contains several options intended to improve compliance for charitable contributions of property. The report does not propose changing the current law rules with respect to cash gifts or gifts of publicly traded securities which do not present valuation concerns.

First, in general, for contributions of appreciated property, the report proposes that the tax deduction be equal to the taxpayer's basis in the property. This is the present law rule for gifts to most private foundations, as well as gifts of certain property to public charities.

In most cases, basis is a more certain amount than fair market value and subject to easier proof by the taxpayer and verification by the IRS. Thus, this option could be expected to improve compliance, reduce burdens and disputes, and lessen the amount of IRS enforcement effort.

The general treatment of gifts of property just discussed would not be helpful for gifts that have depreciated in value, such as clothing and household items. In such cases, the deduction is limited to the value of the property. Thus, a determination of value is still necessary.

The relatively small value of any item of clothing or household good makes it unlikely that the IRS challenges many of these deductions, leaving taxpayers with significant flexibility in valuing such gifts.

Moreover, taxpayers may have a natural tendency to over-value such items due to their attachment to them. Because this situation is vulnerable to error and noncompliance, the report proposes that, at a minimum, the potential amount of error should be capped. Thus, the report suggests limiting the deduction of gifts of clothing and household goods to $500 per year.

In the case of conservation easements, a rule limiting the charitable deduction to the taxpayer's basis in the easement is of no help in easing the potential noncompliance problem. If a deduction is to be allowed for such easements, a determination of value is still necessary.

For several reasons, determining the value of conservation easements may be even more difficult than in the general case. First, the value of the interest given away is a function of the contract terms crafted by the donor and will vary from case to case. There may be few, if any, comparables to help determine value.

Second, conservation easements constitute only a partial interest in the property rights held by the taxpayer, meaning that valuation must consider the taxpayer's continuing interest in the property after the gift.

Third, in many cases, taxpayers who make these contributions are already subject to significant State and local restrictions on the use of their property. Such restrictions vary considerably from jurisdiction to jurisdiction, and would have to be taken into account in valuing the easement.

Because these valuation difficulties present the greatest challenge in the case of easements placed on property used by the taxpayer as a personal residence, the report proposes that no deduction be allowed for such contributions.

For other gifts of easements, the report proposes limiting the deduction to 33 percent of the value of the easement, or in the case of historic structures, to the lesser of that amount, or 5 percent of the value of the structure.

Moreover, the gift must be pursuant to some clearly articulated Federal, State, or local government policy in favor of the conservation objective. The report also proposes heightened appraisal standards and requirements in the case of these contributions.

The second broad category of noncompliance in the exempt organization area is in the operation of the organization. An organiza-

tion that is granted exemption from Federal income tax warrants exemption not as a matter of right, but as one of privilege.

To maintain exemption on an ongoing basis, organizations are required always to conduct their operations in a manner that is consistent with the basis of the exemption.

Under present law, organizations are required to obtain a determination from the IRS that they are tax-exempt as a charity and, thus, eligible to receive deductible contributions.

However, once charitable status is granted, it rarely is revoked. There is no mechanism in present law requiring a periodic review of the basis for an organization's charitable status.

The report proposes to change this situation by requiring that every 5 years charitable organizations other than churches file information that would enable the IRS to determine whether the organization continues to be organized and operated exclusively for exempt purposes.

The proposal will apply to new organizations and those receiving charitable status within 10 years of enactment of the proposal.

Related to the issue of an organization's ongoing basis for tax-exemption is the effect of a public charity's dissolution, or other termination, of exempt status. Federal tax law requires that, upon dissolution, the charitable assets of the organization continue to be dedicated to charitable purposes, yet there is no Federal enforcement mechanism of this requirement in the case of public charities.

In order to provide the Federal Government with a means to enforce the dedication to charity requirement, the report proposes a termination tax on liquidation or conversions of a public charity. The tax would also apply to private foundation terminations. The tax could not be recovered against assets held by the charity for charitable purposes.

The proposal also is designed to ensure that when insiders are involved in the acquisition of a charitable organization, the acquisition is subject to the present law rules that tax abusive insider transactions.

One of the primary compliance concerns in tax law today is abusive tax shelters. The increasing involvement of exempt organizations as accommodation parties in tax shelter transactions contributes to the erosion of the tax base by improperly extending the benefit of the tax exemption to non-exempt parties.

The report provides for an excise tax on the participation by any exempt organization, not just charitable organizations, in listed or certain reportable transactions.

Under the proposal, if an exempt organization participates in such a transaction knowing, or with reason to know, that the transaction is prohibited, the entity is subject to tax of 100 percent of the entity's net income attributable to the transaction.

If the exempt entity is eligible to receive deductible contributions, the Treasury Department may suspend eligibility for 1 year. The entity-level tax does not apply to certain pension plans and similar tax-favored accounts.

An excise tax would also apply to the entity managers that approve the entity's participation in the transaction. A lesser penalty would apply in cases in which an exempt organization participates

in a transaction that is later determined by the Treasury Department to be a prohibited tax shelter transaction.

Mr. Chairman, I see my time is about up. I know you have a number of witnesses. I appreciate very much the time you have given to my testimony.

Let me just assure the committee that we will continue to examine potential areas in the exempt organization area, as well as other areas, where noncompliance concerns may be present.

The CHAIRMAN. Thank you, Mr. Yin.

[The prepared statement of Mr. Yin appears in the appendix.]

The CHAIRMAN. Now, our former colleague, Mr. Panetta.

STATEMENT OF LEON PANETTA, DIRECTOR, PANETTA INSTITUTE FOR PUBLIC POLICY, CALIFORNIA STATE UNIVERSITY, SEASIDE, CA

Mr. PANETTA. Mr. Chairman, thank you. It is a pleasure to be back visiting with a number of my old friends on this panel.

I testify here in my capacity as a member of the Citizens Advisory Group to the Panel on the Nonprofit Sector. The panel was convened at your encouragement and, as you know, issued this interim report which helps to, I think, identify some of the steps that need to be taken in order to ensure that these organizations meet higher ethical standards.

During the course of my career, I have had the opportunity, obviously, to work with and review the work of charities, foundations, and nonprofits from the perspective as a member of Congress, Director of the Office of Management and Budget, Chief of Staff to the President, and now as a co-director with my wife of a nonprofit institute that tries to encourage young people to get into public service.

Whether large or small, these organizations—and there are some 1.3 million charities, foundations, and religious congregations—I think are absolutely crucial to fulfilling the needs of the Nation.

Alexis de Tocqueville recognized the unique role of citizens working together to care for one another, to build communities. Let me quote from de Tocqueville: "Americans of all ages, all stations of life, and all types of disposition are forever forming associations. Where in France you would find the government, or in England, some territorial magnate, in the United States you are sure to find an association." He recognized the importance of these groups to our democracy.

It is true today. American people contribute $201 billion to these organizations, largely because of their independence and their remarkable ability to innovate, to collaborate, to provide services in nutrition, in health, in education, and other areas of social needs, to test creative ideas, to build communities, and to support the arts. They generally do it with less bureaucracy, less red tape, fewer dollars, and bigger bang for the bucks than a government organization.

Today, I think these organizations, I might say, are perhaps more important than ever, and more valuable than ever. At a time of huge deficits, budget cuts, and diminished resources, they are vital to meeting the basic human and social needs that are critical to our democracy.

But to be effective, to justify the Federal and State incentives that are provided to the donors, they must operate with integrity and trust, particularly at a time when trust is being undermined in a number of the basic institutions in our society.

Unfortunately, there have been, and there continue to be, abuses: siphoning off of funds, misuse of dedicated contributions, self-dealing, scams for tax avoidance such as the non-cash contribution scam that was reported in the *Washington Post.*

They represent a small percentage of those organizations, but as always, because of what they do, they undermine trust in the work of the entire nonprofit sector. I join with you in saying that these abuses must be brought to an end.

I commend you for your vigilance and your commitment. I believe that your actions have already encouraged efforts to try to improve this sector. The challenge, as always—and I think all of you understand this—is to find the right balance, the right balance between new laws and regulations, the balance for a need for stronger enforcement by the IRS, and in addition, the need for tougher self-regulation by the nonprofit sector itself.

The panel's interim report provides a framework for this action, and I would commend it to you. Obviously, in terms of actions by the Congress, you have heard suggestions.

I would agree that you have to require audits for organizations over a certain level. You have to define and clarify rules for donor-advised funds, along with a number of other steps relating to conflicts and whistle-blower protections. Our institute has implemented a lot of these on the basis of best practices.

In IRS enforcement, you absolutely have to increase IRS funding. We have been through this, as you know. In the budget negotiations, we always look to the IRS as one of the important factors to try to find needed funds. They ought to be supported because they, in fact, are crucial to the collection of fees and the enforcement of penalties.

I would give them the software to enable electronic filing of the 990 series, as well as allow attorneys general to share in access to the IRS information, with appropriate restrictions.

Lastly, on self-regulation, because in the end you cannot legislate honesty, and all of the good will in the world is simply not enough, to be credible and effective, standards must be enforced by the nonprofit sector. They must be given the authority to investigate, to implement an administrative process, and to enforce penalties. I would strongly recommend that the nonprofit sector establish a national council on nonprofit accreditation.

It would provide standards on governance, transparency, and accountability. It would make the appropriate adjustments so that you meet the diverse needs of small, intermediate, and large organizations.

It would provide the necessary education and training that is so sorely needed. I have to tell you, in this area, most nonprofits have no understanding of the management requirements, the needs that we are seeing with Sarbanes-Oxley.

The importance of self-regulation is that it would relieve the burden of the IRS, or help relieve their burden, it would preserve the

independence of the sector, and, most importantly, would place responsibility where it belongs.

These organizations do public good, they are important to our democracy, but they cannot do this without public trust. I hope you will work with us in establishing that trust.

Thank you, Mr. Chairman.

The CHAIRMAN. We have appreciated the report that the private sector has put out in regard to the nonprofits.

[The prepared statement of Mr. Panetta appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Panetta.

Now, General Hatch?

STATEMENT OF HON. MIKE HATCH, ATTORNEY GENERAL, STATE OF MINNESOTA, ST. PAUL, MN

Mr. HATCH. Mr. Chairman, members of the committee, I submitted a statement. I would like to make a few additional comments.

Nonprofits have changed. We have all changed over the years. Not all of them, but many have. They have grown. They are huge.

Let me put it a different way. All the members of this committee could easily be making more money somewhere else. You are here for a reason. You are here because you are mission-driven. The nonprofit area is the same way. It was started, it began, and it was fostered because of mission-driven people.

But today, many of these nonprofit organizations are very large. There has been lots of merging activity that has gone on. We have now entered the era of the professional executive. That is fine, but sometimes these professional executives lose the sense of mission.

The problem that has been created is that these large nonprofits no longer have accountability tools in place for their stakeholders. If we take a look at other organizations, like city councils, you have accountability by election, by a State auditor, by Freedom of Information Act laws, and by open meeting laws. There are all sorts of restrictions on the public official in terms of accountability, even though I think most people go into politics or government because of a mission-driven sense. It does not matter what political party, they are mission-driven.

Public stock corporations also have accountability. The executives are accountable to a board and, like it or not, there are institutional investors that have the stock that make the board accountable. Plus, in a public corporation, there is a pretty easy measurement gauge, namely profit. If you are not making a profit, you are out. So, there is a pretty strong accountability standard in a for-profit company.

The hardest group in terms of accountability, however, are nonprofits. There are many stakeholders and many issues that are confronted by the nonprofit executive. But as nonprofits have evolved over time and grown in size and use, for the professional, non-mission-driven executive, the first priority for that executive has now become, what is in it for me? When my office conducted our nonprofit audits—and issued reports on them—we saw some remarkable abuses.

We have seen abuses in big nonprofits as well as small nonprofits. I do not want to cast a broad brush here over all charitable organizations, but there are significant problems. The acts of a few bad apples lose trust for all charitable organizations.

Self-regulation will not do it. The governing board of a nonprofit is the directors. Most of those directors are selected by the executives themselves. They are indebted to the executives when they go on that board. They are mission-driven in some cases. They are not going to pay attention, however, to the finances of a multi-billion or multi-million dollar nonprofit.

In some cases, the board members are community-driven activists who have a sense of mission but do not have the expertise to read, digest, and discuss the financial statements of a charitable organization that may have tens or hundreds of millions of dollars in assets and/or revenue.

In other cases, board members may be executives who do have that sophistication, but very frankly, they are concerned about the mission, too. They know, if they are going to start pulling up rocks on the administrative costs, they are not going to have the executives being friendly to what they want as the mission for that organization.

So, people on the board, when you are dealing with, in some cases, a multi-billion-dollar organization, they simply do not have the time, the ability, or the sophistication to be able to work through the detail that is necessary to demand the accountability from that professional executive.

The reforms you have proposed make sense. For instance, one proposal relates to the conversion of nonprofits. I have seen many occasions where not-for-profits have been converted to for-profits with a huge loss of mission to the public. I have seen examples where for-profits basically manipulate and run a not-for-profit organization.

The nonprofit becomes a virtual shell, paying out all their money in administrative costs, which loses the mission of that organization. You see individual abuses by executives that simply should not be tolerated.

These proposals, I do not think, harm the nonprofit industry, they help it. They reform it. They allow it so that you, and I, and everybody else can make contributions, knowing full well that the best people are involved in that process.

I will leave the rest of my time.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Hatch appears in the appendix.]

The CHAIRMAN. Now we will take 5 minutes in the order people are coming. First of all, me, as Chairman, then Senator Rockefeller, then Senators Jeffords, Wyden, Bunning, and then Senator Hatch. We will have 5-minute rounds.

I am going to start with you, Commissioner Everson, but I would also ask General Hatch to join in.

I read with great interest your discussion in the March 30 letter about compensation. The difficulty of enforcement in this area seems to be great. I also read, Mr. Hatch, your thoughtful comments about high salaries.

There are too often cases of high salaries in the charitable sector that the general public views as outrageous. However, the unfortunate reality is that the law limiting outlandish compensation is too uncertain and difficult for the IRS to effectively administer.

So, could both of you give me your thoughts on this issue in general, as well as whether it would be beneficial for Congress to revisit the current laws if we are going to expect the IRS to be able to effectively deal with the problems of compensation?

In particular, I would also like your views on the Joint Committee on Taxation proposal in this area, and if we should also require organizations to first consider nonprofit comparisons in terms of determining salaries.

Mr. Everson, and then General Hatch.

Mr. EVERSON. Yes, sir. I would be happy to comment on that. We are concerned about compensation. You may remember, last year we actually initiated 2,000 contacts with different organizations on this subject, asking them to explain to us what their compensation policies were, how they reviewed compensation, to try to establish a standard of comparability.

We are in the course of going through that information. So far, we have completed about 500 of those inquiries and we see problems in this area, particularly with loans to people who work in the organizations, and also with other perks. So, it is an issue.

I think the issue is a little bit broader than that, though, because it extends to the dealings with related parties. It is not only compensation that is important here. Someone can have an interest, an indirect interest, in other related parties, something we have seen in the credit counseling organizations.

So, I would suggest that you not limit the scope of your inquiry here or any policy changes to merely compensation. It is a basket of areas. We do think comparability is an important launching point.

I think the Joint Committee has talked about shifting the burden of proof, if you will, on what is reasonable here. That could be something that would be quite workable.

The CHAIRMAN. General Hatch?

Mr. HATCH. Mr. Chairman, the rebuttable presumption of reasonable standard needs to go. One of the problems, particularly in the health care area, the nonprofits, is you have a whole industry of consultants out there who are making money, and a large amount of money, simply pushing up salaries.

Right now, the standard is, as long as you have an outside consultant saying what the salary ought to be, and as long as the board of directors is independent in approving it, you are home free. You have a nice safe harbor there.

The IRS and my office, and no other office, is going to contest it because you have got this rebuttable presumption of reasonableness standard. That has got to go. I mean, the CEO of a for-profit HMO in my State took home $111 million last year.

With that, in a for-profit, basically it is Katie-bar-the-door for every other health care corporation in America, because all they have to do is point to that and they can take all the money they want, and the IRS and the AGO are going to have a tough time dealing with it. That is what they point to.

A not-for-profit is different than a for-profit. They ought to be. They are not acting any differently now, in the health care area. When we audit these hospitals, we are finding they are not doing any charity care. The charity care that they claimed was charity was the bills that they could not collect. It was bad debt.

The for-profits have bad debt as well. They did not even have a charitable list to offer to the people coming into the hospital. They would offer, they would comply, with emergency room treatment and offer it there, but they would hound them afterwards on the collections. There was no charity care.

So, on the salary side of it, again, the nonprofit executive will have a consultant for the board who will point to the salary of the for-profits. But it should be a different standard. A not-for-profit executive is not going to be thrown out if there is not a profit. The not-for-profit executive stays on forever. It is his board. Very rarely are you going to see that kind of a change.

Then you have these consultants going back and forth, displaying the salary statistics of the "median" executive. And of course the board of a nonprofit hospital feels that their hospital is better than average. It is called the "Lake Wobegon" effect. Nobody is going to go on a board who feels that it is below average.

So, as long as you have consultants to tell you that your hospital is above average, and you believe that it is, you are going to award your executives an above-average salary. The consultants then go to the next hospital and point out that we have just got the salaries up at that hospital, and we can get your salary up, too.

And so you have this ratcheting effect. You will see articles out there pointing out that executive compensation in this area is accelerating the highest in the country.

I think it is the highest group in the country. The reason is because of this standard that is being applied. We have created a whole industry of consultants going around increasing the salary.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. General Hatch, that is actually a very interesting statement, and one which I am inclined to agree with.

I do not remember those consultant groups. Back when I was serving on, frankly, some family foundations, it was done from within. Is that a recent development? Because I agree with you.

In public service these days, I mean, all of our constituents think that we are over-paid. It is just that some people cannot afford to keep a home here in Washington and back in some other State that they may be representing.

How long has that been going on?

Mr. HATCH. Mr. Chairman and Senator Rockefeller, I do not know. I am not a historian on it. I can tell you, though, I gave a speech to a group of people, and I made reference to the days of the hospital bake sale. People under 40 did not know what I was talking about. They did not understand that term.

So, something is going on. Something has changed. You will notice, and I suspect when the hospital bake sale went out, in came the professional and in came the consultants.

The rebuttable presumption of reasonableness standard begs for consultants to go out and make a career of getting executive sala-

ries higher. It gives them a nice, safe haven. You use those consultants, and they can up the salary of the executive.

By the way, guess who retains them? Who is the first one to interview these consultants? And who recommends them to the board? Of course, it is the executives whose salaries are going to be increased.

The CHAIRMAN. Just for information, my staff tells me—and I will ask George for verification—but this was a change in the law that came in 1987, Section 4958.

Mr. YIN. It was 1996, Mr. Chairman.

The CHAIRMAN. 1996?

Mr. YIN. And it was part of the intermediate sanctions rules that came in 1996. In our report, we did recommend that that rule be abolished.

The CHAIRMAN. All right.

Give Senator Rockefeller more time. Go ahead.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

This would be to Commissioner Everson. You indicated that the amount of the percentage or the number of people who will be working on these problems—and we all recognize that there are these problems—will be going up by 20 percent, even though, in a sense, the more fundamental statement is that the half a percent increase that you got, because that means that 20 percent, is coming from somewhere else, which is important.

Mr. EVERSON. Yes, sir.

Senator ROCKEFELLER. I will not ask you where it is coming from, because you may not have decided yet.

There is an enormous amount of backlog. I think in Cincinnati you have about a 6-month backlog there in trying to look for people who are applying for tax-exempt status.

Sort of realistically, in the way of what we do in government, so often what we say is, we will just triple the amount of people who are working on that, and then it is not necessary that you get those people or that those people are not siphoned off into other jobs because of priorities that then shoot their public profile up that you have got to go after it.

What is your philosophy on that, and how certain are you that you can get them as it relates to the 6-month backlog? What can they do? I mean, this is a backlog of people applying.

Mr. EVERSON. Yes.

Senator ROCKEFELLER. We are also talking about trying to reduce abuses.

Mr. EVERSON. You are covering a lot of ground there. We start from something that actually goes back to Director Panetta's days at the OMB, when GPRA, the Government Performance and Results Act, first came into play.

We have established a strategic plan that I made reference to before, where we have established these four mutually reinforcing enforcement priorities, one of which gets to the charitable sector and governmental entities.

What that does is, it keeps us focused on the fact that we have to allocate appropriate resources to that task. So as we go forward, that guides our internal decision making within the agency.

When we look at things in this area, you are right. The initial determination is an important task when we look at whether someone deserves this exemption when they come in with a proposal. We get something like 90,000 requests a year for exemption. We have to look at those carefully.

We have just updated the information we request in that context. But we have to balance that work with audits, of course. I would stress to you that audits in this sector are the lowest of anything we do as a percentage.

They are lower than individual audits which, while we have recovered individual audits from 618,000 in the year 2000 to over a million last year, that is still less than 1 percent.

In this sector, they are down less than half a percent. So, that is what we are doing. We are trying to ramp up the audits as well and get current on those determinations.

Senator ROCKEFELLER. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Now, Senator Jeffords?

Senator JEFFORDS. Mr. Everson, I appreciate the work you and your organizations are doing to combat abuse in this area with the limited resources that you have. I think there is a special outrage of the scams involving charities because of the cynical portrayal of public trust.

I realize a precise accounting is impossible, and I wonder if you could give us at least some idea of the revenue impact, even if it is only an educated guess. With the recent update of the tax gap study, I think it would be helpful to get a sense of what share the nonprofit sector might be contributing.

Mr. EVERSON. Yes, Senator. We are now refining the information in the tax gap. What we announced last week, and which will be the subject of the committee's hearings next week, are really the preliminary results that size the overall gap. We have provided a range that we will work to refine as the year goes on.

Deductions are clearly a problem in here. Our information on deductions indicates that, out of the total gross tax gap—which is before the recoveries the IRS gets; we size it at $312 billion to $353 billion—that something in excess of $10 billion, about $15 to $18 billion, is overstatement of deductions by individuals.

Charitable contributions are in there. I would decline at this stage to give you a specific accounting of that until our statisticians have done more work. I have been cautioned many times by them not to get out in front of the results. But this is a contributor to the tax gap, just as the Chairman said.

Senator JEFFORDS. Mr. Yin, I recognize that there may be problems in setting values for real property donations, but I do not accept the notion that only cash in publicly traded securities should receive full value for donations.

Simply put, a farmer donating his land or an easement on his land deserves full value every bit as much as a donor of cash or securities.

The government has no trouble taxing land-based appraisals, so I do not think we can have it both ways. Can you expand on the steps we take, and can take, to improve compliance while still granting full value for such donations?

Mr. YIN. Senator, I would be happy to do that. Our proposal and report was focused on the issue of noncompliance, but obviously we are not oblivious to the policy implications of our recommendations as well.

In the area of charitable contributions, I think the focus of the committee should really be on two things. First, you need to get some sense of, to what extent does the tax benefit actually induce a higher level of giving? Presumably, the policy goal of the committee is to induce a greater amount of giving.

When you examine that, you need to differentiate between an actual permanent level of greater giving as opposed to simply giving in a different form or at a different time, which may be of lesser concern from the committee's standpoint.

The second thing is to say, if we want to induce a certain amount of giving and we want to induce a certain amount of increased permanent giving, what would be the best way to do that from the tax side?

There you need to evaluate the relative efficiency of different mechanisms to provide tax incentives to induce giving. If you provide a mechanism that is susceptible to noncompliance, essentially the cost to the government of the noncompliance portion buys the government nothing. That simply is a waste of taxpayer dollars.

So, if there is some alternative mechanism, either through the tax system or outside of the tax system, that would provide the same degree of additional giving in the charitable sector without the degree of noncompliance, then it is a win-win situation. You have the same degree of charitable giving that you are trying to induce. You have it at a lesser cost to the government, thereby saving the taxpayer's dollar.

So, we are happy to work with you, Senator, and obviously with the committee and your staffs, to see if we can come up with suggestions along those lines.

What we are trying to present here is that property gifts are susceptible to noncompliance, and therefore there is an element there of wasted taxpayer money that buys nothing from the government standpoint.

Senator JEFFORDS. Commissioner Everson, you indicate in your testimony that the IRS is currently auditing 50 donors of conservation easements. Can you expand a bit on the types of transactions that concern you most? Could you do the same for two other categories you mentioned, open space and facade easements?

Mr. EVERSON. I would say, generally, Senator, that we have piloted programs in this area in a couple of different locations, in a couple of cities around the country. This is of concern to us. We are trying to get at it when we make our audit selections for individuals, typically high-income individuals, where what we have done is we have doubled the audits of high-income individuals over the last 4 years. This is definitely in the mix.

Now, what we are also doing within our structure that looks at the organizations is going to the organizations themselves and trying to see what they are doing to bring in this kind of activity.

Again, the general statement here would be that there are two sides of this. One is the individual who is seeking to reduce tax. The other is the organization that is seeking to bring in funds or

some benefit through fees, through these kinds of problems, or other transactions where they are in the more typical tax shelter area. So, we go after it from both sides in all these areas.

Senator JEFFORDS. Thank you, Mr. Chairman.

The CHAIRMAN. Yes.

Now, Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Everson, to begin with you, it seems to me that responsible charities are becoming the last strand in the social services safety net. If you do not get this right, which I would define as drawing a bright line between the abusers and the responsible, one of two bad things is going to happen: more low-income people get hammered again or taxpayers get fleeced.

I want to ask you some questions with respect to drawing that bright line. The first picks up on a suggestion my good friend, Leon Panetta, and you both have touched on, and that is the question of electronic filing.

Why not simply say that everything has to be online in one place so that you all, prospective donors, everybody is in a position to see who is a rip-off artist and who is responsible? Would that not make sense and be a relatively low-cost exercise?

My understanding—and Leon, maybe you can correct me on this—is that the responsible charities are willing to do this. We have talked to them. They have said, put it all online. So if we are going to do what you have suggested, have this electronic filing, let us do it fast, let us put it all online in one place, and everybody knows where we are.

Mr. EVERSON. Let me first say that I concur with your assessment, Senator, of what is at stake for our country. Those stakes are very important.

Again, I do not want to say that we have already reached a point of no return. Hardly the case. This committee, the Congress, and the administration all have the ability to get on this before this really gets bad, the way the tax shelters as a whole did, or corporate governance as a whole did. So, I applaud the sentiment you are speaking to.

Transparency. This sector has transparency. The rules are different. Tax returns for corporations or individuals are not public information. There is a reason why the law provides this transparency, so that that scrutiny that washes out the bad apples, in many instances, takes place. So, we do believe in increased transparency and we do believe in the mandatory electronic filing which will get that information out there.

Senator WYDEN. Well, again, I want to go on. But you have called for electronic filing. It is not that great to just have the filing and then not put it in one place where everybody can be held accountable.

Now, let me ask you about something else. I am told that you all collect these excise taxes from private foundations' investment earnings, and that only a small portion of that money is used for oversight in this area. Somehow, $500 million, or thereabouts, gets collected from excise taxes from private foundations' investment earnings, but only about $30 million is being used for enforcement in the area.

Now, is that right? If not, why do we not use more than $400 million, again, to try to draw that bright line and separate out the abusers and the non-abusers?

Mr. EVERSON. I am generally familiar with what you are speaking to. I do not know the precise amounts, and will certainly check and get back to you on that. I do believe there is an opportunity for us to use those fees, probably more effectively, to augment our resources.

But I have to look at it. I have asked our people to look at it, and also, of course, to talk to OMB and make sure that we are all in accord with the proper policies here.

Senator WYDEN. I think we ought to get on with it. Again, both of these areas, it seems to me, go to the heart of striking the balance I am interested in.

The last point. Mr. Yin, I want to be clear with respect to donated property, because many Oregonians have been coming to me, and these are the pillars of our community, with questions about this.

They want to make sure that people could deduct the fair market value. Now, these are people, again, who have long histories in our State. I gather that you say it is hard to do because we have got all these problems making these calculations.

Well, how do we figure out a way to make sure we do not chase away the legitimate donors because of some kind of bureaucratic inconvenience? I would like your recommendations in that area.

Mr. YIN. Well, Senator, that is a very fair question. It is, of course, similar to what Senator Jeffords was asking. I again would just say that you need to think of the cost/benefit analysis. The benefit that presumably the committee is striving for is to encourage a degree of charitable giving. That is the objective.

Then you need to look at the cost side to figure out, well, if it is going to be a tax provision, what kind of a tax provision would induce that? Let me give you an example. It generally is viewed that cash gifts are less susceptible to noncompliance than property gifts. I think most people would generally agree with that.

It would be possible for the committee to consider a rule, a change, that would give even greater tax incentives to cash gifts than is true currently, and conversely take away, reduce, eliminate the tax incentives from property gifts.

With the proper mix, it might be possible to have little or no effect on the level of permanent charitable giving, and yet the benefit to the government would be that, if in fact cash gifts have less noncompliance, there would be a lesser cost to the government to produce that benefit of a given level of permanent charitable giving.

Senator WYDEN. My time is up. But it sounds to me like you are interested in trying to build the monitoring costs so as to ensure, again, that there are not abuses into the overall work that is done with the tax code, and I think that is a step in the right direction.

Mr. Chairman, I thank you and look forward to working with you.

The CHAIRMAN. Thank you.

Now, Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Yin, I would like to follow up on what Senator Wyden was just questioning. If you are having problems evaluating a piece of property for a donation, or an easement, or whatever it might be, for gift purposes, for the tax code, why is it that we do not use the assessed value of that taxed property? That is what they are paying taxes on.

In other words, if I own a piece of property, or I want to give this piece of property to a tax-exempt organization, I am paying taxes on that piece of property. Why is that assessment that I have not a fair value?

Mr. YIN. Well, that is a good question, Senator Bunning. Let me try to give you a couple of responses.

Senator BUNNING. Do not tell me about the PVAs.

Mr. YIN. I do not know what PVAs are.

Senator BUNNING. Property value administrators.

Mr. YIN. Thank you, sir.

No. I was going to say two thoughts that come to me. One is that of course not all of the property that is being given in a charitable contribution is property that is subject to some kind of an assessment. Obviously, you can think of the household goods and items like that.

Senator BUNNING. But you have put a value on household goods in your suggestion.

Mr. YIN. That is correct. That is correct. But my general point is, not all property that would be subject to the kind of charitable contributions would be assessed, so there would not be an assessed value.

The larger point, I suppose, is that the assessed value will vary from jurisdiction to jurisdiction as to exactly what it is that they are assessing and how the manner of assessment is.

Some jurisdictions will assess at 100 percent, some jurisdictions will assess at less than that. Some jurisdictions are very current in their assessments, some jurisdictions have assessments that really have not been reviewed for years.

Senator BUNNING. Then why can you not have a formula built in? If they are assessed at 60 percent, you have a formula that would make it 100 percent. The same goes with those jurisdictions that are supposed to be assessing value at 100 percent of property value.

Mr. YIN. Again, I think some formulas and rules of thumb might be developed, but there are going to be, certainly, any number of instances where you simply do not have a current assessment or one that you would consider to be reliable enough to base the tax consequence upon.

Senator BUNNING. Well, there is a very, very fine line that you are trying to draw, and it is almost impossible to draw it, as far as what this piece of property is worth if I give it to a non-taxable organization.

Mr. YIN. Well, Senator, I completely agree with that statement. That is why what we are really trying to do is, we are asking, or suggesting to the committee, that it might want to consider moving away from that line which is under current law and moving to a line which does not require that kind of an inquiry.

Because as you point out quite correctly, that is an extremely fine and difficult line to figure out. It is very difficult for the taxpayer initially, very burdensome to the taxpayer, and very difficult for the IRS to verify and enforce.

Senator BUNNING. Mr. Commissioner, in testimony that was submitted by the United Way for the second panel today that we will be hearing, the suggestion was made that nonprofits be asked to report concrete results annually that are tied directly to their mission and not just be asked to report on the level of activity that they engage in. The suggestion was made that this type of reporting could be made on the annual form 990.

Could you comment on this suggestion? From a practical point of view, how could such information be quantified and reported?

Mr. EVERSON. I have not studied the testimony in detail, but I am intrigued by this idea, because it does go to the heart of the idea that a charity should be operating for the public good. So, getting back to what you are doing that has advanced the public good in a report to the public—because, again, this information does all become public—that is the distinction here from other tax returns. That seems to me that is something we ought to take a look at.

Again, if we can get all this stuff up online through the mandatory electronic filing, there will be a lot more transparency, and you will be able to tinker with the reporting in just this kind of manner, or in other areas, to get the information that you and other members of the Congress think is important to understanding what is happening.

Senator BUNNING. Well, you can see why United Way would like it that way, because they think they are pretty up front on the way they handle their contributions, and they would like others to do likewise, I believe.

Mr. EVERSON. Transparency is a very good thing in this area.

Senator BUNNING. Thank you.

The CHAIRMAN. Thank you.

Senator Lincoln, now.

Senator LINCOLN. Thank you, Mr. Chairman. Mr. Chairman, I would like consent to have a statement from the Arkansas Community Foundation included in the record at the appropriate place.

The CHAIRMAN. Of course. We will receive that.

Senator LINCOLN. Thank you, Mr. Chairman.

[The prepared statement of the Arkansas Community Foundation appears in the appendix.]

Senator LINCOLN. Thank you to the panel here that has been very helpful today. Just a couple of questions.

Mr. Yin, to the extent that abuse in the charitable world is leading to this tax gap in terms of missed revenue, which baseline is the abuse affecting the most? Are most of the people seeking to avoid estate taxes through trust arrangements or are they seeking more income tax evasion? Do you have any estimates as to where we are losing the money and the breakdown of how much we are losing to each of those baselines?

Mr. YIN. I do not have that information. I can certainly try to obtain the information for you. I would say, just as a general reaction, because the estate tax only applies to relatively few taxpayers, whereas the income tax applies much more broadly, the breadth of

the tax gap concern would be presumably greater on the income tax side than on the estate tax side.

On the other hand, of course, there are some very large gifts that are being given at the time of death that would not typically occur in an inter-vivos way. So, it may be that, looking at the two, there would be some kind of trade-off between the two, but we could certainly try to get that information for you.

Senator LINCOLN. I would appreciate it. If you could help us decipher some of that information, that would be helpful.

[The information appears in the appendix.]

Senator LINCOLN. Mr. Everson, looking at, I guess, the partnering that you mentioned, about partnering with the States and the Federal Trade Commission, could you describe to us a little bit more in detail about this Federal Investigation Unit that is now under organization, as you have testified to be online, what will it do? When will the specific plans be in place and on the drawing board? Do we have time lines for that?

Mr. EVERSON. As we augment our enforcement efforts in this sector, we are doing a number of things. One of them is what you just mentioned. We are looking at potentially criminal activities in this area in a way that strengthens the link between our staffs internally who are doing exams, and then the criminal investigating unit, which is a separate unit of the IRS. So, we are working on that and pushing forward.

The broader point that you are making, though, gets to the protection of taxpayer privacy. We cannot share the specific results of either our audits or our criminal investigations with regulators in your, or other, States that look over these activities. That is the rub. We can only sit down and say, here is what we are seeing generically.

But if a charitable organization is doing something bad in Minnesota and in Vermont, we cannot sit down and say, this is what we are seeing with XYZ organization in Vermont, these are the real facts, and then that regulator in Minnesota can marry that information up and reach a more informed conclusion of what is wrong.

Senator LINCOLN. So does that mean the transparency does not help us as much if we cannot overcome that hurdle?

Mr. EVERSON. I think that is an absolute limitation on the effect of transparency. Yes, it is, Senator.

Senator LINCOLN. The other thing you mentioned is shifting resources in order to be able to accomplish these things. Are there any other areas that are going to become a problem if you shift resources over to the nonprofit away from those other areas? Do we need to be alarmed about that?

Mr. EVERSON. I think that you are asking a question that gets generally to the President's budget request for 2006. I believe that the request the administration made is a strong and balanced request. We are asking for an additional 8 percent in funding for enforcement activities.

This brings back direct revenues to the country. Our enforcement revenues increased last year up to $43 billion. It is a great return. There are indirect benefits when people do not play fast and loose with their own return.

Now, having said that, we have been asked to do some belt-tightening on the service side of the organization. I am comfortable with what has been requested. We have been asked to take a 1 percent cut on the service side of the organization.

We have detailed plans that we are developing now. This level of belt-tightening is consistent with what other domestic, non-homeland, non-DoD agencies are being asked to do in this difficult period, as you know.

Senator LINCOLN. Thank you.

Mr. Panetta, it is great to see you. Coming from a small, rural State where we are very dependent on very small nonprofits in our small communities to really take up a lot of slack, as we look at other types of Federal reimbursements in the budget and the types of cuts that we are looking at, particularly in terms of Medicaid and others, as some of those reimbursements are being advocated to go down in some areas where it will seem drastic, do you have any ideas of what that impact might mean, when you have got a State like mine where 76 percent of my nursing home residents are covered by Medicaid and 50 percent of my births are? We talked a little bit about health care and some of these other nonprofits that take up some of that slack.

Mr. PANETTA. That is what I mentioned, that I cannot think of a more important time to try to ensure that these organizations continue to meet the needs of people, as you go through budget cuts that are clearly going to impact service to people in need.

In California, if you combine the Medicaid cut with cuts at the State level that are part of the State budget, you are going to have a huge impact in terms of people that are going to need to have services of one kind or another. The only place that that is going to come from—it is not going to come from the county, it is not going to come from other organizations—is from the nonprofit sector.

Senator LINCOLN. So it is essential we get it right.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Hatch, then Senator Schumer.

Senator HATCH. Well, thank you, Mr. Chairman. I welcome all of you to the committee. Leon, it is great to see you again. I appreciate all of the service you have given, both during your service in Congress, and afterwards as well.

Mr. Yin, like others, I am concerned about the staff of the Joint Committee's recommendations to eliminate the deduction of the fair market value of donations of appreciated property.

Now, you mentioned in your testimony that changing the deduction to the basis of the property would improve compliance, reduce burdens and disputes, and lessen the IRS enforcement effort. I have no doubt that this is all true. However, I believe this change would also result in fewer donations to charities.

Now, have you analyzed the potential effect on the amount of donations, or a change in the deductible amount from fair market value to the basis the property might have, and are there other ideas to reduce potential over-valuation abuse in the donations of appreciated property that might not be part of reducing donations to legitimate charities?

Mr. YIN. Well, Senator, again, our focus was on noncompliance. But on the policy implications of the proposal, there certainly have been various studies that have tried to measure the responsiveness of taxpayers to the tax incentives. Roughly how much additional charitable giving is stimulated by a dollar of revenue cost? How much does that produce? There is a range.

I am not sure that the studies focus on the difference between tax benefits in the form of cash contributions as opposed to property contributions. So in direct answer to your question, there would be a degree of uncertainty as to what the effect would be.

I would just like to, again, reiterate the point I tried to make earlier, which is that there are a variety of ways in which the committee might try to induce a certain level of charitable giving, assuming that that is the committee's objective.

Senator HATCH. I will look at your remarks.

Mr. YIN. And to the extent a mechanism can be designed which is less susceptible to noncompliance, then you are able to accomplish your goals at a lower taxpayer cost.

Senator HATCH. All right.

General Hatch, I want to spend a few minutes with you because you have raised some very important issues on nonprofit hospitals, in particular. You indicated that some of these nonprofit hospitals are over-paying executives, at least many believe that. They are giving emergency care, but then dunning the people to such a degree that they never come back. They would not even think of coming back.

In addition, I have heard that some of them are secreting their funds offshore instead of using them for truly charitable purposes, which is to help people. On the other hand, I have heard the other side of the coin too, where one of the leading hospital chains has at least $800 million a year in uncompensated care.

So, tell me about that. Tell me what we should do about this.

Mr. HATCH. There are a number of issues that are raised in your question.

Senator HATCH. I mean, cousin to cousin, I am throwing you a real softball here.

Mr. HATCH. You are. [Laughter.] That is a tough one, actually. We are talking, number one, about cost shifting. You see health care premiums going up double digits. One reason is for uncompensated care. Somebody is going to have to pay it. We know that there have been cutbacks in various funding programs, the end result being there is going to be higher levels of charity care. We know there are more uninsured in this system.

The health care system, in and of itself, has no accountability. There are about 15 transactions between the time that an employer and an employee pay a premium to the time that a provider is providing treatment to the patient. Those 15 transactions are a huge bureaucracy. Over 40 percent of our health care right now is just spent on administrative costs.

Senator HATCH. Part of that is our fault here, too.

Mr. HATCH. Well, it is our system.

Senator HATCH. That is right.

Mr. HATCH. It is a system that needs to be radically changed.

Senator HATCH. I agree with you.

Mr. HATCH. Because employers cannot afford this any more, and we cannot afford it any more.

Senator HATCH. Am I right that a lot of these nonprofits are shipping their funds overseas so they do not have to use them charitably?

Mr. HATCH. That, I am not aware of. We did not find that. It could have happened and we just did not see it, but I am not aware of that.

There are two issues that come up that I think are not being discussed here. One, is criminal, but one is more regulatory. A lot of the issues I raised in my statement are more regulatory. For instance, the HMO executive takes a $35,000 trade mission to Brazil, even though the HMO can only do business in Minnesota. I would not call that criminal, but I would say it is an awful lavish waste of money. Or spending $10,000 to go to Australia to attend a seminar that is entitled, "Are We Pricing the Consumer out of the Cost of Health Care?"

Or the Alina executives that went on a wine retreat in Napa Valley, spending about $40,000 on hot air balloons. They came back and they said the purpose of the trip was to "find their moral center."

When the accountant asked them, is this really a business purpose for Alina and the guy says, well, we do not think the media will catch on. In other words, what was significant to the executive was not whether the attorney general would catch on or the IRS, it was whether the media would catch on.

These are not criminal, but they are just awfully stupid, and they are things that ought not occur. We do need better oversight. These are very large institutions. It is very hard to ask executives, civic organizers, community activists to sit on the board of a billion dollar company and effectively know what is going on. It is just too hard.

Mr. PANETTA. Could I comment, too?

Senator HATCH. Sure. Then I would like Mr. Everson to comment on my totality of questions here, what is happening to these funds and are they being treated fairly.

Mr. PANETTA. Senator, if I could just comment. It goes back to Senator Rockefeller's concern about establishing compensation. We have seen this in the private sector. I have served on private boards, I have served on nonprofit boards.

On private boards, you could make the same accusations about boards of directors that you are making with regards to nonprofit boards. I mean, boards of directors generally went there, did the golf tournament, signed off on most of the things that were done. That has changed.

I mean, the boards I am on now, the boards of directors are taking much more interest in what goes on in the organization. You have got to place larger responsibility on these boards of directors. Yes, they are from the community. I serve on a board for a community hospital in my area.

I have to tell you, that board is, today, a lot more vigilant about what is going on in terms of compensation, in terms of these other requirements because of the pressure that has been brought to

bear because of some of the scandals that have taken place in the corporate world.

Senator HATCH. Mr. Everson, I would like your comments on all of this.

Mr. EVERSON. A couple of comments. First, Senator, we have not yet seen significant indications of funds going overseas. Now, I will follow up to see whether there is anything that I am not aware of, but that has not been brought to my attention.

Generally, talking about hospitals or other issues of like kinds of organizations, my concern here would be that you are seeing a slow melding, an indistinguishable difference, if you will, between profit making and nonprofit entities.

So, those that are nonprofit are paying the same high salaries, perks, benefits and everything to individuals associated with the organization, and it is increasingly difficult to draw a distinction between what they are doing for reasons that you are talking about of providing, say, charitable care, and what our profit-making entity is doing.

So the real stake here is that, over time, not just with people inflating their deductions for grandma's painting, but that more and more of the supposedly taxed economic activity of the country will end up in this sector that is not taxed because it is easier to organize there. There is less scrutiny and people can live well with less accountability.

So, we think this is something that needs to be looked at. A lot of it comes back to adequate enforcement by us. The bright lines here are difficult to draw. It relies, in fact, on the good judgment of our career examiners, sir.

Senator HATCH. Thank you. Thank you very much.

The CHAIRMAN. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman.

I want to thank all of our witnesses, and particularly welcome my former roommate of 10 years, Leon Panetta, who lived in our little house on D Street until he was asked by President Clinton to be OMB chair, and his wife came to Washington, and he preferred her to us. I do not blame him. [Laughter.] She was a lot neater, too.

In any case, I want to thank the Chairman and Ranking Member for holding this hearing. It is a subject I have a great deal of interest in, and I am sorry I could not be here all morning. We had the Patriot Act hearing in the Judiciary Committee.

I would like to work more closely with you and your staff as we look at the process of reforming tax-exempt organizations. I have a few questions, but first I want to make a few brief comments.

First, while charities and nonprofits play an important role in all our States, they play an integral role in New York. They are part of the fabric that makes New York a great and special place. In no other State represented on the committee do tax-exempt organizations play such an essential role.

In fact, the New York metropolitan area contains the largest concentration of philanthropic capital in the world. We have, in New York City, more than 27,000 nonprofit organizations that employ 528,000 people. There is an annual payroll of $22 billion, and they serve more than 2.2 million city residents, most of them poor, most

of them indigent. So it is immensely important to both the economy and the provision of social service in my State that the nonprofit sector be healthy. While people may immediately think of large organizations like the Ford Foundation, the truth is, most of these tax-exempt organizations are actually very small. Nationally, of 65,000 private foundations, the vast majority have assets under $50 million. Of 1.4 million public charities, 98 percent have revenues under $5 million.

So as the commission ponders necessary reforms, I urge them to consider what Derrick Box said at last June's hearing, namely that crafting new, one-size-fits-all rules for all tax-exempt groups, regardless of size, may be unduly burdensome for many of the smaller organizations that support or directly provide important social services.

Second, I was stunned to learn about Commissioner Everson's new report on the tax gap. According to the IRS, $300 billion in tax revenue goes uncollected every year due to tax avoidance and evasion.

I have heard that the gap could be closed with better enforcement of existing laws, not passing new laws. In my view, Congress has to provide the IRS, your organization, with the resources it needs to do the job.

But I would argue that the same is true in large part for tax-exempt organizations, because my constituents tell me many reforms sought by the committee could be better accomplished with greater enforcement of the laws on the books.

I urge the committee to consider which areas truly require new laws, such as regulating donor-advised funds and supporting organizations, and which abuses would be better reduced with the threat of better tax enforcement.

Finally, I know the panel on the nonprofit sector was formed at the urging of the Chairman and the Ranking Member. It has produced an excellent interim report. Hundreds of dedicated people committed thousands of hours to the panel's work. I think we owe it to those who have worked so hard to craft the panel's recommendations to wait until the final report is presented before the committee considers specific legislation.

Now, two questions. First, for Mr. Yin. One of the Joint Tax Committee's recommendations involves requiring a taxpayer who donates appreciated property, other than publicly traded stock, to take a deduction for their basis in property rather than the fair market value. I understand there have been abuses here. I know Senator Hatch mentioned this.

But there are many successful entrepreneurs who donate to charity by giving shares of restricted stock in their company. I know you, Commissioner, mentioned, well, let us look at ways they can give cash. These folks do not have cash. They have the stock and not much else.

So, if we were to greatly restrict this, you would end up with fewer charitable contributions, not a switch from stock to cash. The anecdotal evidence I have received from my constituents is that such a change would be devastating. I was wondering if the Joint Committee has done any analysis as to how limiting these deduc-

tions to one's basis in the property might reduce charitable giving by the entrepreneurial sector.

Mr. YIN. Thank you, Senator. In the case of closely held stock, certainly there may be situations where the donor would have a limited amount of liquid resources. On the other hand, there are often situations where, for example, there is an ample amount of liquid resources within the company itself. In fact, one of the standard tax planning devices that is often used to attract donations of stock of that sort is to have the donor donate the stock of a closely held company to a charity, and then to have that stock be redeemed by the company through a cash payment to the charity.

After all, if in fact there really is little or no market for this stock, the stock is of little value to the charity as well. So, the charity, in the end, would like to get some cash. By carrying out the transaction in that way, the effect, really, is simply to do nothing more than to allow the donor to avoid paying capital gains taxes or dividend taxes on that cash coming out of the company.

Senator SCHUMER. But are there not a lot of companies that would not want to do the process that you suggested?

Mr. YIN. I think, on the contrary, for most closely held companies, that is exactly the way they would prefer to carry out the transaction because they are not interested in having somebody other than themselves or somebody very close to them own stock in the company. They are interested, however, in avoiding paying some taxes and this is, again, a fairly standard way in which they can accomplish that end.

Senator SCHUMER. All right. Well, I will certainly look at that. But from what I have heard, it may not do the job.

Can I ask one more question, Mr. Chairman? Are we running late?

The CHAIRMAN. Yes.

Senator SCHUMER. All right.

The CHAIRMAN. But I do have to go to the Ranking Democrat here to ask one additional question that he wanted, then I am going to go to the second panel.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

First of all, the Ranking Member is Max Baucus.

The CHAIRMAN. But you are now the Ranking Member.

Senator ROCKEFELLER. I know.

The CHAIRMAN. How does this sound: the next Ranking Member?

Senator ROCKEFELLER. I want to ask unanimous consent that his statement be included in the record. He asked me to do that, so I am obliged to do that.

The CHAIRMAN. I do not know whether he can do that or not. [Laughter.]

Senator ROCKEFELLER. Will you contemplate that then?

The CHAIRMAN. Yes. We will do that.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

[The prepared statement of Senator Baucus appears in the appendix.]

Senator ROCKEFELLER. I want to ask a somewhat deliberately provocative question of you, Mr. Everson.

The CHAIRMAN. I thought it was a little question.

Senator ROCKEFELLER. The statement was made earlier that about $16 to $18 billion—I am not even sure that I heard it correctly—has to do with tax evasion, et cetera. I am quite sure that not all of it has to do with foundations.

Two questions. Number one. I am just asking you, do you know of any studies that have been made of the percentage of foundations that exist in this country that do for large States like Senator Schumer's and small States like mine what we think they do, and they are important, how many of them are, in a sense, cheating or abusing? That fellow who raised his salary so he could get his daughter married, which is an all-time disgusting example.

But those things catch attention and they raise an issue enormously. But then on the other hand, we went to the $350 billion or $320 billion of individuals or corporations that are not paying their taxes.

In a proportionality sense, when you say you are going to raise by 20 percent the number of people who are focused on foundations, I wonder what happens.

Are you doing an equal thing with respect to corporations and individuals who are not paying their taxes? Because those folks are probably not helping with Medicaid in New York or West Virginia hospitals.

Mr. EVERSON. Certainly. The budget request we put forward for fiscal year 2006 requests about $265 million of new enforcement monies. As I indicated at the top of the hour, about $14.5 million of that, or 5 percent, goes to the tax-exempt government entities.

The measures that I took, in 2005, to try to increase this funding for tax-exempts by 20 percent were unsuccessful, frankly, despite the good efforts of this committee to help the IRS receive the President's request. The monies that I was given were fairly meager compared to what the President had requested. He had asked for about $500 million, we got $48 million.

So, I have sort of said, what am I going to do with the little bit of money we got? I decided to try to move the needle in this area because the stakes were so great. Does this go after the tax gap, per se, that augmentation I spoke of on the exempt organizations? No, but it goes to Senator Schumer's point.

We cannot only attack the tax gap. The IRS's responsibilities are many. They extend beyond the taxable segment of the economy. We have been given the responsibility to ensure the integrity of tax-exempt organizations, so that is what we are doing in this instance.

Senator ROCKEFELLER. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank this panel. I am glad it took a long time, because you all have good information for us, and I think we will make good use of that information. Thanks to all of you.

Now we go to the panel of Dr. Jane Gravelle from CRS, a very detailed, independent analysis in three areas of concern to our committee: donor-advised funds, supporting organizations, and donation of property. Dr. Gravelle's report will be included in the record. I strongly encourage anyone interested in these matters to read this report that is very nonpartisan and look at it closely. It is an eye-opener in terms of problems that we face in these three areas.

Let me add that I think it is an example of the type of analysis that we need more of, but do not get nearly enough of, be it from government, academia, or think tanks.

This analysis from CRS looks at specific tax code sections, as well as organizations that are created by tax code regulations, and holds them up to a hard light of analysis to see what is actually happening in the everyday life of nonprofits. It is too rare, if we ever get this. I thank Dr. Gravelle. Thank you very much for your efforts.

The second person is an attorney from Tennessee, Mr. Richard Johnson, who will let us have a first-hand experience of his efforts to deal with a private foundation where the wheels came off.

Then Mr. David Kuo, who was, until recently, at the White House, where he was a senior advisor to the President's Faith-Based and Community Initiatives.

Then we go to Brian Gallagher, president of United Way. He knows first-hand the problems that confront charities and will speak to United Way's efforts to bring reform internally, as well as comment on proposals for reform.

Finally, Ms. Diana Aviv, whom we had a news conference with, who is president of the Independent Sector, an umbrella group of many of our Nation's charities, and is spearheading this effort of the Nonprofit Panel that was formed in response to a letter from Senator Baucus and me to the Independent Sector asking them to provide input from the charitable sector. That preliminary report was aforementioned to the first panel.

We will go just the way I introduced you. So, Dr. Gravelle?

STATEMENT OF DR. JANE GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Dr. GRAVELLE. Mr. Chairman, members of the committee, thank you. I am Jane Gravelle, Senior Specialist in Economic Policy at the Congressional Research Service, and I thank you for the opportunity to appear here today.

I discuss two types of entities that allow individuals to deduct contributions before the gift is actually made to a charity: donor-advised funds and supporting organizations.

Payments to donor advised funds are treated as completed gifts for tax purposes and the fund is legally controlled, but the donor effectively makes the choice. I also discuss gifts of appreciated property, and I relate this discussion to the Senate staff discussion proposals and the Joint Tax Committee proposals.

My main findings may be summarized as follows. Donor-advised funds and supporting organizations allow the tax-free accumulation of assets intended for charitable purposes, as is the case of a private foundation, whether or not subject to private foundation rules. They are, therefore, uniquely tax-favored.

Both donor funds and supporting organizations have grown rapidly and are a significant part of the mix of charitable assets. Distributions from large donor funds and supporting organizations are a third the size of distributions from private foundations, which in turn account for 10 percent of all giving. Assets and large donor

funds grew at an average annual rate of 25 percent from 1995 to 2003, increasing 5-fold over that period.

There are two issues. First, do these organizational structures increase giving or do they harm charities by deferring giving? Second, are these organizational forums used for private benefits rather than charitable purposes?

Concerns that funds may not be paid out to charities appear justified. A survey of several community donor funds found that 19 percent of donors made no distributions during the year. Data on large supporting organizations showed that 25 percent made no distributions, and two-thirds distributed less than 5 percent.

While tax subsidies should increase giving, econometric studies of charitable giving suggest that the response of donors to timing is much, much more powerful than aggregate giving responses.

A well-known study found that the effects encouraging delay are 3 to 28 times the size of effects encouraging giving. This analysis also showed that a dollar of tax revenue lost encourages from 8 cents to 51 cents of additional permanent giving, and much more, of course, in shifting.

When giving is funneled through these special organizations, it may also be reduced by management fees. In addition, emerging econometric evidence and economic research on the effects of default roles is relevant to the effect of these forms of tax-preferred giving.

These studies suggest that individuals disproportionately choose options that require no action. After making contributions to donor funds and receiving the tax deduction, individuals may simply leave them there.

While there are no data to quantify abuses, there is considerable indication of their existence from witness testimony, practitioner websites, and from supporting organizations' data on loans made back to the donors. Among the abuses is a practice called round tripping, where donor-advised funds donate to foundations and the foundations then donate to donor-advised funds.

Type III supporting organizations may be particularly vulnerable to abuse because the supported charity does not have control of the organization. Although even where the supported charity does have control, there is certainly pressure to take into account the preferences of the donor.

Gifts of appreciated property that account for 25 percent of giving by tax itemizers rises to 50 percent at the highest income levels. Again, statistical evidence suggests that tax benefits for appreciated property gifts are much more likely to shift the form of giving rather than the level.

Data also suggest that there may be problems in valuing a significant fraction of these gifts because they are not publicly traded. Options for revision include eliminating the additional tax benefit for donor-advised funds and supporting organizations or applying all of the private foundation rules.

The Senate staff discussion proposals are actually much more modest than these approaches. They suggest applying self-dealing to all charities, eliminating Type III supporting organizations, and applying a minimum distribution requirement to donor funds. Let

me say, a minimum distribution requirement for donors funds is much less restrictive than a per-account minimum distribution.

Gifts of appreciated property to donor funds would be sold within a year or disallowed as gifts altogether. Donor funds could not make grants to foundations or to individuals, and foundations could not give to donor funds.

Donor funds cannot be used for grant selection. Such a provision would prevent, for example, the fund paying for the donor and family to snorkel the reefs of Cozumel to ascertain the degree of reef damage before providing a grant for reef damage reduction. I think we have heard today many other instances of this kind of use of funds.

For appreciated property that is not publicly traded, the Joint Tax Committee would restrict the deduction to basis for all donations. The Senate staff proposal is much more limited. It would subject valuation disputes to final offer arbitration, which should induce more realistic valuations and a greater willingness to reach a negotiated agreement with the IRS.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Gravelle appears in the appendix.]

The CHAIRMAN. Now, Mr. Johnson?

STATEMENT OF RICHARD JOHNSON, MEMBER, WALLER LANSDEN DORTCH AND DAVIS, PLLC, NASHVILLE, TN

Mr. JOHNSON. Thank you, Mr. Chairman and distinguished members of this committee, for allowing my law partner, Joseph Woodruff, who is standing over there, and myself the opportunity to provide you with our assessment as to how this committee's proposed reforms may have affected the situation in the Maddox Foundation and the regulatory efforts to correct that situation we are currently litigating.

Also, due to the unselfish efforts of our client, Ms. Tommye Maddox Working, who is also here with us today, these problems are now in the process of being rectified by the District Attorney General of metropolitan Davidson County, Tennessee, Hon. Victor S. Johnson, III, in a private, relator-type civil action.

Our written testimony details the history and the purpose of the Maddox Foundation, the assumption of control by its current director, Ms. Robin Costa after the Maddox's death, and the removal of the foundation from its intended home in Tennessee.

Likewise, our written testimony details the many allegations of breaches of fiduciary duties that have occurred since the Maddox's death, and how the proposed reforms might have prevented the problems we are now facing.

For the sake of brevity, please allow me to focus the committee's attention on only three of what we consider the most significant abuses: purchase of professional sports teams, director compensation, and excessive administration expenses, and three of the most significant areas of proposed reform: governance, compensation of disqualified persons, and enhanced enforcement.

As we detail in our written testimony, Ms. Costa has used what we estimate as over $8 million of foundation assets, first, to pur-

chase and then to operate, two minor league professional sports teams. In 1 year alone, in 2003, Ms. Costa spent more than $4 million of foundation money to operate these for-profit sports teams.

In documents filed with the court, Ms. Costa admits that the foundation entered into a contract with a casino for purposes of the foundation providing lodging to visiting hockey team players, as well as players coming to try out for the hockey team. All of these expenditures are claimed on the foundation's tax returns to be charitable contributions.

Ms. Costa attempts to justify this characterization by claiming that the sports teams are program-related investments. She even has attempted to obtain the endorsement of the Internal Revenue Service on this characterization by filing, more than a year after the fact, a request for a private letter ruling. Now, that private letter ruling request is still pending.

The characterization, we submit, is totally inappropriate, for a number of reasons, not the least of which would be that these sports teams are jeopardy investments, and Ms. Costa is holding herself out to the public as their owner and president.

In fact, when the purchase of the teams was announced, the hockey team issued a press release which quoted Ms. Costa saying that she "fell in love with hockey and with the River Kings," and "as a new owner, you'll see a lot of me."

Since moving the foundation out of Tennessee, Mrs. Costa has been able to operate the foundation without independent oversight. She alone decides how the foundation money is used.

Her compensation is not reviewed and approved by an outside board. Consequently, she has paid herself annual compensation from the foundation calculated on what was represented to be the total value of the foundation's assets, although the foundation did not own all the assets at the time.

Plus, she paid herself compensation out of a wholly owned company that comprises one of these foundation assets. This double dip, however, is not the end of the compensation story. She also paid to herself, without prior court approval, executor and trustee's fees, again calculated on the Maddox's assets. The total through 2003 of this triple dipping is in excess of $3.2 million. We do not yet know the whole story.

Until last November when the probate court in Nashville ordered an accounting of the foundation, Ms. Costa had never opened the books and records to an independent audit. We have prepared two charts graphically to demonstrate the magnitude of disparity between the Maddox Foundation expenses and the genuine charitable contributions.

Mr. Chairman, as you can see, in total, out of $16 million of foundation funds spent, $5.4 million went directly to charities. Or if you will look at our pie chart, 66 cents out of every dollar went to overhead, compensation, and operation of sports teams, as well as to payments to third parties.

We have also provided examples in our written testimony of the harmful impact the manipulation of the Maddox Foundation has had on charities in our State, and we can reach no other conclusion than that the charities are the victims.

Establishing national standards for governance, oversight and financial accounting as proposed would help prevent these types of excesses. Requiring that independent directors set and approve compensation paid to disqualified persons would help to avoid circumstances where a foundation director holds a compensation committee meeting by merely looking in the mirror.

Providing funding to States to prosecute claims, including claims based on the violation of the Internal Revenue Code, and expanding the jurisdiction of the public's access to the U.S. Tax Court will greatly enhance the tool box available to regulators. Common-sense reforms such as those under consideration by this committee could have preserved Dan and Margaret Maddox's legacy for their intended beneficiaries, the charities of Middle Tennessee.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Johnson appears in the appendix.]

The CHAIRMAN. Mr. Kuo?

STATEMENT OF DAVID KUO, FORMER SPECIAL ASSISTANT TO THE PRESIDENT AND DEPUTY DIRECTOR, WHITE HOUSE OFFICE OF FAITH-BASED AND COMMUNITY INITIATIVES, ALEXANDRIA, VA

Mr. KUO. Chairman Grassley and members of the committee, I am David Kuo. For 2½ years, I served as Special Assistant to the President and Deputy Director of the Office of Faith-Based and Community Initiatives at the White House under President George W. Bush.

My perspective on the topics we discuss this morning is informed by various vantage points on the charitable sector I have had during the past 15 years.

I have worked in senior positions here in the U.S. Senate, in advocacy organizations, and in the White House. I founded, and for 3 years built, a charitable organization to objectively determine the efficacy and the efficiency of social service organizations.

I was even recruited by a dotcom company with the promise that I would be able to manage what was going to be a remarkably huge foundation. They were going to give away 1 percent of gross revenue to charity. Since they would be making hundreds of billions of dollars annually, that meant a lot of money for charity. Suffice it to say, things did not turn out quite as promised.

I also approach this from a certain philosophical perspective. I believe in government's inviolable duty to help the poor. This is not just a political philosophy for me, it is also theology.

I believe that Jesus's command to care for the least among us means that we have to bring to social problems every available resource and every best effort. It is in that spirit that I want to speak today to government, to the nonprofit sector, and to us as individuals.

I believe in President Bush's compassionate, conservative philosophy as articulated at the start of his 2000 campaign: "It is not enough for conservatives like me to praise charitable efforts. Without more support and resources, both public and private, we are asking charities to make bricks without straw."

His proposals for $8 billion per year in new spending and charitable tax incentives for non-itemizers and IRA roll-overs were important policies that sent the unmistakable message to the public that charity, compassion, and care for the poor were to be cornerstones of his domestic policy.

Four years later, these tax incentives and other spending programs have not yet been enacted. The White House certainly could have done more. That has already been said. However, were it not for the President's interest in these issues, we probably would not be here today.

But what about Congress? Save for the tireless action of this committee that has repeatedly pushed for charitable tax incentives, I have been astounded by the lack of interest in these matters by your colleagues.

The CARE Act is a perfect example. For the last 4 years, the CARE Act has had overwhelming bipartisan support and has gone nowhere. Why? In large part, it is because of widespread Congressional apathy and a desire for political gamesmanship on all sides.

The White House does know how to get what it wants, but just as certainly, Congress knows how to get what Congress wants. Why has Congress not been a passionate advocate on behalf of charities and the poor in the midst of an economic crisis, a downturn in charitable giving, and an upturn in social service needs?

As members of the U.S. Senate, you are called and pulled in every different direction. Every problem, every constituency demands more from you, and of you. But I can think of no other area in American politics so ignored by American political leaders than matters of charity, of care for the poor, and of substantive debate and discussion on matters of civil society.

No, America's poor do not have a powerful voice. They are not likely to flood your office with calls, e-mails, or letters. Yet, there are more poor Americans today than ever before. It is always easy politics to blame either the other party or the White House, but I just wonder why these matters have been such a low priority for the U.S. Congress.

It is not, however, just Congress that has ignored these charities. Without any doubt, the charity abuse stories that we hear today are the result of a lack of IRS enforcement of existing laws.

Having had my own 501(c)(3) organization that examined other groups, I saw first-hand cases of willful misuse of funds. That kind of stuff was hardly a secret in the charitable world.

Yet, where is IRS enforcement of these existing laws? It has been AWOL. But now we are to believe that new laws are the answer? By themselves, they are not. They may serve the appetite of a public that wants action, because nothing spells action louder than a new bill. But without dramatic enforcement enhancements, we will all be back having the same debate years from now.

Make no mistake, however. I am not some shiny, happy charity cheerleader. If we do not face the fact that loopholes need to be closed, reforms made, and accountability had, we will have failed just as much as if we had done nothing.

The IRS cannot enforce laws that make no sense or that provide loopholes for the wealthy in the name of charity. Clearly, more stringent rules need to be put in place regarding the use of donor-

advised funds, and it hardly seems a stretch to require accounts to pay out a certain amount annually to charities.

More publicly disclosed information about charities also seems to be a no-brainer. Charities are, by their very definition, here to serve the public interest. The public deserves to know what they are doing.

I would like to add one more thing. We need to begin looking at information in different ways. To date, charities tend to be judged by how well their accountants make their books look like all the money is going to serve targeted populations.

Why? Because that is how "efficient" charities are judged and have been ranked by media, like *U.S. News & World Report.* Unfortunately, this mind-set has prevented us from asking a more important question: how well?

Efficacy is a far more important and relevant gauge than efficiency. We need to begin asking charities to tangibly measure how well they are doing their jobs, not just how efficiently.

Charitable abuses are real and offensive. They must be eliminated. Serious fines must be imposed. Violators need to be exposed. But we must be careful amidst these reports not to allow these abuses to create new laws that punish the overwhelming majority of donors, organizations, and the recipients of nonprofit services. I am concerned about changes in non-cash deductions—in clothing deductions, for instance—that may be examples of disproportionate use, given the problems.

Finally, the United States faces record budget deficits, not because of abuses in the charitable sector, but because of choices and priorities that our government has made.

Much of the rhetoric around charity that we have been hearing lately seems to suggest that the charitable sector is just a great target for raising more funds to ensure the continuity of our existing ways of government waste. Does that not strike the committee as a bid odd, perhaps even a bit perverse?

Everything we are discussing today is about the culture of charity that we are creating. The culture of charity is hurt by a lack of enforcement. It is hurt by loopholes and exemptions and tricks that benefit the rich in the name of the poor.

It is also hurt by laws that inadvertently discourage charitable giving. Nowhere is that clearer than in the estate tax. Congress will be revisiting this matter in the coming months.

As it does so, I hope that it, and this committee, will bear in mind the huge consequences that matter has to the charitable community. Conservative estimates show that a total repeal of the tax would cost the charitable sector more than $10 billion per year. That is a lot of money, and it certainly discourages the culture of charity.

I want to close by again thanking you, Senator Grassley, and thanking the committee and the exceptional staff, for pushing this. We are having a vigorous debate this morning about charity, about giving, and about helping others. Everyone here should be excited about that debate, because this sector will emerge stronger and more powerful in the end.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Kuo appears in the appendix.]

The CHAIRMAN. Mr. Gallagher?

STATEMENT OF BRIAN GALLAGHER, PRESIDENT, UNITED WAY OF AMERICA, ALEXANDRIA, VA

Mr. GALLAGHER. Thank you, Mr. Chairman, Senator Rockefeller, distinguished members of the committee. I appreciate the opportunity to speak to you today about issues of governance, accountability, and performance in the nonprofit sector.

As president of United Way of America, I am here today representing my organization, but also 1,348 local United Ways around the country.

When I first came to United Way of America 3 years ago, my goal was to rally local United Ways around our true mission, which is to improve lives by mobilizing individuals and organizations into collective action.

But traumatic world events interceded. There were the attacks of 9/11 and the response of the charitable community to that event. There were a series of corporate scandals: Enron, WorldCom, Tyco, and after that, a scandal closer to home for us, the United Way of the National Capital Area. This was now my local United Way, and it made me sick.

When the *Washington Post* story came out, I received a letter from Chairman Grassley asking how United Way of America monitors the work of local United Ways and what changes we would make to improve those operations across the system, and the sector as a whole.

Across the Nation, United Ways were operating ethically and doing great work. It does not matter if the vast majority of United Ways are operating at the highest level, however, if one, or two, or three are not. It erodes confidence in all of us. I knew I needed to focus on accountability first so that we could get on to the real work, which is mission. Change needed to happen fast.

In a front-page *Washington Post* article, I made it clear that the volunteer board and the CEO at the National Capital Area United Way had to go, and they did. New volunteer and professional leaders enacted real reform, and since then have rebuilt trust and confidence.

Next, United Way of America rewrote all of our membership standards. I personally reviewed those new standards with Senator Grassley before they were implemented within our system.

Working with Senator Grassley's office was one of the reasons that these stronger standards were adopted overwhelmingly by our members in less than a full year. The new standards have successfully raised the bar on our operations, and we have instituted third-party review and oversight over all local operations.

We disaffiliated more than 50 local United Ways that failed to meet one or more of our new membership requirements, and for the rest of us, this was a reaffirmation of the values of transparency, accountability, and disclosure.

United Way action was necessary, and now the entire sector needs to wake up on this issue. We all must ensure and promote greater accountability. If we cannot, then there should be legislation that makes meaningful and common-sense reforms.

Last summer, the staff of the Senate Finance Committee circulated a white paper containing a number of options for improving accountability in the nonprofit sector. For the record, we agree with much of what is in this paper. In fact, some of the language used in the paper, especially related to the IRS Form 990, was taken from United Way's new membership requirements.

Specifically, we agree with the proposals around responsibility, disclosure, and effective operations, including that the chief executive officer, not just the chief financial officer of a nonprofit, should be required to sign and be responsible for the information on the Form 990. There should also be a certification that the volunteer board has reviewed the annual Form 990 and all audits.

Second, that the IRS should review every nonprofit's tax-exempt status every 5 years to ensure that they continue to operate exclusively for charitable purposes.

Finally, Congress should increase funding for IRS enforcement. We support this increase, even if funding must be provided through increases in fees assessed on our own sector, as long as we can be certain that the new fees will be used for their intended purpose.

Finally, if I ended my remarks now after addressing financial and legal accountability only, I would be doing our sector a huge disservice. Research shows that, while trust in nonprofits is alarmingly low, more regulation is not what people are looking for. Financial accountability is just table stakes. Yes, we do need to get that right first, but ultimately the American public should hold our sector accountable for delivering on our missions.

In fact, the number one reason that people do not have faith or trust in the nonprofit sector, is that donors do not know how charities spend their money. The American public does not give us money just because our operations are clean. They really give us money because they want to make a difference, they want to improve people's lives.

To that end, I respectfully suggest that the "results" section of the annual Form 990 be expanded and strengthened. Nonprofit organizations should be asked to report concrete results annually that are tied directly to their missions, not just on the level of their activity.

This section should be moved from Part III of the annual form to Part I, reflecting its importance. We owe it to the public to demonstrate that their investments are making a difference and getting real results.

Thank you for your time, your commitment, and your consideration.

[The prepared statement of Mr. Gallagher appears in the appendix.]

The CHAIRMAN. Now, Ms. Aviv?

STATEMENT OF DIANA AVIV, PRESIDENT AND CEO, INDEPENDENT SECTOR, WASHINGTON, DC

Ms. AVIV. Chairman Grassley, Senator Rockefeller, and distinguished members of the committee, I come before you as the president and CEO of Independent Sector, a national coalition of charities and foundations and corporate philanthropy programs that

collectively represents tens of thousands of nonprofit organizations across the country.

I am also here as the executive director of the Panel on the Nonprofit Sector, convened last October by Independent Sector.

We welcomed your encouragement to form the panel because we recognize how important it is for our sector to operate according to the highest possible ethical standards.

We know that the wrongdoing of even a few can damage the public's trust in all organizations, even though the vast majority of organizations operate legally and ethically. Therefore, our goal is to eliminate abuse.

This commitment to higher ethical standards is shared across the sector by the 24 distinguished leaders who comprise the panel, by the 150 experts who are participating in the panel's work and advisory groups, and by thousands of people who have joined our conference calls, submitted comments, and are now attending our field hearings across the country.

These people are all volunteering their time because they understand the importance of this work. On March 1, the panel released its interim report, and I ask that it be submitted for the record.

[The interim report appears in the appendix on p. 85.]

Ms. AVIV. Maintaining public trust in charitable organizations requires a balance between a viable system of self-regulation and effective government oversight.

The panel's report recommends actions to be taken by charitable organizations, by the IRS and State charity oversight officials, and by Congress. Together, these create a comprehensive package of reforms in which no single action stands alone. I will highlight a handful of these recommendations.

First, penalties should be increased on managers and board members of foundations who, at the expense of the organization, receive or approve improper financial benefits.

Second, making reliable and timely information about charitable organizations easily accessible to all interested parties will go a long way toward deterring unethical behavior.

We encourage the IRS to mandate electronic filing of all Forms 990, with adjustments to be made to accommodate the relevant attachments. We will offer recommendations in June on how the forms themselves can be improved to ensure consistency, reliability and accuracy.

Third, we believe that organizations whose annual receipts fall below $25,000 should file an annual notice with the IRS providing some basic information. Additionally, organizations with annual revenues of more than $2 million should be required to have an audit, and those above $500,000 should be required to have an auditor review their financial statements.

Fourth, Congress should remove the barriers that prevent the IRS from sharing information about ongoing investigations with State charity regulators, something it now does with State revenue officers.

Fifth, more needs to be done so that taxpayers do not over-value property that they donate to support charities. However, we have deep concerns about the proposals that would discourage donors from giving appreciated property to charitable organizations.

We do not want to see these programs damaged by solutions that throw out the baby with the bath water. We will be getting back to you on this with specific recommendations on how to address the problem without hurting the program.

Sixth, although donor-advised funds are an important channel for stimulating philanthropy, gaps in current law have allowed improper use by some of these charitable assets. We need explicit rules that prohibit improper benefits to the donor. Our report contains a number of recommendations in this regard.

Seventh, the panel strongly believes that effective law enforcement is integral to eliminating harmful behavior. We want to build on the good work of Commissioner Everson to ensure that there are adequate resources for oversight and education. We urge you to work with your colleagues to see that additional funds are earmarked for this purpose.

Finally, the key to meeting our goal of no abuse is the actions of the sector itself. We have recommended a series of steps that are vital for charitable organizations themselves to take, such as the establishment and dissemination of conflict of interest policies, the inclusion of financially literate people on their boards of directors, and the creation of independent audit committees.

The panel is just halfway through its work. Our final report is due to this committee in June, and we intend to make recommendations on such issues as board composition, compensation, and governance. While we understand the desire to begin moving forward now, we believe that you will be well-served by considering the recommendations in our final report as well.

I want to extend special thanks to you, Chairman Grassley, and to Senator Baucus, for your leadership in this area, which already has had a significant impact on our sector's practices and procedures.

As I travel around the country, I am constantly asked for more information on the issues and guidelines for action, which I believe are as a result of your calling attention to these issues.

You all know about the invaluable work charitable organizations undertake in your respective States and in your communities. The nonprofit sector must remain a vital component of American life. It must maintain its independence and its creativity. It must always be responsible and transparent.

Governments should provide vigorous oversight of the sector without discouraging legitimate charitable activity; but at the heart of this effort to improve ethics and operations must be the actions of the sector itself.

Mr. Chairman, Senator Rockefeller, members of the committee, I would be happy to answer any questions.

[The prepared statement of Ms. Aviv appears in the appendix.]

The CHAIRMAN. All right. If it is all right with Senator Rockefeller, here is what I would like to do. I would ask four questions, myself, and then I will give you whatever time you need to ask questions. Then I have a closing statement, even though it might take a little bit longer than 5 minutes.

Senator ROCKEFELLER. All right.

The CHAIRMAN. Before I ask the first question, for Mr. Kuo, you raised the point about the frustration with the CARE Act not being

passed. I said at the start of the hearing, we intend to work with Senator Santorum to enact a package of CARE Act reforms.

As you know, last Congress the Senate did act. Unfortunately, we had objections from going to conference. Hopefully, we will not encounter that this particular year, and we will be able to move that through the Senate and to conference.

I am going to start with Dr. Gravelle. I was very interested in your comments about the impact of beneficial tax treatment of gifts and appreciated property on cash, and then, of course, on the other side of it, non-cash giving.

You spoke about tighter rules on gifts of appreciated property, that you do not anticipate a real decline in charitable giving, but that individuals will look at then giving cash instead, if we would have these reforms to determine a more reasonable value for gifts. Would you comment on that, please?

Dr. GRAVELLE. Well, on the econometric study, the statistical study that I cite in my report, which tried to look at this issue of substitutability between our gifts of appreciated property and cash, what they found was there was a very, very high degree of substitution.

This is much like the timing effect, an order of magnitude of the timing effect I talked about, which, as I indicate, was about 3 to 28 times. Twenty-eight is for very high income donors. So, that statistical evidence, which is all the evidence that we have right now, suggests that there is a big substitution effect, but not a very large permanent effect.

That would suggest, if people found the tax benefits for gifts of property to be reduced, they would most likely give cash instead. Cash, of course, I think in most cases, is much more valuable for the charities.

In fact, if you look on the Internet, you will find charities discussing the problems they face with peculiar gifts of property and how difficult sometimes it is to cash them in or to use them.

The CHAIRMAN. All right.

Mr. Johnson, you indicated in your testimony that Ms. Working, the Maddox's step-granddaughter, I believe it is, is funding the litigation with her own personal funds. Now, that does not happen very often, and it surprises me.

Would you explain her motives? I would also like to ask you to comment on the importance of the authority Ms. Working has under the relator statute to bring this action to address these issues.

Mr. JOHNSON. Thank you, Mr. Chairman, for the question. In the 18 years that I have been practicing law, I have not worked with a client as unselfish as Ms. Working.

What I attribute it to is, I find that she has a deep desire, or she almost feels there is an obligation on her part, to make sure that her grandfather's charitable intentions are carried out. She sees those charitable intentions being frustrated. I will give you several examples.

First, for example, Mr. and Mrs. Maddox attended Covenant Presbyterian Church there in Nashville. The minister there has filed an affidavit in our case. What had happened was the Maddox's wanted to have a new sanctuary built. After their untimely

deaths, the foundation had made a commitment to pay $2 to $4 million to the church for building that sanctuary.

Well, after the foundation moved to Mississippi, Ms. Costa told the minister, well, we cannot fulfill that commitment, that the foundation does not have the assets to do that, and instead gave the minister $5,000 for the church.

Now, there is testimony from a witness who has stated that Ms. Costa referred to those types of gifts as gag gifts, go away gifts. In addition, there was, for example, the administrative expenses and travel expenses.

Mr. Maddox was a supporter of Belmont University. If you would look on the 2002 990 PF, it would show that there was a $5,150 charitable contribution to Belmont University. Well, $500 of it was cash and $4,650 of it was for expenses for charter trips by Ms. Costa back and forth to Nashville.

Then the administrative expenses. I will be brief, Mr. Chairman. The foundation had credit cards. Ms. Costa charged to the foundation meals for the hockey players, gas, florists, pet store charges.

There was an $8,000 charge to a casino, approximately $4,000 to a LaCosta Resort & Spa, approximately $13,000 for statuary from the Colleton Gallery in La Jolla, California. So, these are the reasons why she feels like she needs to pursue it.

As to your second question, the private relator action, as a practical matter, we saw that this was, in Tennessee, the only mechanism we had to pursue this foundation. The District Attorney's resources are very slim.

With your proposed reform, adding a Federal alternative would have been something that we would have seriously looked at, because as I read it, either the Internal Revenue Service is carrying the ball, or at least we are sharing the ball. And I can tell you, Ms. Working has spent a lot of money pursuing this.

The CHAIRMAN. That brings up a short question, and the last question for you. Do you know what, if anything, the IRS is doing about this situation at the foundation?

Mr. JOHNSON. Ms. Costa, in her answer in the litigation, attached a letter from the IRS that in effect said that the 2001 tax year was clean. There were no changes to the 990 PF. Now, we believe that what they will argue is, they are going to use this letter to suggest that the IRS has blessed the way the foundation is being administered. We are skeptical of that claim.

However, if you adopt some of the reforms that you have suggested, and I would ask Mr. Woodruff to show this, it is easy to show you, if you will look at 2001, there is $450,000 of compensation to the director, Ms. Costa.

Now, with your reforms, the disclosure of affiliated entity compensation, the disclosure of how you justify and rationalize the compensation, you would find that, in addition to what was shown on the 990 PF, which was $275,000 of compensation, that was, based on the testimony of the consultant, on $180 million of assets rather than $49 million of assets.

You would also see that $125,000 was also paid to her from a wholly owned company that the foundation now owns, plus $50,000 from trusts that the Maddox's assets went through to the foundation.

So, your proposed reforms would provide greater disclosure, greater transparency, and may make the IRS's job a little easier. We do not know what the IRS looked at to make that determination.

The CHAIRMAN. All right.

Now, Ms. Aviv, my last question. We, like you, have looked at some organizations assisting Native American communities, particularly in education, and find that little money is going to help those in need. I know you are familiar with those things.

This is similar to a situation that our Finance Committee has investigated with the attorney general of Pennsylvania of an organization cashing in on public support for the Make-A-Wish Foundation by raising money for a similarly named organization.

I understand from your recent field hearings you conducted that you have come across similar concerns. Could you mention those for the benefit of the committee?

Ms. AVIV. Sure, Senator Grassley. I was in Denver about 2 weeks ago, and we had a field hearing in which the charities and foundations from around the Denver area joined Senator Worth and Senator Brown and me at these field hearings. There was an individual who stood up by the name of Rick Williams from the American Indian College Fund who attended the field hearing, and he indicated that there are a number of problems within the American Indian community with respect to fraudulent charities attempting to raise money on the backs of poverty issues within those particular communities, and that it simply was not going to those folks who needed the money most.

So the problem is in two categories. The first is fraudulent claims in direct-mail letters about crises in communities in order to raise considerable sums of money that do not go to the tribes.

The second is scams allowing businesses to donate large quantities of goods that are, in essence, useless and dumping them in American Indian communities. Now, both of these practices are illegal, although they say that they are continuing and that they are not getting the kind of relief they need, so their view is that they need this prosecuted.

They have sent to me just yesterday about a foot and a half of material supporting all of this, which I am happy to share with you and your staff, on the background of this. The specifics of the case, I am not as familiar with as to what he said.

But he also issued a warning to everybody in the room who was listening to this. Do not assume that because people raise funds in the name of charity that we should automatically assume that they are honorable. We really need to do our homework ourselves to see that the funds do go for charitable purposes.

The CHAIRMAN. Yes.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman. I will not ask a question. I will just make a very brief statement. I think this has been a superb panel. Both of them are that way.

I should point out to the panel that our Chairman has an unbelievable knack for raising questions that cause all kinds of concepts that have not been carefully reviewed before, or budget priorities, or things, and it always ends up in doing good. If the private sec-

tor, the foundation sector, is concerned, you ought to try the folks at the Department of Defense. They live in terror of Chairman Grassley.

The next thing I would like to say is, I was very moved by what everybody said. David Kuo, I was profoundly moved by what you said, the way in which you said it, and the terms that you used to, in essence, voice what I was feeling all weekend as I watched nonstop the death of the pope and the reaction of the people. And they were all young people. They were all young people, at least where the television reached.

I think that that was because, not so much they knew him or they agreed with everything that he had ever said, or they honored his historical courage, but I think it was for this very simple question that you raise, and that is, people reaching out to the dispossessed and poor.

He went to 139 countries, which I still cannot absorb into my thinking, and he did it when there was no enormous reason for him to do it, except, I think, to say, we care everywhere about every person who is hurting and is in trouble and does not have representation, and I will represent them, he said.

I am not a Catholic, but I found myself just extraordinarily moved by that weekend. I found it very much in consort with the spirit of what you said, very much in consort.

That leads me to my final statement, Mr. Chairman. I use the example of, somebody raised their salary so their daughter could get married. I abhor abuse in the foundation sector, the third sector, whatever you want to call it.

I abhor it. I abhor it because of the damage it does to others because people grab onto it, the media grabs onto it, it becomes an enormous factor, and then people generalize and assume everything is that way. I know it is not. I know it is not, because I have just seen enough that are trying to do the right thing.

I also felt, Mr. Chairman, in this hearing, from both sides of the dais here, that there is, I think, a very workable approach to solving these problems. A lot will come, as some have said, from within.

I think a very good example of that is the Nature Conservancy, who have done a superb job in reforming themselves and were shocked by what they went through, and then set about to make themselves, as I indicated, kind of a gold standard.

But I think there is a real desire to make this work right without affecting the inherent beauty of the American people which de Toqueville referred to, not in them and their organizations, but in their desire to give of themselves to others.

That is religious in its derivation, and it is also that America was formed in a very different way. People moved out west in the middle of the 19th century, they got their land, they put up white fences, and worried about educating their children. But it has always been in the American spirit, partly because of religion, this desire to help other people.

I will extend it to say that I can remember when I was Governor, we had terrible floods in West Virginia, where only 4 percent of the land is flat, and 96 percent is one shape or another of a mountain.

So, the water gathers very quickly and places are ruined easily. Virtually every time in the 8 years I was Governor I would open up National Guard armories, and nobody would come.

The reason they did not come is because their neighbors were taking them in. It was a sense of family. I think it is tremendously important that that not be destroyed in what we are doing here, that foundations are needed more than ever, that the American spirit is needed more than ever to contribute to foundations, for people to get on boards of foundations, and to do much more disciplined work, which perhaps they are now doing, where some foundations are so staff-driven, that boards become almost rubber stamps. It is a terrible thing when that happens, and it does.

But I think when you look at transparency, governance, oversight, I think we can do things here. We can pass legislation that will be effective, together with what is being done already within the foundation community.

I think the foundation community has been rocked by this. They have been rocked at least two other times I can think of in the 20 years that I have been here. But they survived because that is the American spirit, that is the American way of contribution. People want to do it.

One little caveat, just as a warning, on proving what you have done each year. I tend to think that is a good idea, on balance. I think one has to be careful, however, when one is dealing with, for instance, agricultural sciences.

I know one foundation that was trying to figure out how to take a grain of rice and quadruple what it produced, and it did, but it took a long time. I doubt the reports during all of those years would have been very easy to write, and were certainly very boring to read. Also, in medical science, where you are talking about the cure of extraordinary diseases.

On the other hand, all things being said, I think people should do that. Now, I worry about, will they have the resources in some smaller foundations to be able to do that? Because that is a very hard task to be looked at by the Commissioner, and all the rest of it.

But on balance, I think, Mr. Chairman, we are on our way here because of your good work in your classic Iowa manner in which you identify a problem with ferocity, and yet love, and then we all react to it. I see solutions coming, and I feel good for the future of foundations, provided we act prudently, which I think we will.

Thank you, Mr. Chairman.

The CHAIRMAN. I think, Senator Rockefeller, your statement says better than I have ever said the motivation behind making sure that the tax exemption is used wisely by charitable organizations, because we do, as you suggest, want to promote greater use of charitable giving and foundations and organizations, and you have expressed it very well, and I would associate myself with your remarks. I would say, in summation, that that is the purpose of the work that we have been doing for the last year.

I would just like to summarize a little bit for myself, in about 2 or 3 minutes.

The testimony today has made it clear that there is a need for reform, and particularly reforms that deal with this part of the tax

gap. We have heard good suggestions that will allow us to address the problems.

Balancing these efforts, I want to make certain of the vitality of nonprofits, in the same vein as Senator Rockefeller just expressed. Particularly, though, I want to make sure that, in keeping that vitality, in anything we do, as far as normal charities and churches are concerned, that they are not unduly burdened by government's reforms.

I want to note the work of the Nonprofit Panel which has been well represented here today by Ms. Aviv, Mr. Gallagher, and Mr. Panetta. So as you do your work in the next few months, consider that today we have heard extensive and thoughtful comments of problems in the nonprofit sector. These comments need to be passed on and made clear to the charitable sector as you conduct your discussions and meetings.

Too often, as charities across the country consider proposals for reform, they do so in an atmosphere that does not reflect the unfortunate realities that are coming out in a hearing like this.

I strongly encourage the Nonprofit Panel that their work must be one not only of dialogue with charities, but informed dialogue that starts with serious and significant education of the problem before it. Without education, it is only natural that some charities will respond as if the sky is falling.

It is, unfortunately, those who turn a blind eye to the problems of the charitable sector or seek only a fig leaf of reform who are potentially causing real long-term damage for nonprofits. Those who are seeking real reforms to address the issues raised by the Commissioner and others today will help ensure continued public confidence and support for nonprofits. By doing so, they act in the true interests of their charities.

Given the limited time frame, I encourage the Nonprofit Panel to concentrate its work, first, on the area of governance. It is particularly vital that the panel provide us serious proposals that the IRS can efficiently administer in the areas of self-dealing, governance, and payment of benefits.

The Finance Committee has taken a rare step of reaching out extensively. It is my hope that this experiment is not only a success in terms of trying to bring change to charities, but it also may be something we can build on in other areas in the work of this committee. It is an experiment where I hope we will see serious proposals, and see them quickly. Thank you.

Do you have one question you want to do?

Senator LINCOLN. I do.

The CHAIRMAN. How long is it going to take? I have a meeting. Could you adjourn the meeting?

Senator LINCOLN. Sure. Absolutely.

The CHAIRMAN. I trust her. [Laughter.] Here is what I would like to do, though, before she goes. Obviously, you have been around here for 3 hours now, and have presented your testimony. I thank you very much and look forward to working with you, particularly if you continue your panel work. Thank you very much.

I will turn it over to you. When you are done, then the hearing automatically is adjourned.

Senator LINCOLN. Absolutely. And thank you, Mr. Chairman, for putting such detail into a very important issue, and all of these groups that do a tremendous amount, the good actors, deserve that. So, thank you, Mr. Chairman.

I guess I have been a little bit concerned, and I wanted to get your response here, about what looks to be some of the illegal integration of politics in some of the nonprofits and not-secular industries. I guess my specific alarm came from recent reports that show that obviously there are politicians who have been able to raise money for lobbying and funnel that money to people who can arrange broadcasting and advertising for nonprofits, particularly on religious radio and TV stations. The stations then broadcast information, propaganda, what have you, supporting those politicians, the positions of the lobbyists and their clients.

So much of all that we know, oftentimes—until we get to this point where we have testimony and witnesses—is what we read in the news, read in the papers.

But from your standpoint, being so involved with a lot of those different groups when you were in the Office of Faith-Based Initiatives, were you aware of any of the nonprofit religious-based media organizations that were willing to participate in that political strategy or messaging in exchange for dollars, exchange for money?

Mr. KUO. No, Senator. I am not aware of any sort of quid pro quo, so to speak, where there was any explicit, implicit, or any other "plicit" acknowledgement.

I think behind your question is the question, was there sort of a pay or play, play for play sort of thing, were religious groups given money in exchange for support, or vice versa? I am not aware of anything remotely resembling that, no.

Senator LINCOLN. Again, some of the accounts that we hear in the reports indicate that, again, all of what we are investigating is making sure that those who are in the nonprofit arena and those that are taking that political status through the tax code are doing the things that they are designated to do, but not going forward, and a lot of that.

So if you did not see any or were not aware of any of that kind of activity that occurred——

Mr. KUO. And I am specifically speaking in terms of government grants. I assume that was what was behind your question, were groups brought in for support in exchange for government grants. That is what I understood your question to be.

Senator LINCOLN. Well, not necessarily just grants. I mean, we are talking about, certainly, the political arena—the whole political arena, not just government dollars that come through—but certainly in terms of the context of what nonprofits are there to do, whether or not they were working on behalf of politicians in return for what lobbyists were doing and what political support was going on in the direction for those politicians.

Mr. KUO. Again, I do not know of anything specific along those lines.

Senator LINCOLN. Did you see any of the reports or see any of the articles that were concerning the casino gambling, particularly, on the nonprofit radio?

Mr. KUO. No, none at all. But again, I left the White House in December of 2003.

Senator LINCOLN. Those are just accounts in the media.

Mr. KUO. No. I am not aware of any of those.

Senator LINCOLN. All right.

Well, thank you all so much for your help. I appreciate it, and I know the Chairman does. We are looking forward to coming up with some of the solutions that we can. Thank you.

The committee is adjourned.

[Whereupon, at 12:55 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF DIANA AVIV

Chairman Grassley, Senator Baucus and distinguished members of the Committee, I am Diana Aviv, executive director of the Panel on the Nonprofit Sector and President and CEO of INDEPENDENT SECTOR, a national nonprofit, charitable organization with approximately 500 members including public charities, private foundations and corporate philanthropy programs. I am pleased to be here today to share with you the recommendations contained in the Interim Report developed by the Panel on the Nonprofit Sector and to tell you about the remarkable process that resulted in these interim recommendations and that will continue for the next few months as we consider additional recommendations that will be included in the Final Report that you will receive in late spring.

INDEPENDENT SECTOR is a 501(c)(3) organization whose mission is to advance the common good by leading, strengthening, and mobilizing the independent sector. INDEPENDENT SECTOR's membership collectively represents tens of thousands of charitable groups serving causes in every region of the country, as well as millions of donors and volunteers. Long before the creation of the Panel on the Nonprofit Sector, INDEPENDENT SECTOR was working with our member organizations on identifying best practices and setting the highest standards of ethics and accountability. A Model Code of Ethics was developed and posted on our website last year, along with a guide for adopting and implementing a code. In 2002, INDEPENDENT SECTOR published a guide for nonprofit managers and trustees on the laws and regulations regarding intermediate sanctions. Currently IS committees are working on recommendations for a conflict of interest policy, a guide to creating and working with audit committees, and policies and procedures to encourage and protect those who make credible reports of illegal or unethical behavior. All of these publications and policy recommendations will be widely available to charities and foundations across the country.

The Panel on the Nonprofit Sector was convened by INDEPENDENT SECTOR in October 2004, with encouragement from the leadership of this Committee, in order to bring together an independent group of leaders from the nonprofit, charitable sector to consider and recommend actions that would strengthen governance and oversight of public charities and private foundations. The 24 distinguished leaders we contacted immediately agreed to serve on the Panel because they recognized that the unethical actions of some charitable organizations, coupled with the corporate scandals of recent years, had the potential to erode the public trust that is the lifeblood of charitable and philanthropic organizations.

Abuses in the nonprofit sector also prompted state and federal public officials, including this Committee, to seek ways to stop and prevent abuses by directors, staff leaders, donors, and those doing business with nonprofit organizations, possibly through new laws or regulations. At the Senate Finance Committee hearing in June 2004 and the roundtable discussion in July, INDEPENDENT SECTOR, among others, discussed initiatives we had previously undertaken to help

our member organizations improve their practices and meet high standards of governance and accountability. We were honored to have an opportunity to convene some of our sector's leaders in a more formal process to discuss these issues, to hear from experts from other sectors, and to share our best thinking with this Committee, with other public officials and, of course, with our colleagues in the charitable and philanthropic community.

Before I proceed with describing the work of the Panel, it is important to state clearly that the vast majority of America's 1.3 million charitable organizations are now, and have always been, responsible, ethical and accountable in the conduct of their programs and the management of their funds. The public annually entrusts these institutions with over $200 billion in direct charitable contributions, and the nation's 65,000 private foundations and corporate giving programs provide an additional $40 billion to support charitable endeavors. Some bad actors in our field have undermined the good works of all and we must respond, but we also must keep in mind that our goal is to eliminate bad practice, not to stifle the generosity of Americans whose gifts of time and money are essential to the work of charitable organizations, nor to impede the creativity of and the delivery of services from these organizations. The enthusiasm and speed with which the Panel, its work groups and advisory groups are conducting their work reflects our collective determination to assure the public and Congress that we are serious about preventing and punishing misconduct in the nonprofit sector and equally serious about preserving an environment in which the hundreds of thousands of lawful, ethical and accountable nonprofit organizations can continue to serve and enrich our communities, our nation and the world.

The Panel, Work Groups and Advisory Groups

INDEPENDENT SECTOR announced the formation of the Panel on the Nonprofit Sector on October 12, 2004. The 24 Panel members are all distinguished leaders from public charities and private foundations. Their collective experience reflects large and small nonprofit organizations, community foundations and membership associations, organizations that operate worldwide and those serving a single state. The missions of these organizations encompass a broad spectrum of causes, all of which are intended to promote the public good. The co-conveners of the Panel are Paul Brest, President of the William and Flora Hewlett Foundation in Menlo Park, California, and M. Cass Wheeler, Chief Executive Officer of the American Heart Association based in Dallas, Texas. (A complete list of Panel members and brief biographies are attached.)

As impressive as their experience and knowledge is, the members of the Panel recognized from the beginning of their work that it would be vitally important for them to benefit from the immense expertise within the sector as well from the views of experts outside the nonprofit world. To that end, the Panel established five Work Groups that collectively utilize the talents of more than 100 nonprofit professionals and experts, all of whom volunteered to participate in the Panel's work. Work Group members include leaders of national, regional and local organizations, academics and practitioners, state oversight officials, and executives of charities, foundations and corporate giving programs. Four of the Work Groups focus on issue areas—Governance and Fiduciary Responsibilities; Government Oversight and Self-Regulation; Legal Framework; and Transparency and Financial Accountability—while the fifth focuses on the special considerations of small organizations.

In addition, two Advisory Groups were created. The Expert Advisory Group draws its members from academia, law and nonprofit oversight, and offers the Panel particular expertise in the issue areas. The Citizens Advisory Group is comprised of leaders of America's business, educational, media, political, cultural and religious institutions who provide a broad perspective on how these issues affect the public at large.

Each of the Work Groups met three times between November 2004 and January 2005. They reviewed materials prepared by the Panel's staff and legal team analyzing issues raised in the Finance Committee's staff discussion paper on nonprofit governance, fiscal management and ethical practice. In between meetings, members actively shared opinions, comments and information via listservs and phone calls. By early 2005, each Work Group had developed recommendations to be submitted to the Panel for its deliberations. The Expert Advisory Group reviewed the Work Groups' recommendations and added its own comments and suggestions.

Because the Panel wanted to make its work as inclusive and transparent as possible, we created a website at www.NonprofitPanel.org. The recommendations of the five Work Groups and the comments of the Expert Advisory Group were all posted on the website; the Panel then encouraged members of charitable organizations to review and comment on them. In addition, three national conference calls were convened to answer questions and gather feedback from the field. Nearly 1,500 members of the nonprofit community participated in these calls.

On March 1, the Panel presented its Interim Report to Chairman Grassley at an event attended by press and members of the nonprofit community and shared with Senator Baucus, Congressman Thomas, and Commissioner Everson and distributed to all other Members of Congress. The Panel's work and deliberations benefited from the broad experience and collective wisdom of all these people. In the end, however, the recommendations contained in the Interim Report are those of the Panel.

You all have before you the Interim Report, which I request be submitted for the record in its entirety. Since the report was released, more than 200 organizations have endorsed its recommendations, and others continue to sign on. A list of endorsing organizations to date is attached to this testimony, and the list on our website is updated daily

The Panel asks this Committee to remember that we are only about half way through our process. As this hearing is taking place, Work Groups are well into the second phase of their work, and the Panel intends to offer many more recommendations in its Final Report in June. While we understand the desire to begin moving the legislative process forward, we believe that any bill on the critical issues of how to improve conduct within our sector should be informed by the recommendations that result from the profound effort of hundreds of groups that have come together in good faith to offer their views. These issues are so important and the effort so great that we fervently hope you will allow the Panel the opportunity to complete our work for you before introducing a bill.

I hope to have another opportunity to speak to the Committee when the Panel's Final Report is completed in June.

Mr. Chairman, your leadership in this area, the hearing and roundtable discussion the Finance Committee held last year, and the IRS's focus on exempt organizations have already had a significant effect on the sector's practices and procedures. As I travel around the country for field hearings on the Interim Report, I am constantly asked for more information on the issues and guidelines for action. Organizations are examining their own governance structures and identifying best practices. Leaders across the sector want to know what to do and how to improve their organizations. You have raised the level of awareness and stimulated a positive energy for change. Your leadership has already made a positive impact on raising the standards of conduct within the sector.

I elaborated on the process that resulted in the Interim Report because it speaks to the depth of the commitment within the charitable and philanthropic community to raise standards and improve practices in order to strengthen the public trust in the nonprofit sector and encourage the voluntary spirit that has since its earliest days been one of the distinguishing features of our country.

Guiding Principles

The Panel began its work with a discussion of the principles that should guide the recommendations it would make. The decision to establish this kind of framework led to a fascinating and edifying conversation that allowed us to step back from the detailed legal and accounting issues to think about the evolution of the sector, the role it has played in shaping the history and character of America, the millions of people who dedicate their time as volunteers, and the billions of dollars donors freely contribute to support not only individual programs or specific organizations, but the *idea*, uniquely American, that individuals can ban together in groups or associations to address problems, advance ideas, alleviate suffering, encourage artistic endeavors, protect freedoms, preserve the environment and improve our lives.

We are here today to talk about the details, the recommendations for forms and filings, audits and aggregates, and I will get to them in just a minute. Before I do, however, I ask this very knowledgeable Committee to do what the Panel members did: step back for a moment and remind yourselves that the task before us is to strengthen and improve the third sector of our society, the nonprofit sector, which along with government and business is a fundamental support of our nation and its people.

The eight principles that guided the Panel are:

Principle 1: A vibrant nonprofit sector is essential for a vital America.
Principle 2: The nonprofit sector's effectiveness depends on its independence.
Principle 3: The nonprofit sector's success depends on its integrity and credibility.
Principle 4: Comprehensive and accurate information about the nonprofit sector must be made available to the public.
Principle 5: A viable system of self-regulation is needed for the nonprofit sector.
Principle 6: Government should ensure effective enforcement of the law.
Principle 7: Government regulation should deter abuse without discouraging legitimate charitable activities.

Principle 8: Demonstrations of compliance with high standards of ethical conduct should be commensurate with the size, scale and resources of the organization.

The Interim Report briefly elaborates on each of these principles. Together, these eight principles touch on the value of the nonprofit sector, the responsibilities of nonprofit organizations as stewards of the public trust, and the roles of both the sector and government in maintaining the integrity of the sector and deterring abuse. We urge you to consider how any legislative changes would support or weaken these principles.

Recommendations of the Panel on the Nonprofit Sector

Maintaining the public trust in the nonprofit sector requires a balance between a self-regulatory system for charitable organizations, including a viable system of management and governance standards and proactive educational programs, and vigorous governmental oversight and enforcement. The recommendations in the Interim Report include suggested actions to be taken by the charitable organizations individually and the charitable sector as whole, actions to be taken by the IRS, and legislative actions to improve governance and oversight of the sector. *It should be emphasized that these recommendations are part of a comprehensive package of reform efforts in which no single remedy or recommendation stands alone.* Work Group members and Panel members repeatedly emphasized the imperative of viewing the recommendations contained in this Interim Report as a set, not to be divided up and carried out piecemeal.

The Interim Report divides the issues examined by the Panel into three categories and offers recommendations to:
1. Strengthen government oversight of charitable organizations;
2. Improve transparency in charitable organizations; and
3. Enhance governance of charitable organizations.

In the Interim Report each issue is described; actions are recommended for charitable organizations, for legislation, and/or for regulatory improvements; a rationale for each recommendation is offered; and other considerations, if any, are mentioned.

In its Final Report the Panel will offer recommendations on a range of other issues that are currently under consideration.

Since each of you has a copy of the full Interim Report, I will only highlight the key recommendations in the three categories at this time.

I. Recommendations to Strengthen Government Oversight of Charitable Organizations

In its Interim Report, the Panel identified several areas where current legal standards have proven inadequate to allow government regulators to deal with those who deliberately abuse the public trust and exploit nonprofit organizations for personal gain. The Panel and its Work Groups have, and continue to, examine new approaches to strengthen the regulatory framework to address and deter abuses without inhibiting the countless numbers of responsible volunteers and donors from

contributing their time and money to serve charitable organizations. In considering changes to the laws governing charitable organizations, the Panel is also aware of the need to contain the administrative and financial burdens of compliance for charitable organizations so that they are not forced to curtail or cease legitimate charitable activities.

First, the Panel believes that the legal framework for donor-advised funds must be strengthened to reduce the potential for abuse of these important charitable instruments. There is currently no statutory definition of a donor-advised fund, but it is generally understood to be a fund that is owned, controlled and administered by a public charity where the donor retains the right to make recommendations regarding the investment and/or distribution of the fund's assets for charitable purposes. Donor-advised funds have evolved as an important means of stimulating charitable contributions from donors who do not want the administrative and regulatory burdens of creating and maintaining their own foundation and who are willing to give up control of decisions regarding the investment and distribution of funds to gain the many benefits a donor-advised fund can offer.

The Panel believes it is essential that Congress enact a statutory definition of donor-advised funds to provide the context for specific rules to ensure that public charities administering donor-advised funds do not intentionally—or inadvertently—use those funds to provide inappropriate benefits to the donor or parties related to the donor. We have identified some of the components that should be included in that definition in our Interim Report and will recommend specific language for the definition in our Final Report. We have also recommended a number of statutory and regulatory changes that would prohibit grants from donor-advised funds to private non-operating foundations and prohibit grants, reimbursement or compensation to donor-advisors or related parties for services rendered, if all or substantially all of such compensation is paid from the relevant donor-advised fund.

We also recommend that public charities holding donor-advised funds be subject to minimum activity rules to ensure that funds are not permitted to remain inactive for extended periods and we are currently in the process of developing specific recommendations for such rules for this Committee's consideration. The principle of funds being required to have some activity directly addresses the concern of certain donors reaping the tax benefit of creating such accounts without distributing some of the funds for charitable purposes.

Second, the Panel believes that managers, directors and other "disqualified persons" should be subject to strict penalties when they receive improper or excessive financial benefits from the charitable organizations with which they are affiliated or when they approve or participate in illegal or improper transactions. Current penalties for self-dealing transactions by foundations leaders should be increased and the standard for imposition of first-tier excise taxes on organization managers should be modified to provide a realistic possibility that such penalties will be imposed on managers who approve or fail to oppose a prohibited transaction. The Panel is studying the proposals made by the Joint Committee on Taxation in its January 27, 2005, report and will make specific recommendations to this Committee for strengthening the system of penalties for those who knowingly participate or approve participation of others in abusive transactions. These recommendations will be forthcoming in the Final Report.

Third, the Panel recommends that Congress enact specific targeted rules to eliminate the inappropriate use of Type III supporting organizations for the personal benefit of contributors and their family members, while not eliminating altogether this type of organization. Supporting organizations are public charities that are organized and operated for the benefit of one or more other public charities. They allow a public charity to use separate entities to insulate assets from liability or to separate certain functions such as investing or fundraising. Type III supporting organizations should have a close and continuous relationship with the charities they support, but the charities have no legal control over the Type III organizations that support them. The flexibility currently allowed for Type III supporting organizations makes them uniquely suited to meet the needs of public charities, governmental entities, and donors in a variety of circumstances, but they have also been targets for abuse. The Panel is currently studying specific proposals made by the Joint Committee on Taxation, the American Bar Association, and others and will make specific recommendations for targeted anti-abuse rules in its Final Report.

Fourth, the Panel recommends that Congress enact appropriate anti-abuse provisions to deter charitable organizations from participating in abusive tax avoidance transactions. The Panel is deeply troubled by the participation of some charitable organizations in abusive tax shelter arrangements, but notes that such activity is a complex problem whose reach extends beyond charitable organizations. The Panel is currently studying proposals by the Joint Committee on Taxation and others to deprive charities of any financial benefits from prohibited tax shelter transactions and to penalize managers who approve such transactions, knowing or having reasons to know that the transaction is a prohibited transaction, and will make specific recommendations for corrective legislation in our final report. The Panel is also examining how organizations in our sector can work more effectively with the Internal Revenue Service to educate managers and directors about tax shelter transactions in order to prevent charities from becoming unwitting participants in abusive schemes. Recommendations on these issues will be forthcoming in the Panel's Final Report.

Fifth, the Panel recognizes that both current laws and recommended changes in the laws governing charitable organizations can only deter abuse if there is effective law enforcement. Today, oversight and enforcement of regulations governing charitable organizations is hampered by legal restrictions that prevent the IRS from sharing information about ongoing investigations with state attorneys general and other state officials charged with overseeing charitable organizations. This inability to share information about ongoing investigations increases the cost of oversight and enforcement, results in duplication of effort, and impedes the efforts of state and federal officials to weed out wrongdoing efficiently and effectively. In 2003, this Committee led the way to eliminate this barrier through a provision in the CARE Act that would allow state attorneys general and other state officials charged with overseeing charitable organizations the same access to IRS information currently available by law to state revenue officers. As you know, the CARE Act was passed by the full Senate by an overwhelming margin, although Congress was unable to resolve differences between the Senate and House versions of that bill before the end of the 108th Congress. We hope that this Committee will again lead the way to make sure that this important change is enacted into law this year.

Sixth, effective enforcement also requires adequate resources to ensure that the Internal Revenue Service is able to conduct audits and investigations to identify and pursue wrong-doing by

charitable organizations, as well as by individual and corporate taxpayers who misstate their tax liabilities. I want to commend Commissioner Everson for his actions in reallocating resources within the IRS budget to strengthen oversight and enforcement in the Exempt Organizations Division and to move ahead with electronic filing of the annual information returns filed by public charities and private foundations. I also want to express our appreciation to Commissioner Everson and the staff of the Exempt Organizations Division for their efforts to improve the information provided to managers and directors of charitable organizations through the IRS website and regional trainings. At the same time, we know that more resources are needed to ensure that the IRS is able to provide adequate oversight and enforcement of tax laws for *all* taxpayers, including those who may be overstating the value of their contributions to charitable organizations to reduce their tax liability inappropriately. We urge this Committee to work with your colleagues on the Appropriations Committees and with the Administration to increase the resources available to the IRS to ensure that the tax laws you enact are enforced fully.

Seventh, and last, the Panel believes that this Committee and Congress should take a careful look at the appropriate valuation and disposition of property donated to charitable organizations. Non-cash contributions are a significant source of support for countless charitable organizations and it is clear that the current tax laws provide important incentives for such contributions. A study by Michael Parisi and Scott Hollenbeck of 2002 individual income tax returns indicates that non-cash contributions represented nearly 25 percent of the contributions claimed as tax deductions by individual taxpayers who itemized deductions.[1] While many of these contributions are likely to be gifts of publicly traded stock, many Americans now hold their assets in real estate, privately held businesses and other personal property, and choose to make gifts of those assets to charitable organizations. The current tax incentives which allow individual taxpayers to claim the fair market value of those assets as a tax deduction, subject to rules for obtaining appraisals or other substantiation of that value and reporting those values to the IRS, appear to be a significant benefit for taxpayers who itemize deductions. The Parisi and Hollenbeck study shows that nearly 53 percent of taxpayers who itemized deductions claimed deductions for non-cash contributions totaling $34.3 billion in 2002.

The Panel shares your concerns, Mr. Chairman, about preventing and penalizing actions by individual and corporate taxpayers in over-valuing property they contribute to charity for the purpose of avoiding taxes they are obligated to pay. We also believe that it is essential for Congress not to create barriers that could severely damage a significant source of contributions for charities throughout the country. The Panel is currently examining a variety of proposals and data regarding ways to strengthen regulations, procedures and penalties to address the concerns raised by the Joint Committee on Taxation and will make specific recommendations for action by the Senate Finance Committee and the Internal Revenue Service in our Final Report.

INDEPENDENT SECTOR is working with a broad range of charitable organizations that are deeply concerned about the impact these proposals could have on their ability to fulfill their missions and serve community needs. I would like to share with you some of the specific concerns our community has regarding these proposals.

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[1] Michael Parisi and Scott Hollenbeck, Individual Income Tax Returns, 2002, SOI Bulletin Fall 2004.

1. The Joint Committee's proposal to limit the charitable deduction for clothing and household items to an aggregate annual total of $500 per taxpayer would create a significant disincentive for these gifts that are vitally important to the support of charitable activities. While many donations of clothing and household items may have minimal resale value, some may be given directly to families in need while other gifts, such as high-quality furniture, electronics, new or slightly used clothing and jewelry, are used in fundraising auctions, or sold through auctions and thrift stores to support vital charitable activities. Families often choose to donate the entire household furnishings and goods when closing an estate rather than conducting an auction or hiring an estate liquidation service, and these goods are of significant value to charities for their direct use or resale value. Setting a cap of $500 would be a significant disincentive to making these "higher-end" contributions for many taxpayers. We note that the Joint Committee does allow that the $500 limit "could be adjusted higher or lower," and we strongly encourage the Finance Committee to examine the impact of this proposal and consider alternatives proposed by the charitable community before determining the most appropriate manner of preventing taxpayer abuse without unduly harming this important revenue stream for our nation's charities.

2. We are deeply troubled by the Joint Committee's proposals to limit deductions on donations of property (other than publicly traded securities) to the lesser of the donor's basis or the fair market value. A significant number of Americans, particularly in rural areas, hold their wealth in real estate and in private business. Their basis is often significantly less than the current market value of their property and limiting deductions to the basis would likely cause many taxpayers to continue to hold these assets or to sell them, resulting in no gifts or a significantly lower gift to charity. Other aspects of the Joint Committee proposal would require the charity to dispose of donated property in a manner that could significantly diminish its financial value. The Panel agrees that we must have clear, consistent methods for determining the fair market value of such gifts, as well as stringent standards to assess the quality of appraisals used by taxpayers in determining the value of their gifts of property. We are studying the alternatives offered by the Joint Committee as well as other alternative approaches to address the concerns about possible over-valuation without incurring significant new costs for taxpayers or the IRS or greatly reducing incentives for taxpayers to make such contributions to charitable organizations. The goal, however, should be to end abuses, not eliminate donations of property which are important assets for religious organizations, community foundations, educational institutions and thousands of other charitable organizations.

3. Finally, we have concerns about the proposed changes to the charitable deduction for contributions of conservation and façade easements. Recent press stories have highlighted abuses by both charities and taxpayers in the valuation and treatment of such contributions, and we commend both the IRS and organizations in the conservation community, such as the Land Trust Alliance, for the actions they have taken to clarify rules, identify and penalize abusers, and prevent future abuse. There must be tighter rules and higher standards for appraisals and appraisers, and the IRS must have the resources it needs to conduct an effective review and audit program to address and correct taxpayer abuse. We are prepared to work with this Committee to determine the most effective and appropriatesystem for establishing reasonable procedures and requirements that must be

met by both charities and individual taxpayers to prevent or punish such abuses, but it should be done without placing barriers in the way of qualified conservation contributions that enable charitable organizations to pursue their charitable purpose.

II. Recommendations to Improve Transparency of Charitable Organizations

Effective oversight requires that regulators and the public have access to accurate, clear, timely and adequate information about the activities and finances of charitable organizations. It is also critical that donors, trustees, consumers of services, and other interested members of the public have access to such information to assure ongoing confidence in the sector's work. The Panel therefore has made three key recommendations to improve the flow of information between charitable organizations and the IRS, increase the accuracy of the information available, and make information about public charities and private foundations more readily accessible to the public.

First, the annual information returns filed by charities and private foundations with the IRS need significant improvements as this Committee heard from numerous witnesses at its hearings last June. Again, we thank Commissioner Everson and his staff for the improvements they have already made in the forms used to apply for tax-exempt status and efforts underway to improve the format and instructions of the Form 990 series returns. Last year, the IRS made it possible to file the Form 990 and 990-EZ returns electronically and they have recently made plans to require charitable organizations that file at least 250 tax returns annually to file their annual information returns electronically—a move we strongly endorse.

The Panel recommends that the IRS require mandatory electronic filing of **all** Form 990 series returns as expeditiously as possible, with all necessary adjustments for separate attachments and other changes necessary to ensure that charitable organizations of all sizes can comply with such requirements in a timely, cost-effective manner. Electronic filing will be enormously helpful in addressing concerns about incomplete and inaccurate returns. We recommend that the IRS require the highest ranking officer or trustee of the organization to sign the Form 990 or 990-PF return, thereby attesting to its accuracy and completeness. We also recommend that penalties currently imposed on income tax preparers of personal and corporate tax returns for omission or misrepresentation of information or disregard of rules and regulations should be extended to professional tax preparers of Form 990 series returns.

The Panel is in the process of reviewing the entire 990 series of returns used by charitable organizations and will be making recommendations in its final report on specific changes that would improve the utility of these forms for charities, regulators and the public.

Second, the quality of financial information on charitable organizations available to boards of directors, regulators and the public can be improved if financial statements were independently audited or reviewed according to accounting and auditing standards. The Panel recommends that all charitable organizations currently required to file a Form 990 return[2] and that have total

[2] Excluded 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.

annual revenues of $2 million or more be required to have an audit conducted of their financial statements and operations. Organizations with total annual revenues between $500,000 and $2 million should be required to have their financial statements reviewed by an independent public accountant. Those larger organizations required to have audited statements should also be required to file those statements with their Forms 990 or 990-PF and make them available for public inspection in the same manner as those Forms. The Panel recognizes that financial audits can be a substantial expense for a charitable organization, depending on its size, scale, complexity and location. We are continuing to assess whether our threshold figures are the right ones or whether regional adjustments might be necessary and we will report to you if we find the need to make any changes in these figures.

Third, the public and the IRS should be able to identify easily all organizations that currently qualify for tax-exemption but because organizations with annual gross receipts under $25,000 are not now required to file annual information returns, the IRS does not know and cannot inform the public where their current offices are located or whether those organizations even continue to exist. The Panel recommends that Congress enact legislation requiring all organizations recognized under section 501(c)(3) that are currently exempt from filing an annual information return solely because their annual receipts fall below the $25,000 threshold be required to file an annual notice with the IRS with very basic information about their current contact information, total revenues and expenditures, and current mission. In addition, the IRS should be required to automatically suspend the tax-exempt status of organizations that have been given sufficient notice from the IRS but still fail to file the required notification form for three consecutive years.

III. Recommendations to Enhance Governance in Charitable Organizations

The Panel recognizes that effective governance of charitable organizations is the key to achieving the highest standards of ethical conduct, legal compliance and charitable performance. The Panel is currently studying a number of proposals addressing the composition and responsibilities of the boards of charitable organizations and the education of board members and staff leaders to strengthen governance of our organizations. In the Interim Report, the Panel has recommended three specific actions that ***charitable organizations*** should take both individually and collectively, as a sector, to improve and strengthen governance.

First, every organization should adopt and enforce a conflict of interest policy tailored to its specific needs and its state laws. There can be many instances where board members and staff leaders have interests in other organizations and businesses that can be of great benefit to a charitable organization, but these overlapping interests can lead to inappropriate transactions if all leaders are not aware of the potential conflict of interest and how the organization manages such conflicts.

Second, boards of directors must be aware of and have the capacity to fulfill their responsibilities to ensure that all financial matters of the organization are conducted legally, ethically and in accordance with proper accounting rules. The Panel recommends that all charitable organizations ensure that they have individuals with some financial literacy on their board of directors and consider establishing a separate audit committee to assist the board in overseeing the audit process.

Third, all charitable organizations should establish 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. Such information is critical for boards and staff managers to correct or stop wrong-doing before further harm is done to the organization.

The Panel urges the charitable sector to implement a vigorous sector-wide effort to educate all charitable organizations and encourage the adoption of these recommendations. Recognizing that such an educational effort will require significant resources, the Panel is assessing what private funds might be available and may return to Congress with a recommendation that some public funds be made available as well.

For the Panel members, this section is perhaps the most important because it addresses the way charitable organizations do their business. It is about the integrity of our work. Although the Interim Report contains no recommended actions for Congress to take at this time to improve governance of charitable organizations, the Panel is taking a hard look at areas of great concern including board compensation, board responsibility for executive compensation and travel and expense reimbursement policies. We will have further recommendations on these issues in the Final Report.

These are some of the recommendations from the initial phase of the Panel's work. Some issues discussed during phase one require further study and have been referred back to the Work Groups for further study and consideration by the Panel for its Final Report due to this Committee in the spring. The Final Report will include specific recommendations for a statutory definition of donor-advised funds, targeted rules to prevent the abuse of Type III supporting organizations and participation by charities in abusive tax avoidance schemes, and the appropriate size of penalties assessed by the IRS for violations of self-dealing rules. In addition, the Final Report will address issues of board and executive compensation, rules to address taxpayer over-valuation of charitable contributions of property, and other recommendations to strengthen governance and self-regulation of charitable organizations.

Panel Research and Field Hearings

To assist the Panel in making informed recommendations in the second phase, three research projects have been initiated. These studies will analyze:

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

This research will be completed within the next month so that Panel members will be able to utilize the findings in their deliberations and the final recommendations will be informed by these timely results.

In addition, as part of its continuing effort to encourage the participation of the nonprofit community in its work, the Panel is holding field hearings across the country in March, April and May. These hearings offer another opportunity for thousands of nonprofits— large, intermediate and small; local, regional and national—to come together to hear directly from Panel members, share their reactions to the Interim Report and offer comments, feedback, and questions for the Final Report. Nonprofit staff, board members, consultants, and volunteers are all invited to participate in these hearings to let Panel members know about their experiences, their thoughts about additional issues that should be discussed, their questions about the final report, and any other concerns they may have. In the past two weeks I have been to Denver and San Francisco for the first two hearings; both were at capacity, as hundreds of organizations came to learn and to contribute. These have been constructive and collaborative meetings, serious conversations about how to improve the way nonprofits do business in order to retain the public trust and more effectively serve the public good. There is no doubt in my mind about the collective commitment these organizations have to reaching for the highest standards of ethics and accountability, transparency and effectiveness.

Everywhere I have been people are hungry for information and guidance. They are clamoring to learn what to do. This is reflected in the comments of a participant in our San Francisco hearing less than a week ago. Anna Marie Jones, executive director of Collaborating Agencies Responding to Disasters, a nonprofit facilitating the work of many relief organizations, said to me, "Please give us the information and the recommendations on what organizations can do now to improve practice and accountability and I will happily take them to our members today." Over and over again I hear the need for education. The Panel, INDEPENDENT SECTOR, and many other national organizations are planning ways to bring the Panel's recommendations to members, affiliates and other local and regional nonprofit organization. As I mentioned earlier, this effort will be demand significant resources, both human and financial. We will get back to you as our program plans become clearer.

Another message I bring to you from my travels is that many of these wonderful organizations are determined to meet higher standards and adopt recommended practices, but they are struggling with how to balance the added cost of compliance with their need to put as many dollars as possible into the programs that meet community needs. There is no easy answer to this chronic dilemma. Comments to the Panel have urged caution and asked that we take into account regional differences in costs as we make final recommendations on thresholds. A $2-million charity in San Francisco, for instance, will not have the same funds to spend on programs as a $2-million charity in Des Moines because its rent, personnel, transportation and other costs are so much higher. The Panel is examining options for dealing with this issue and will have more to say in the coming months.

Mr. Chairman, I am grateful to be able to be here today to represent these dedicated individuals and organizations, and I am humbled by the incredible work they do. Tomorrow I will go to New York City for a field hearing that had to be moved to a larger space to accommodate the hundreds of organizations interested in participating. Thereafter we hold field hearings in Des Moines, Minneapolis, San Diego, Dallas, Chicago, Washington, D.C., Atlanta, Detroit, Helena, and Seattle. The interest in the field in coming together to solve these problems and raise the

standard of our practice is reflective of how seriously the charitable sector takes these important issues.

Next Steps

A large part of the Panel on the Nonprofit Sector's work lies ahead. In addition to the issues held over from phase one, there are numerous other concerns related to strengthening the governance, ethics and accountability of charitable organizations that are being addressed in the second phase. A process similar to that in phase one is already underway with Work Groups drafting recommendations. The Expert Advisory Group and Citizens Advisory Group will again provide comments to the Panel for its consideration. One public conference call has been convened since the release of the Interim Report and others will take place prior to the release of the Final Report.

The Panel anticipates that there may be a need for further consideration of some issues following the release of the Final Report. Therefore, Panel members have agreed to continue to meet through the fall of 2005 and may bring some additional comments back to the Finance Committee.

Final Thoughts

Normally, when I testify before a Congressional committee, I begin my remarks with a brief overview of the nonprofit sector and the role charitable organizations have played throughout our history. Because I have testified before the Finance Committee before, and because I know that the Committee members are all aware of the work of nonprofit organizations in your states, I did not start today's testimony with facts and figures about our nation's charitable organizations. Instead, I began by reporting on the efforts we were taking before the Senate Finance Committee issued its discussion paper and those that are underway now. The Committee's hearings and the Panel process have energized our work and given the sector new determination to improve our practices and raise our standards. This work will continue to go on long after any legislative or regulatory reforms are implemented. We will work with you because our sector is committed to being worthy stewards of the public's trust and of the funds entrusted to us.

Our focus today is on areas that need improving in the nonprofit sector, but I cannot end my remarks without saying just a few words about what is right in the sector. Nonprofit organizations each day serve, educate, assist, enrich and empower millions of Americans in thousands of local communities. From the earliest colonists to tomorrow's leaders every generation has contributed to and benefited from the work of charitable organizations and by so doing has ingrained the concept of voluntarism deep into the American culture.

America's nonprofit organizations serve many functions. As proving grounds for innovative programs they pioneered many of the services we take for granted today such as public libraries and public schools, fire stations (many of which are still volunteer companies) and national parks. In these cases, the success of the voluntary efforts was so clear that governments (federal, state or local) took responsibility for them, expanding them so that all citizens could share the resources. The reverse has also been true, that is, governmental programs have benefited by

collaboration with nonprofit organizations that can appropriately tailor national services to meet the needs of individual communities and populations in need. Working in partnership with the charitable sector often enables public programs to provide even greater assistance by adding philanthropic resources to the public ones. Programs for the homeless, child care centers, health clinics and numerous other examples abound in our communities.

Philanthropic institutions are frequently incubators of ideas, sustaining research and development until such time as the ideas mature or die, but were at least given a chance to bloom. Such philanthropic initiatives enabled Jonas Salk's work that resulted in the polio vaccine, built the great museums of America, advanced rocket science research, and created the 9-1-1 emergency response system.

I could, but won't, go on and on about the invaluable work of the charitable sector. You all know what these organizations do in your states and for your communities. So I will end where the Panel began, with the principles that guided our work. The nonprofit sector must remain a vital component of American life; it must maintain its independence and creativity; it must operate with the highest standards of integrity and credibility; and it must always be responsible, accountable and transparent. Government should provide oversight and regulations for the sector to deter abuse, without discouraging legitimate charitable activity. The Panel on the Nonprofit Sector is committed to offering Congress, the IRS and the charitable and philanthropic community its best advice on how to meet those goals.

Mr. Chairman, Senator Baucus, members of the Committee, I look forward to continuing this dialogue throughout Phase Two of the Panel on the Nonprofit Sector and beyond.

APPENDIX A
PANEL MEMBERSHIP

The Panel on the Nonprofit Sector is comprised of 24 nonprofit and philanthropic leaders from a wide spectrum of public charities and private foundations from all parts of the country, reflecting diversity in mission, perspective, and scope of work. Paul Brest, president of the William and Flora Hewlett Foundation of Menlo Park, California, and Cass Wheeler, chief executive officer of the American Heart Association of Dallas, Texas, will serve as co-conveners of the group. Diana Aviv, president and CEO of INDEPENDENT SECTOR, is executive director.

Learn more about the Panel by visiting www.NonprofitPanel.org.

Co-Conveners:

- Paul Brest, President, William and Flora Hewlett Foundation, Menlo Park, Calif.
- M. Cass Wheeler, Chief Executive Officer, American Heart Association, Dallas, Texas

Panel Members:

- Susan Berresford, President & CEO, Ford Foundation, New York, N.Y.
- Linda Perryman Evans, President & CEO, The Meadows Foundation, Dallas, Texas
- Marsha Johnson Evans, President & CEO, American Red Cross, Washington, D.C.
- Brian Gallagher, President & CEO, United Way of America, Alexandria, Va.
- Kenneth L. Gladish, Chief Executive Officer, YMCA of the USA, Chicago, Ill.
- Robert Greenstein, Executive Director, Center on Budget and Policy Priorities, Washington, D.C.
- Stephen B. Heintz, President & CEO, Rockefeller Brothers Fund, New York, N.Y.
- Wade Henderson, Executive Director, Leadership Conference on Civil Rights, Washington, D.C.
- Dorothy A. Johnson, President Emeritus, Council of Michigan Foundations, Grand Haven, Mich.
- Paul Nelson, President, Evangelical Council for Financial Accountability, Winchester, Va.
- Jon Pratt, Executive Director, Minnesota Council of Nonprofits, St. Paul, Minn.
- William C. Richardson, President & CEO, W.K. Kellogg Foundation, Battle Creek, Mich.
- Dorothy S. Ridings, President & CEO, Council on Foundations, Washington, D.C.
- John R. Seffrin, President & CEO, American Cancer Society, Atlanta, Ga.
- Sam Singh, President & CEO, Michigan Nonprofit Association, Lansing, Mich.
- Edward Skloot, Executive Director, Surdna Foundation, New York, N.Y.
- Lorie A. Slutsky, President, New York Community Trust, New York, N.Y.

- William E. Trueheart, President & CEO, The Pittsburgh Foundation, Pittsburgh, Pa.
- William S. White, President, Charles Stewart Mott Foundation, Flint, Mich.
- Timothy E. Wirth, President, United Nations Foundation, Washington, D.C.
- Gary L. Yates, President & CEO, The California Wellness Foundation, Woodland Hills, Calif.
- Raul Yzaguirre, President & CEO, National Council of La Raza, Washington, D.C.

Executive Director:

- Diana Aviv, President & CEO, INDEPENDENT SECTOR, Washington, D.C.

BIOGRAPHIES OF THE MEMBERS OF THE PANEL ON THE NONPROFIT SECTOR

Co-Conveners

Paul Brest is the president of the William and Flora Hewlett Foundation in Menlo Park, California. The foundation's grantmaking focuses on education, environment, performing arts, population, and global economic development. Mr. Brest was previously a professor at Stanford Law School, where he focused on constitutional law and problemsolving/decisionmaking, and he served as dean between 1987 and 1999. He is coauthor of *Processes of Constitutional Decisionmaking* and currently teaches a law school course on *Problemsolving, Decisionmaking, and Professional Judgment*. He also was a law clerk to Judge Bailey Aldrich and Supreme Court Justice John M. Harlan, and practiced with the NAACP Legal Defense and Educational Fund, Inc., in Jackson, Mississippi, doing civil rights litigation. Mr. Brest received an A.B. from Swarthmore College in 1962 and an LL.B from Harvard Law School in 1965. He holds honorary degrees from Northeastern Law School and Swarthmore College and is a member of the American Academy of Arts and Sciences.

M. Cass Wheeler is chief executive officer of the American Heart Association, a national voluntary health agency whose mission is to reduce disability and death from cardiovascular diseases and stroke. Mr. Wheeler joined the organization at its Texas affiliate in Austin in 1973, where he became vice president for field operations and later executive vice president. He came to the National Center in Dallas in 1982 as chief operating officer, assumed the position of senior vice president for field operations in 1996, and was named CEO in 1997. Under his leadership, the association merged its 56 individual state and metropolitan affiliates into 12 regional affiliates and adopted a single corporate structure. Previously chair of the Board of Directors for the National Health Council, Mr. Wheeler is currently on the boards of Partnership for Prevention, National Center for Tobacco-Free Kids, Research!America, and the National Assembly of Human Service Organizations. He is also on the boards of INDEPENDENT SECTOR and Advisors of Discovery Health Media, Inc. and is on the Citizens Advisory Council for the Campaign for Medical Research and Advisory Council of the Campaign for Public Health. Mr. Wheeler received a bachelor's degree in business from the University of Texas at Austin in 1963, after which he served in various roles at the American Cancer Society; between 1969 to 1973, he was a stockbroker in Dallas. A native Texan, Mr. Wheeler is an elder in the First Presbyterian Church of Dallas.

Members

Susan Berresford was named president of the Ford Foundation in 1996. One of the largest foundations in the United States, Ford supports programs around the world that strengthen democratic values, reduce poverty and injustice, promote international cooperation and advance human achievement. Ms. Berresford joined the foundation's Division of National Affairs in 1970 and later became officer in charge of its women's

programs and then vice president for the U.S. and International Affairs programs. After serving as vice president in charge of worldwide programming, she was named executive vice president and chief operating officer of the foundation, a position she held until she became president. Prior to joining Ford, Ms. Berresford was a program officer for the Neighborhood Youth Corps and worked for the Manpower Career Development Agency, where she was responsible for the evaluation of training, education, and work programs. She attended Vassar College and then studied American history at Radcliffe College, from which she graduated cum laude. She is on the board of the Council on Foundations and a member of the Trilateral Commission and the American Academy of the Arts and Sciences.

Linda Perryman Evans is president and CEO of The Meadows Foundation, one of the nation's largest private philanthropies. The foundation is dedicated to enriching the lives of Texans, particularly in the areas of public education, mental health and the environment. A trustee of the foundation since 1975, Ms. Evans has held a wide range of positions since receiving her B.A. from the University of Texas. In Washington, D.C., she worked for President Ford's re-election campaign, the American Enterprise Institute, the late Senator John Heinz, and the White House Office of Media Relations and Planning for President Reagan. In Dallas, Ms. Evans was an active partner in a public relations firm before assuming her current position. She has been deeply involved in the city's nonprofit community, currently and previously serving on the boards of education, arts, and health care organizations. Her dedication has been recognized many times: in 2002, she received the Prism Award from the Greater Dallas Mental Health Association for her work in improving mental health services, and the Encomienda de la Orden de Isabel La Catholica, one of Spain's highest honors, for enhancing relations between Spain and the United States. Ms. Evans currently serves on the Legislation and Regulations Committee for the Council on Foundations, is president-elect of the Conference of Southwest Foundations, and chairs the Mid-America Foundations Task Force on Standards and Accountability.

Marsha Johnson Evans became president and CEO of the American Red Cross in August 2002. She leads an organization that annually assists the victims of more than 70,000 natural and human-caused disasters, collects six million units of blood donations, trains more than 11 million people in lifesaving skills, transmits emergency messages for military families around the globe, and provides international relief and development programs. Born in Springfield, Illinois, she graduated from Occidental College in Los Angeles and immediately began a 30-year career in the U.S. Navy. Ms. Evans retired in 1998 as a rear admiral, one of the few women to reach that rank, and soon after became head of Girls Scouts of the USA. There she led efforts to increase substantially the number of adult volunteers, and she created or expanded cutting-edge programs to enhance girls' knowledge of science, technology, sports, money management, and community service. Since coming to the Red Cross, Ms. Evans has championed the recruitment of volunteers and employees from diverse backgrounds and has developed a new strategic plan with input from 6,000 Red Crossers, community leaders, and other stakeholders. Among her many awards are the prestigious 2002 John W. Gardner Legacy

of Leadership Award by the White House Fellows Association. She lives with her husband, a retired Navy jet pilot, in metropolitan Washington, D.C.

Brian Gallagher became president and CEO of United Way of America in January 2002. He now leads the national United Way movement, which includes approximately 1,400 community-based United Way organizations, each of which is independent, separately incorporated and governed by local volunteers. Mr. Gallagher began his 20-year United Way career immediately after college, when the organization selected him as a management trainee. He most recently served as president of the United Way of Central Ohio, leading the organization as it redesigned itself from a fundraising federation to a collaborative community leadership organization focused on the region's most pressing issues. Prior to moving to Columbus in 1996, Mr. Gallagher spent nearly six years at the United Way of Metropolitan Atlanta, including two years as executive vice president and CEO. He currently serves on the board of INDEPENDENT SECTOR. Born in Chicago and raised in Hobart, Indiana, Mr. Gallagher received his bachelor's degree in social work from Ball State University and a master's degree in business from Emory University.

Kenneth L. Gladish became the national executive director of the YMCA of the USA in February 2000. Together, the nation's more than 2,500 YMCAs make up America's largest not-for-profit community service organization, working to meet the health and social service needs of 18.9 million men, women and children. Dr. Gladish entered the Y as a boy in suburban Chicago, where he first joined and later volunteered and worked at his local branch. He came to his current position following six years as executive director of the Indianapolis Foundation and William E. English Foundation and three years as president of the Central Indiana Community Foundation. Dr. Gladish has volunteered as a college trustee, Rotary Club president, elder in the Presbyterian Church, and commissioner of the Indiana Martin Luther King Holiday Commission. He currently serves on several boards, including those of American Humanics, the Association of Professional Directors, Chicagoland Chamber of Commerce, and the National Human Services Assembly. Dr. Gladish received his bachelor's degree from Hanover College in Indiana and his master's and doctorate in foreign affairs from the University of Virginia. He and his wife have two children and live in the Chicago area.

Robert Greenstein founded and is executive director of the Center on Budget and Policy Priorities, one of the nation's most respected analysts of federal and state fiscal policy and of public programs that affect low- and moderate-income families and individuals. Mr. Greenstein's expertise on the federal budget and in particular, the impact of tax and budget proposals on low-income people, was illustrated in 1996, when he was awarded a MacArthur Fellowship. He has written numerous reports, analyses, op-ed pieces, and magazine articles on poverty-related issues and is frequently asked to testify on Capitol Hill. In 1994, he was appointed by President Clinton to serve on the Bipartisan Commission on Entitlement and Tax Reform. Prior to founding the center, Mr. Greenstein was administrator of the Food and Nutrition Service at the U.S. Department of Agriculture, where he directed the agency that operates the federal food assistance programs, with a staff of 2,500 and a budget of $15 billion.

Stephen B. Heintz joined the Rockefeller Brothers Fund in February 2001 as its fourth president. Founded in 1940 by the sons and daughter of John D. Rockefeller Jr., the RBF is an international foundation supporting social change to help build a more just, sustainable, and peaceful world. Before joining the RBF, Mr. Heintz held leadership positions in both the nonprofit and public sectors. He dedicated the first 15 years of his career to politics and government in Connecticut, where he served as Commissioner of Social Welfare and Commissioner of Economic Development. In 1988, he helped draft and secure passage by Congress of "The Family Support Act," the first major reform of the nation's welfare system. Between 1990 and 1997, Mr. Heintz was executive vice president and chief operating officer of the EastWest Institute, where he worked on issues of economic reform, civil society development, and international security in Central and Eastern Europe. Most recently, Mr. Heintz was founding president of Dēmos: A Network for Ideas & Action, a public policy research and advocacy organization working to enhance the vitality of American democracy and promote more broadly shared economic prosperity. He is a magna cum laude graduate of Yale University.

Wade Henderson is executive director of the Leadership Conference on Civil Rights and counsel to the Leadership Conference on Civil Rights Education Fund. The nation's premier civil and human rights coalition, LCCR encompasses over 180 national organizations, including those representing persons of color, women, children, organized labor, persons with disabilities, older Americans, gays and lesbians, civil liberties and human rights interests, and major religious institutions. Under Mr. Henderson's leadership, LCCR has become one of the nation's most effective defenders of civil and human rights; it currently works on election reform, federal judicial appointments, public education reform, prevention of hate crimes, criminal justice reform, and immigration and refugee policy. He graduated from Howard University and the Rutgers University School of Law (Newark) and was previously Washington bureau director of the NAACP and associate director of the Washington national office of the American Civil Liberties Union. His many awards include the Congressional Black Caucus Chair's Award; the District of Columbia Bar's William J. Brennan Award; and the Everett C. Parker Award from the Office of Communication, Inc. of the United Church of Christ.

Dorothy A. Johnson served as President of the Council of Michigan Foundations for 25 years. The Council, an association of more than 400 Michigan foundations and corporations offering grants for charitable causes, is the largest regional association of grantmakers in the nation; its mission is to enhance, improve, and increase philanthropy in the state. Ms. Johnson is currently on the boards of the W. K. Kellogg Foundation, the Kellogg Company, AAA–Michigan, Grand Valley State University, and the Corporation for National and Community Service. Her past experience was equally varied, with service on the boards of National City Bank, the Grand Haven Area Community Foundation, the Presbyterian Foundation, the Council on Foundations, and Independent Sector. Many organizations have recognized her work: the Council of Foundations named her Distinguished Grantmaker of 2000; and the Michigan Women's Foundation gave her its Women of Achievement and Courage Award. Ms. Johnson has also been president of the Community Foundation Youth Project, a program created to develop

youth philanthropy programs. She received her BA from the University of California at Berkeley.

Paul Nelson has been president of the Evangelical Council for Financial Accountability for the last 10 years. ECFA, which is now celebrating its 25th anniversary, is an accreditation agency for over 1,100 nonprofit Christian organizations that share a common Statement of Faith. Mr. Nelson joined ECFA after serving for nine years as executive vice president and CEO of Focus on the Family, a nonprofit radio ministry founded by Dr. James Dobson. He began to work at Focus on the Family in 1985 after spending 23 years in financial management in the chemicals and oil industries. He has represented Focus on the Family and ECFA as a speaker and instructor in both national and international venues, and he has been recognized many times for his service to the nonprofit community including *The NonProfit Times* "Executive of the Year" in 1996. Mr. Nelson graduated from Adelphi College with a degree in business, and he and his wife, Elaine, reside in Winchester, Virginia.

Jon Pratt is director of the Minnesota Council of Nonprofits, an association of 1,500 organizations that sponsors research, training, lobbying and negotiated discounts to strengthen the state's nonprofit sector. Before coming to the council in 1987, he worked as attorney/lobbyist for an environmental organization (Minnesota Public Interest Research Group), as regional director for an alternative foundation (the Youth Project), and as director for a coalition formed by nonprofits to reform corporate and foundation philanthropy (the Philanthropy Project). Mr. Pratt currently co-chairs the Public Policy Committee of the National Council of Nonprofit Associations, which is made up of 39 statewide nonprofit associations with a combined membership of 20,000 organizations. He is also contributing editor of the *Nonprofit Quarterly*, a national journal based in Boston, and has been recognized several times by *The NonProfit Times* as one of the 50 most influential nonprofit leaders in the United States. Mr. Pratt has a law degree from Antioch School of Law and a M.P.A. from Harvard University. He lives in Minneapolis.

William C. Richardson is president and chief executive officer of the W. K. Kellogg Foundation. The Foundation is dedicated to building the capacity of individuals, communities, and organizations in solving challenging issues. Before becoming head of the Kellogg Foundation, Dr. Richardson was president of the Johns Hopkins University; he has also been executive vice president and provost of Pennsylvania State University and served as dean of the graduate school and vice provost for research of the University of Washington. Dr. Richardson has been active with all three sectors of society, non-profit institutions, government, and corporations. He is a trustee of the Council of Michigan Foundations, a former chair and board member of the Council on Foundations, and a fellow of the American Academy of Arts and Sciences and the American Public Health Association. He is a member of the Institute of Medicine of the National Academy of Sciences and chaired its Committee on the Quality of Health Care in America. He serves on the boards of directors of the Kellogg Company, CSX Corporation, and The Bank of New York. Dr. Richardson graduated from Trinity College with a bachelor's degree in history and later earned an M.B.A. and Ph.D. in business from the University of Chicago Graduate School. Dr. Richardson and his wife, Nancy, have two children and live in Hickory Corners in southwestern Michigan.

Dorothy S. Ridings is president and CEO of the Council on Foundations, a national association of more than 2,000 foundations and corporations whose grants this year will total approximately $18 billion. Before joining the Council in 1996, Ms. Ridings spent eight years as publisher and president of Knight-Ridder's *Bradenton Herald* in Bradenton, Florida. She previously served as a Knight-Ridder general executive in Charlotte and held editorial and reporting positions at *The Kentucky Business Ledger*, *The Washington Post* and *The Charlotte Observer*. Ms. Ridings was president of the League of Women Voters from 1982 to 1986, and was a member of its board of directors from 1976 to 1986. She serves as board chair of the National Civic League and of the Louisville Presbyterian Theological Seminary, and she is also a member of the boards of the Foundation Center and the Commission on Presidential Debates. Formerly a trustee of the Ford Foundation and a director of the Benton Foundation, she is currently a member of the council that accredits journalism schools. She holds a bachelor's degree in journalism from Northwestern University's Medill School of Journalism and a master's degree from the University of North Carolina, and she taught journalism at the University of Louisville and the University of North Carolina.

John R. Seffrin is chief executive officer of the American Cancer Society, the world's largest voluntary health organization devoted to fighting cancer. Prior to being named CEO in 1992, Dr. Seffrin was professor of health education and chair of the department of Applied Health Science at Indiana University. During 20 years as an ACS volunteer, he chaired the Indiana Division board of directors and, later, the national board from 1989 to 1991. Two governors of his home state of Indiana have recognized Dr. Seffrin's work, and he was awarded an honorary Doctor of Science degree from his undergraduate alma mater, Ball State University. He is a member of the board of directors of INDEPENDENT SECTOR and is currently finishing his third year as chair. He has also served numerous public service and governmental agencies, including as vice president of the American Lung Association's national board of directors and as a member of the U.S. Surgeon General's Advisory Committee on Smoking and Health. Dr. Seffrin is recognized as an international cancer control leader who has spoken on public health issues throughout North America, Australia, Europe, and Asia. In June 2002 he became President of the International Union Against Cancer, the only global NGO whose singular purpose is to advance the worldwide fight against cancer. Dr. Seffrin lives in Atlanta with his wife.

Sam Singh is the president and CEO of the Michigan Nonprofit Association, a 750-member organization dedicated to promoting an effective nonprofit sector by convening key nonprofit organizations, encouraging voluntary giving and service, and taking an active role in nonprofit public policy. Before joining MNA, Mr. Singh worked at several other nonprofit organizations, including the Volunteer Centers of Michigan, the Michigan Community Service Commission and the Points of Light Foundation. He currently serves on the Board of Directors for the Points of Light Foundation, the Capital Area Transit Authority (CATA), the Michigan Association of United Ways, and the Capital Regional Community Foundation. A graduate of Michigan State University with a B.A.

in history, he lives in East Lansing, where he was re-elected to serve a four-year term on the City Council and is currently serving as Mayor Pro Tem.

Edward Skloot is executive director of the Surdna Foundation, a family foundation headquartered in New York City that makes grants in five fields: the environment, neighborhood revitalization, youth organizing, arts, and nonprofit sector issues. The foundation's first professional employee, Mr. Skloot has built a staff of 20 and helped Surdna, which has assets of nearly $700 million, earn a national reputation for entrepreneurial grantmaking, collaborative approaches with other funders and grantees, and aggressive solution-finding for complex problems. Mr. Skloot previously founded and ran New Ventures, a consulting firm that created the field of social venturing and nonprofit entrepreneurship; he also wrote the first article ever published on the subject, in the Harvard Business Review in 1983. He currently serves on the board of Consumers Union (publisher of *Consumer Reports*) and Venture Philanthropy Partners, a group of venture capitalists helping youth-serving organizations in the Washington, D.C. region. He is a member of the advisory board of the Bridgespan Group, a nonprofit consulting firm. Mr. Skloot has written and spoken widely on the subjects of nonprofit management, social venturing and sectoral leadership and is also a member of the Editorial Board of the *Stanford Social Innovation Review*. He graduated from Union College in Schenectady, New York, and from the Columbia University School of International Affairs.

Lorie A. Slutsky has been the president of The New York Community Trust, the country's largest and one of its oldest community foundations, since 1990. Though it also funds other projects, the Trust focuses on four areas: arts, education, and the humanities; children, youth, and families; community development and environment; health and people with special needs. Ms. Slutsky began at the Trust in 1977 as a grantmaker for education, housing, government and urban affairs, and neighborhood revitalization. She was appointed vice president for special projects in 1983 and executive vice president in 1987, when she assumed responsibility for strategic planning, personnel and budget management, and oversight of all departments. Ms. Slutsky received her B.A. from Colgate University, where she was a trustee for nine years, and her M.A. from New School University, where she is currently a trustee. Ms. Slutsky serves on the boards of the United Way of New York City and BoardSource and is a director of Alliance Capital Management, one of the nation's largest investment management firms. A former board chairman of the Council on Foundations and vice chairman of the Foundation Center, she also has served on the boards of Hispanics in Philanthropy, the Nonprofit Finance Fund, the Nonprofit Coordinating Committee of New York, the DeWitt Wallace Fund for Memorial Sloan Kettering Cancer Center, and the Lila Acheson Wallace Fund for the Metropolitan Museum of Art.

William E. Trueheart is president and chief executive officer of the Pittsburgh Foundation, which since 1945 has worked to improve the quality of life in its region by addressing community issues, promoting charitable giving, and connecting donors to critical needs. Dr. Trueheart has had a richly varied career with nonprofit organizations, including work at several major universities. After many years at the University of

Connecticut, including as a Dean, he moved to Harvard University, where he was associate secretary of the university and assistant dean and director of the Master in Public Administration program at the John F. Kennedy School of Government. He then moved to Bryant College in Rhode Island, serving as executive vice-president before becoming the school's first African-American president. Immediately before his current position, he served as president of Reading Is Fundamental, Inc. Dr. Trueheart has consulted with the National Park Service, the Ford Foundation, the Lilly Endowment, and the Mary Reynolds Babcock Foundation. He has extensive experience on the boards of local and national nonprofits: he has been nominated to serve as chair of Independent Sector, and he was previously chair of the Rhode Island Independent Higher Education Association, vice chair of the National Council of Presidents for the Association of Governing Boards, and a director of the American Institute of Certified Public Accountants. He earned his B.A. from the University of Connecticut, his M.P.A. from the John F. Kennedy School of Government, and his Ed.D. from the Graduate School of Education at Harvard.

William S. White is chairman, president and CEO of the Charles Stewart Mott Foundation, a private philanthropy based in Flint, Michigan, committed to supporting projects that promote a just, equitable and sustainable society. Mr. White joined Mott in 1969, became its president in 1976, and assumed the role of chairman in 1988. He currently serves on the boards of the European Foundation Centre, United States Sugar Corporation (chairman), Network of European Foundations for Innovative Cooperation, the After-School All-Stars, INDEPENDENT SECTOR, the C. S. Harding Foundation, and the Isabel Foundation. He has previously served on the boards of GMI Engineering & Management Institute (now Kettering University), CIVICUS: World Alliance for Citizen Participation; Council of Michigan Foundations; the Flint Public Trust, Council on Foundations, the Flint Area Focus Council, American Friends of the Czech Republic, American Water Works, Daycroft School, and Adventures Unlimited. In the 1980s Mr. White was a member of President Ronald Reagan's task force on private sector initiatives, and in the 1990s he served on the Carter Center's observer delegation to the Palestinian elections, on the U.S. Presidential Delegation to observe the Bosnian elections, and on a Presidential Economic and Business Development Mission to Croatia and Bosnia. He received a B.A. and M.B.A. from Dartmouth College, and is the recipient of several honorary degrees. Mr. White is married and has two children.

Timothy E. Wirth is the president of the United Nations Foundation and Better World Fund, both of which were founded in 1998 to support and strengthen the work of the United Nations. Sen. Wirth began his career in government as a White House Fellow under President Johnson and later became Deputy Assistant Secretary for Education in the Nixon Administration. In 1975, he returned to his home state of Colorado and won the first of six consecutive terms for the U.S. House of Representatives, where he concentrated on communications technology and budget policy. Sen. Wirth was elected to the U.S. Senate in 1987 and shifted his focus to environmental issues, especially climate change and population stabilization. After choosing not to run for re-election, he served as the first Undersecretary of State for Global Affairs, coordinating U.S. foreign policy on refugees, population, environment, science, human rights and narcotics.

President of the UN Foundation since its inception, Sen. Wirth has developed its mission and program priorities, which include the environment, women and population, children's health and peace, security and human rights. Sen. Wirth graduated from Harvard College, where he has since served as a member of the Board of Overseers, and holds a Ph.D. from Stanford University. He is married to Wren Wirth, president of the Winslow Foundation; they have two grown children.

Gary L. Yates is president and chief executive officer of The California Wellness Foundation, which works to improve the health of the state's people by making grants for health promotion, wellness education and disease prevention. His more than 30 years of experience in public health and education include serving as associate director of the division of adolescent medicine at Children's Hospital Los Angeles. A licensed marriage and family therapist, Mr. Yates is also assistant clinical professor of pediatrics at the University of Southern California School of Medicine. He serves on the boards of the Council on Foundations, the Foundation Consortium, and INDEPENDENT SECTOR. He has received official commendations from the governor of California, the California State Senate, the city of Los Angeles, and the Los Angeles County Board of Supervisors. Mr. Yates was also the recipient of the 1999 Hispanic Health Leadership Award from the National Coalition of Hispanic Health and Human Services Organizations and the 1998 recipient of the Los Angeles Free Clinic's Lenny Somberg Award. He received his undergraduate degree in government from American University in Washington, D.C., and his master's degree in counseling psychology from the University of Northern Colorado.

Raul Yzaguirre is president of the National Council of La Raza, the largest constituency-based national Hispanic organization and leading Hispanic think tank in America. Born in the Rio Grande Valley of South Texas, he began his civil rights career at 15, when he organized a junior auxiliary of an Hispanic veterans organization. After four years in the U.S. Air Force Medical Corps, he founded the National Organization for Mexican American Services, and a proposal he wrote for NOMAS led to the creation of what is now NCLR. Mr. Yzaguirre joined NCLR in 1974 and has spearheaded its emergence as the country's most influential and respected advocate for Hispanics. Mr. Yzaguirre has been honored on many occasions for his work: for example, he was the first Hispanic to receive a Rockefeller Public Service Award from Princeton University, and he received the Order of the Aztec Eagle, the highest honor given by the government of Mexico to noncitizens. He serves on the board of directors of numerous organizations, including Sears, Roebuck and Co., United Way of America, AARP Services, Inc., National Hispanic Leadership Agenda, and the Leadership Conference on Civil Rights; he is also a past chairman of INDEPENDENT SECTOR. Mr. Yzaguirre, who lives in the Washington area, received his B.S. from the George Washington University.

Executive Director

Diana Aviv is president and CEO of INDEPENDENT SECTOR, a nonprofit, nonpartisan coalition of approximately 600 national organizations, foundations, and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state in the nation. Its mission is to advance the common good by leading,

strengthening, and mobilizing the independent sector. Prior to joining IS in 2003, she spent nine years at United Jewish Communities as vice president for public policy and director of the Washington Action Office. Ms. Aviv was formerly associate executive vice chair at the Jewish Council of Public Affairs, director of programs for the National Council of Jewish Women, and director of a comprehensive program serving battered women and their families. She is immediate past chair of the National Immigration Forum, is an advisory board member of the *Stanford Social Innovation Review* and the Center for Effective Philanthropy, and is a member of the Board of Governors for the Partnership for Public Service. A native of South Africa, Ms. Aviv graduated with a B.S.W. from the University of Witwatersrand in Johannesburg and received her Master of Social Work degree at Columbia University.

APPENDIX B

LIST OF ENDORSERS OF THE INTERIM REPORT

The following organizations and individuals have signed on in support of the recommendations in the Panel on the Nonprofit Sector's Interim Report. This list is current as of April 2, 2005, and is updated daily at www.NonprofitPanel.org.

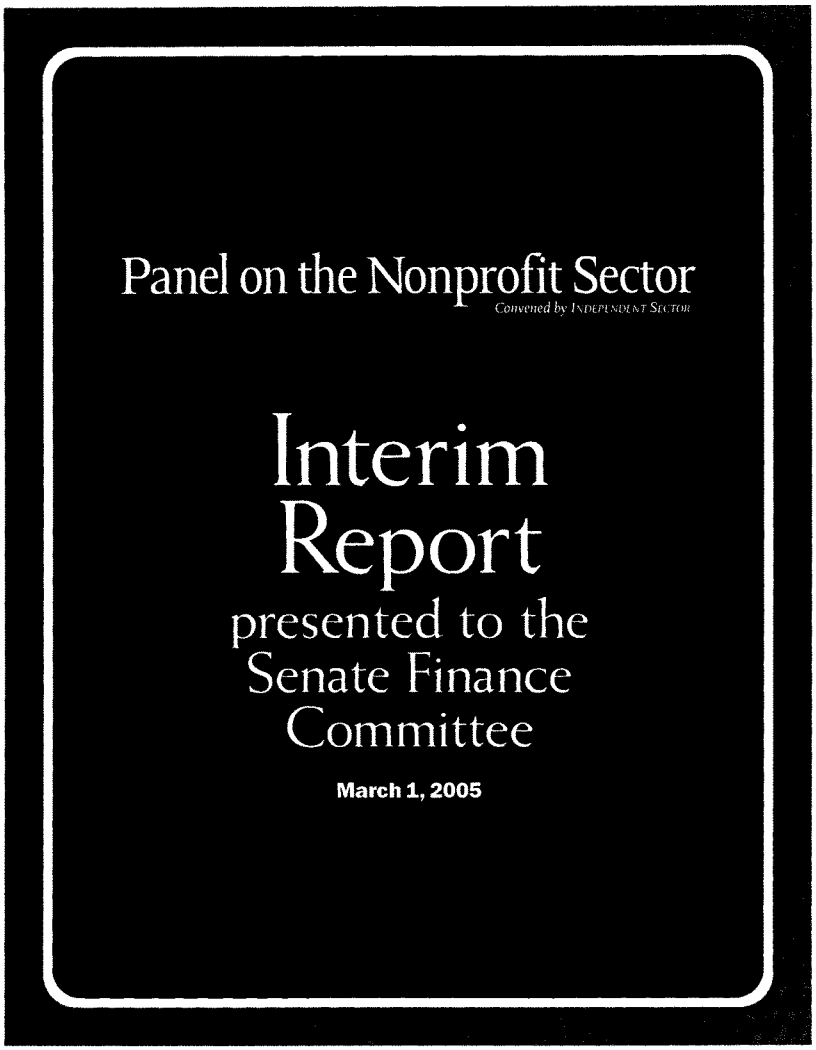
Alliance for Advancing Nonprofit Healthcare
Alliance for Children and Families
Alliance for Nonprofit Management
Alliance of Nonprofits for Insurance, Risk Retention Group
Altria Group, Inc.
American Association of Retired Persons (AARP)
American Cancer Society
American Heart Association
American Lung Association
American Red Cross
American Society of Association Executives
Anti-Defamation League
Asian American Federation of New York
W. Todd Bassett, National Commander, The Salvation Army
Claude Worthington Benedum Foundation
Susan Berresford, President and CEO, Ford Foundation
Willard Boyd, Director, Waterman Iowa Nonprofit Resource Center
BoardSource
Nick Bollman, President, California Center for Regional Leadership
Brain Trauma Foundation
Pam Buckmaster, Organizational Development Consultant, Pam Buckmaster & Associates
The California Wellness Foundation
The Campagna Center
Carnegie Corporation of New York
CBM Credit Education Foundation
Center for Nonprofit Advancement
Center for Non-Profit Corporations
The Chicago Community Trust
Children's Medical Research Institute
Children's Research Triangle
The Cleveland Foundation
Close Up Foundation
Collaborative Opportunities for Raising Empowerment
Colorado Association of Nonprofit Organizations
The Columbus Foundation
Community Foundation for Monterey County
Community Foundation of Greene County, Pennsylvania

The Community Foundation for Greater Atlanta, Inc.
The Community Foundation of Westmoreland County
The Community Foundation Serving Richmond and Central Virginia
Community Human Services Corporation
Community Involvement Foundation
CompuMentor
Connecticut Council for Philanthropy
Connelly Foundation
The Conservation Fund
Council of Michigan Foundations
Council on Foundations
Demos: A Network for Ideas and Action
Des Moines Neighbors
The Donors Forum of Chicago
Easter Seals Goodwill Industries, New Haven, CT
Easter Seals Northwestern Ohio
Marcie Eberhart, Director, American Eagle Outfitters Foundation
Edna McConnell Clark Foundation
Linda Perryman Evans, President and CEO, The Meadows Foundation
FEGS Health and Human Services System
Jeannette Ferro, President, Aid for Animals, Inc.
Forum of Regional Associations of Grantmakers
The Foundation Center
The Foundation for the Mid South
Franklin McKinley Education Foundation
Girl Scouts of the USA
Kenneth Gladish, CEO, YMCA of the USA
Goodwill Industries International, Inc.
Goodwill Industries of Central Texas
Goodwill Industries of Colorado Springs
Goodwill Industries of East Central Ohio, Inc.
Goodwill Industries of El Paso
Goodwill Industries of Kanawha Valley
Goodwill Industries of Middle Georgia and the CSRA
Goodwill Industries of Middle Tennessee, Inc.
Goodwill Industries of North Central Wisconsin Inc.
Goodwill Industries of Northwest NC, Inc.
Goodwill Industries of San Joaquin Valley, Inc.
Goodwill Industries of the Valleys
Goodwill Industries of West Michigan, Inc.
Goodwill of Grand Rapids
Goodwill of Greater Washington
Goodwill Southern California
Goodwill Suncoast/Tampa, St. Petersburg, Florida
Grantmakers for Effective Organizations
The Greater Cincinnati Foundation

Anne E. Green, Vice Chairman, The Alliance for Nonprofit Governance
Florence Green, Executive Director, California Association of Nonprofits
Robert Greenstein, Executive Director, Center on Budget and Policy Priorities
Paul S. Grogan, President, The Boston Foundation, Inc.
Guardian Angels Foundation
GuideStar
Gulf Coast Community Foundation of Venice (Florida)
Walter and Elise Haas Fund
Hands On Network
Erin Hardwick, Executive Director, South Carolina Association of Nonprofit Organizations
The Harry Singer Foundation
Stephen Heintz, President, Rockefeller Brothers Fund
Wade Henderson, Executive Director, Leadership Conference on Civil Rights
F.B. Heron Foundation
William and Flora Hewlett Foundation
Ira Hirschfield, President, Evelyn and Walter Haas, Jr. Fund
Honored to Serve, Inc.
INDEPENDENT SECTOR
Indiana Grantmakers Alliance
Institute for Global Ethics
The Interfaith Alliance
International Center for Environmental Arts (ICEA)
The James Irvine Foundation
Dorothy A. Johnson, President Emeritus, Council of Michigan Foundations
Bobbi Johnson, President & CEO, Goodwill Industries of the Inland Northwest
The Joyce Foundation
Joy of Sports Foundation
JA Worldwide (Junior Achievement)
KaBOOM!
Diane Kaplan, President, Rasmuson Foundation
John S. and James L. Knight Foundation
Knowledge Exchange Center of Rhode Island
The Susan G. Komen Breast Cancer Foundation, Inc.
Charles W. Lamb, President and CEO, Air Force Village West, Inc.
Land Trust Alliance
Carol S. Larson, President and CEO, The David and Lucile Packard Foundation
Laurel Foundation
The Leighty Foundation
Lucent Technologies Foundation
Lutheran Services in America
The John D. and Catherine T. MacArthur Foundation
March of Dimes
Marilyn Klenck, President and CEO, Community Foundation Alliance
John E. Marshall, III, President and CEO, The Kresge Foundation
Maryland Association of Nonprofit Organizations

Massachusetts Council of Human Service Providers, Inc.
Katherine Mabis McKenna Foundation
Mental Health Association in Jefferson County (Texas)
Oliver B. Merlyn Foundation
Michigan Nonprofit Association
Ricardo Millett, President, Woods Fund of Chicago
Minnesota Council of Nonprofits
Mississippi Center for Nonprofits
Monterey Peninsula Foundation
Mortar Board, Inc. & Mortar Board National Foundation
Risa Lavizzo-Mourey, President and CEO, The Robert Wood Johnson Foundation
MPA Program in Nonprofit Organizations, High Point University
National 4-H Council
National Architectural Trust
National Association for Visually Handicapped
National Center on Nonprofit Enterprise
National Conference for Community and Justice
National Medical Fellowship
The Nature Conservancy
Paul Nelson, President, Evangelical Council for Financial Accountability
New Hampshire Center for NonProfits
New Hampshire Charitable Foundation
New Hampshire Community Action Association
Nonprofit Coordinating Committee of New York
Non-Profit Leadership League
Nonprofits' Insurance Alliance of California
North Carolina Center for Nonprofits
Northern California Grantmakers
Pacific Salmon Conservation Foundation
Peninsula Community Foundation
Pennsylvania Association of Nonprofit Organizations
The Pew Charitable Trusts
The Dr. P. Phillips Foundation
The Pittsburgh Foundation
Public Agenda
Public Radio International
Rainbow Center, Inc.
Bart Rauluk, Treasurer, Pittsburgh AIDS Task Force
Research!America
William C. Richardson, President and CEO, W.K. Kellogg Foundation
Riverside Community Health Foundation
Rochester Area Community Foundation
The Rockefeller Foundation
Rose Community Foundation
Seventh-day Adventist Church

The Harry Singer Foundation
The Skillman Foundation
Skoll Foundation
Lorie Slutsky, President, New York Community Trust
Richard and Susan Smith Family Foundation
Robert G. Smith, President and CEO, Goodwill Industries of Lower South Carolina
Adam M. Solender, Executive Director, Jewish Federation of Greater Manchester
Sonora Area Foundation
Tracy Souza, President, The Cummins Foundation
Surdna Foundation
Szekely Family Foundation
Take Charge America, Inc.
Tickets for Kids Foundation
Tides Center
Transatlantic Partners Against AIDS
Travelers Aid International
United Way of America
Joseph Valentine, Executive Director, Morris Stulsaft Foundation
Valley Care Association
Verizon Foundation
Steve Vetter, President, Eureka Communities
Volunteers of America
Waitt Family Foundation
Wallace Alexander Gerbode Foundation
Washington Grantmakers
The Watertown Family YMCA
The Wesley Institute
West Loch Elderly Association
William S. White, President, Charles Stewart Mott Foundation


Panel on the Nonprofit Sector
Convened by Independent Sector
Interim Report
presented to the Senate Finance Committee
March 1, 2005

PANEL ON THE NONPROFIT SECTOR

Co-Conveners

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Dorothy Johnson, President Emeritus,
Council on Michigan Foundations,
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for Financial Accountability,
Winchester, Virginia

Jon Pratt, Executive Director,
Minnesota Council of Nonprofits,
St. Paul, Minnesota

William C. Richardson, President and CEO,
W.K. Kellogg Foundation,
Battle Creek, Michigan

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John R. Seffrin, President and CEO,
American Cancer Society,
Atlanta, Georgia

Sam Singh, President and CEO, Michigan
Nonprofit Association, Lansing, Michigan

Edward Skloot, Executive Director,
Surdna Foundation, New York, New York

Lorie A. Slutsky, President, New York
Community Trust, New York, New York

William E. Trueheart, President and CEO,
The Pittsburgh Foundation,
Pittsburgh, Pennsylvania

William S. White, President,
Charles Stewart Mott Foundation,
Flint, Michigan

Timothy E. Wirth, President,
United Nations Foundation,
Washington, D.C.

Gary L. Yates, President and CEO,
The California Wellness Foundation,
Woodland Hills, California

Raul Yzaguirre, Immediate Past President
and CEO, National Council of La Raza,
Washington, D.C.

Preface

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

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

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

PAUL BREST
President
William and Flora Hewlett Foundation

M. CASS WHEELER
Chief Executive Officer
American Heart Association

Co-Conveners, Panel on the Nonprofit Sector

Table of Contents

Executive Summary

PRINCIPLES TO GUIDE IMPROVING THE ACCOUNTABILITY AND GOVERNANCE OF CHARITABLE ORGANIZATIONS

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

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

RECOMMENDATIONS

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

Recommendations to Improve Transparency of Charitable Organizations

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

Recommendations to Enhance Governance in Charitable Organizations

To improve governance practices, every charitable organization should:

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

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

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

Recommendations to Strengthen Government Oversight of Charitable Organizations

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

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

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

e. Require public charities that own and administer donor-advised funds to include on forms used to recommend potential grantees a donor certification that the grant will not provide any substantial benefit to, or relieve any obligation of, the donor, the advisor or any related party.

f. Prohibit public charities that own and administer a donor-advised fund from knowingly making grants from that fund to satisfy a legally binding charitable pledge of the donor/advisor.

8. The appropriate valuation and disposition of non-cash contributions deserves close examination in the context of *all* public charities. New legal safeguards against abuse by charities or taxpayers may be required, but any changes to federal law should not discourage individuals or corporations from making valuable non-cash contributions to charity nor force charities to dispose of donated property in a manner that would diminish its financial value to the charity.**

9. Penalties and anti-abuse rules should be modified carefully to deter inappropriate actions without unjustly punishing individuals for inadvertent violations. Congress should:

a. Increase first-tier excise taxes imposed on foundation managers and disqualified persons who knowingly participate in self-dealing transactions.**

b. Modify the standard for imposition of penalties on organization managers to provide a realistic possibility that such penalties will be imposed on managers when appropriate.**

10. Congress should enact targeted anti-abuse rules, accompanied by appropriate penalties, to eliminate the inappropriate use of Type III supporting organizations while maintaining the availability of such organizations for legitimate charitable purposes.**

11. Congress should develop appropriate anti-abuse provisions, with sufficient penalties, to deter charitable organizations from participating in listed tax shelter transactions.**

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

12. Encourage states to incorporate federal tax standards for charitable organizations into state law.

13. Increase the resources allocated to the IRS for oversight and enforcement of charitable organizations and also for overall tax enforcement.

14. Allow state attorneys general and other state officials charged by law with overseeing charitable organizations the same access to IRS information currently available by law to state revenue officers, under the same terms and restrictions.

Next Steps

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

SECTION I

Introduction

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

Among the great accomplishments of this sector:

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

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

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

DIMENSIONS OF THE NONPROFIT SECTOR

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

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

THE PANEL ON THE NONPROFIT SECTOR

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

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

While recognizing that only a small number of charitable organizations engaged

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

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

Convening of the Panel on the Nonprofit Sector

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

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

Report Timetable

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

Panel Work Groups

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

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

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

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

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

Panel Advisory Groups

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

Panel Research

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

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

Staff Support and Funding

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

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

About the Process

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

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

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

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

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

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

SECTION II

Principles to Guide Improving the Accountability and Governance of Charitable Organizations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6. GOVERNMENT SHOULD ENSURE EFFECTIVE ENFORCEMENT OF THE LAW

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

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

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

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

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

SECTION III

Recommendations of the Panel on the Nonprofit Sector

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

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

Recommendations to Improve Transparency in Charitable Organizations

1. INTERNAL REVENUE SERVICE INFORMATION RETURNS

Issue

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

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

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

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

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

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

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

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

1. INTERNAL REVENUE SERVICE INFORMATION RETURNS continued

Recommendation for Charitable Organization Action[5]

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

Recommendations for Internal Revenue Service Action

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

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

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

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

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

1. INTERNAL REVENUE SERVICE INFORMATION RETURNS continued

Other Considerations

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

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

2. FINANCIAL AUDITS AND REVIEWS

Issue

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

Recommendations for Legislative Action

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

Rationale

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

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

2. FINANCIAL AUDITS AND REVIEWS continued

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

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

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

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

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

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

Other Considerations

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

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

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

3. ANNUAL NOTIFICATION REQUIREMENT FOR ORGANIZATIONS NOT FILING INFORMATION RETURNS

Issue

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

Recommendations

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

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

Rationale

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

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

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

Other Considerations

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

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

Recommendations to Enhance Governance of Charitable Organizations

4. CONFLICT OF INTEREST POLICY DISCLOSURE

Issue

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

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

Recommendations for Charitable Organization Action

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

4. CONFLICT OF INTEREST POLICY DISCLOSURE continued

Recommendation for Internal Revenue Service Action

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

Rationale

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

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

5. AUDIT COMMITTEES

Issue

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

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

Recommendation

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

Recommendations for Charitable Organization Action

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

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

5. AUDIT COMMITTEES continued

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

Other Considerations

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

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

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

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

6. REPORTING OF SUSPECTED MISCONDUCT OR MALFEASANCE

Issue

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

Recommendation

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

Recommendations for Charitable Organization Action

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

Recommendations to Strengthen Government Oversight of Charitable Organizations

7. DONOR-ADVISED FUNDS

Issue

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

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

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

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

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

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

7. DONOR-ADVISED FUNDS continued

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

Recommendations for Internal Revenue Service Action

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

Recommendations for Legislative Action

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

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

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

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

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

7. DONOR-ADVISED FUNDS continued

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

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

Other Considerations

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

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

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

8. RULES FOR VALUATION OF PROPERTY CONTRIBUTIONS

Issue

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

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

Recommendation

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

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

Rationale

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

9. PENALTY TAXES ON SELF-DEALING AND OTHER VIOLATIONS

Issue

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

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

Recommendations for Legislative Action

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

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

[6] Section 4962 of the Internal Revenue Code.

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

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

Rationale

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

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

10. TYPE III SUPPORTING ORGANIZATIONS

Issue

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

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

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

Recommendation

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

Rationale

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

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

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

11. TAX SHELTERS

Issue

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

Recommendation

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

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

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

Rationale

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

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

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

12. STATE ENFORCEMENT OF FEDERAL LAWS

Issue

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

Recommendation for Legislative Action

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

Rationale

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

13. FUNDING FOR FEDERAL AND STATE ENFORCEMENT

Issue

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

Recommendations for Legislative Action

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

Rationale

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

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

14. INFORMATION SHARING BETWEEN FEDERAL AND STATE OFFICIALS

Issue

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

Recommendation for Legislative Action

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

Rationale

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

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

15. PUBLIC DISCLOSURE OF INTERNAL REVENUE SERVICE DETERMINATIONS

Issue

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

Panel Note

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

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

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

SECTION IV

Issues the Panel Will Consider for Its Final Report

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

ISSUES REFERRED FROM THE INTERIM REPORT

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

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

ADDITIONAL ISSUES FOR EXAMINATION

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

Transparency

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

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

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

Governance

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

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

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

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

Accreditation and Standard-Setting

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

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

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

Government Oversight

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

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

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

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

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

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

SECTION V

Appendix

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Kyle Hybl, General Counsel, El Pomar Foundation, Colorado Springs, Colorado
Jane Leighty Justis, Executive Director, The Leighty Foundation, Cascade, Colorado
Lawrence Kelly, Executive Director, Tri-County Community Action Program, Berlin, New Hampshire
Brian Magee, Executive Director, Montana Nonprofit Association, Helena, Montana
Richard Moyers, Program Officer, Nonprofit Sector Advancement Fund, Eugene and Agnes E. Meyer Foundation, Washington, D.C.
Cao O, Executive Director, Asian American Federation of New York, New York, New York
Miyoko Oshima, President, Southern California Grantmakers, Los Angeles, California
George Penick, President, Foundation for the Mid South, Jackson, Mississippi
Michael Piraino, Chief Executive Officer, National CASA, Seattle, Washington
Willa Seldon, Executive Director, Tides Center, San Francisco, California
Jonathan Small, President, Nonprofit Coordinating Committee of New York, New York, New York
Tim Walter, Chief Executive Officer, Association of Small Foundations, Bethesda, Maryland

Staff

Marcia Sharp, Millennium Communications Group
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Ruth Madrigal, Associate, Caplin & Drysdale, Chartered, Washington, D.C.

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*Portion of a grant made to INDEPENDENT SECTOR includes work to support the Panel

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

September 22, 2004

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

Dear Ms. Aviv:

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

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

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

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

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

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

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

Cordially yours,

Charles E. Grassley
Chairman

Max Baucus
Ranking Member

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

RESPONSES TO QUESTIONS FROM SENATOR HATCH

Question: Ms. Aviv, I want to start by commending Independent Sector for convening the Panel on the Nonprofit Sector and for yours and the panel's hard work in producing the interim report. It is my understanding that the Finance Staff's initial discussion draft last summer called for the repeal of the exemption for Type III supporting organizations. The Interim Report of the Panel on the Nonprofit Sector acknowledges that there have been some Type III supporting organization abuses, but recommends targeted anti-abuse rules, accompanied by appropriate penalties to eliminate the abuses, instead of repeal of the exemption. Is this correct?

Answer: Thank you, Senator Hatch, for your commendation of the work of Independent Sector and the Panel on the Nonprofit Sector. The panel is continuing its work examining problem areas within the sector and carefully considering specific remedies that would deter abuse and punish willful wrongdoing. Our final report will be ready in June with additional recommendations for action. You are correct

in stating that the Senate Finance Committee's discussion draft called for the elimination of Type III supporting organizations, while the Panel on the Nonprofit Sector supports preserving Type III organizations. The panel does acknowledge in its interim report that there have been inappropriate uses of Type III supporting organizations, but we also believe there is a legitimate and unique charitable purpose served by Type III supporting organizations, and that most of these organizations provide real benefit to the charities they support. The panel recommends targeted anti-abuse rules and increased penalties for misconduct. We are currently reviewing specific recommendations regarding the nature of anti-abuse rules and specific penalties, including a number of the suggestions made to the committee by Mr. John Dedon. The panel's recommendations will be included in the final report.

Question: Can you describe to the committee the benefits to the community provided by Type III supporting organizations and how you would stop the acknowledged abuses short of repealing the exemption for these organizations?

Answer: A Type III supporting organization is a public charity organized and operated exclusively for the benefit of one or more other public charities. As with other types of supporting organizations there must be a close and continuous relationship between the Type III and the supported organization. The uniqueness of a Type III supporting organization is that legal control of a Type III lies neither with the supported organization nor with the contributor or his/her family. Instead, the rules for Type III supporting organizations allow for independent ownership and management of assets that are exclusively dedicated to the benefit of one or more supported charities.

Communities benefit from Type III supporting organizations in a variety of ways, depending on the kind of charitable institutions receiving support through them. In general, the flexibility currently allowed in the use of Type III supporting organizations provides a way for charitable organizations to receive valuable assets for public purposes that might otherwise be retained for the private benefit of the donors and their families. In our review of Type III supporting organizations, the panel identified a number of instances in which Type IIIs were uniquely suited to meet the needs of the charity, the donor, and, in some cases, governmental entities. Some examples are:

- A donor wishing to ensure that a gifted collection is exhibited by a museum and not sold to support other activities could contribute the collection to a Type III supporting organization which would provide it to the museum but retain independent legal control. Without such an entity to ensure that the collection is both displayed and retained, the donor might well keep it in private hands.
- Type III supporting organizations have proved useful to governmental entities in advancing their public purposes. In one instance, agreement on the conversion of a nonprofit hospital was reached when the parties agreed to place the sale proceeds in a supporting organization to the community foundation. A Type III supporting organization was created at the insistence of the State attorney general, because it would give the new entity a strong separate identity from the community foundation.
- Public colleges and universities often have Type III supporting organizations that independently hold and manage important assets, such as technology assets, that might otherwise become subject to control and potential appropriation by State governments for other, unrelated State programs.
- Type III supporting organizations are also useful when a donor wishes to support a number of charities with differing short- and long-term needs. The independent management of Type IIIs allows for more effective balancing of charities' competing goals.

The panel has found that the flexibility that makes Type III supporting organizations uniquely suited to meeting the needs of donors and charities also provides room for abuse by some. There are cases where donors have inappropriately maintained de facto control over assets, creating the functional equivalent of a private foundation, while avoiding the rules that apply to private foundations. The panel believes that clarification of current guidelines and regulations is needed along with new, targeted anti-abuse rules and appropriate penalties. Specific recommendations for anti-abuse rules will be included in the panel's final report.

Question: Ms. Aviv, it appears we have a real problem with tax abuse by a few bad apples in the non-profit sector. How can we best prevent these abuses without harming or discouraging those whose only intent is to do good?

Answer: The vast majority of America's 1.3 million nonprofit organizations are now, and have always been, responsible, ethical and accountable in the conduct of their programs and the management of their funds. But, yes, there are bad apples who have called into question the work of all charitable organizations. Independent Sector and the Panel on the Nonprofit Sector are determined to assure the public

and the Congress that we are serious about preventing and punishing misconduct in the nonprofit sector and equally serious about preserving an environment in which the hundreds of thousands of lawful, ethical and accountable nonprofit organizations can continue to serve and enrich our communities, our Nation and the world.

Maintaining the public trust in charitable organizations requires a balance between a self-regulatory system, including a viable system of management and governance standards and proactive educational programs, and vigorous governmental oversight and enforcement. In our interim report, the panel recommended actions for the charitable sector and charitable organizations, actions that might be taken by the IRS, and legislative actions to improve governance and oversight of the sector. The panel is currently looking at complex and difficult issues, such as the valuation of non-cash gifts, rules for board compensation and the board's role in setting executive compensation, prudent investment rules, regulation of international grantmaking and charitable organizations. Recommendations on these and other issues will be contained in the final report along with more specific language to strengthen the general recommendations contained in the interim report. For instance, where the interim report stated that there should be a legal definition of donor-advised funds, the final report will suggest what that definition should be.

As in any aspect of life, those who set out to deceive others or violate laws will likely find a way to do so. The nonprofit sector is no exception. The panel is determined, however, to make it as difficult as possible to break the rules for exempt organizations and to make it as certain as possible that those who willfully abuse nonprofit status will be detected and punished. We are working from within the sector on codes of ethics and accountability, models of transparency and good governance. We are working with the IRS on designing better forms that provide the type of information needed for good law enforcement, but also for more informed philanthropic decisions by the public. And we will continue to work with Congress to help shape the most effective laws to target abusive behavior. At the same time, we are also hoping that Congress will continue to encourage charitable giving and seek to assure the American public that most charities are worthy of their support.

Question: Ms. Aviv, do you see any significant difference between the donation of a facade easement and the donation of a conservation easement? Is there a difference in the level of abuse in these two areas? Should there be different rules governing the deduction of such donations?

Answer: Current law provides several distinct, and often complex, rules for donations of land and real property for conservation and historic preservation purposes. Generally, no deduction is available if the use of the property is inconsistent with the conservation or historic preservation purposes of the gift or for transfers that have no material effect on the value of the property or that enhance, rather than reduce, the value of the property for the donor.

The panel is currently studying areas in the current laws and regulations governing such donations to make recommendations in its final report. Specifically, we have identified some gaps in the standards for appraisers and the penalties that can be imposed on appraisers that provide gross misstatements of a property's value for taxpayers to use in claiming income tax deductions. We are also looking at steps that the IRS is undertaking to address some of the alleged abuses reported in recent press stories. Finally, the panel is studying steps that charitable organizations can take to more effectively monitor how the property is used following the original donation and to assist efforts to ensure that the valuations claimed by taxpayers for these important charitable contributions are fair and accurate. We expect to provide detailed recommendations in the near future.

Response to a Question From Senator Rockefeller

Question: Adam Meyerson, the president of the Philanthropy Roundtable, has raised some concerns about the possibility of the IRS reviewing the tax-exempt status of organizations every 5 years.

He expressed concern that inviting the IRS to review nonprofits every year could lead to politically motivated interference. Specifically, he worried that the IRS could impose enormous administrative burdens on organizations as part of a review process, and that, under some circumstances, the IRS may be acting to sideline an organization the administration does not support.

Does this concern ring true to you? How can Congress protect against politically motivated enforcement actions while we encourage the IRS to take a more active role in overseeing tax-exempt entities?

Answer: Charitable organizations are stewards of the public's generosity, serve a public purpose and should be open to public scrutiny. If the information collected

on a 5-year review would add significantly to the transparency needed by donors to make good philanthropic decisions, then there might be merit to warrant the additional paperwork. It is important to weigh any gain in transparency, however, with the additional costs that would be incurred by the charitable organizations and by the IRS, which would have to review all the reports.

The panel is currently reviewing this proposal and other opportunities for increasing transparency and accountability. Two new subgroups are currently looking into possible revisions of the annually filed forms 990 and 990–PF to see if including additional information on these forms would meet the same need as a new 5-year report. We have not yet drawn a conclusion on the usefulness of a 5-year review versus filing expanded 990s annually.

It seems to me that whether or not the IRS should review the tax-exempt status of charitable organizations every 5 years is a separate question from how to prevent politically motivated enforcement actions. Even without a 5-year review process in place, I get calls from nonprofit organizations who believe that Federal and/or State charity regulators are investigating them for political reasons. It is not only the IRS that has the power to audit or harass a charity, but virtually any public agency with which charities contract or participate in grant programs. Because we live in a democracy with elected officials and political appointees, some very partisan, in positions of power, there is always the possibility that someone will overstep the line and engage in politically motivated actions. Fortunately, most public servants know where the line is and respect the rule of law.

Abuse of power is a subject Congress, executive branch agencies, State agencies and nonprofit organizations must guard against all the time. The solution to halting bad practices in the public sector is the same as the solution to halting bad practices in the charitable sector: clear rules, tough penalties, and sufficient training to assure that office holders—elected and appointed—understand their responsibilities. I would also add that the Panel on the Nonprofit Sector has made a recommendation that charitable organizations should have policies and procedures to protect whistleblowers with credible information about wrongdoing. Federal and State government agencies already have such policies, but employees may not know about them or the laws may not be adequately enforced. A review of such procedures for new employees might help, as would a reminder to supervisors to take reports of wrong-doing seriously.

PREPARED STATEMENT OF HON. MAX BAUCUS

Thank you, Mr. Chairman.

Winston Churchill once said, "We make a living by what we get. We make a life by what we give." We are here today to discuss how Congress can encourage more giving, while preventing abuse by bad actors.

We are lucky to live in a country where people give of both their riches and their energy to make a better world. In my home State of Montana, small charities with few resources provide many essential services.

The Flathead Foodbank in Kalispell prepared over 11,000 boxes of food and served almost 8,000 people just last year. This group makes sure that the sick, elderly, and poor in Northwest Montana have someone to depend on.

At the Montana Job Training Partnership, over three-quarters of folks who walk through their door are able to find good stable jobs. This group helps Montanans build a better future for themselves and their families.

And if you hike among the pristine wilderness of the Elkhorn Mountains, you can thank the 3-person team at the Prickly Pear Land Trust for protecting over 1,500 acres of wildlife, trails, open space, streams and productive agricultural land in central Montana.

These charities, while limited in the funds they employ, provide a powerful benefit to Montana. They add to my State's quality of life, making Montana a compassionate and environmentally attractive place.

When I consider the reforms that we are here to discuss today, I am going to keep groups like the Flathead Food Bank, the Montana Job Training Partnership, and the Prickly Pear Land Trust in mind. I recognize that any reform effort needs to be a balance between cracking down on the bad guys, and not unduly burdening the good guys.

That said, I am serious about working together with Senator Grassley to root out abuse where it exists. Today we'll hear from IRS Commissioner Everson and others about charities that are used to foster personal wealth rather than good deeds.

In January, I sent a letter with Senator Grassley to the IRS asking them to look at the most significant compliance issues that they could identify within the tax-

exempt sector. I appreciate the IRS's prompt and thorough response. IRS cited some troubling practices by individuals who use charities to engage in tax shelters.

We must forcefully address incidents of deliberate cheating among tax-exempt organizations. Failure to do so undermines the public's confidence in the charitable sector and the tax system in general.

We will also hear from the Independent Sector—the charitable community's nationwide representatives—and their distinguished representative, Leon Panetta. Welcome back, Leon. I am glad to hear that Independent Sector brought you on board to help with their Panel on the Nonprofit Sector. The panel has done a good job recognizing the need for reforms in the charitable sector to promote transparency, best practices and good governance.

When Senator Grassley and I sent a letter to Independent Sector last September, we asked them to provide guidance to us in a timely fashion. They have done so. Their response provides an excellent starting point to begin the discussion on reforms. I look forward to your testimony.

George Yin, from the Joint Committee on Taxation, will also testify today about proposals the Joint Committee on Taxation has developed to address abuses in the nonprofit sector. I commend the hard work of the staff at the Joint Committee in this area, even if I cannot endorse every proposal they have put forward.

In particular, I am concerned that their proposal on land conservation may have gone too far. While I want to make sure that scams in the land preservation field are addressed, I also want to ensure that farmers and ranchers in Montana can continue to get a fair deduction for donating easements that protect valuable open space.

The Joint Committee proposal would eliminate the deduction for charitable contributions of conservation easements that include a principal residence. This would prevent many working farmers and ranchers from claiming a deduction for donations of easements.

One of Montana's greatest resources is its open space. I want to make sure that generations of future Montanan's can appreciate the clean streams, rolling fields, and rugged mountains as I did growing up. I intend to work to ensure that farmers and ranchers continue to play a key role in preserving Montana's open space.

I am eager to hear from the other witnesses scheduled to testify today. Brian Gallagher has done a terrific job turning the United Way around, and Diana Aviv is a tireless and effective advocate for charities at the Independent Sector. I am glad that they are here today to share their thoughts about reform.

I am also pleased to welcome Attorney General Hatch. States play an important role in regulating charities, and I am eager to hear about the successful steps he has taken in Minnesota to ensure a vibrant charitable sector.

Finally, I am glad to welcome the rest of our witnesses—David Kuo, Jane Gravelle, and Richard Johnson. Thank you for appearing here today and contributing to this important conversation.

PREPARED STATEMENT OF HON. JIM BUNNING

Thank you, Mr. Chairman.

I am pleased that the committee is examining charitable institutions today. There have been many recent press reports about abuses in the charitable arena, and these reports have had a negative impact on the reputations of charitable organizations everywhere. It has become obvious there are certainly some bad actors taking advantage of the charitable community, but I think it is important that we don't lose sight of the millions of souls who are doing good everyday through charity work. In order to ensure that the above-board organizations are able to continue to raise the funds and gather the volunteers that they need to continue to make the important—and in some instances life-saving—contributions to our society, we need to work to make sure that public confidence is not eroded.

I support the efforts that this committee is undertaking to ensure that charitable contributions go toward the charitable purposes which the donor intended and which the public expects of those organizations to which we grant special privileges through our tax laws. I look forward to working closely with Chairman Grassley and Senator Baucus on these issues in the coming months in order to achieve the goal of shutting down abusive practices. As we examine proposals, however, I plan to work to make sure that, while we go after bad actors, we do not impede the millions of individuals who are providing necessary services to our country and its citizens.

I look forward to hearing today's testimony. Thank you.

PREPARED STATEMENT OF HON. MARK EVERSON

Mr. Chairman, Senator Baucus, distinguished members of the committee, thank you for the opportunity to discuss a number of issues relating to tax-exempt organizations. The country rightfully takes pride in its tax-exempt sector. It is composed of millions of dedicated volunteers and staff who faithfully and impressively carry out critically important work. On them, many within the United States and throughout the world rely.

My remarks will focus on problems with abuse that we are encountering in the tax-exempt area. In making these observations, I am not talking about the inspiring work that the charitable community does day-in and day-out. Nor am I overlooking that the overwhelming majority of these organizations try hard to comply fully with the letter and spirit of the tax law.

But we must recognize that we are now at an important juncture. We can see that abuse is increasingly present in our sector, and we must work to address it. We will act vigorously, for to do otherwise is to risk the loss of the faith and support that the public has always given to the charitable community. And if that is lost, the bountiful vitality of the American charitable sector will wither.

The administration strongly encourages and supports donations to our charities. But you and I share the same concern. Some entities now use their privileged status to achieve ends that Congress never imagined when it conferred tax exemption. They are wantonly abusing the generosity and faith of the public. I therefore appreciate your efforts, and those of the Joint Committee on Taxation, to consider changes that will make our oversight of this area stronger, our ability to remediate abuse swifter, and the strength of the charitable sector more secure.

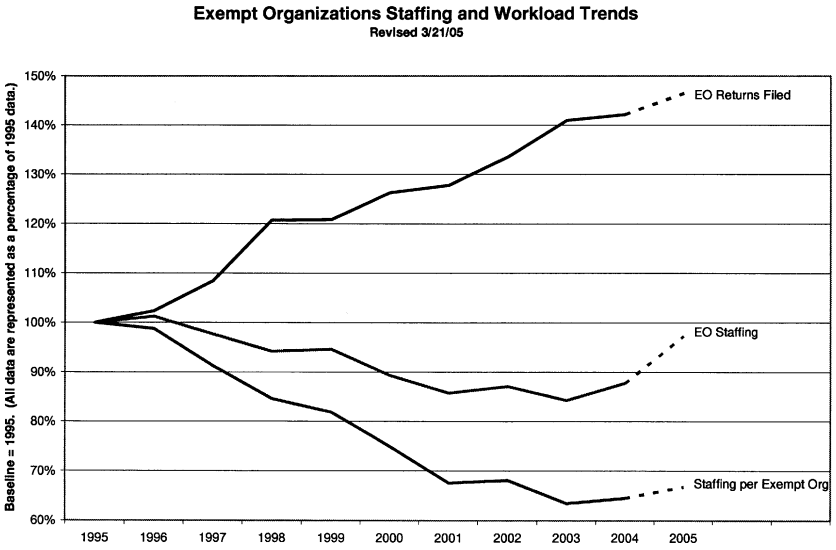
As I begin, let me also extend my appreciative congratulations to the Panel on the Nonprofit Sector, convened by Independent Sector, for its fine interim report. I have read it from cover to cover. It represents an impressive effort to move the tax-exempt community to a better place. The IRS strongly supports the Eight Guiding Principles of accountability and governance, and commends Independent Sector and the Panel on the Nonprofit Sector for their role in encouraging adherence to these standards of excellence.

Good governance and accountability are important, given the size and impact of the tax-exempt sector in our economy. Although our exempt organization master-file data is imprecise, the IRS lists 1.8 million tax-exempt entities, and the number is constantly growing. More than 300,000 entities have been added to our rolls since 2000. Total assets of these organizations approximated $2.5 trillion in 2002, with revenues of $1.25 trillion. Collectively these organizations file more than 800,000 annual returns.

The IRS Strategic Plan for 2005–2009 recognizes the significance of this sector for tax administration. The Strategic Plan sets out four key objectives designed to enhance tax law enforcement over the next 5 years. One of these objectives directly addresses the charitable sector. That objective is to "Deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance and other unintended purposes."

Despite the importance of this sector, until recently our enforcement budget was not keeping up with its growth. From 1995 through 2003, there was an increase of over 40 percent in the number of exempt organization returns filed, yet IRS staffing of the exempt organizations function steadily declined.

The chart below shows how we are turning this around. Using 1995 as a benchmark, the chart shows the percentage increase in exempt organization returns filed, together with the percentage changes in staffing and staffing per exempt organization, on a year-by-year basis. Although our staffing devoted to exempt organizations has declined, we have begun to reverse this trend.



Although I will discuss this at greater length later, let me say here that by September we will see a 30-percent increase in enforcement personnel for Exempt Organizations over September 2003 levels.

I will divide my testimony today into four parts. First, we outline external factors currently impacting this sector. Second, we outline our findings regarding compliance issues facing this sector and specific steps we have taken. Third, we outline our broader response to these compliance problems. Finally, we identify unresolved policy issues that should be part of any discussion on reform.

EXTERNAL FACTORS IMPACTING THE SECTOR—A LESS COMPLIANT ENVIRONMENT

A number of factors are impacting compliance in the tax-exempt area. As might be expected, these factors do not necessarily operate independently of one another. Taken together, however, they add up to a culture that has become more casual about compliance and less resistant to non-compliance. These are attitudes that we must work together to change.

Increase in size and complexity of the tax-exempt sector. This sector has grown rapidly over the past decade, and this growth has impacted the manner in which organizations do business. The number of exempt entities on our master-file has increased by almost 500,000 since 1995, to 1.8 million today. In fiscal year 2002, the reported value of the assets of these organizations was approximately $2.5 trillion. Further, most recent figures show reported annual revenues for Internal Revenue Code (Code) section 501(c)(3) organizations at $897 billion. This growth impacts our ability to regulate and creates other pressures within the sector. For example, competition for donations has increased, and with that pressure we have seen changes in fundraising practices and reporting. We have seen many organizations that might be considered inefficient when considering the ratio of fundraising expenses to charitable outlays. In addition, as individual organizations grew, the skyline changed, with more organizations entertaining complex business structures and transactions. The prime example in this area is the transformation of health care providers and the increased merger activity in the health care sector that we saw in the 1980s and 1990s.

The lack of an adequate enforcement presence in recent years. In the Tax Exempt and Government Entities Division (TE/GE), as in the rest of the IRS, our enforcement presence faded in the late 1990s. A number of factors contributed to this decline. In the area of exempt organizations, we were, and continue to be, struggling with yearly increases in the number of applications for tax exemption. In TE/GE's Exempt Organizations (EO) function, overall staffing declined and fewer and fewer employees were deployed to do traditional enforcement work.

This decline in enforcement presence, combined with the significant growth of the tax-exempt sector noted above, created opportunities for noncompliance. We simply

did not do enough "policing" in the area to support the good actors in their quest to voluntarily comply with the rules.

Lax attitudes towards governance. An independent, empowered and active board of directors is the key to ensuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust. Unfortunately, the nonprofit community has not been immune from recent trends toward bad corporate practices. Like their for-profit brethren, many charitable boards appear to be lax in certain areas. Many of the situations in which we have found otherwise law-abiding organizations to be off-track stem from the failure of fiduciaries to appropriately manage the organization. For example, as we will discuss below, we have found issues relating to how executive compensation is set and reported by nonprofits. Similarly, issues exist as to whether sufficient due diligence and care is taken in filing tax and information returns.

The rise of abusive transactions: tax shelters and artifices to pay personal expenses. As in the governance area—and arising in part from the same lax practices—some parts of the regulated community have become involved in abusive transactions.

In the tax shelter area, abusive programs often require a "tax-indifferent party" to make the scheme work. Tax-exempt organizations are natural candidates. We are concerned that tax-exempt entities are being used as accommodation parties to enable abusive tax shelters. Of the 31 categories of listed transactions, nearly half may involve tax-indifferent parties either as accommodation parties or as active participants.

We believe that the tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status. Some shelter promoters use tax-exempt organizations to create abusive shelters where, for a fee, the tax-exempt entity lets the promoter exploit its tax-free status.

Other abusive transactions involving charities are less complex, but just as corrosive to the credibility of the tax system and to the public's faith in our charitable sector. These transactions often share the same guiding principle: a donor receives a deduction for a charitable contribution while maintaining control over the contributed assets, often using them for personal gain. We list several examples below, including abusive donor-advised funds and supporting organizations.

The terrorist acts of September 11, 2001. One of the most disconcerting revelations since the horrors of September 11 has been that certain terrorist organizations have used charities to raise and move funds or otherwise support terrorist activity. Especially troubling is the fact that the 40 charitable organizations designated as financing terrorist activity include six U.S.-based charities. Although those represent a minuscule part of the charitable sector, curtailing possible corruption and abuse is a critical element in how we now regulate the charitable sector. September 11 has had an impact on the way we design, process, and review forms and the business processes by which we recognize exemption and review continued operational compliance.

Improved transparency in the tax-exempt sector. A positive development in recent years is the improvement in "transparency" within the tax-exempt sector. "Transparency" refers to the ability of outsiders—donors, the press, interested members of the public—to review data concerning the finances and operations of a tax-exempt organization. By creating a means by which the public may review and monitor the activities of tax-exempt organizations, we promote compliance, help preserve the integrity of the tax system, and help maintain public confidence in the charitable sector. To achieve these goals, we began in the mid- to late-1990s to image Forms 990, the annual information returns filed by many tax-exempt organizations. We put this information on CDs and provide it to members of the public, including a number of watchdog groups that monitor charitable organizations. These groups put the information up on their websites, where it is available to the press and to the public. This process has resulted in increased press and public scrutiny of the tax-exempt sector, which we believe is highly desirable. It has also increased the ability of the IRS and State regulators to access Form 990 data, because they are more readily available.

CURRENT COMPLIANCE PROBLEMS IN THE CHARITABLE SECTOR—ABUSES AND MISUSES OF EXEMPT ORGANIZATIONS

Now I want to turn to some of the specific reasons why our emphasis on the tax-exempt sector is required. Each year the IRS publishes a list of its "Dirty Dozen," the schemes that have the dubious honor of sinking to the lowest level of tax abuse. This year, for the first time, abuses involving exempt organizations have a significant representation on the list, occupying four spots.

One can divide these abuses into two broad categories. The first group involves charities that abuse their tax-exempt status. The second group involves charities that are misused by third parties. Both of these groups are targets of the strategic objective I mentioned a moment ago: to deter abuse *within* tax-exempt and governmental entities, and also to deter *the misuse of* tax-exempt and governmental entities by third parties.

Charities that abuse their status

One group of organizations that abuse their status is charities established to benefit their donors. Generally, the abuses share the same theme: a donor receives a charitable contribution deduction while maintaining control over the contributed assets, often using them for personal gain. I will list several examples.

Abusive donor-advised fund arrangements. A donor-advised fund typically is a separate fund or account established and maintained by a public charity to receive contributions from a single donor or a group of donors. These funds can offer a convenient way for a donor to make charitable gifts. However, for the payment to a donor-advised account maintained by the charity to qualify as a completed gift to the charity, the charity must have ultimate authority over how the assets in each account are invested and distributed in furtherance of its exempt purposes. Although the donor may recommend charitable distributions from the account, the charity must be free to accept or reject the donor's recommendations.

We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer's personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible under section 170 of the Code. Also, they often claim that the assets transferred in the funds can grow tax-free and later be used to benefit the donor in the form of compensation for purported charitable projects, to reimburse them for their expenses, or to fund their children's educations.

We have a compliance team that is vigorously addressing abuses of these funds. Currently, we are examining the returns of over 200 donors, and have several organizational examinations underway, with more planned. We have denied the exemption application of one organization that is now challenging our action in court, and have proposed revocation of tax-exempt status in another case.

Section 509(a)(3) supporting organizations established to provide benefits to founders. Supporting organizations are public charities that, in carrying out their exempt purposes, support another exempt organization, usually another public charity. The category can cover many types of entities, including university endowment funds and organizations that provide essential services for hospital systems. The classification is important because it is one way a charity can avoid classification as a private foundation, a status that is subject to a much more restrictive regulatory regime. There are three types of these organizations, depending upon the relationship between the supporting organization and the organizations it supports. Briefly, Type I supporting organizations are controlled by the supported organization in a manner comparable to a parent and its subsidiary. Type II supporting organizations share common supervision and control with the supported organizations. Most problems we are finding are in Type III organizations, where the relationship is least formalized. We have found some issues with the Type I organizations as well, where the supported organization may be controlled by the promoter.

Some promoters in this area have encouraged individuals to establish and operate supporting organizations purportedly described in section 509(a)(3) that they can control for their own benefit. There are a variety of methods of abuse, but a common theme is a "charitable" donation of an amount to the supporting organization, and a return of the donated amount to the donor, often in the form of a purported loan that may never be repaid.

For example, we have seen contributed amounts that have ultimately been returned and then used by the donor to purchase residential property. To disguise the abuse, the transaction may be routed through one or more intermediary organizations controlled by the promoter, some of which may be offshore.

We are aggressively combating this abuse. An IRS compliance team has obtained the client lists of several promoters. We have approximately 100 examinations underway, with more planned. We have revoked the exempt status of one supporting organization, which is challenging our determination in Tax Court. Two cases involving individuals who claimed charitable contribution deductions to supporting organizations are currently docketed in Tax Court. Fifteen individuals are under examination for promoter penalties, and three cases involving supporting organizations are being considered for criminal investigation.

Corporation sole abuses. Corporations sole are a repeat entry on our dirty dozen list. A corporation sole is an entity authorized under certain State laws to allow religious leaders to hold property and conduct business for the benefit of a religious entity. The leader can incorporate under State law in his capacity as a religious official. A corporation sole may own property and enter into contracts as a natural person, but only for the purposes of the religious entity. Title in property that vests in the officeholder as a corporation sole passes to the successors in office, and not to the officeholder's heirs. The purpose of a corporation sole is to ensure continuity of ownership of property dedicated to the use of a religious organization.

The corporation sole form of organization serves a valid function for legitimate religious entities. However, some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under the pretext of being a "bishop" of a religious organization or society. The idea promoted is that the arrangement entitles the individual to exemption from Federal income taxes as a nonprofit, religious organization as described in section 501(c)(3).

The position is without merit. In Rev. Rul. 2004–27, 2004–12 I.R.B. 625, the IRS announced that persons relying on this scheme to avoid Federal income tax could be subject to civil and criminal penalties. Similar sanctions will be applied to the promoters of this abuse. We have almost 50 promoter investigations underway involving corporation sole abuses, and the Department of Justice has obtained permanent injunctions against seven promoters. Three persons have been indicted in connection with corporation sole scams. In addition, almost 250 returns have been identified as having links to abusive corporation sole arrangements and have been placed in the examination process. Of these, 90 returns are under active examination and several are under consideration for the application of fraud penalties.

Charitable trust problems and abuses. Some promoters have set up purported charitable or split-interest trusts that can be used for the taxpayer's personal benefit. There are a variety of schemes, without legal merit, designed to allow individuals to deduct amounts that ultimately will be used for their personal expenses. The charitable trust typically is a nonexempt charitable trust that serves as a holding entity of the individual's assets. Individuals retrieve these assets at will, generally through loan transactions, gifts, or by having the trust pay for expenses directly.

We have also seen a variety of abusive promotions involving charitable remainder trusts, which have both charitable and non-charitable elements. These trusts are typically funded with highly appreciated property. One marketed scheme attempts to abuse the tax rules governing the character of distributions from the trust to the transferor by timing distributions in a year when the trust has little or no ordinary income or capital gain. The claim is that the transferor thus avoids any significant tax liability from the sale of the trust's appreciated property. This type of abuse is specifically prohibited by Treasury regulations, and this transaction and other similar transactions have been designated as listed transactions.

There are other variations on this theme, and we are still investigating the extent to which these schemes have been sold. In sum, trusts that are designed for charitable purposes are being manipulated for tax avoidance by their creators. We have over 40 charitable remainder trust examinations underway involving variants of the above abuse in which the total amounts sheltered exceed $1 billion.

Abusive credit counseling organizations. Certain credit counseling organizations are abusing their tax-exempt status, albeit in a much different manner. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

We are taking strong actions to eliminate the abuses. To date, we have identified 60 credit counseling organizations for examination. Of those, almost 50 examinations have begun, accounting for over 50 percent of the industry by gross receipts. We have revoked or proposed revocation of tax-exempt status for credit counseling organizations representing over 20 percent of the industry's gross receipts. We are using the knowledge we have gained from examining industry abuse to screen new applications more effectively.

To help our credit counseling compliance activities, our recent revision of Form 1023, the application for recognition of tax exemption filed by charities, now asks questions to help identify applicant organizations that have close ties to service organizations owned by insiders. On the Form 990, the annual information return filed by exempt organizations, we now ask whether organizations provide credit

counseling, debt management, credit repair, or debt negotiation services to help us identify organizations that have shifted to or added credit counseling activities after having established tax-exempt status as a different kind of charitable organization.

Finally, we are partnering with the States and the Federal Trade Commission (FTC) to leverage our resources. We are developing strategies to address consumer concerns, coordinate our enforcement actions, and share information.

Organizations recognized by the IRS as described in section 501(c)(3) often are excluded from coverage under FTC rules, as well as State and local consumer protection laws. We remain very concerned that the potent combination of exemption from income tax and from consumer protection laws is encouraging those who are motivated by profit rather than charity to seek tax exemption. Our vigilance on credit counseling is even more important given that the bankruptcy legislation that recently passed the Senate includes a provision mandating credit counseling for many debtors. If this legislation is enacted into law, it is imperative that we ensure that those individuals in bankruptcy receive the required counseling from legitimate organizations.

Misuse of charities by third parties

I have discussed charities that abuse their tax-exempt status. Others charities are misused by third parties, often unknowingly, but sometimes with the charity's knowledge and consent.

Overstated deductions. A common problem occurs when a taxpayer takes an improper or overstated charitable contribution deduction. This happens most frequently when the donation is of something other than cash or readily marketable securities. Last year, when I appeared before this committee, I listed several specific concerns in this area, and I would like to take this opportunity to thank the Congress for the provisions in the American Jobs Creation Act of 2004 that will reduce compliance problems with donations of vehicles and intellectual property. Let me discuss some problems that remain.

Conservation easements. In recognition of the need to preserve our heritage, Congress allowed an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings for future generations.

The IRS has seen abuses of this tax provision that compromise the policy the Congress intended to promote. We have seen taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In some cases, taxpayers claim deductions when they are not entitled to any deduction at all (for example, when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements). Further, the conservation easement rules place the charity in a watchdog role. In a number of cases, however, the charity has not monitored the easements, or has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions.

Another problem arises in connection with historic easements, particularly facade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the facade of their historic house and they give an easement to this effect to a charity. However, if the facade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.

Last year, we published Notice 2004–41, 2004–28 I.R.B. 31, which describes another abuse. A charitable organization purchases property and places a conservation easement on the property. The charity then sells the property subject to the easement for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the buyer makes a second payment designated as a charitable contribution to the charity. The total of the payments fully reimburses the charity for its cost. In some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution.

Now let me explain what we are doing about these problems. Notice 2004–41 describes a specific abuse, but it also provides a warning. The IRS will look at the substance, rather than the form, of abusive transactions, and will impose appropriate penalties against the abusers.

We are modifying our tax forms to aid in the identification of abuse. We added new questions to Form 1023, the application for recognition of tax exemption filed by charities, that will help us identify organizations with conservation donation programs. We are considering changes for our next revision of Form 990, the annual information return filed by exempt organizations, that will allow the IRS and the public to better identify organizations that take easements and to understand what they do with them. We also will revise Form 8283, the form the donor files to sup-

port a non-cash charitable contribution, to clarify what is permissible and to disclose better information on the type of property donated.

While this will enable us to better target our enforcement efforts in the future, we have an active enforcement program now as well. We are currently looking at the activities of more than a dozen promoters. We are examining charities that we believe may have been involved in particular abuses and those charity officials who may have unduly profited from their positions with a charity. We are currently examining 48 easement donors and also are reviewing deductions taken for nearly 400 open-space easements, to be followed with a review of over 700 facade easements. We will use all civil and criminal tools at our disposal to combat abuses.

Other non-cash charitable contributions. We also have persistent problems in taxpayers' valuation of deductions taken for non-cash charitable contributions. Valuation issues are often difficult. Overvaluations may arise from taxpayer error or abuse, as well as from aggressive taxpayer positions. Additional enforcement concerns are whether consideration has been received in return, and whether only a partial interest has been transferred.

I have read with much interest the Joint Committee on Taxation's description of problems in the area of clothing, household items, and other contributions of property, and I agree that these are resource-intensive for us to audit. Overvaluations are difficult to identify, substantiate, and litigate. Further, donors and the recipient charities do not have adverse interests that would help establish a correct valuation.

As I mentioned, the Congress addressed two major abuses with legislation that targets vehicle donations and patent and other intellectual property donations. This has greatly helped us administer this area of the tax law, but problems remain with respect to the valuation of other property.

Abusive tax shelters involving tax-exempt accommodation parties. An "accommodation party" is a term generally used to describe a tax-indifferent party's involvement in a transaction that does not necessarily affect the entity's primary function, but is designed to provide tax benefits to a taxable third party. We have seen an increased use of various tax-exempt entities, including charities and other tax-exempt organizations, private and government retirement plans, Indian tribal governments, and municipal governments, to achieve abusive results.

In one listed transaction, Notice 2003–81, involving tax-avoidance using offsetting foreign currency option contracts, we have found both otherwise-legitimate and suspect charities to have been involved.

Disclosure is an important way for the IRS to identify participants in abusive transactions. The IRS requires participants to disclose their participation in listed and other reportable transactions on Form 8886, which must be filed with the organization's annual return. We have begun to name accommodation parties as participants in listed transactions (*see* Notice 2004–30). However, not all potential accommodation parties have a return-filing requirement. Those that do not file returns include churches, small exempt organizations, State and local governments, State and local government retirement plans, and Indian tribal governments. Thus, even where we specifically designate accommodation parties as participants, these entities are not required to disclose their participation in these transactions. As I reported to you last year, we have worked around this problem to some degree by revising Form 8886 to require the other participants to identify the tax-exempt parties in a listed transaction.

Increased disclosure to the IRS will help in this area, even without a sanction. However, it is as yet unclear whether disclosure to the IRS will prove a meaningful deterrent to exempt entities engaging in this behavior. We welcome a discussion of the issues raised by this committee and the Joint Committee on Taxation staff, as well as the Panel on the Nonprofit Sector.

Compensation issues. There has been much publicity about high salaries and generous compensation at some charities and foundations. An exempt organization is entitled to pay reasonable compensation for the services it receives. Moreover, what some may consider excessive levels of compensation may meet the requirements of current law in this area. High compensation is not necessarily an abuse under the law if it is warranted based on the value of services performed for the exempt organization. The key to this determination is whether the compensation is comparable to that paid by similar organizations for similar work. The organizations being used for comparison may be nonprofit and for-profit organizations, but it is not always clear that the comparison actually used in a particular case is appropriate for the particular position. In addition, there is a major risk that organizations that effectively allow key executives too great a voice in determining their own compensation will not end up with objective and reasonable compensation levels.

Excess compensation by an exempt organization is not permissible. An organization that overcompensates its officers and directors risks revocation of its tax-ex-

empt status. In the case of charities and social welfare organizations, the IRS also can impose an excise tax on certain individuals who receive more than their due.

Last year, we began a comprehensive enforcement project to explore the seemingly high compensation paid to individuals associated with some exempt organizations. This is an aggressive program that includes both traditional examinations and correspondence compliance checks. Its purpose is to enhance compliance by identifying practices organizations use to set compensation, learning how organizations report compensation to the IRS and the public, and creating positive tension for organizations as they decide on compensation arrangements. This project also has an educational component.

We are contacting a broad spectrum of nearly 2000 public charities and private foundations and asking for detailed information and supporting documents on their compensation practices and procedures, and specifically how they set and report compensation for specific executives. We also are asking organizations for details concerning the independence of the governing body that approved the compensation, and for details concerning the duties and responsibilities of these executives. We also are looking at organizations that failed to supply, or did not fully complete, compensation information on Form 990. We are requiring them to file amended returns immediately to supply information missing on any part of the Form 990.

We have completed our review of over 500 of these contacts. It is too early to state any findings definitively, but we are seeing issues in the reporting of loans and deferred compensation, as well as whether all "perks" are being appropriately reported. There may also be an issue of spreading compensation among several affiliated organizations, which decreases transparency.

Terrorist financing. We want to ensure that U.S. charities have no role in financing terrorist activity, and we continue to assist in the fight against terrorism and those who fund it. On the criminal side, we have ongoing investigations concerning potential terrorist financing. Efforts by special agents in our Criminal Investigation function have played an important part in designations of several entities as terrorist organizations by Treasury's Office of Foreign Assets Control. Since 2001, in conjunction with other agencies, our actions have contributed to the sentencing of 44 individuals in terrorism-related cases, 32 of them for money-laundering.

We have created a Lead Development Center to pilot a counter-terrorism project, including a focus on the abuse of charities. It uses advanced analytical technology and subject matter experts to support ongoing investigations and proactively identify potential patterns and lawbreakers. The center is staffed with personnel from both our criminal and civil functions, and it integrates its work with the larger Federal law enforcement community, chiefly through our participation in the Joint Terrorism Task Forces led by the FBI. Using data from tax-related information that is protected by disclosure laws, the center can analyze information not available to other law-enforcement agencies. By combining that data with public-source information and with data gathered by other law-enforcement agencies, the center can perform a complete analysis of all financial information relating to specific investigations.

On the civil side, the tax-exempt status of six entities has been suspended automatically by operation of section 501(p). We are also exercising due diligence to ensure that individuals designated as terrorists have no place in U.S. charities. Applications for tax-exempt status are screened for terrorist names. We have adopted procedures and are developing the electronic capability to review filed Forms 990 and 990–PF for terrorist names. Name matches are coordinated with the appropriate office for verification or further action.

We are seeking better information about U.S. charities with international activities. Our recent revision of Form 1023 asks for more specific information on foreign activities, and we expect that our forthcoming revision of Form 990 will have similar questions. We also are seeking better baseline information about the practices of organizations that make grants to foreign entities, and the level of oversight the organizations exercise over the use of the funds abroad. For this purpose we are examining over 100 charities that make grants or have operations overseas. Depending upon what we find, we will institute new compliance programs or issue new guidance or educational material, as appropriate.

In addition, we asked for public comments on international grant-making. Among other things, we are interested in the practices that charities find work best for them to ensure that their assets are used only for their intended charitable purposes. The IRS intends to issue a publication that discusses some of the methods used by charities with international operations.

Political activity of non-profits. Section 501(c)(3) organizations are statutorily prohibited from intervening in political campaigns. Each election cycle we become involved with significant allegations of wrongdoing, and this problem shows no indica-

tion of abating. In 2002, a mid-term election year, our records indicate that we received approximately 70 complaints alleging campaign activity by charities. In 2004, a presidential election year, that number was over 200. These are difficult cases, and our actions often trigger questions and concerns from the public and the Congress.

In the 2004 election cycle, we took a more active stance than we have in the past in an attempt to reduce the number of violations. Early in the campaign year we issued a news release, as well as a mailing to political parties explaining the prohibition against campaign intervention. During this past summer, we began a project designed to respond to reports of campaign intervention on an expedited basis. We also pursued other educational avenues, including the sponsorship of seminars and the distribution of plain-language publications that explained the rules. Our objectives were to ensure that charities understood the rules and the need to avoid political campaign activity, without chilling the ability of charities to speak out on important issues of public policy.

A committee of experienced career employees selected about 130 organizations for examination by our revenue agents. The selected organizations represented all segments of the political spectrum. We intend to repeat this project in future election cycles, with modifications that include, among other things, an earlier starting date in the election year and greater up-front publicity.

IRS RESPONSE: REVITALIZING AND REFOCUSING EXEMPT SECTOR ENFORCEMENT AND ENHANCEMENTS TO TRANSPARENCY

Revitalization—recent budget increases

Because of the priority we have given to the charitable sector, as expressed in the key objective in the Strategic Plan to deter abuse and misuse of tax-exempt entities, the budget for our EO function increased significantly in fiscal year 2004 and fiscal year 2005. Although the IRS budget increased only one-half of one percent in fiscal year 2005, the TE/GE budget increased 9 percent, the EO budget increased 13.8 percent, and the EO examinations budget increased 21 percent. In EO examinations, this increase will translate, by September, into a 30-percent increase in staffing over September 2003.

We have translated the increase in funding into concrete results. In fiscal year 2004, we added 70 new agents to conduct exempt organizations examinations, and additional employees for our new EO Compliance Unit, which reviews Forms 990. This year, the fiscsal year 2005 budget supports the creation of the EO Financial Investigations Unit, and I have reallocated resources to EO to hire 69 additional compliance employees.

For next fiscal year, fiscal year 2006, the administration has requested a 4.3-percent increase in the IRS budget, with nearly an 8-percent increase in enforcement. If the Congress approves the request, the amount we plan to dedicate to the tax-exempt area would be used to combat abusive promotions involving tax-exempt entities, to start examinations quickly when we detect a risk, to give agents better information for their first contact with taxpayers, and to increase vigilance against the misdirection of exempt organizations' assets for illegal activities or private gain.

Refocusing of efforts—pursuing the right cases

We also are refocusing the way we approach exempt organizations. We are expanding our presence in the community, and making data about exempt organizations more accessible to our agents and to the public.

To enhance compliance, we are interacting with a greater number of exempt organizations. We established two new offices to help us do this. First, our new EO Compliance Unit is designed to review Forms 990 and correspond with organizations on inconsistencies, errors, and other matters that do not require an examination. For example, the EO Compliance Unit may correspond with a non-filer to solicit a Form 990 when we know from other sources, such as a State bingo regulatory agency, that the organization has gross receipts that exceed the $25,000 filing threshold. The Compliance Unit has also sent educational letters to charities that report the receipt of substantial contributions that, coupled with low fundraising expenses, could indicate a reporting problem. Our letters provide instruction on the proper reporting of fundraising income and expenses. We will monitor future returns of these organizations to see if their behavior has changed. This unit has also played a key role in our compensation initiative.

At the tougher end of the compliance spectrum is our Financial Investigations Unit, which we are now organizing. This unit will specialize in our most difficult and significant cases in the civil context, including fraud and terrorism, and will serve as a strike force when we need to move quickly.

These new units will be aided by two new groups. The Data Analysis Unit, which became operational in 2004, will use innovative data capture to better select cases for examination. The comparison of State bingo databases to our master-file is an innovative example of the type of work this unit will perform. A separate, newly funded group will identify and follow up with selected Form 990 filers in the first years of their operations, bridging the gap between what an applicant organization tells us when it applies for exemption and how it actually operates.

We have also refocused our staff to work the most troublesome areas. EO is devoting approximately one-third of its examination staffing to EO's priority compliance areas this year, all of which are among the issues I have referred to earlier, up from a much lower percentage in fiscal year 2004.

Enhancements to transparency

Transparency is a lynchpin of compliance within the sector. Therefore, part of our work is to improve exempt organization transparency, including better data quality and better data availability. With our e-filing initiatives, planned changes to Form 990, expanded imaging of returns, and changes to the application process and the Form 1023, we expect substantial progress toward this goal.

All exempt organizations can now file their annual returns electronically. Electronic filing was available for Form 990 and 990EZ filers in 2004, and is now available this year for private foundations, which file Form 990–PF. We want to encourage e-filing because it reduces taxpayer errors and omissions and allows us, and ultimately the public, to have ready access to the information on the return. For this reason, we have required e-filing in certain cases. Under proposed and temporary regulations, by 2007 we will require electronic filing for larger public charities and all private foundations. Due to statutory restrictions, discussed below, at this time we can only do so for organizations that file at least 250 returns with us annually.

We are also working on improving the Form 990. The current form is not particularly "user-friendly," and does not give us all the information IRS agents need to do their jobs; the public is similarly constrained. We are at work revising the form. We anticipate that the revised form will have specific questions or even separate schedules that focus on certain problem areas. For example, filers should not be surprised to find specific schedules or detailed questions relating to credit counseling activities, supporting organizations, compensation practices, and organizational governance. The timing of the revision of the Form 990 is somewhat dependent on our partners, including the States, 37 of which use the Form 990 as a State filing, and software developers.

We are also expanding our Form 990 imaging capabilities. We already image the returns of public charities and private foundations. This month, for the first time, we are imaging the returns of our many categories of exempt organizations that are not section 501(c)(3) organizations. This will allow our agents immediate access to these returns, and will allow us to respond quickly to public requests for returns. While important at this time, it is our hope that imaging will become a relic of the past as electronic filing becomes the norm.

In November, 2004, we revised Form 1023, the form that charities file when they apply for tax exemption. This was a comprehensive redesign. We ask many new questions that focus on potential problem areas, and others that are designed to reduce the need for our personnel to request more information from the applicant. We also ask questions that we hope will lead our charity applicants to focus on self-governance issues and organizational best practices.

As we move forward, we will increase compliance efficiency by making closed application files more accessible. As budget permits, we intend to replace our antiquated microfiche storage system by imaging the application files so that they can be readily viewed by our compliance personnel and the public.

IRS FOCUS AREAS FOR DISCUSSION OF REFORMS—UNRESOLVED ISSUES

Notwithstanding our revitalized and refocused program, we believe there are several areas that should be included as part of any discussion of reform in the tax-exempt area. The first such question is whether there are additional bright-line tests that are available to aid the public in complying with, and the IRS in administering, the law. A debate on reform also should include the following questions, identified below.

Have changes in practice or industry created gaps in the statutory or regulatory framework? There has been huge growth in the tax-exempt sector, but much less change in the law governing those organizations that qualify for tax-exempt status. Since 1969 there has been only limited review of the rules relating to tax-exempt organizations. Some within the community have argued that it is time for a more thorough review, and we welcome that.

As we regulate various parts of the TE/GE community, compliance in some areas becomes difficult to administer, where industry practice, or the industry itself, changes, but the rules remain constant decade after decade. An example we noted above is the credit counseling area. This industry grew up in a different time, under different rules, but now has evolved into something substantially different from what it was. There also have been great changes in technology that should be considered. One important issue, for example, is how rules that are several decades old apply in an Internet, often virtual, environment.

Does the IRS have the flexibility to respond appropriately to compliance issues? We believe a discussion about reform should address whether we have the proper range of tools to enforce compliance in a measured way, where appropriate. In many areas of our jurisdiction, our remedial tools are not effective. Often our only recourse is revocation of tax exemption, a "remedy" that may work a disproportionate hardship on innocent charitable beneficiaries. Moreover, even where we have an intermediate sanction, it may not work as intended.

Similar discussions may be worthwhile with respect to the rules on political intervention in campaigns by exempt organizations and the reporting requirements for political action committees.

With regard to abusive tax shelter transactions, the accuracy-related penalties imposed by the Code are not sufficient to deter a tax-exempt accommodation party, which has no taxable income to understate. Likewise, IRS's compliance sanctions for exempt organizations do not fit these situations. Participating in a transaction as an accommodation party rarely affects the tax status of a charity or other tax-exempt entity.

In some areas, activities of exempt organizations have transformed greatly in recent decades, but the rules governing tax exemption have not, leaving the IRS with difficult and fact-intensive administrative challenges. An example is health care, an evolving industry that has changed dramatically over the last few decades. Some tax-exempt health care providers may not differ markedly from for-profit providers in their operations, their attention to the benefit of the community, or their levels of charity care. Further, some exempt providers have entered into joint ventures with for-profit organizations, sometimes placing their entire health care operation in the venture and transforming themselves into what is effectively a tax-exempt holding company with a charitable grant-making function. Although this is not impermissible, we insist that the charitable entity ensure that the charitable purposes of the venture are not sacrificed for the sake of maximizing profits. However, it can be difficult for the IRS and the courts to wrestle with fact-intensive cases.

Finally, in our attempts to ensure that exempt organization funds are not diverted to improper purposes, including terrorism, we do not have tools comparable to those applicable to private foundations to sanction public charities that fail to monitor their grants. For those organizations that need not file for exempt status and do not file annual returns, such as small organizations that normally receive not more than $5,000 annually and churches, the problem is compounded because we have little ability to monitor their operations against diversion of assets.

Should more be done to promote transparency? Transparency is a lynchpin of compliance within the tax-exempt sector. However, there are legitimate questions about whether to enhance transparency, and if so, how to proceed. As I noted to you last June, limitations on our ability to communicate with State charity officials prevent us from fully leveraging the relationship and jurisdiction we share with them. Further, there are segments of the TE/GE community that we are unable to track, including several categories of legal non-filers (for example, those exempt organizations that are not required to file a Form 990, such as churches and organizations with less than $25,000 in gross receipts). Our master-file is replete with errors concerning these organizations.

Finally, one of our key transparency initiatives is the establishment of electronic filing for Forms 990 and 990–PF. The recent report by the Panel on the Nonprofit Sector, referenced above, supports mandatory electronic filing for all returns for nonprofits, and we have issued temporary regulations requiring such filing for certain groups. While this will markedly advance the ability of the Service, the States, and the public to access Form 990 data in real time, our ability to mandate e-filing is limited at this time by statutory restrictions that prevent us from mandating electronic filing for any organization that files fewer than 250 returns with us. The administration's 2006 budget proposal echoes this concern. The administration's proposal would lower the current 250-return minimum for mandatory electronic filing, but would maintain the minimum at a level high enough to avoid imposing undue burden on taxpayers.

Does the IRS have the resources it needs to do the job? While this is a topic worthy of discussion, I have outlined what we have done to expand our resources in the

tax-exempt area. I believe we have done a credible job of recognizing the task before us and preparing to meet that challenge. To continue this work, I would ask the committee to support the administration's 2006 budget proposal, which calls for an 8 percent increase in our enforcement budget.

CONCLUSION

To conclude, let me briefly outline where I believe the IRS must head in the next 5 years if it is to be successful in reining in abuse and appropriately regulating the tax-exempt sector.

First, while we must continue to maintain a high level of quality service to the sector, we also must continue to strengthen our enforcement activities. To do this we need to concentrate on the following tasks. We need to improve our business processes. We need to develop and increase partnerships with other regulatory agencies, such as the FTC, the Federal Election Commission, and State charity officials, so that we can better leverage resources. We need to increase our ability to identify potentially problematic areas and high-risk cases. We need to continue to ensure a fair allocation of resources to exempt organization examinations to increase our audit presence in the community. And we need to improve our case-building ability through better access to researchable data.

Second, we need to increase electronic submissions. This is not only with respect to Form 990 and 990–PF, for which we now have the capability to accept e-filing, but also Form 1023 and other forms as well. This will increase the amount of data accessible to IRS employees, other regulatory agencies and the public, and will allow us to focus on problem areas faster.

Finally, we need to further tailor our compliance efforts by focusing on specific segments of the EO community. This will allow us to target our resources, including educational resources, to those areas where they will have the greatest impact.

I thank the committee for its attention. I am pleased to respond to your questions.

RESPONSES TO QUESTIONS FROM SENATOR HATCH

Question: Commissioner Everson, I think your testimony today was excellent. I share your concern that we must ensure that abuse in the charitable sector is kept to a minimum. However, I believe it is very important that we do not allow the pendulum to swing too far in the other direction to the point where we are discouraging citizens and businesses to donate to charitable causes. How can we make sure we do not, in our efforts to crack down on abuses, also create roadblocks to charitable giving?

Answer: We are aware of the vital role that charities have in our communities. Without the funding that comes from donors, our charities simply cannot continue to provide the services so many Americans, and people throughout the world, rely on. It would indeed be unfortunate if well-intentioned efforts to stem abuses in some organizations were to result in diminished giving to our many, many well-run charities. I would hope that whatever remedies the Congress adopts to curtail the bad apples are not so broad in scope as to reduce the flow of much-needed funds to good charities.

In our view, a vigorous enforcement program that is appropriately targeted will bolster, not damage, the culture of charitable giving. We also believe that a more knowledgeable public will be better able to discern the most worthy organizations. Many of our efforts will improve the information available to donors. These include our efforts with Form 990, such as imaging the form, making it publicly available, establishing and promoting electronic filing, and reviewing the form and corresponding with organizations on questionable entries.

I also believe that the charitable sector can provide much assistance to us as well as to the committee in our endeavors to ensure that any reforms are good reforms. I applaud the good work that the Independent Sector and the Panel on the Nonprofit Sector are doing to promote stronger governance and oversight of charities, and I have every confidence that these and other voices in the charitable community will continue to offer excellent advice to Congress and guidance to their members.

Question: Mr. Commissioner, I have been told that the area of charitable hospitals is rife with abuse. Has the IRS examined tax-exempt hospitals and, if so, what recommendations do you have for legislative or regulatory reform in this area?

Answer: Hospitals have been a substantial part of the IRS Exempt Organizations Compliance Program for at least a decade. Our examinations during that timeframe have covered in excess of 1,500 hospital or hospital-related entities. The examinations involved a wide range of tax issues, including unrelated business income, inurement, taxable subsidiaries, joint ventures, physician recruitment programs, excise tax, excess funded pensions, the tax status of health maintenance organizations,

employment tax, fundraising and several other issues. In addition, we also have a compliance project regarding the issue of whether medical residents are eligible for the student exception to FICA that now encompasses some 365 health organizations and 1,950 residents.

As mentioned in my testimony, this area is of concern because of its size, complexity and increasing difficulty in the ability to determine the difference between for-profit and tax-exempt hospitals. In an effort to better measure the compliance levels within the hospital area of the exempt community, we began a market segment study of hospitals in 2003, reviewing our work to date in this area. We are scheduled to conclude this study this summer. This study is a considerable undertaking, because examinations of hospitals are extremely complex and fact-intensive, requiring large teams of examiners to handle each case. We expect the final study to include recommendations as to how to improve the compliance level within the health field and will be working with the Office of Tax Policy at the Department of the Treasury and with committee staff on needed reforms. Of course, we will be more than happy to discuss our findings as we move forward.

Question: Mr. Commissioner, do you believe the Service has the resources it needs to go after abuses in the tax-exempt area in general and specifically where known abuses occur, whether in tax shelter accommodation, overvaluation, tax-exempt hospitals, or wherever the specific problems are?

Answer: One of our strategic objectives is to deter abuse of tax-exempt entities and misuse of such entities by third parties. As stated in my testimony, I have increased the resources we are devoting to our Tax Exempt and Government Entities Division (TE/GE), which oversees the tax-exempt area. In fiscal year 2005, our budget for TE/GE's Exempt Organizations (EO) function increased 13.8 percent, and our compliance staffing will increase dramatically in this area. It is vitally important that the Congress approve the administration's request for a 4.3-percent increase in the fiscal year 2006 IRS budget, which includes a nearly 8-percent increase in enforcement. If the Congress approves the request, the amount we plan to dedicate to the tax-exempt area would be used to combat abusive promotions involving tax-exempt entities, to start examinations quickly when we detect a risk, to give agents better information for their first contact with taxpayers, and to increase vigilance against the misdirection of exempt organizations' assets for illegal activities or private gain.

Question: The number and size of tax-exempt entities appear to have grown very significantly in the past few years. Is there any indication that this growth rate will slow? How will the IRS keep up with this sector, especially as some who would abuse the rules become more sophisticated and their improper actions become harder to detect?

Answer: We have no reason to believe that current growth trends will not continue, though in the last 2 years the growth in applications for exempt status has slowed.

In our efforts to improve our front-end determination process, we have revised Form 1023, the application form for charitable status, which now asks for more information. We hope this will reduce the need for our staff to correspond with applicants. We also have introduced a program to identify cases that may involve abusive transactions early in the determination process, and to ensure consistent application of the law. Ultimately, we will pursue electronic filing of the Form 1023.

To better identify and select problem organizations for examination, we are pursuing improved data in both quality and quantity available. Electronic filing will help in this regard.

To administer tax law in an increasingly large and complex environment, we are becoming more innovative and proactive in the ways we do business. We have established a Data Analysis Unit to provide trend research and analysis to improve workload selection for our EO examination function. It will support EO compliance activities through identification of trends, support improved examination case selection, and identify potential compliance issues through use of the Internet and various IRS and non-IRS databases.

We are also establishing a new office in EO to combat fraud and suspect financial transactions in the tax-exempt area. This Financial Investigations Unit will address complex fraud and tax avoidance cases. The unit's staffing will include revenue agents, forensic accountants, and data miners, and it will serve as a strike force when we need to move quickly in a specific case.

Question: I have been told that the current-law 2-percent excise tax on the net investment income of private foundations was intended to fund IRS enforcement operations? Is this true, and is that what the money raised from this tax is used for?

Answer: When the tax on the net investment income of private foundations (section 4940 of the Internal Revenue Code) was adopted in 1969, a rationale for the

tax was that private foundations should share the burden of the cost of more rigorous enforcement of tax laws relating to exempt organizations. *See* Staff of Joint Committee on Taxation, 91st Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1969, 29 (Joint Comm. Print 1970). This excise tax was originally set at 4 percent, but was lowered to 2 percent in 1978.

In 1974, the Congress established the Office of Assistant Commissioner for Employee Plans and Exempt Organizations (EP/EO) and authorized the use of the section 4940 tax to carry out the functions of EP/EO in former section 7802(b) of the Code. Notwithstanding the authorization, the excise tax revenues have never been appropriated for IRS use, and have always represented a part of general revenues. The authorization to use these tax revenues for EP/EO was repealed in 1998, as was the establishment of EP/EO itself, when the IRS was restructured pursuant to the Internal Revenue Service Restructuring and Reform Act.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: I understand that a large number of IRS agents hired during implementation of the 1969 Tax Act are becoming eligible for retirement. What impact will this have on the EO division's ability to continue its current work and, potentially, to take on additional duties? What are your plans for ensuring sufficient staff resources to ensure a smooth transition during this time?

Answer: We do not anticipate that near-term retirements will disproportionately affect our existing workforce of EO revenue agents. However, we do expect it to be necessary to replace many of our EO managers and technical staff. We have developed a hiring plan that foresees the need to replace EO employees lost through attrition, but we expect a challenge in finding and developing interested and capable management candidates in some areas. Our efforts in replacing staff will be assisted by hiring in 2004 and 2005. In fact, by September 2005, we will have a 30-percent increase in EO Examinations staffing over September 2003.

Question: I understand that there is about a 6-month backlog in the Cincinnati office for consideration of exempt status for new organizations. If this is true, how will the EO division be able to handle additional work?

Answer: By way of background, EO has two major arms: EO Examinations is headquartered in Dallas and examines exempt organizations to ensure they remain in compliance with the requirements of law. EO Rulings and Agreements is headquartered in Washington, DC, and has jurisdiction over the Cincinnati office that handles new applications. Each arm has its own agents. To handle processing of an increasing number of applications, prior to 2003 EO used many examination agents to assist in processing the increasing volume of applications. As a result, the number of EO examinations seriously declined. Since that time, EO has maintained a strict policy of dedicating specific personnel to each function. Today, an increase in workload or change in staff levels in one arm should not ordinarily affect the operations of the other. Because the number of applications has normally increased each year, we have fallen behind in processing them. This was necessary to restore our enforcement presence in the community. We are taking steps to alleviate the backlog.

We are improving the ability of the Cincinnati office to process its workload through a combination of increased staffing and efficiencies in the workplace. As part of my redirection of resources to EO, we will hire new determinations specialists to complement its existing staff. In November, 2004, we introduced a completely redesigned application form for charitable status (Form 1023), which asks for more information. We hope this will reduce the need for our staff to correspond with applicants. We are also developing a "cyber-assistant" for applicants that should reduce errors and omissions in the application process and thereby reduce staff time devoted to corrections. We expect this Internet application to be available in 2007. Ultimately, electronic filing of applications is the answer, and the "cyber-assistant" is a step in that direction.

Question: If the proposal requiring a 5-year review for every exempt organization gets enacted, how will the IRS handle review of ⅕ of filings every year? How many exempt organizations are currently examined every year? How will the IRS increase its capacity to examine a greater number of organizations? How many revenue agents are dedicated to oversight and review of exempt organizations? Has the number increased or decreased over the past 2 years? Past 5 years?

Answer: The 5-year review proposal represents a challenge if the expectation is a review of each filing. The Joint Committee version, as proposed, is for newer exempt organizations to file every 5 years (older organizations are exempted), with no mandated requirement that IRS review those filings. Even this effort would require diversion of existing staff resources or an increase in staffing.

We recognize the need for follow-up after exemption. This year we are establishing an office that will review filings from "at risk" organizations, including a portion of those that have been in operation only 3 years.

EO examined 5,754 entities in fiscal year 2003 and 5,800 in fiscal year 2004. In addition, EO's new Compliance Unit began operations in fiscal year 2004 with 1,475 correspondence compliance contacts. These numbers should increase with the infusion of new staffing. As I mentioned in testimony, we hired 70 new EO examinations agents last year and expect to hire additional agents by the end of fiscal year 2005. By September, 2005, I expect our EO examinations staffing level to be around 531 employees, up from 395 in September, 2003.

Question: Anecdotal information and media reports indicate wrongdoing and questionable activities of a few organizations. How widespread do you believe these problems to be? Do you know of any credible studies assessing exempt organization compliance? How can Congress determine the size and scope of the noncompliance problem in the area?

Answer: We have seen problems in the areas I mentioned in my testimony, but it is impossible to say with certainty how great the problems are. What I can say is that, at least in those areas I have discussed, we need to act quickly to counter a perception of corruption that derives, quite naturally, from continued press reports of scandals.

The universe of tax-exempt organizations has many different segments with very diverse purposes and activities. In the long run we will be looking at many parts, if not all, of the tax-exempt community. We are performing market segment studies, which seek to profile particular sectors of the tax-exempt community by using sampling techniques to determine whether, and to what extent, compliance issues are present. Generally, these initiatives and studies rely on taxpayer contacts and field examinations to obtain information. When we complete these studies, we will be in a better position to provide information on specific potential compliance problems, or the particular market segments we have reviewed.

Question: Congress enacted the excise tax on private foundation income to fund the cost of IRS oversight of exempt organizations, but I don't believe that the revenue generated has ever been used for this purpose. In 2001, the Joint Committee on Taxation recommended elimination of the excise tax as part of their plan to simplify the tax code. In his fiscal year 2006 budget, President Bush called for a flat 1 percent excise tax. How much money is raised annually from the excise tax? How much of that is used for enforcement? Should this tax be eliminated, or at least flattened?

Answer: You are correct that the revenue from the section 4940 excise tax is not used to fund the cost of IRS oversight of exempt organizations. It is part of general Federal revenues and is not appropriated for enforcement. In 1974, the Congress established the Office of Assistant Commissioner for Employee Plans and Exempt Organizations (EP/EO) and authorized the use of the section 4940 tax to carry out the functions of EP/EO in former section 7802(b) of the Code. Notwithstanding the authorization, the excise tax revenues have never been appropriated for IRS use, and have always represented a part of general revenues. The authorization to use these tax revenues for EP/EO was repealed in 1998, as was the establishment of EP/EO itself, when the IRS was restructured pursuant to the Internal Revenue Service Restructuring and Reform Act.

The amount raised from the tax has varied widely in recent years. Receipts of about $503 million in fiscal year 2000 increased to $720 million in 2001, declined to $490 million in 2002, $290 million in 2003, and $240 million in 2004. The administration has proposed simplifying the tax. Under the current two-tier structure of the tax, a foundation may be discouraged from significantly increasing grant-making in a particular year because doing so makes it more difficult for the foundation to qualify for the reduced 1-percent excise tax rate in subsequent years.

PREPARED STATEMENT OF BRIAN GALLAGHER

Thank you, Mr. Chairman, Senator Baucus, and distinguished members of this committee. I welcome the opportunity to speak to you today about issues of governance, accountability and performance in the nonprofit sector.

I am Brian Gallagher, President of United Way of America. I am here today representing my organization and 1,348 local, independent United Ways across the country that are working hard to improve people's lives and have a measurable, positive impact in communities across America.

When I first came to United Way 4 years ago, I was hired to change the organization's mission—to get United Way to focus on work that would show results. But

traumatic world events interceded. We had the attacks on 9–11 and the response of the charitable community to that event. There were corporate scandals at Enron, WorldCom, and Tyco. And then a scandal erupted here, right in our own backyard, at United Way of the National Capital Area.

I was embarrassed by that scandal, and it made me sick. Soon after it broke in the *Washington Post,* we got a letter from Chairman Grassley asking how we monitor our local United Ways and what changes we would recommend to improve the way nonprofit organizations work.

It became clear to me that no matter how many United Ways operate ethically and do great work, a handful can make us all look bad and erode the confidence people have in us. I realized that if I didn't focus on accountability first we would never get to our real work around mission.

So I took advantage of the opportunity this request from Chairman Grassley gave us to accelerate changes within United Way. First, I put pressure on the National Capital Area United Way to make significant changes—and they did. United Way of the National Capital Area has taken the necessary steps since then to institute real reform.

Next, I called for a review and an overhaul of our existing membership standards, which was adopted overwhelmingly by our members in less than a year. We moved fast and aggressively. The revised standards (see Attachment 1) have successfully brought other United Ways into line, and, as a result, we disaffiliated over 50 United Ways for failure to meet one or more of our new membership requirements. But for every United Way that remained in the system, we reaffirmed the values of transparency, accountability, and disclosure through compliance with these new, higher standards.

We at United Way needed a wake-up call and have taken the necessary steps to restore trust, but the entire non-profit sector also needs to wake up on this issue. If we in the sector can't make meaningful, common-sense reforms that will promote greater accountability, then there should be legislation—because changes in nonprofit accountability *must* be made in order to restore trust.

Last summer the staff of the Senate Finance Committee circulated a White Paper containing a number of options for improving accountability in the nonprofit sector. For the record, we agree with the overall thrust of this paper. In fact, some of the language used in the paper, especially related to the IRS Form 990 reforms, was taken verbatim from United Way's new membership requirements. I had personally reviewed these requirements with Chairman Grassley before they were implemented within our system.

Specifically, we agree with the proposals around responsibility, disclosure and effective operations—key elements of trust—including:

- That the Chief Executive Officer—not just the Chief Financial Officer—of a nonprofit should be required to sign and be responsible for the information on the IRS Form 990.
- That the IRS should review every nonprofit's tax-exempt status every 5 years to ensure that they continue to operate exclusively for charitable purposes.
- That Congress should increase funding for IRS enforcement—and we support this increase even if funding must be provided through increases in fees assessed on our sector, as long as we can be certain that the new fees will be used for their intended purpose.

But we don't agree with everything included in the White Paper. For example, we disagree:

- That the size of nonprofit boards of directors should be limited by Federal law.
- That there should be government-mandated accreditation for nonprofits. Government regulation should focus on whether operations are legal, accountable, and transparent, not on micromanagement.

But while we disagree on some of the details, we agree overall. We need to look seriously at fundamental changes if we plan to change the operation and culture of our sector. This is a great opportunity to address the trust issues that are facing us.

Finally, if I ended my remarks now—after addressing financial and legal accountability only—I'd be doing our sector a huge disservice.

In a recent Internet poll conducted by United Way, we found that, while trust in nonprofits is low, regulation isn't what people are looking for. Only 35 percent of respondents said that they thought there should be more regulation of charities by the Federal Government.

The number one reason that people don't have faith or trust in the non-profit sector is that donors don't know how charities spend their money. It's overwhelming—71 percent of respondents who don't trust charities said that their trust in non-profits would be greater if they knew how the money was spent.

Financial accountability is just table stakes. You *have* to get that right first. But ultimately, the American public should hold our sector accountable for delivering on our missions. Unlike the business world, we don't have market forces in play that directly reward the creation of value or punish the lack thereof.

To address that concern, I respectfully suggest that nonprofit organizations be asked to report concrete results annually that are tied directly to their missions, not just the level of activity. Perhaps a results section such as that can be added to the annual Form 990.

We should be asked to report concrete results that are tied directly to our missions, not just the level of activity we produce. When you're asking people to contribute, you're asking for an investment in your mission. And like a for-profit business, you are then accountable to your investors, not just for keeping good books, but for creating value and offering a concrete return.

For those of us in human development, that means efforts that lead to measurable improvements in people's lives ought to be the ones rewarded with public or private investment. In other words, the organizations that produce the greatest results should grow and be rewarded. Those that do not should be forced to change or go out of business.

Producing results has become the major focus for United Way—we're looking at the conditions that exist in the world today and we're transforming our business—what we do, how we do it and, most importantly, how we define success.

Why should we change? Because our helping systems were built for a different economic time and a different set of social conditions. In the U.S. we have evolved from an agrarian economy to an industrial economy, to a service economy, and finally an information and technology economy. And we are now in a global marketplace which changes how money is earned and how wealth and income are accumulated and distributed. It is why, during one of the longest macroeconomic expansions in our history during the 1990s, we did not make real progress on some of our most difficult social issues. Our systems were built for a time when economic good times would lift all boats. It just doesn't work that way anymore. So unless we get a laser beam-like focus on real results, our health systems, education systems, child protection systems, and United Way systems will not create different strategies, work with different partners, invest our resources differently, use the right metrics of success, and therefore make progress which will satisfy donor and taxpayer aspirations, and thereby earn their trust and confidence.

Getting results is a huge part of rebuilding and maintaining trust. We know from our research that, when people see their local United Way as a leader in getting results in the community, their trust is significantly higher than our national average. In addition, these local United Ways also outperform our system averages in the amount of money they raise. I believe that if we applied the same logic to the entire nonprofit sector, we'd find the same thing.

The American public doesn't give us money just because our operations are clean. They expect that they are clean, and they should have every right to do so. Why they really give us money, however, is because they want to make a difference. They want to improve lives. And we—at United Way and throughout the sector—owe it to them to be able to demonstrate that their money, invested through us, is indeed making a difference and getting results.

Thank you for your time and consideration. I would be happy to answer any questions that you may have.

ATTACHMENT 1

UNITED WAY OF AMERICA MEMBERSHIP STANDARDS

STANDARD A: TAX-EXEMPT STATUS

Be recognized as exempt from taxation under Section 501(c)(3) of the Internal Revenue Code as well as from corresponding provisions of other applicable state, local or foreign laws or regulations and files IRS Form 990 annually in a timely manner. *Annually, all Metro 1 and 2 members will submit entire IRS Form 990 to United Way of America.*

Purpose: Donors have an expectation that their gifts will be an eligible deduction on their tax returns. It is essential for all United Ways to be recognized by the IRS as tax-exempt 501(c)(3) in order to meet donors expectations.

STANDARD B: LEGAL REQUIREMENTS

Comply with all other applicable legal local, state, and federal operating and reporting requirements (e.g., nondiscrimination).

Purpose: The leadership of a United Way must be aware of its obligation to meet legal requirements.

STANDARD C: GOVERNANCE

Have an active, responsible, and voluntary governing body, which ensures effective governance over the policies and financial resources of the organization.

Purpose: This standard ensures that United Ways maintain strong governance practices and embrace accountability.

Resource: BoardSource, www.boardsource.org, 800-883-6262.

STANDARD D: DIVERSITY

Adhere to a locally developed and adopted statement to ensure volunteers and staff broadly reflect the diversity of the community it serves.

Purpose: United Ways must welcome, reflect and engage the full range of their constituency. This is achieved by ensuring that the staff, volunteer and donor base is diverse.

Resource: Diversity Toolkit, available on United Way Online.

STANDARD E: TRADEMARK

Represent itself as a United Way in accordance with all United Way of America trademark standards and requirements, including those contained in the licensing agreement.

Purpose: To preserve the integrity of the United Way brand, and to ensure consistent presentation of its brand identity and accurate representation of United Way's mission and values.

Resource: United Way of America's Creative Studio.

STANDARD F: MEMBERSHIP INVESTMENT

Provides financial support to United Way of America in accordance with the agreed upon membership investment formula.

Purpose: To ensure quality products, services, and research are available for members of United Way of America (UWA).

Due Date: June 30, 2004.

STANDARD G: CODE OF ETHICS

Adhere to a locally developed and adopted code of ethics for volunteers and staff, which include provisions for ethical management, publicity, fundraising practices and full and fair disclosure. *All Metro 1 and 2 members will submit a copy of their current code of ethics to United Way of America.*

Purpose: A code of ethics will serve as a resource to guide United Ways with questions of conflict of interest, personnel issues or even United Way practices in general. A code of ethics will foster an ethical environment and maintain public confidence in the organization.

Resource: Code of Ethics Toolkit, available on United Way Online.

STANDARD H: AUDIT

Have an annual audit conducted by an independent certified public accountant whose examination complies with generally accepted accounting standards and GAAP. (Organizations with annual revenue totaling less than $100,000 may have their financial statements reviewed by an independent public accountant.) *Annually, all Metro 1 and 2 members will submit a copy of their most recent audit to United Way of America.*

Purpose: To ensure financial responsibility and accountability, all United Ways must be subject to the standard of an independent audit or review (depending on level of revenue).

Resource: CFO Deskbook, available on United Way Online.

STANDARD I: SELF-ASSESSMENT

Conduct and submit to United Way of America every three years a volunteer-led self-assessment of their community impact work, financial management, and organizational governance and decision making.

Purpose: To support performance excellence by a periodic, internal, volunteer-led review.

Resource: Operational and Governance Self Assessment Tool and the Community Impact Survey, available on United Way Online.

Due Date: To be completed every three years beginning in 2004 or 2005 or 2006.

STANDARD J: DATABASE II

Annually submit Database II Survey and Amounts Raised Card to United Way of America.

Purpose: To provide system-wide, accurate campaign results.

Resource: UWA's Research Services Team and the NPC Policy for Reporting Total Resources Generated.

Due Date: May 15, 2004 (Database II Survey) and March 1, 2004 (Amounts Raised Card).

STANDARD K: INCOME AND EXPENSE SURVEY

Biennially submit Income and Expense Survey to United Way of America.

Purpose: To measure operating efficiency, particularly cost ratios (overhead).

Resource: UWA's Research Services Team.

Due Date: March 31, 2004.

STANDARD L: CAMPAIGN REPORTING

Adhere to standard reporting guidelines contained in Database II Survey for reporting campaign revenue and resources generated to United Way of America.

Purpose: To ensure standardized, comprehensive campaign results for the United Way System, with no duplication in count of amounts raised.

Resource: NPC Policy for Reporting Total Resources Generated.

STANDARD M: COST DEDUCTION STANDARDS

Adhere to the following cost deduction standards on designations (agency transactions):

a) **fees charged will be based on actual expenses**
b) **will not deduct fundraising or processing fees from designated gifts originating by or from another United Way organization.**

Purpose: Assure the public that: 1) donors are charged no more than the actual cost incurred to process and transfer gifts, 2) there are no duplicate charges or redundant services to the donor, and 3) United Ways have a consistent, fair and understandable methodology for calculating and allocating fundraising, processing, disbursement and management and general expenses to designations.

Resource: The Financial Issues Committee will put forth implementation guidelines in June 2004.

ATTACHMENT 2

United Way
of America

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UNITED WAY
STANDARDS OF EXCELLENCE

BACKGROUND

United Way of America (UWA) first published its Standards of Excellence in 1973. The last update of the Standards was in 1988. The new Standards, which provide a comprehensive description of benchmark standards and best practices, reflect the organization's strategic shift from its traditional role as strictly a fundraiser to a new mission focused on identifying and addressing the long-term needs of communities. The Standards also represent a proactive effort by UWA to maintain an extraordinarily high standard of accountability and transparency. Developed in conjunction with the National Professional Council, a leadership forum of local United Way professionals from throughout the country, the standards are designed to enhance the effectiveness of the 1,350 United Way affiliates.

The new Standards of Excellence were developed by and for United Way leaders to help their organizations—and, therefore, the entire system—to be more successful in achieving the community mission. The purpose of the Standards is four-fold:

- To define how to be a "great" United Way, pursuing and achieving community impact;
- To establish aspirational benchmarks for individual United Way and system performance;
- To provide clear definitions and a common language to describe United Way's business today; and
- To provide a vehicle to help enhance stakeholder understanding of the "new" United Way.

The Standards will help local United Ways by providing the following benefits in their respective communities:

- Staff and volunteer leaders will increase their knowledge of what is required to fulfill the United Way's mission in local communities.
- Leaders will have an effective framework for organizational assessment, planning and performance improvement.
- Staff, board members and volunteers will understand and use common terms when communicating about the United Way.
- Partners and other stakeholders will have an increased awareness of the United Way's work and, therefore, an increased desire to support its efforts.

STANDARDS OVERVIEW

A comprehensive document of more than 100 pages, the new Standards provide highly detailed descriptions for five key areas of operation. Each includes multiple standards for performance:

Component 1: Community Engagement and Vision

This component focuses on engaging and inspiring communities to create a shared vision for the future and set goals for collective action. The Standards include:

- **Knowledge of the Community.** United Way identifies, understands and engages existing and emerging communities and builds relationships with community leaders and people of influence in all sectors.
- **Community Engagement and Mobilization.** United Way listens to, learns from and motivates diverse individuals, groups and sectors to better understand, become involved in and take action on priority issues.
- **Shared Community Vision.** United Way and the community establish a shared vision for the future by creating a collective understanding of key community interests, aspirations, assets and concerns which represent the perspectives of diverse groups, individuals and sectors.
- **Public Policy Engagement.** Because the government is a critical decision-maker and the major provider and funder of health and human services, United Way must actively engage in public policy and develop partnerships that include local, state and federal governments along with the private sector and nonprofit sector.

Component 2: Impact Strategies, Resources & Results

The scope of Component 2 includes development of "impact strategies" that will achieve measurable and lasting change in community conditions and mobilization of necessary resources by putting them to work to produce positive results and improve lives. The Standards include:

- **Impact Strategies.** United Way and other partners engage the community in developing a comprehensive plan for impacting selected priority issues and identifying the lasting changes sought and specific strategies needed. All those with an interest in the outcomes are included. United Way determines its role in the plan and focuses on selected strategies.
- **Partner Engagement.** United Way deliberately and actively builds quality relationships with traditional and non-traditional partners and involves them every step of the way. United Way engages partners around priority community issues, shared strategies and corresponding resource development.
- **Resource Development and Mobilization.** United Way mobilizes the many community assets—money, people, knowledge, relationships and technology—needed to implement strategies and achieve meaningful results. United Way builds personal relationships with donors/investors, segments markets based on interests and recognizes all contributions.

- **Implementation and Action.** United Way recognizes that community impact cannot be achieved through any single strategy, action or investment. United Way implements a diverse array of impact strategies and actions to achieve desired results and improve lives (beyond merely funding agencies, programs or services). In all activities, United Way strives to include those individuals most affected by an issue. United Way explores strategies that go beyond our traditional service orientation and address root causes, as well as system-level barriers and challenges.
- **Measure, Evaluate and Communicate Results.** United Way and its partners evaluate the effectiveness of impact strategies in order to continuously improve. They identify appropriate measures, collect and analyze results, and assess progress toward desired outcomes. Outcomes may be measured at multiple levels (i.e., programs, systems and community). What is learned may cause United Way and partners to re-think, change or adjust strategies, actions and investments.

Component 3: Relationship Building and Brand Management

This component focuses on the development, maintenance and growth of relationships with individuals and organizations, in order to attract and sustain resources to support United Way's mission. The Standards include:

- **Relationship-Oriented Culture.** United Way culture (i.e., norms, values and work practices) supports building relationships that help achieve its mission.
- **Market Intelligence.** United Way collects, analyzes and uses critical information about the market and target audiences, in order to better respond to market trends and customer requirements.
- **Segmentation and Prioritization.** United Way identifies and prioritizes key customer segments and partners to build relationships important to achieving community impact goals.
- **Active Cultivation.** United Way *actively* cultivates, maintains and grows key relationships to increase loyalty and convert ambivalence or inertia, where it exists, to passionate support.
- **Unique, Positive Brand Experience.** United Way aspires to be the ideal partner for people who want to make a real difference in the community. We deliver results, engage, communicate and create a consistent brand experience for our corporate and individual investors and key partners.
- **Prominent Stature and Reputation.** United Way has impeccable standing in the community and is recognized as a key leader on selected priority issues, as well as a strong partner on a range of other community issues.

Component 4: Organizational Leadership & Governance

The scope of Component 4 is leading local United Ways to successfully fulfill its mission, and in doing so, garner trust, legitimacy and support from the local community and the United Way system. The Standards include:

- **Mission.** United Way has a clearly stated mission, approved by the board, in pursuit of improving lives by strengthening local communities. All organizational activities

are consistent with the mission and all who work for or on behalf of United Way understand, articulate and support its stated purpose.

- **Staff and Volunteer Leadership.** United Way's CEO and volunteer leaders provide visible, active and effective leadership for the United Way and the community. The CEO and volunteer leaders hold themselves accountable for achieving community impact and organizational goals and fulfill the responsibilities described in the practices below.
- **Governance.** United Way's volunteer board of directors is effective in setting direction for the organization, ensuring necessary resources (i.e., human, financial, relationship) and providing oversight of programs, finances, legal compliance and values.
- **Strategic and Business Planning.** United Way establishes short and long-term goals and identifies strategies to accomplish them. Strategies are based on data and analysis, address United Way's selected priority issues and drive resource development, marketing, financial and operational plans (collectively, a "business plan"), as well as staff work plans (i.e., accountability). United Way assesses progress annually and makes changes as needed.
- **Alignment.** Leaders align all organizational elements and resources (functional areas, systems, skills, staff, board, volunteers, structure, culture, mindset and investments) to support United Way's mission and community impact and organizational goals. United Way measures group and individual performance against these goals. Adjustments are made as needed.
- **Organizational Learning and Talent Development.** United Way continuously improves performance by: 1) anticipating and reacting to change, complexity and uncertainty, 2) cultivating a culture committed to the innovation of products and services and 3) facilitating the development, growth and succession of talent. United Way leaders create the optimal culture, processes and infrastructure for continuous learning at organizational and individual levels. United Way staff, volunteers and partners translate new learning into action that achieves results.
- **Inclusiveness.** United Way recognizes that in order to effectively engage communities to achieve goals, the staff, volunteers, donor/investors and community partners should include the communities United Way serves. The organization's culture, recruitment, partnerships and other business practices demonstrate inclusiveness. Formal policies and practices promote and measure inclusiveness in all aspects of internal and external functions.
- **System Citizenship.** Local United Way's relationships with other United Ways, state associations and UWA acknowledge that each member bears responsibilities toward the others. The successes and failures of any one member impact the entire system. Local United Way fosters a high level of trust, information exchange and mutual help with others in the system to further our community impact mission, create a consistent brand experience and support a strong network of United Ways locally, regionally and nationally.

Component 5: Operations

Component 5 deals with providing efficient and cost-effective systems, policies and processes that enable the delivery of United Way's mission-related work and ensure the highest levels of transparency and accountability. The Standards include:

- **Strategic Back Office.** United Way provides high-quality and cost-effective operational support of all core business functions through internal capacity, national and regional solutions, United Way collaboration, external professionals, or a combination thereof.
- **Administrative Back Office.** United Way provides high-quality non-core business functions (i.e., human resource administration, finance, information technology and procurement) through internal capacity, national and regional solutions, United Way collaboration, external professionals, or a combination thereof.
- **Cost Analysis.** United Way utilizes its resources effectively and efficiently, yielding maximum value while incurring minimum cost.
- **Risk Management.** United Way is intentional and comprehensive in the protection of the organization's assets (brand, financial, property and people).
- **Business Continuity.** United Way has a comprehensive business continuity plan to ensure appropriate and timely internal actions following major crises, disasters or loss of key staff.
- **Facilities.** United Way provides a safe, welcoming physical environment that is accessible, practical, recognizable and expressive of the organization's mission.
- **Financial Policies.** In order to maintain the public's trust, written policies and procedures are in place to ensure strong financial management, compliance with legal and regulatory requirements, compliance with all UWA's membership requirements and internal controls over all United Way resources.
- **Internal Controls.** To properly ensure the accuracy of financial statements, safeguard assets and maintain an appropriate separation of duties for all financial transactions and functions, United Way maintains effective internal controls, policies and procedures, which are reviewed by auditors and approved by the audit committee of the board of directors.
- **Sarbanes-Oxley Legislation (SOX).** Although SOX legislation primarily applies to publicly traded companies and the audit firms that serve them, two provisions of the law apply to all corporate entities, including nonprofits.
- **Public Reporting and Transparency.** United Way is open and candid about its activities and operations. It provides public access to appropriate documents to ensure transparency in governance, finance, allocation and ethics matters.
- **Investment Policies.** United Way has board-approved, sound and prudent investment policies and financial practices that adhere to fundamental fiduciary duties of loyalty, impartiality and prudence in maintaining overall portfolio risks at a reasonable level.

LETTER FROM IRS COMMISSIONER MARK EVERSON
SUBMITTED BY SENATOR GRASSLEY

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

March 30, 2005

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to respond to your letter of January 18, 2005, concerning the most significant compliance issues within the responsibility of the Tax Exempt and Government Entities Division (TE/GE) of the Internal Revenue Service (IRS). TE/GE's three major business units – Exempt Organizations (EO), Employee Plans (EP), and Government Entities (GE) – oversee a wide range of taxpayers, from small volunteer community organizations to sovereign Indian tribes to large pension funds. These entities are not subject to Federal income tax, but they nonetheless represent a significant component of tax administration. Approximately three million entities make up this sector of the economy. They control approximately $8 trillion in assets and pay over $300 billion in employment tax and employee income tax withholding.

We recognize the significance of this sector for tax administration in the IRS Strategic Plan for 2005 – 2009. The Strategic Plan establishes four key objectives aimed at enhancing the enforcement of the tax law over the next five years. One objective focuses directly on the tax-exempt and government entities sector:

> To deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.

This letter will focus on problems with compliance that we are now encountering in this sector. This focus should not overshadow the inspiring work that the tax-exempt community does day-in and day-out, nor should it detract from the fact that the overwhelming majority of tax-exempt entities do their utmost to comply fully with the letter and the spirit of the tax law. However, we must recognize that we are now at an important juncture. We can see that tax abuse is increasingly present in the sector, and we intend to address it. We will act vigorously, for to do otherwise is to risk the loss of the faith and support that the public has always given to this sector.

I know this is a concern that you share, as well, and I want to thank you and your Committee for your leadership in this area. I also want to compliment your staff and the

staff of the Joint Committee on Taxation for their attention to areas under TE/GE jurisdiction.

I also wish to acknowledge the leaders of the tax-exempt sector who are exploring options to address abuses in their community. I particularly salute the Independent Sector, the sponsor of the National Panel on Nonprofits, which recently delivered a thoughtful and constructive report to your Committee. The report declares that the "government should ensure effective enforcement of the law," and it calls for tougher rules for charities and foundations. The report also calls for stronger action by the IRS to hold accountable those charities that fail to provide the public with accurate and timely information about their operations.

Introduction

As you requested, we outline below the top compliance issues that we are encountering in the TE/GE area. Your letter also requests that we provide revenue impacts of the compliance issues we identify. Unfortunately, we have no precise way to gauge the revenue impact of these issues, and will not be able to answer those parts of your request. Moreover, in the tax-exempt area of the Internal Revenue Code (Code), revenue is not the key objective. Instead, we focus on insuring that the tax expenditures associated with this sector of the economy achieve their intended goals. Thus, our list of compliance issues was selected not by reason of revenue impact, but rather on the basis of other factors, such as the nature of the noncompliant behavior, whether the behavior is on the rise, and the corrosive impact of such behavior on voluntary compliance and public trust in nonprofit organizations.

This letter is divided into four parts. First, we outline external factors currently impacting this sector. Second, we list the top compliance problems by function within TE/GE. Third, we outline actions we have taken to address these compliance problems. Finally, we identify unresolved policy issues that should be part of any discussion of reform.

I. External Factors Impacting The Sector – A Less Compliant Environment

A number of factors are impacting compliance in the TE/GE area. As might be expected, these factors do not necessarily operate independently of one another. Nor are they all negative. Taken together, however, they add up to a culture that has become more casual about compliance and less resistant to non-compliance.

Increase in size and complexity of the tax exempt sector. Most parts of the TE/GE sector have grown rapidly over the past decade, and this growth has impacted the manner in which organizations do business. The number of tax exempt organizations on our master-file has increased by almost 500,000 since 1995, to 1.8 million today. In the period from FY 1998 to FY 2002 alone, the reported value of the assets of these organizations grew from approximately $2 trillion to more than $3 trillion. While the

number of employee plans has generally remained stable, the reported value of the assets held by those plans has increased by approximately $2.3 trillion since 1995.

In the tax-exempt bond area, the trend is similar. Debt outstanding has more than doubled since 1995, as has the number of issuances.

With respect to Indian tribal governments, a significant portion of the tribal community has been transformed by the advent of gaming. The number of Indian gaming casinos has more than quadrupled since 1995, to 440, and estimated revenues from these operations have gone up by more than 300 percent, to $16.7 billion, in the same period.

The lack of an adequate enforcement presence in recent years. In TE/GE, as in the rest of the IRS, our enforcement presence faded in the late 1990s. A number of factors contributed to this decline. In the area of exempt organizations, we were, and continue to be, struggling with yearly increases in the number of applications for tax exemption. The enforcement presence also declined in the retirement plan area. In both EO and EP, overall staffing declined and fewer and fewer employees were deployed to do traditional enforcement work. This decline, combined with the significant growth of the tax-exempt sector noted above, created opportunities for noncompliance.

Lax attitudes towards governance. An independent, empowered, and active board of directors is the key to insuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust. Unfortunately, the nonprofit community has not been immune from recent trends toward bad corporate practices. Like their for-profit brethren, some charitable boards appear to be lax in certain areas. Many of the situations in which we have found otherwise law-abiding organizations to be off-track stem from the failure of fiduciaries to appropriately manage the organization. For example, as we will discuss below, we have found issues relating to how executive compensation is set and reported by nonprofits. Similarly, issues exist as to whether sufficient due diligence and care is taken in filing tax and information returns.

Arising in part from the same weak governance practices, some parts of TE/GE's regulated community have become involved with abusive transactions. In the tax shelter area, abusive programs often require a "tax-indifferent party" to make the scheme work. TE/GE customers are natural candidates. We are concerned that tax-indifferent parties are being used as accommodation parties to enable abusive tax shelters. Of the 31 categories of listed transactions, nearly half have the potential to involve tax-indifferent parties either as an accommodation party or as a more active participant.

Whether the transaction involves a municipal pension plan or a charity, we believe that the tax-indifferent party that involves itself, or allows itself to be used, may be inappropriately trading on its privileged tax-exempt status. Some shelter promoters use tax-indifferent parties to create abusive shelters where, for a fee, the entity lets the promoter exploit its tax-free status.

Other abusive transactions are less complex, but just as corrosive to the credibility of the tax system and to the public's faith in our tax-exempt sector. These transactions often share the same guiding principle: a donor receives a deduction for a charitable contribution while maintaining control over the contributed assets, often using them for personal gain. We list several examples below, including abusive donor-advised funds and supporting organizations.

The terrorist acts of September 11, 2001. One of the most disconcerting revelations since the horrors of September 11 has been that certain terrorist organizations have used charities to raise and move funds or otherwise support terrorist activity. Especially troubling is the fact that the forty charitable organizations designated as financing terrorist activity include six U.S.-based charities. Although those represent a minuscule part of the charitable sector, curtailing possible corruption and abuse is a critical element in how we now deal with the charitable sector. It has had an impact on the way we design, process, and review forms and the business processes by which we recognize exemption and review continued operational compliance.

Improved exempt organization transparency. A positive development in recent years is the improvement in "transparency" within the tax-exempt sector. "Transparency" refers to the ability of outsiders – donors, the press, interested members of the public – to review data concerning the finances and operations of an exempt organization. By creating a means by which the public may review and monitor the activities of tax-exempt organizations, we promote compliance, help preserve the integrity of the tax system, and help maintain public confidence in the sector. To achieve these goals, we began in the mid-to-late 1990s to image Forms 990, the annual information returns filed by many tax-exempt organizations. We put this information on CDs, and provide it to a number of watchdog groups that monitor charitable organizations. These groups post the information to their websites, where it is available to the press and to the public. This process has resulted in increased press and public scrutiny of the tax-exempt sector, which we believe is highly desirable. It has also increased the ability of the IRS and state regulators to access Form 990 data, because they are more readily available.

II. Top Current Compliance Problems Facing TE/GE

I would like to turn now to the identification of the most significant compliance problems currently facing TE/GE. We will discuss abusive organizations, organizations that are abused by third parties, and other compliance challenges within the TE/GE sector. We will group related abuses and associate them with the function within TE/GE that is primarily responsible for responding to them.[1]

[1] Tax issues related to the donor of a charitable contribution, such as deductibility, are generally not within the jurisdiction of TE/GE.

Exempt Organizations

EO-1. Charities established to benefit the donor. As mentioned above, this group of compliance issues shares the same general principle: a donor receives a charitable contribution deduction while maintaining control over the contributed assets, often using them for personal gain. Examples include abusive organizations in the following categories:

Abusive donor-advised fund arrangements. A donor-advised fund is a separate fund or account maintained by a public charity to receive tax-deductible contributions from a single donor or a group of donors. These funds can offer a convenient way for a donor to make charitable gifts. However, for the payment to qualify as a completed gift to the charity, the charity must have ultimate authority over how the assets in each account are invested and distributed in furtherance of its exempt purposes. Although the donor may recommend charitable distributions from the account, the charity must be free to accept or reject the donor's recommendations.

We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer's personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible under Code section 170. Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donors to reimburse them for their expenses, or to fund their children's educations.

Section 509(a)(3) supporting organizations established to provide benefits to founders. Supporting organizations are public charities that, in carrying out their exempt purposes, support one or more other exempt organizations, usually other public charities. The category covers many types of entities including university endowment funds and organizations that provide essential services for hospital systems. The classification is important because it is one way a charity may avoid classification as a private foundation, a status that is subject to a much more restrictive regulatory regime. There are three types of these organizations, depending upon the relationship between the supporting organization and the organizations it supports. Briefly, Type I supporting organizations are controlled by the supported organization in a manner comparable to a parent and its subsidiary. Type II supporting organizations share common supervision and control with the supported organizations. Most problems we are finding are in the "Type III" organizations where the relationship is least formalized. We have found some issues with the Type I organizations as well, where the supported organization may be controlled by a promoter.

Some promoters in this area have encouraged individuals to establish and operate supporting organizations purportedly described in section 509(a)(3) that they can control for their own benefit. There are a variety of methods of abuse, but a common theme is a "charitable" donation of an amount to the supporting organization, and a return of the

donated amount to the donor, often in the form of a purported loan that may never be repaid.

For example, we have seen contributed amounts that have ultimately been returned and then used by the donor to purchase residential property. To disguise the abuse, the transaction may be routed through one or more intermediary organizations controlled by the promoter, some of which may be offshore.

Corporation sole abuses. A corporation sole is an entity authorized under certain state laws to allow religious leaders to hold property and conduct business for the benefit of a religious entity. The leader may incorporate under state law in his capacity as a religious official. A corporation sole may own property and enter into contracts as a natural person, but only for the purposes of the religious entity. Title in property that vests in the officeholder as a corporation sole passes to the successors in office, and not to the officeholder's heirs. The purpose of a corporation sole is to ensure continuity of ownership of property dedicated to the use of a religious organization.

The corporation sole form of organization serves a valid function for legitimate religious entities. However, some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under the pretext of being a "bishop" of a religious organization or society. The idea being promoted is that the arrangement entitles the individual to exemption from Federal income taxes as a nonprofit, religious organization described in section 501(c)(3). The position is utterly without merit.

Charitable trust problems and abuses. Some promoters have set up purported charitable or split-interest trusts that can be used for a taxpayer's personal benefit. There are a variety of schemes, all without legal merit, designed to allow individuals to deduct amounts that ultimately will be used for their personal expenses. The trust typically is a nonexempt charitable trust formed under state law that serves as a holding entity of the individual's assets. Individuals retrieve these assets at will, generally through loan transactions, gifts, or by having the trust pay for expenses directly. Because the trusts are not tax-exempt, they generally do not seek confirmation of their status with the IRS.

We have also seen a variety of abusive promotions involving charitable remainder trusts, which have both charitable and non-charitable elements. One marketed scheme uses these trusts to avoid capital gains on highly appreciated property. The property is transferred to the trust, which sells the property and provides the bulk of the sales proceeds to the transferor relatively quickly, but structures the formal consummation of the sale to occur in a later year when the transferor has little gain to report. The transferor avoids reporting the gain received in the earlier years. There are other variations on this theme and we are still investigating the extent to which these schemes have been sold. In sum, trusts that are designed for charitable purposes are being manipulated for tax avoidance by their creators.

EO-2. Abusive credit counseling organizations. Increasingly, it appears that certain credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

EO-3. Regulation and reporting of political activity of non-profits. We have seen an apparent increase in the political activity of tax-exempt organizations during the recent election. Section 501(c)(3) organizations are statutorily prohibited from intervening in political campaigns. Each election cycle we become involved with significant allegations of wrongdoing and this problem shows no indication of abating. In 2002, a mid term election year, our records indicate that we received approximately 70 complaints alleging campaign activity by charities. In 2004, a presidential election year, that number was over 200. These are difficult cases and our actions often trigger questions and concerns from the public and Congress.

EO-4. Misuse of charities for charitable deductions. The problem in this area often concerns an overstatement by the taxpayer of the value of the donation.

Conservation easements. In recognition of the need to preserve our heritage, the Congress allowed an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings for future generations.

The IRS has seen abuses of this tax provision that compromise the policy the Congress intended to promote. We have seen taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In some cases, taxpayers claim deductions when they are not entitled to any deduction at all (for example, when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements). Further, the conservation easement rules place the charity in a watchdog role. In a number of cases, however, the charity has not monitored the easements, or has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions.

Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.

Non-cash charitable contributions. We also have persistent problems in taxpayers' valuation of deductions taken for non-cash charitable contributions. Valuation issues

are often difficult. Overvaluations may arise from taxpayer error or abuse and from aggressive taxpayer positions. Additional enforcement concerns are whether consideration has been received in return, and whether only a partial interest has been transferred.

EO-5. Abusive tax shelters. We are concerned about tax-indifferent parties being used as accommodation parties or otherwise to facilitate abusive tax shelters. An "accommodation party" is a term used to describe a tax-indifferent party's involvement in a transaction that does not necessarily affect the entity's primary function, but is designed to provide tax benefits to a taxable third party. We have seen an increased use of various tax-indifferent parties, including charities and other tax-exempt organizations, private and government retirement plans, Indian tribal governments, and municipal governments, to achieve abusive results.

Almost half of the 31 transactions we have identified to date as listed transactions under the tax shelter disclosure regulations involve the use of a tax-indifferent party. In one listed transaction, Notice 2003-81, involving tax-avoidance using offsetting foreign currency option contracts, we have found both otherwise-legitimate and suspect charities to have been involved.

EO-6. Compensation issues. There has been much publicity about high salaries and generous compensation at some charities and foundations. An exempt organization is entitled to pay reasonable compensation for the services it receives. Moreover, what some consider excessive compensation may meet the requirements of current law in this area. High compensation is not necessarily an abuse under the law if it is warranted based on the value of services performed for the exempt organization. The key to this determination is whether the compensation is comparable to that paid by similar organizations for similar work. The organizations being used for comparison may be nonprofit and for-profit organizations, but it is not always clear that the comparison actually used in a particular case is appropriate for the particular position. In addition, there is a major risk that organizations that effectively allow key executives too great a voice in determining their own compensation will not end up with objective and reasonable compensation levels.

Excess compensation by an exempt organization is not permissible. An organization that overcompensates its officers and directors risks revocation of its tax-exempt status. In the case of charities and social welfare organizations, the IRS also can impose an excise tax on certain individuals who receive more than their due.

EO-7. Funding of terrorism. We want to ensure that U.S. charities have no role in financing terrorist activity, and we continue to assist, in both the criminal and civil arenas, the fight against terrorism and those who fund it. We have established a number of mechanisms to insure that our Criminal Investigation and EO functions work together on potential cases involving terrorist financing. EO is also working to develop better baseline information about the practices of organizations that make grants to

foreign entities and the level of oversight the organizations exercise over the use of the funds abroad.

Employee Plans

EP-1. Abusive retirement vehicles. We have found a number of areas where retirement plans are being promoted for abusive purposes either to shelter income or accelerate deductions.

Certain Roth IRAs. Contributions to a Roth IRA are limited by law. To circumvent these limits, various schemes have been promoted in which taxpayers try to improperly inflate the value of a Roth IRA. A frequent theme is the transfer to the Roth IRA of property at less than fair market value by the Roth IRA owner. For example, a Roth IRA may control a shell corporation that enters into transactions at less than fair market value with an already-existing business of the owner of the Roth IRA. The result of the transactions is a transfer of value from the owner's business into the Roth IRA. Another theme is the transfer of a shell corporation established by the Roth IRA owner to the Roth IRA. The IRA-owned corporation then begins operations and the Roth IRA owner provides services to the business on a below-market basis. The resulting increase in value of the corporation later is distributed tax free.

Abuses using life insurance in qualified plans. Deductions for contributions to qualified retirement plans are limited by law, as are the benefits payable. Employers have attempted to avoid the Code's limitations on deductible contributions to qualified retirement plans and the maximum benefits payable under these plans by contributing excessive amounts to Code section 412(*i*) plans that are funded exclusively by individual life insurance contracts. The excess contributions and benefits are masked using various strategies. For example, life insurance contracts are purchased on the lives of plan participants and upon termination of the participant's employment or termination of the plan these contracts are distributed to the participants at artificially low values.

S-corporation management ESOPs. In 2001, the Congress enacted legislation, effective in 2005, to limit the tax benefits derived from the ownership of S corporations by Employee Stock Ownership Plans (ESOPs). However, there are arrangements that were created before the effective date of the new law that are abusive and, in addition, violate other provisions of the Code. In these arrangements, taxpayers attempt to exclude the income of an operating business through the use of a combination of an S corporation and an ESOP.

We have found that in many of these arrangements, the ESOP fails to satisfy the requirements of the Code for a valid ESOP.

EP-2. Pension funding. We have found problems in the level of funding of certain defined benefit plans. Weaknesses in the pension funding rules have resulted in serious plan underfunding, and benefit losses to plan participants, and the termination

of underfunded plans has resulted in record deficits for the Pension Benefit Guaranty Corporation (PBGC). Part of the underfunding problem relates to transitions in the economy as it becomes less centered on manufacturing, but part relates to the tax and non-tax funding rules and to limits on their enforcement.

EP-3. Boise Cascade decision. Code section 404(k) allows employers who sponsor ESOPs to deduct dividend payments paid in cash to ESOP participants. Section 404(k) was intended to apply to ordinary dividends paid by the employer on its stock. However, in 2003 the U.S. Court of Appeals for the Ninth Circuit held that Boise Cascade could, in effect, use section 404(k) to deduct payments made to redeem stock when participants in the ESOP terminate employment.

This decision opens the door to potential abuses of ESOPs. It also is directly contrary to Code section 162(k), which disallows deductions for redemptions of stock. Further, Code section 404(k) has no applicability to the redemption of stock on employees' termination of employment. A redemption of stock cannot be considered a dividend when the redemption occurs solely to pay out the terminating employees. Finally, treating such payments as deductible contributions would vitiate important protections for ESOP participants and would duplicate an earlier deduction for the same economic expense because the original contribution of the stock was deductible under Code section 404(a).

Government Entities

GE-1. Pooled financings designed to earn and divert illegal arbitrage. In a pooled financing, a State or local government issues tax-exempt bonds to finance loans to a group of other local governments or charitable organizations. Using pooled financing allows smaller, less creditworthy entities to borrow money at reduced interest rates and spreads the costs of issuance.

There are several abuses, with a common thread of over-issuance of pooled financing obligations and diversion of arbitrage earned. Arbitrage rules require that arbitrage profits be repaid to the U.S. Government in these cases; however, through multiple methods, arbitrage earnings have been diverted and used to fund higher-than-normal issuance costs and profits to transaction participants.

GE-2. Indian tribal government issues. We have found certain compliance issues in the Indian tribal government area. As stated, these arise in the context of the economic development boom enjoyed by some tribes that have entered the gaming industry.

Under the Indian Gaming Regulatory Act, revenues from tribal gaming can be used for several authorized purposes, including funding tribal government operations, providing for the general welfare of the tribe, and making taxable per capita payments to tribal members. Per capita distributions are subject to Federal income tax, and must be reported on Form 1099. In order to reduce the tax consequences to members, certain tribes have created mechanisms to classify payments as general welfare programs,

often through liberal interpretations of what constitutes a "need-based" program, or have created or invested in income deferral programs.

In addition, there has been a significant increase in financial products being offered to tribes and tribal members to shelter gaming distributions from taxation. While some programs may legitimately achieve that goal, we are seeing an increase in abuse of tribal government programs solely to shelter income for members, as well as an increase in aggressive shelter products being marketed to tribes.

Tribes have contacted the IRS on some abusive schemes being promoted directly to them, or being marketed to members.

III. The IRS Response

To address these compliance challenges, to dissuade promoters and others from initiating new ones, and to achieve our key objective of deterring abuse and misuse of tax-exempt and governmental entities, we are revitalizing our enforcement program in the tax-exempt sector, and refocusing the methods we use to identify and examine potentially non-compliant organizations.

Revitalizing Enforcement in the Tax-Exempt Sector. The FY 2004 and 2005 budgets have increased for TE/GE, and especially for the EO function. While the budget for the IRS increased approximately 0.5 percent in FY 2005, TE/GE received an 8 percent increase, EO received a 14 percent increase, and EO examinations received a 21 percent increase. In EO examinations, this increase will translate, by September, into a 30 percent increase in staffing over September 2003.

For next fiscal year, FY 2006, the Administration has requested a 4.3 percent increase in the IRS budget, with nearly an 8 percent increase in enforcement. If the Congress approves this request, the amount we plan to dedicate to the tax-exempt area would be used to increase vigilance against the misdirection of exempt organization assets for terrorism or private gain, to combat abusive promotions involving TE/GE entities, to start examinations quickly when we detect a risk, and to give agents better information for their first contact with taxpayers.

Refocusing of Efforts – Pursuing the Right Cases. We have translated the increased funding into concrete results in all parts of TE/GE. In FY 2004, we added 70 new agents to conduct EO examinations and 13 additional employees for the new EO Compliance Unit, which reviews Forms 990. The Administration's FY 2005 budget supports the creation of an EO Financial Investigations Unit. I also reallocated more than $20 million to TE/GE for FY 2005 to fund, among other things, the following:

- New positions to create an EP Compliance Unit to build off the success enjoyed by the EO Compliance Unit.
- New exam positions for TE/GE's Federal, State and Local Governments function to pursue Federal agency compliance and to establish a

large-case program in employment tax and withholding for governmental agencies.

- Expanded imaging of EO returns, including all Forms 990 and 8038, to support efforts to clean up the Forms 990, assist in counter-terrorism, and enhance bond enforcement.
- New positions to enhance our compliance presence by expanding the efficient EO Compliance Unit.
- New positions in EO to create a classification unit that will check high-risk organizations' compliance.
- New revenue agent positions to bolster compliance through additional examinations across TE/GE.
- Restoration of funding from other cuts to enforcement expenses.

We are at work on all the compliance problems discussed above. For example, in response to credit counseling abuses, we have over one-half of the industry, measured by gross receipts, under examination, and we have revoked or proposed revocation of exemption for over 20 percent of the industry, also measured by gross receipts. We have worked to ensure that compliance problems involving tax-exempt entities are addressed across all IRS business units. For example, to stop abuse in donor-advised funds, the Small Business/Self-Employed Division of the IRS has more than 200 examinations of donors underway, and TE/GE has revoked the exemption of one entity and proposed the revocation of another.

On the conservation easement matter, we have almost 50 donor audits, several exempt organization audits, and an ongoing pre-audit review of 400 open-space easements, to be followed by a similar review of 700 façade easements.

We are using all enforcement tools available to us, including the pursuit of promoters, the use of referrals to the Office of Professional Responsibility, and criminal prosecution, where appropriate.

IV. IRS Focus Areas for Discussion of Reform – Unresolved Issues

Notwithstanding our revitalized and refocused program, we believe there are several areas that should be included as part of any discussion of reform in the TE/GE area. The first such question is whether there are additional bright line tests that are available to aid the public in complying with, and the IRS in administering, the law. A debate on reform also should include the following questions, identified below.

Have changes in practice or industry created gaps in the statutory or regulatory framework? There has been huge growth in the tax-exempt sector, but much less change in the law governing those organizations that qualify for tax-exempt status. For example, since 1969 there has been only limited review of the rules relating to tax-exempt organizations. Some within the community have argued that it is time for a more thorough review, and we welcome that.

As we regulate various parts of the TE/GE community, compliance in some areas becomes difficult to administer where industry practice, or the industry itself, changes, but the rules remain constant decade after decade. There have also been great changes in technology that should be considered. One important issue, for example, is how rules that are several decades old apply in an Internet, often virtual, environment.

Does the IRS have the flexibility to respond appropriately to compliance issues? We believe a discussion about reform should address whether we have the proper range of tools to enforce compliance in a measured way, where appropriate. In many areas of our jurisdiction, our remedial tools are not effective. Often our only recourse is revocation of tax-exemption, a "remedy" that may work a disproportionate hardship on innocent charitable beneficiaries, retirement plan participants, or bondholders. Moreover, even where we have an intermediate sanction, it may not work as intended.

Similar discussions may be worthwhile with respect to the reporting requirements for political action committees.

With respect to defined benefit plans, the funding rules are based on the assumption that the plans will continue into the future. These rules may result in substantial underfunding of a plan that terminates, even in the case where the sponsor has made all required minimum contributions.

With regard to abusive tax shelter transactions, the accuracy-related penalties imposed by the Code are not sufficient to deter a tax-exempt accommodation party, which has no taxable income to understate. Likewise, the IRS's compliance sanctions for exempt organizations do not fit these situations. Participating in a transaction as an accommodation party rarely affects the tax status of a charity or other tax-exempt entity.

In some areas, activities of exempt organizations have transformed greatly in recent decades, but the rules governing tax exemption have not, leaving the IRS with difficult and fact-intensive administrative challenges. An example is healthcare, an evolving industry that has changed dramatically over the last few decades. Some tax-exempt health care providers may not differ markedly from for-profit providers in their operations, their attention to the benefit of the community, or their levels of charity care. Further, some exempt providers have entered into joint ventures with for-profit organizations, sometimes placing their entire health care operation in the venture and transforming themselves into what is effectively a tax-exempt holding company with a charitable grant-making function. Although this is not impermissible, we insist that the charitable entity ensure that the charitable purposes of the venture are not sacrificed for the sake of maximizing profits. However, it can be difficult for the IRS and the courts to wrestle with the resulting fact-intensive cases.

Finally, the events of September 11 have brought an awareness that some of our ways of doing business need to be re-evaluated to inhibit the designs of those who wish us ill. In our endeavors to ensure that exempt organization funds are not diverted to improper purposes, including terrorism, we do not have tools to sanction public charities that fail

to monitor their grants comparable to the available tools with respect to private foundations. For those organizations that need not file for exempt status and do not file annual returns, such as small organizations and churches, the problem is compounded because we have little ability to monitor their operations against diversion of assets.

Should more be done to promote transparency? Transparency is a lynchpin of compliance within the tax-exempt sector. However, there are legitimate questions as to whether to enhance transparency, and if so, how to proceed. As we noted here last June, limitations on our ability to communicate with state charity officials prevent us from fully leveraging the relationship and jurisdiction we share with them. Further, there are segments of the TE/GE community that we are unable to track, including several categories of legal non-filers (e.g., those exempt organizations that are not required to file a Form 990). Our master-file is replete with errors concerning these organizations.

Finally, one of our key transparency initiatives is the establishment of electronic filing for Forms 990 and 990PF. The recent report by the Independent Sector, referenced above, supports mandatory electronic filing of all returns for nonprofits, and we have issued temporary regulations requiring such filing for certain groups. While this will markedly advance the ability of the IRS, the States, and the public to access Form 990 data in real time, our ability to mandate e-filing is limited at this time by statutory restrictions that prevent us from mandating electronic filing for any organization that files fewer than 250 returns with us. The Administration's 2006 Budget proposal echoes this concern. The Administration's proposal would lower the current 250-return minimum for mandatory electronic filing, but would maintain the minimum at a high enough level to avoid imposing undue burden on taxpayers.

Does the IRS have the resources it needs to do the job? While this is a topic worthy of discussion, I have outlined what we have done to expand our resources in the tax-exempt area. I believe we have done a credible job of recognizing the task before us and preparing to meet that challenge. I would ask the Committee to support the Administration's 2006 budget proposal, which calls for an 8 percent increase in our enforcement budget.

Thank you for the opportunity to highlight what we believe to be our greatest compliance challenges. We look forward to working with the Committee on problems in the TE/GE-regulated community and exploring ways to better equip the IRS to deal with these problems.

I am sending a similar letter to Senator Baucus. If you have any questions, you may call me or Martha Sullivan, Director, Exempt Organizations at (202) 283-2300.

Sincerely,

Mark W. Everson

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service

Before

The Committee on Finance
United States Senate

April 5, 2005

on
Charities and Charitable Giving: Proposals for Reform

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss the proposals for reform of charities and charitable giving. Although I discuss options and approaches, please note that the Congressional Research Service takes no position on legislative options.

My discussion is focused particularly on two types of entities that allow individuals to deduct contributions without the gift actually going to charity: donor advised funds and supporting organizations. These entities experience treatment similar to private foundations, but are not subject to the rules affecting foundations (including provisions to address the risk of using the funds for private benefit, minimum distribution requirements, and certain excise taxes). This discussion also addresses issues surrounding gifts of appreciated property. The analysis is related to potential tax revisions including those contained in the Senate staff discussion draft released in 2004[1] and those in a recent Joint Committee on Taxation study.[2]

The bullet points below summarize the important findings of this analysis.

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[1] *Tax Exempt Governance Proposals: Staff Discussion Draft*, posted at http://www.senate.gov/~finance/sitepages/2004HearingF.htm/hearings2004.

[2] *Options to Improve Tax Compliance and Reform* , Joint Committee on Taxation, JCS-02-05, Jan. 27, 2005.

- Donor advised funds and supporting organizations allow the tax free accumulation of assets intended for charitable purposes, just as is the case for a private foundation, but are not subject to private foundation rules, such as minimum payout requirements and restrictions on self dealing. They are, therefore, uniquely tax favored.

- Evidence suggests that both donor advised funds and supporting organizations have been growing rapidly, and are a significant part of the mix of charitable assets. Distributions from large donor advised funds and large supporting organizations are about a third the size of distributions from private foundations, who in turn account for 10% of all giving. Assets in large donor advised funds have grown at an average annual rate of 25% over the years from 1995-2003.

- Although complete data are not available, concerns that funds may not be paid out for charitable purposes appear justified. A survey of several community donor advised funds found that 19% of donors made no distributions during the year. Data on large supporting organizations showed that 25% made no distributions, 47% distributed less than 3%, and 65% distributed less than 5%.

- While tax subsidies should increase giving, econometric studies of charitable giving that attempted to separate permanent and transitory effects of tax subsidies on giving suggest that the effects encouraging delay are 3 to 28 times the effects encouraging increased giving. These analyses showed a dollar of revenue loss encourages from 8 cents to 51 cents of additional permanent giving.

- While there is no method of determining how widespread are uses of these forms of giving for personal benefit, there is considerable indication of the existence of abuses from witness testimony, statements on web sites of practitioners, and, in the case of supporting organizations, data on extensive loans made back to donors.

- Gifts of appreciated property account for 25% of total inter-vivos giving of itemizers, and these shares rise at higher income levels, reaching 50% at the top income level. Econometric analysis suggests that the tax benefits for appreciated property gifts are much more likely to shift the form of giving than the level.

- While there is no way to determine what share of these non-cash transfers are not gifts of publicly traded securities and therefore pose valuation problems, evidence from estate tax returns suggest that about half of the total of real estate, business property, and stock is in publicly traded stock, suggesting a significant potential for contributing assets that are difficult to value.

Donor Advised Funds

Donor advised funds allow individuals to make a gift to a fund, which is organized as a charity, and then advise the fund on distributions from the donor's account.

The first donor advised funds generally date to the 1930s, when they were mostly associated with community foundations. In 1992 Fidelity started a commercial fund and

other firms have followed, including Schwab, Merrill Lynch, Vanguard, and T. Rowe Price.[3] These funds generally charge both an administrative fee to the donor and a fee to the money manager. Merrill Lynch is partnering with a number of community foundations which may change the share of assets in commercial funds.[4]

Contributions to donor advised funds are deductible to the individual donor because technically the contribution is a completed gift to a charity and the fund has legal control over the distributions. For practical purposes, however, the donor determines when and to whom the payments will be made.[5] Some donor advised funds end at the original donor's death while others allow the fund to be passed on to children and in some cases later generations. There is no requirement in many cases to make any type of distribution to a charity.

Two general issues have been raised about donor advised funds: their potential use for private benefit and the need to curb abuses, and the effect of providing an easy substitute for private foundations on the timing of gifts to charity.

The Growth and Characteristics of Donor Advised Funds

Donor advised funds have grown dramatically in the past decade. Assets in a survey of funds in 1995 were $2.4 billion, growing to $7.5 billion in 1999, $11.3 billion in 2000 and $12.3 billion in 2001, for an average annual growth rate of 31%.[6] The surveys for 2002 and 2003 are not comparable because a major community fund did not respond to the survey. For the funds covered, assets fell slightly between 2001 and 2002 (by 2.2%), which is attributed to the poor economy, but rose by 9.4% between 2002 and 2003. In the final survey, the total was $11.3 billion, but since that survey excludes a community fund with assets of over $2 billion, the total is probably over $13 billion, and the total for all funds even larger.[7] One article estimates the total as over $15 billion.[8] These numbers suggest an

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[3] See "Getting Help with Your Giving," *Business Week Online*, Dec. 24, 2001, www.businessweek.com.

[4] "Merrill Eyes Donor Advised Fund for Charitable Giving," *Mutual Fund Market News*, Mar. 10, 2003

[5] To quote one article: "As a practical manner (sic) the fund will honor your request unless you want to pay your grandchild's tuition bill or try to give the money to al-Quaeda." See William Barrett, "Private Foundations on the Cheap," Forbes.com, February 19, 2003, www.forbes.com. Actually, some critics have alleged that donor advised funds have been used for private benefits including paying tuition for related parties (although this would be considered an abusive practice), and that contributions have been made to terrorist groups. Another quote: "Retaining control of the fund, the donor does not have to be personally involved in the day to day administrative tasks, making it a better option than private foundations for a wide range of donors." See Gordon Jenkins, "Advised Funds versus Private Foundations, *Community Matters on Line*, www.wsfoundation.org.

[6] Based on data from the Chronicle of Philanthropy reported in Elfrena Foord, "Philanthropy 101: Donor-Advised Funds," *Journal of Financial Planning*, Nov. 2003, posted on the Internet at http://www.fpanet.org.

[7] See Marni D. Larose, Brad Wolverton and Stanley Krauze, "Donor Advised Funds Experience Drop in Contributions, Survey Finds," *Chronicle of Philanthropy*, vol. 15, issue 15, May 15, 2003; and Leah Kerkman, Nicole Lewis and Stanley Krauze, "Donor Funds on the Rise Again," *Chronicle*

(continued...)

average annual growth rate of about 25% per year over the eight year period from 1995-2003, although that rate appears to be slowing. During those eight years, assets have increased by 500%.

This $11.3 billion asset total covered 90 funds that responded; those funds distributed $2.1 billion.[9] Thus, distribution during the year divided by year end assets was slightly under 19%. These distributions varied considerably across funds, with some distributing less than 2% and others almost a third. The largest amount of assets in a single fund was in the Fidelity Charitable Gift Fund ($2.4 billion); commercial funds altogether accounted for about a third of the total of commercial, community and other funds, (and Fidelity for about a fifth). Fidelity had over 30,000 individual accounts. Note, however, that the commercial share is smaller because the excluded funds are community and other funds.

The total share distributed was smaller for the community and other funds (slightly under 17%) than for the commercial funds (slightly over 22%). The amounts distributed were more variable among the community and other funds (ranging from less than 2% to about 30%) than among the commercial funds (ranging from 7% to 28%).

Of course, the variability among individual accounts in the funds is even greater (although some funds impose minimum distribution requirements). There are three types of accounts: for annual giving (where most is given out), endowment (only a portion is distributed) and flex funds or mid range funds.[10] Organizations with a mix of types may display significant pay-out ratios in the aggregate even though many individuals funds have little or no payout. As shown in **Graph 1**, a recent survey of community foundation donors in several foundations in 2003 indicated that 19% of the donors made no contributions from their accounts. Another 42% made less than five, 31% made between 6 and 20, and only 7% made more than 20. The share of donors with no contributions varied across fund size: 21% of those with less than $50,000 made no distribution, and 25% of those with between $50,000 and $99,000. Of donors with $100,000 to $250,000, 12% made no distribution and of those with more than $250,000, 7% did not make a distribution.[11] While charities would prefer more distributions and some funds formally require a minimum distribution, most do not, and some funds apparently discourage distributions in order to increase endowment size.[12]

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[7] (...continued)
of Philanthropy, vol. 16, issue 16, May 27, 2004.

[8] "New Guide on Donor Advised Funds Underscores Benefits of Fast Growing Charitable Giving Vehicle to Advisors and Brokers," *Business Wire,* Philadelphia, Nov. 15, 2004.

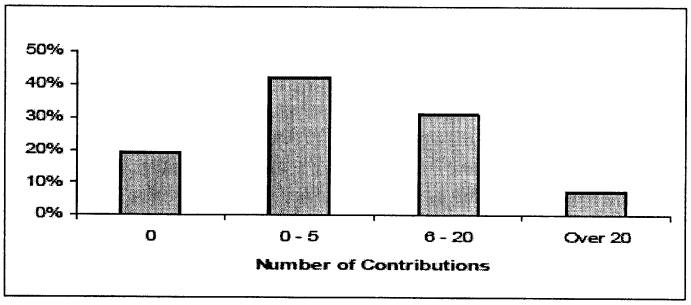
[9] The total number of funds is not known.

[10] "Number of Donor Advised Funds on the Rise," *Business First*, vol. 20, no. 37, June 4, 2004.

[11] Foundation Strategy Group, LLC. "Community Foundation Conjoint Study: Donor Advised Funds." Prepared for Council on Foundations, Sept. 15,2003, at www.foundationstrategy.com.

[12] Leah Kerkman, Nicole Lewis and Stanley Krauze, "Donor Funds on the Rise Again," *Chronicle of Philanthropy*, vol. 16, issue 16, May 27, 2004. The Greater Milwaukee Foundation is cited as one that encourages accounts to contribute no more than 5% per year.

Graph 1: Distribution of Community Donor Advised Fund Donors by Number of Contributions from Their Accounts, 2003



Source: Foundation Strategy Group, LLC.

The Fidelity fund has now become one of the largest charitable organizations in the country, ranking 7th in the most recent survey.[13] Contributions from donor-advised funds to charities are now about 10% of the size of contributions from private foundations, which in turn represent about 10% of all giving.[14]

Most donor advised funds have significant investment minimums (sometimes $10,000, or perhaps $25,000) and administrative and management fees of 1% to 2%.[15] The average amount in the Fidelity fund is about $80,000 but the median is undoubtedly considerably less. A study of donor advised funds in community foundations showed that the size of funds for any individual donor tends to be small by comparison to foundations. Eighteen percent of the funds had less than $10,000 and 58% less than $49,000. Only 3% had assets over $1 million.[16] Some plans pay an individual's financial advisors, and one article stated that some financial planners said those giving more than $10,000 a year create donor advised

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[13] Holly Hall, Leah Kerkman, Cassie J. Moore, Nicole Wallace and Brad Wolverton, "Giving Slowly Rebounds," *Chronicle of Philanthropy*, vol. 17, issue 2, Sept. 28, 2004.

[14] According the *Giving USA 2004*, published by the American Association of Fundraising Counsel in 2004, total giving in 2003 was $249.72 billion. Of that amount $179.36 billion (74.5%), was contributed by individuals, $21.60 billion (9.0%) was via bequests, $26.30 billion (10.9%) was contributed by foundations, and $13.46 billion (5.6%) was contributed by corporations.

[15] Howard W. Wolosky, "Getting Help with Your Giving," *Business Week Online*, Dec. 24, 2001, http://www.businessweek.com.

[16] Foundation Strategy Group, LLC. "Community Foundation Conjoint Study: Donor Advised Funds." Prepared for Council on Foundations, Sept. 15,2002. Posted at www.foundationstrategy.com.

funds, while those giving more than $50,000 create private foundations. They also expected donor advised funds to become more popular in near future.[17]

Arguments Made for Donor Advised Funds

Arguments have been made as to the benefits of donor advised funds for the individual donor, but only some might be viewed as socially beneficial.[18] The benefits for donors include the simplicity of donor advised funds (especially as compared to private foundations, where the paperwork can be complex). Not only is the paperwork simpler, but the rules are more generous because they follow the rules for general charitable contributions: the limits on giving as a percentage of income are higher (50% as compared to 30%) and the limits on gifts of appreciated property as a percentage of income are more generous (30% compared to 20%). There are also no fees or limits on self dealing, no restrictions to cost basis for gifts of appreciated property that are not publicly traded stock, and no minimum distribution requirements. Donor advised funds also facilitate year end tax planning, so that an individual can increase giving at year end without deciding on the particular charity. Donor advised funds may also permit the contribution of an appreciated asset that is not divisible or publicly tradable (such as real estate) which can then be sold to benefit several recipients, thereby permitting the individual to avoid the capital gains tax that would apply were he to sell the asset and distribute the proceeds. Small charities also may not be set up to receive even property such as stock. Donor advised funds allow more privacy than private foundations. Finally donor advised funds confer a tax benefit because the earnings of funds in the account are exempt.

These private benefits do not, of course, necessarily mean that there are social benefits. One private benefit mentioned that might also be a social benefit is that funds may be held back to ensure the charity spends the money wisely, although only in a limited set of circumstances might a donor be in a better position to evaluate the use of funds than the charity. The general social case for government subsidies to donor advised funds should be that they achieve the social purpose of charitable contributions benefits, that is increasing giving. This is the position taken in the recent statement by the Independent Sector: "Over the past century, donor-advised funds have evolved as an important means of stimulating charitable contributions from a broad range of donors. Community foundations pioneered the development of donor-advised funds and such vehicles remain a vital means for donors to make philanthropic contributions today and to build endowments for long-term community needs."[19]

Thus, an important issue is whether donor advised funds increase giving, or whether they may, instead, delay giving – and what the consequences of delayed giving are. Without minimum distribution requirements it is possible to accumulate assets indefinitely in the fund, receiving a charitable contribution deduction without actually completing the charitable

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[17] Joanna Sabatini, "Donor Advised Funds Court Advisers," *Investment News*, June 21, 2004.

[18] For a listing of a number of these private benefits, see Howard W. Wolosky, "Bring Donor Advised Funds into Play: When are Donor Advised Funds the Best Charitable Giving Option?" *The Practical Accountant*, Vol. 36, no. 11, Nov. 1, 2003, p. 42.

[19] *Panel on the Non-Profit Sector Convened by the Independent Sector*, Interim Report Presented to the Senate Finance Committee, March 1, 2005.

gift. Such concerns led to minimum distribution requirements for foundations (set currently at 5% of assets). Another important issue is whether the benefits of giving, and of simplifying giving through an endowment compared to foundations, overcomes the costs of the more limited oversight of donor advised funds, which requires a consideration of the possibility for using funds for private benefit and abuse. Note also, that the same issues apply to supporting organizations which will be considered subsequently.

Analysis of the Effects of Donor Advised Funds on Giving

How do donor advised funds affect giving to charities? Since a tax benefit has been granted, one might expect giving to increase; at the same time, the nature of the tax benefit can cause giving to be delayed.

There is little or no direct evidence on this subject. A survey of donors to Charles Schwab found that, in 2002, 57% of donors reported increasing their giving while in a similar survey in 2003, 47% reported increasing giving.[20] Economists, however, are hesitant to rely on self-reported behavior, because individuals may not really know how their behavior has changed and because survey data have often been found to be incorrect. In any case, these surveys do not indicate how much giving increased, and they also indicate that about half of donors did not report increasing their giving.

The remainder of this discussion relies on economic theory and on econometric and statistical studies. Four different issues are addressed: the standard price effects on charitable giving, assymetric effects on year-end tax planning, the emerging evidence on the effects of default rules on economic behavior, and the incentives faced by commercial funds. These effects, when addressing behavior of the donor, assume those individuals do have a charitable motive and so do not address the issues of use of the funds for personal benefit, which are considered subsequently.

Standard Analysis of Price Effects.

Even if the sole motive of the individual is to provide charitable donations as opposed to other private benefits and the individual is rational and attentive to this purpose, there is an additional tax subsidy granted by the government via the ability to accumulate earnings in the account tax free that has potential consequences for giving. These behaviors are reactions to a reduction in the cost (or "price" of giving). For funds held for many years, this tax subsidy can become quite large. The tax subsidy has two basic effects, one that is beneficial to the charity although probably costing the government more than the charitable benefit, and one that may be costly to the the charity while not affecting the government. The first is the straightforward price effect for an intended future gift, and the second is the incentive to shift contributions across time.

To demonstrate these effects, consider an example with an interest rate of 7% and a tax rate of 35% (the top individual income tax rate, not taking state and local income taxes into account), and to simplify the example consider a gift to occur a year in the future for which the individual puts $100 aside. If the individual simply saves this money on his own, it will grow to $107 in a year, and a tax of 35% will be paid on the $7 in interest, leaving

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[20] Based on a conversation with Kim Wright-Violich, of Charles Schwab.

$104.50.[21] If the $100 is donated to a fund where it can accumulate tax free, it will grow to $107 because there is no tax. If the individual did not alter his original contribution, the tax revenue lost by the government from allowing the accumulation of the money in the asset would simply be transferred to the charity. The individual could, however, also decide to keep his gift fixed and simply keep the tax benefit for his personal consumption by investing only $97.71, an amount that invested at a 7% return would yield $104.50. It is also possible that the individual would set aside more than $100 because the "price" of giving $104.50 in the future has fallen from $100 to $97.71.

One would expect giving to be above $97.71 as long as there is any price response, but the extent to which it is above that amount depends on the price elasticity (the percentage change in quantity divided by the percentage change in price). If the price elasticity is less than 1, the charity's benefit will increase by less than the government's revenue loss, making tax subsidies an inefficient method of inducing spending (in the sense that the increase in gifts to charity is less than the revenue loss to the government). If the price elasticity is 1, the induced giving will be equal to the government's revenue loss. And if the price elasticity is greater than 1, the charity will benefit more than the revenue loss.

The second behavioral effect is the possibility of substitution over time. In this case, we imagine an individual giving a current gift of $100. He could, instead of providing the gift today, save through a normal taxable account, and make a contribution of $104.50 a year from now. The donor advised account, however, offers the possibility of investing in the account and contributing $107 in the future. The substitution across time effect then addresses, holding the total of $100 constant, how much would be diverted into a donor assisted account and given in a year's time. This allocation depends on a timing price elasticity.

In these illustrations, the price effect was relatively small, only 2.3% (which is also the present value of the revenue loss as a percentage of money switched to the donor advised fund from regular saving), but that is because the time period is very short. If the time period is five years, the price effect and (and present value of revenue loss) would be a reduction of 19.5%

The effect on giving depends on the price elasticity. A number of earlier studies of charitable contributions showed the price elasticity to be typically a little above one. These studies also showed the income elasticity (percentage change in giving divided by percentage change in income) to be low which seems counterintuitive (as one would think of charitable contributions as more a luxury than a necessity). However, in the course of examining other tax issues (especially capital gains) analysts became aware that the behavioral responses in these studies (using tax data) which showed people with higher tax rates making higher contributions reflect in part (perhaps in large part) timing decisions. Individuals, that is, time their contributions to be large when tax rates are high and low when tax rates are low. If

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[21] The individual would also save 35% of the contribution when he donates it to charity, or $36.575. However, the value of that tax deduction will be discounted by his rate of return (1.0450) and will be worth $35, the same as if he made the $100 contribution right away and deducted it. This normal deduction would not alter any of the relative prices or behaviors. That is if the quantity of the contribution at the end of the year is fixed at its original amount, the present value of the deduction, discounted at the after tax return, is fixed as well.

people very easily shift their contributions across years, much of the observed response could be due to timing rather than a permanent overall increase in giving.

An important development in the analysis of charitable giving was a study by Randolph that used a long panel (a data set that traces the same individuals over time) that spanned tax law changes that attempted to control for this effect and separate the permanent from the transitory response. This study found a much lower permanent price elasticity (the elasticity that would govern the effect on total giving). [22] He also estimated a transitory elasticity that would also be a proxy for the timing response. (The transitory elasticity is the percentage change in contribution due to a temporary change in price.) This study also found an income elasticity above one, which many people would consider a more reasonable expectation about income effects.

The author reported two permanent elasticities. One of them, for the actual panel that was weighted towards high income individuals (i.e. over-sampled high income taxpayers), was -0.08 and was not statistically significant. This result indicates that a 10% decrease in price would lead to a 0.8% increase in giving. He also weighted the data by giving, and found a larger, significant elasticity of –0.51. For the donor-advised funds the unweighted, lower, elasticity, may be more appropriate because the donor-advised funds probably are held by higher income individuals. Or perhaps some higher value but less than the giving weighted mean would be appropriate. These fairly low elasticities suggest that the giving induced by the tax benefit would be smaller than the revenue the government loses from not taxing the accumulations in the account (induced giving would be 8% to 51% of the government's revenue loss).

A more significant effect would be to delay the contributions to charities because the transitory elasticities were much larger, ranging from -1.55 to -2.27 (the -1.55 elasticity was at the giving weighted mean corresponding to the -0.51 elasticity, and the -2.27 elasticity corresponds to the .08 elasticity). A -2.27 elasticity, for a constant level of giving, means a 10% decrease in price at a future time would decrease giving by 22.7% today and increase it by 22.7% in the future. The values are from 3 to 28 times the permanent responses.

These analyses suggest that the individuals benefit from the tax subsidy, the government, of course, loses, and the charities have offsetting effects. The charities are harmed by any delay in receipt of contributions because they now no longer have the option to spend on current programs if that is deemed more valuable than a later contribution and its accrued interest.[23] They are benefitted, although the magnitude is likely less, by the increased contributions.

The outlook for the charities looks worse, however, although the behavioral responses smaller, if one considers the offsetting effects of high management fees.[24] If these fees are

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[22] Randolph, William C., "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy.* vol. 103, Aug. 1995, pp. 709-38.

[23] For a discussion of the value of receiving donations early, reflecting the possibility of social returns to spending, see Paul J. Jansen and David M. Katz, "For Nonprofits, Time is Money," *The McKinsey Quarterly*, No. 1, 2002.

[24] The management fees may be smaller than the option of starting a private foundation at least for

(continued...)

larger than fees paid for private investment in taxable accounts then the benefit of the government revenue loss is offset by higher management costs. As a result, the shifting of contributions over time harms the charities even if they would have invested the money on their own to fund future benefits, because the management fees reduce the yield. (That is, if excess management fees are 1% then the charity could receive, in our example, $107 in a year while the donor-advised fund would pay only $106.) In five years' time that difference would be $140 compared to $134.

These price effects are also smaller to the extent that individuals invest in corporate stock or other assets that appreciate (and the revenue loss is smaller as well). These earnings are subject to relatively low taxes (or no taxes if the stock itself is contributed and no dividends are paid). And currently dividends are subject to relatively low tax rates of 15% (a provision that expires in 2008 but may be extended). In this case any tax benefit may be easily offset by increased management fees. This analysis suggests that individuals who are contributing appreciating assets that yield little or no current income are probably not motivated by a desire to use the tax benefits of donor-advised funds to increase eventual giving.

A second price effect is the benefit of giving appreciated property whose receipts are ultimately intended for several charities, when the property is not easily divisible or for charities that are not in a position to accept such property. In order to make such gifts directly the property would have to be sold and capital gains tax paid. This provision, because it has a price effect, should induce more giving to the fund. It also, however, is likely to induce individuals to substitute gifts of property for gifts of cash and evidence, discussed subsequently, suggests this is the more important effect. This issue may be less important for donor advised funds than for supporting organizations because of the generally small size of most funds.

Over all, these observations suggest that charities would probably be harmed, or are not likely to benefit much, because of the donor-advised funds, even though the government may lose revenue. They also suggest, however, that these price effects may not be very important in motivating behavior.

Assymetric Year-End Tax Planning.

One of the reasons that there has been such interest in separating permanent and transitory effects of charitable contributions is the recognition that high income individuals with variable incomes are likely to time their contributions to reflect their current marginal tax rates. When tax rates are high, they wish to deduct more of their expected future charitable contributions, while when tax rates are low they wish to deduct less. This planning can be delayed until fairly late in the year if issues of income are not resolved until towards the end of the year (e.g. because of bonuses or because profits are concentrated in

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[24] (...continued)
small investors. (Administrative costs for foundations overall average only about 0.4% of asset value; see CRS Report RS21603, *Minimum Distribution Requirements for Foundations: Proposal to Disallow Administrative Costs*, by Jane G. Gravelle.) Of course if overhead costs became large enough an individual with only a charitable motive would be better off to choose neither donor-advised nor foundation status.

the year end holiday season). If the individual wishes to make a large year-end gift, in the absence of the donor advised fund or similar option, he must transmit the funds to a charitable recipient. The donor advised fund allows him to avail himself of the tax deduction without actually deciding on a recipient.

If the donor is more attentive to and aggressive about the tax benefit than the timing of the gift to charity, he might significantly delay the actual allocation of the gift once he has received the tax deduction, and, on average, charities will receive gifts later than they might if the donor had to make the distribution directly to the charity.

The Importance of Default (Automatic) Rules.

A growing body of evidence has suggested that individual behavior, even by relatively sophisticated individuals, is greatly influenced by default rules, that is, automatic outcomes if the individual takes no action. This evidence has been gathered from studies of firms' 401(k) plans. In some cases, the employee had to take action to enroll in these plans. But in some cases firms switched to automatic enrollment, so that individuals had to take actions to opt out. The basic finding of these studies is that automatic enrollment has dramatic and permanent effects on whether individuals participate in 401(k) plans. For example, in one company automatic enrollment led to almost 100% participation for employees with a one-year tenure, but if the employee had to choose to participate, the enrollment was less than 40%. Enrollment rates tend to rise with tenure, but even with four years of tenure, rates without automatic enrollment tended to be only about 60%.[25] There is reason to believe that some of this difference simply reflects procrastination.[26]

If individuals (or some individuals) are strongly affected by defaults, then donor-advised accounts may, once opened, tend to lead to money simply being retained in the funds, as long as there are no requirements to take any type of action. Such behavior will defer and reduce the receipt of these contributions by charities, without increasing the level of giving.

The Incentives of Commercial Funds.

Commercial firms' fees depend on assets, and therefore there is an incentive for these entities to maximize the amount of assets in these funds. Indeed, when the funds started up there was considerable concern that funds would accumulate, making little or no payments to charities. The fact that these funds are distributing about a fifth of earnings does not mean that they are not discouraging, or at least failing to encourage, individuals to distribute benefits to charities. There is no incentive for the firm to encourage or remind donors to suggest contributions to charity.

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[25] Choi James J., David Laibson, and Brigitte Madrian, "Plan Design and 401(k) Savings Outcomes," *National Tax Journal,* vol. 67, June 2004, pp. 275-298 provide updated estimates and a review of the studies.

[26] The other reason could be that employees take the default as implicit financial advice. Such a view does not seem especially persuasive since firms do offer these plans. In addition, there is evidence that simply forcing a decision (requiring employees to choose actively to participate or not participate) leads to greater enrollment.

The Use of Funds for Private Benefit.

The final attraction of donor advised funds is that they may confer a private benefit on individuals even absent the general tax benefits. Donors who have large accumulated sums in their accounts may enhance their social status in a community – and indeed one common aspect of many types of charitable fundraising is to personalize the contribution (e.g. by allowing funding of particular items in memory or honor of a person). Thus, in general, one of the concerns is that these funds may be used largely to accumulate a large amount of assets that are potentially available to charities but are not actually distributed (parking assets).

But there is a more direct potential use of funds for private benefit which, while perhaps not common, is more freely available to these funds than to foundations. These involve potentially legal actions because there are no self dealing restrictions. Some of these activities have been discussed in recent hearings before the Senate Finance Committee. For example, the Commissioner of Internal Revenue mentioned using funds for personal purposes including school expenses for the donor's children, payments for volunteer work of donors for charities, and loans to the donor.[27] Another witness discussed not only the use of funds to pay compensation for salary and expenses associated with working for the charity, but also the use of funds to pay adoption expenses, private school tuition, family vacations, and swimming pools.[28] Some of these examples can be found advertised on Internet sites. Payment of tuition and costs of family reunions is mentioned in a recent article.[29] And another article discusses the fees paid to donors' private financial advisors as an issue of concern.[30] Finally, one article chronicles the use of a donor advised fund set up in Arizona, which lent, via a for-profit fund set up by the same businessman who set up the donor advised fund, money in the risky real estate market, as well as investing in real estate partnerships. Eventually the developer went bankrupt and the fund had to foreclose on undeveloped land. The founder of the fund made significant profits along the way before ending the arrangement.[31] The Internal Revenue Service listed the contribution of property to supporting organizations and donor advised funds while still retaining control of it as one of its "dirty dozen" notorious tax scams.[32]

Another issue that has emerged is an activity called "roundtripping" where the donor advised fund contributes to a foundation and the foundation then makes a contribution to the donor advised fund, which satisfies the foundation's minimum distribution requirement.

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[27] Statement of Mark W. Everson, Commissioner of Internal Revenue, Charitable Giving Problems and Best Practices, Committee on Finance, U.S. Senate, June 22, 2004.

[28] Testimony of J.J. MacNab, Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities, Committee on Finance, U.S. Senate, June 22, 2004.

[29] Brad Wolverton, "Rethinking Charity Rules," *Chronicle of Philanthropy*, July 7, 2004, p. 31.

[30] Debra E,. Blum, "Fees Paid to Donor's Financial Advisors Stir Debate in Philanthropic World," *Chronicle of Philanthropy*, Nov. 16, 2000.

[31] Harvey Lipman and Grant Williams, "A Risky Mix for Charity," *Chronicle of Philanthropy*, vol. 14, issue 15, May 15, 2002.

[32] IRS Announces the 2005 Dirty Dozen, IR-2005-19, Feb. 28, 2005.

Supporting Organizations

Supporting organizations, like donor advised funds, can make contributions that accumulate before being paid out like private foundations. They are treated similarly to donor advised funds for tax purposes: contributions are deducted when made, and the rules affecting private foundations, including minimum distribution requirements and self dealing restrictions, do not apply.

Supporting organizations are often associated with a particular charity and usually involve much larger minimum amounts (often $500,000 or $1 million).[33] They were formally recognized in the tax law in 1969, when a number of restrictions affecting private foundations were enacted, but organizations serving these functions were already in existence. A familiar example might be a boosters club for a school.

There are three types of supporting organizations. In types I and II either a majority of the board is appointed by the supported charity or charities, or the majority of the board of both the charity (or charities) and the supporting organization are appointed by a third party. A type III does not have a majority of the board representing the charity but has to have a number of specific connecting rules. The family or donor can appoint the board, and serve on it, but cannot control the majority of the board. The supported charities must have a significant voice, and the assets of the supporting organization must be used for the supported charity. Supporting organizations can support more than one charity and may also support community foundations who direct funds to many charitable purposes. There are many technical rules, but in general these rules for type III organizations potentially permit a lot of control by the donor and they do not have the check of a charity determining the policy. They bear, in some respects, a resemblance to donor assisted funds, in that the donor does not have technical, legal control but may have effective control.

Supporting organizations overall are much more significant than donor advised funds. In 2001 there were almost 400 supporting organizations with assets over $50 million, with assets totaling $76.7 billion.[34] In 2004, there were 45,453 supporting organizations associated with public charities according to the National Center for Charitable Statistics. Since the minimum asset size for a supporting organization ranges from $500,000 to $1,000,000 the smaller supporting organizations may account for a significant amount of assets.[35]

A study of supporting organizations of community foundations indicated that supporting organizations had been growing rapidly: in the entire 1980's 46 were established, while in 1997 and 1998, 92 were established.[36] The study also found that assets of supporting organizations of community foundations accounted for $3.2 billion in assets in 1998, a 50%

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[33] Kristi M. Mathisen and Daniel M. Asher, "Deferred Charitable Giving Options, *The Tax Adviser*, vol. 35, no. 4, Oct. 1, 2004, p. 602.

[34] Tax return data gathered by the Urban Institute, National Center for Charitable Statistices..

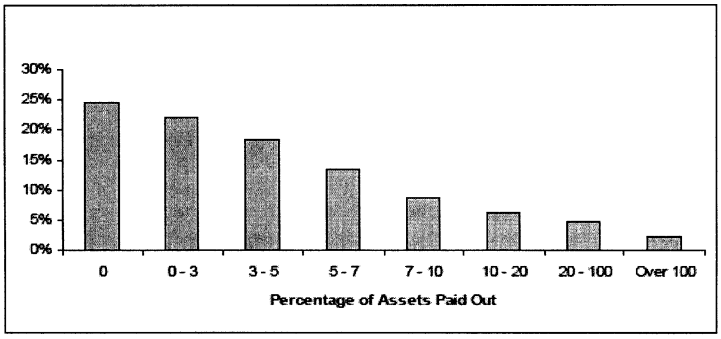
[35] http://nccsdataweb.urban.org/PubApps/profileStateList.htm

[36] Debra E. Blum, "Community Foundations See Sharp Growth in Assets," *Chronicle of Philanthropy*, Nov. 18, 1999, p. 15.

increase over two years. Most of the assets of these organizations ranged from $1 million to $50 million.

In 2001, the average distribution for the almost 400 organizations with assets over $50 million as a percentage of assets was 8.9%.[37] As shown in **Graph 2**, out of the total, 25% had no payout, 22% had positive payout but less than 3% and 18% had payouts of 3% to 5%. Overall, 65% had either no payout or payouts less than 5%. Most of these organizations, therefore distributed less than the minimum requirement for foundations. There is no way to determine the extent to which these were Type I, Type II or Type III organizations.

Graph 2: Percentage of Large Supporting Organizations with Varying Shares of Assets Paid out in Contributions, 2001



Source: National Center for Charitable Statistics

Supporting organizations that permit much more direct involvement of the donors and that can be controlled indirectly by the donor may be more susceptible to large scale business-related abuses such as self-dealing than are donor advised funds. An interesting website that outlines a series of benefits to community supporting organizations is Creative Asset Protection Strategies (www.capstrategies.com). This website spells out how these organizations can make loans, invest in the donor's business, may be co-owner of a title holding corporation which may hold real estate and collect income, pay normal management and other expenses, and may sell to the principal donor. The web site states: "Community Support Organizations (CSO) should be the centerpiece of every financial plan. CSOs offer tax advantages and flexibility of use that are not available through any other form of domestic or offshore planning vehicle."

There are also possibilities for donating assets and buying them back at a discount. Most of these activities are technically illegal (or arguably illegal) but may be difficult to detect.

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[37] There was no apparent trend with respect to size, as the average payout ratio counting each firm's payout ratio equally was 8.4%.

A recent study examined a data file searching for organizations where large loans were made. This study found 18 cases among supporting organizations of loans made to organization directors of $100,000 or more and 10 cases where the loans account for more than half of each groups' assets.[38] However, of those organizations, eight were established by a single individual. For seven of those organizations, the founders contributed $3.1 million and borrowed back $2.5 million.

The issues surrounding supporting organizations are similar to those with donor advised organizations, namely whether regardless of the attraction to donors these organizations serve a social purpose. Supporting organizations, like other donor advised funds, may increase their giving because of the tax benefits allowed. The evidence from statistical studies, as noted above, suggests that the more powerful behavioral effect may be to delay contributions as opposed to increasing them. Indeed, based on the statistical estimates cited above, the argument might be made more strongly with supporting organizations, where the individuals are more heavily concentrated among higher income classes, and where the response of total giving was negligible and the transitory timing response very large. These issues may arise with any supporting organization but is more serious with Type III organizations. Supporting organizations also offer much more potential scope for abuse, at least for the Type III form, and a ready substitute for these organizations may be found in Type I and Type II forms.

One policy issue surrounding supporting organizations is whether to focus primarily on Type III organizations, since Type I and II organizations bear a closer resemblance to ordinary charities and one might rely on oversight by the charities to ensure reasonable payouts and limit self dealing. Of course, the donor may still have considerable influence if the directors appointed by the charity are concerned that making decisions not supported by the donor will affect future contributions to the supporting organizations. Type III organizations bear a more explicit resemblance to donor advised funds (and indeed could use a donor assisted fund to accumulate assets), but the direct involvement in day to day operations facilitates the attainment of private benefits.

Gifts of Appreciated Property

The third major topic discussed in this memorandum is the treatment of gifts of appreciated property. This issue is tied to the benefits of donor advised funds and supporting organizations, since one of the benefits of these organizations is to permit individuals to contribute gifts of appreciated property other than publicly traded stock and take a deduction for the market value. (Contributions of these gifts to private foundations is limited to the cost basis for these assets).

Non-cash contributions are a significant part of giving, accounting for about a quarter of gifts of itemizers. The shares by income class and distribution of each type of giving are shown in Table 1. While there is no way to separate gifts of appreciated property from other

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[38] The results of the study are reported in Harvey Lipman,and Grant Williams, in two reports: "Donors Set up Grant Making Groups, Then Borrow Back Their Gifts," and "One Utah Lawyer Helped Create 8 Groups that Lent Money to Donors or Officers," *Chronicle of Philanthropy*, vol. 16, no. 8, Feb. 5, 2004.

gifts (such as used clothing, furniture, automobiles, etc.), the shares in the higher income levels are most likely appreciated property.

This table demonstrates that the share contributed in property goes up as the income level rises, with individuals with more than $10 million of income providing half their contributions in property – or twice as much as the average. Taxpayers with adjusted gross income over $1 million account for about 18% of cash contributions by itemizers, but account for 40% of property transfers.

The associated issue, which extends beyond the issue of donor advised funds and supporting organizations, is the problem of valuation of appreciated assets, such as stock in closely held firms and real estate, where data on asset values are not publicly available.

There is also no way to separate publicly traded stock from other property such as real estate and closely held stock. However, we may develop some notion of how important property that is not publicly traded is by looking at the ratio of closely held assets and real estate (excluding the personal residence) and business property to the total of those assets plus publicly traded stocks in estates, which is about 45%.[39] These data suggest that assets other than publicly traded stocks are a significant share of assets of high income individuals and therefore may be a significant share of assets given away.

Table 1: Shares of Cash Versus Non-Cash Giving, Returns with Itemized Deductions, 2002

Adjusted Gross Income ($thousands)	Share of Cash Giving	Share of Non-Cash Giving	Non-Cash Giving as a Percent of Total Giving
<50	18.8	12.0	17.6
50-100	30.8	20.8	18.5
100-200	19.4	15.7	21.3
200-500	10.1	9.4	23.7
500-1,000	4.1	4.7	27.8
1,000-5,000	5.1	8.8	36.6
5,000-10,000	4.8	9.6	40.0
>10,000	6.9	21.2	50.5
Total	100.0	100.0	25.0

Source: Internal Revenue Service, Statistics of Income

[39] Internal Revenue Service, Statistics of Income, Estate Tax Returns, 2003.

The contributor of an appreciated asset receives a benefit that is greater than a contribution of cash. Essentially, the donor receives two benefits: a charitable deduction, and also does not have to pay capital gains taxes. This benefit has fallen over the years mainly because the capital gains tax rate has fallen. Under the current tax rate of 15%, and assuming the asset is properly valued, the additional benefit for a 35% taxpayer compared to a cash contribution is up to 43% more (15/35). If the donor is able to increase the valuation of the property, the benefit is even greater. Despite requirements for obtaining appraisals, it is very difficult for the government to monitor the valuation of assets that are not frequently traded, and charities have no reason to reject an undervalued gift (unless it is virtually worthless and costly to maintain or dispose of).

As with other issues of charitable giving, one issue is whether allowing these beneficial treatments for regular charitable giving, including donor advised accounts and supporting organizations, encourages more giving or perhaps harms charities by shifting giving to assets, assets that may be in some cases difficult to deal with because they are not readily marketable. A recent statistical study estimated that the response of individuals to a benefit favoring non-cash over cash giving was very elastic, similar to the substitution across time.[40] This study estimated a variety of specifications, with elasticities well in excess of one (the most typical value was around 2, which is quite similar to the transitory elasticity). If so, the main effect of the beneficial treatment of appreciated property is likely to be a substitution of property for cash.

Gifts of appreciated property can be used in many ways to obtain private objectives. Consider several types of advice given on a university's web site about how to benefit from giving appreciated property.[41] For publicly traded securities, the individual can give the appreciated securities, and then repurchase the same securities in the market. As compared to a cash gift, this approach allows the avoidance of capital gains earned up until that time. Thus the donor will have the same portfolio as before, but stock with a higher basis. (If the securities have losses, the securities should be sold by the individual, and the cash donated, so the individual can take a loss). The website also describes the possibility of donating closely held stock and then selling it back to the corporation (after all, there is no other market) who then retires it, leaving the donor still in control of the company. This approach allows the avoidance of capital gains taxes, which can be very large for a company one founded where the basis is zero.

Certainly one of the most difficult problems is the valuation of property for which there is not an established price. Closely held stock, of course, really has no other market, and the value of real estate and other property can only be estimated. Taxpayers have an incentive to overstate the value so as to maximize the tax deduction, and the charity has little incentive to dispute the value as long as the gift does have some value.

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[40] David H. Eaton and Martin I. Milkman, "An Empirical Examination of the Factors that Influence the Mix of Cash and Non-Cash Giving," *Public Finance Review*, vol. 32, no. 6, Nov. 2004, pp. 610-630.

[41] See http://www.givingto.msu.edu/pgaol/html/appreciated_securities.htm, part of the website of the University of Michigan.

Policy Options

Aa variety of policy options might be considered to address the issues discussed in this memorandum, including the effect of donor advised funds and supporting organizations in delaying the receipt of funds by charities, the potential abuses of the tax provisions discussed including using tax deductible contributions for private benefits and overvaluing stocks. This section discusses some general policy options, including those by the Senate staff discussion draft[42] and the Joint Committee proposals.[43]

Donor Advised Funds

For donor advised funds, one could simply ban these forms of charitable giving, keep the form of the fund with its non-tax attributes but eliminate the tax benefit (by taxing the earnings in the fund and allowing a charitable deduction only for distributions). Or one could provide a more limited number of revisions. One could impose the rules associated with private foundations (including the minimum distribution requirement, rules against self dealing, and excise taxes).

Senate Staff Discussion Draft.

The Senate staff discussion draft presents some more limited provisions that keep most of the tax benefits intact. First, and importantly for both donor advised firms and supporting organizations, would be to apply self dealing rules of foundations to all charities. (Self dealing involves selling property, lending, etc. and other involvements with disqualified persons, who are generally trustees, directors, substantial donors and the relatives of these individuals.)

For donor advised funds in particular, the staff discussion draft proposes a 5% minimum distribution requirement, but this minimum is imposed on the fund in general, and not on the individual donor account. As the data indicate, of the bigger funds, most already satisfy this rule. Of the 88 funds with data on both assets and distributions in 2003 surveyed by the Chronicle of Philanthropy, only 5 had payout ratios below 5%. If the requirement were applied to individual accounts, the effects would be more significant (as noted earlier, in a community foundation survey, 19% of accounts had no distribution, and of the remainder some may have distributed less than 5%). This provision may also affect smaller donor advised funds that are not listed in the survey.

A related provision would be to provide some minimum activity threshold. The specifics are not detailed, but such a provision would address the problem of dormant accounts, where the money is deposited and no other action taken. A minimum activity threshold and/or a minimum distribution requirement per account might deal with some of the economic issues related to procrastination and year end tax planning discussed above, as well as limiting, to some extent, the magnitude of shifting across time. A per fund minimum

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[42] *Tax Exempt Governance Proposals: Staff Discussion Draft*, posted at http://www.senate.gov/~finance/sitepages/2004HearingF.htm/hearings2004.htm.

[43] *Options to Improve Tax Compliance and Reform* , Joint Committee on Taxation, JCS-02-05, Jan. 27, 2005.

distribution requirement would require the affected funds to take some actions with respect to their donors and accomplish some of the same results, although the effects would be more limited.

Another proposal is either to require gifts other than cash or publicly traded securities to be sold within a year (and a plan for sale to exist at the time of the contribution), or, instead, to prohibit donor advised funds from receiving property other than gifts of cash or publicly traded securities. The stronger form of this rule would eliminate the valuation problem for donor advised funds (an alternative would be only to allow deduction of the basis as in the case of private foundations, which would simply make these assets unattractive to give to the funds). If the revision were limited to requiring sale, valuation problems could still arise (but would be much easier to detect), but the asset could not be parked in the fund for a long time.

A series of provisions are aimed at the potential use of the fund for private benefit and abusive practices (in addition to extending self-dealing rules to these funds). A fund would not be permitted to make grants to a non-operating private foundation or to individuals (which would prevent some of the abuses discussed above as well as roundtripping). Also private foundations could not contribute to donor advised funds, part of the roundtripping issue, but also to prevent donor advised funds from allowing foundations to effectively avoid a real pay out requirement. Also the fund could not spend money on selecting the grantee, such as site visits, that extend beyond basic due diligence. (Such a provision should prevent, for example, the fund paying for the donor and family to snorkle the reefs of Cozumel to ascertain the degree of reef damage before providing a grant for reef restoration). A fund would be required to secure from the recipient of a distribution acknowledgment that the donor will not benefit. A fund would be required to disclose its form and satisfaction of rules on its 990 form. Grants to nondomestic organizations would be permitted only if these organizations appear on an approved IRS list. Investment managers would be hired according to arm's length principles and fees for referrals or transfers of funds to a donor advised fund would be limited.[44] All of these provisions are likely to limit the abuses associated with donor advised funds.

The Joint Tax Committee report does not include provisions directed specifically to donor advised funds.

Supporting Organizations

There are a variety of potential approaches to dealing with supporting organizations. These include deferring the tax deduction until distributions are made to chariti8es and taxing earnings (eliminating the tax benefits), applying foundation rules, or applying some or all of the rules similar to those proposed for donor advised funds. At issue, as mentioned earlier, is whether to focus on all supporting organizations, or type III organizations.

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[44] A clarifying provision would state that grants would be permitted to satisfy a donor's charitable pledge, i.e. that this is not a private benefit.

Senate Staff Discussion Draft.

As noted above, the Senate staff discussion draft applies self dealing rules to all charities, which would, of course, include all types of supporting organizations.

The Senate staff discussion draft proposes eliminating Type III organizations. Type III organizations are perhaps the most likely to engage in abusive practices since there is no oversight by the charity. Type III organizations could retain tax benefits, either by adopting Type I and II rules, or, especially if they wish to support a number of charities, by using the donor advised fund approach (which would, of course, now become somewhat more restrictive) or becoming private foundations.

The Joint Tax Committee proposal has no provisions on supporting organizations.

Gifts of Appreciated Property

One could eliminate the special tax benefits for gifts of appreciated property by allowing only the basis to be deducted. As a result, the best option for the donor would be to sell the property and donate the cash (the benefits of the charitable deduction for value in excess of basis would exceed the capital gains tax due), or donate cash in lieu of the property. Charities might benefit from this rule assuming the effect on total giving was small (although gifts of publicly traded securities are easy to deal with) because of the shift in form. However, since capital gains are not taxed at death, there might be an incentive to shift to a bequest, which could be significant because it is a timing benefit. (The 2001 tax act, which repeals the estate tax, has a provision for taxing capital gains held until death, but with a very large exemption. Also, technically the provisions expire after 2010, although many expect them to be made permanent.)

Senate Staff Discussion Draft and Joint Tax Committee Proposals.

An alternative would be to focus on the valuation problem. Currently donations to foundations allow only basis deductions for property other than publicly traded securities and the staff proposal discusses the possibility of extending that treatment to donor assisted accounts. The Joint Tax Committee proposals would allow only basis deduction for these non-publicly traded assets for all purposes, an approach that would eliminate the problem entirely.

One could also have a look back provision by requiring the charity to sell the asset immediately (or within a year) and any valuation would have to be consistent with that sales price – the same sort of approach used in the recent treatment of donated automobiles.

The Senate staff proposal has an alternative approach, mandatory final offer arbitration over valuations (also referred to as baseball arbitration). In final offer arbitration each party proposes a solution and the arbitrator can only pick one offer (i.e., he cannot choose an intermediate position). There is an extensive economics literature on final offer arbitration,

but basically it suggests that the parties will be more likely to negotiate a solution because of the risk of having the other party's offer chosen.[45]

The proposed arbitration system has some aspects that might lead taxpayers to avoid claiming excessive valuations. First, the final offer for the taxpayer will be amount claimed on his tax return. Secondly, the IRS examiner will see the taxpayer's valuation which, assuming there is some evidence on the value, would allow the IRS to usually pick a winning offer in circumstances where the taxpayer has greatly over valued the asset. The IRS would be in the position to propose a solution that understates the value, because this value will still be more reasonable than the taxpayer's more excessively inflated offer. This plan should not only encourage the taxpayer who is being audited to settle, but also encourage taxpayers to claim reasonable valuations for fear of having to face this situation.

Other Proposals

Senate Staff Discussion Draft.

There are a number of other proposals in the staff discussion draft that in many cases would affect the organizations and issues discussed in this memorandum. These proposals are in response to general concerns about abuses of non-profit organizations and donors, although some are targeted to specific groups (private foundations, credit counseling agencies, and conversions of non-profits, such as hospitals, to profit status).

They include some general monitoring and anti-abuse provisions such as IRS review of exempt status every five years, rules for credit counseling groups (nonprofit credit counseling groups have come under scrutiny), and revoking the charitable status of an organization that participates in certain tax shelters.

For foundations, the draft proposes expansions on self dealing rules (most of which would extend to charities) including expanding a disqualifying person to include a corporation or partnership where the disqualified person is of substantial influence, and increasing taxes for self-dealing. For private foundations, the discussion proposes disallowing or limiting payments to trustees, restricting compensation to disqualified persons, requiring submission of information on administrative expenses, and disallowing administrative costs in excess of 35%. Foundations that pay out more than 12% would not have to pay excise taxes.

Charities' expenses for travel meals and accommodations subject to standard rate (government or private) applies to all charities, but those other than foundations would not be affected if disclosed on tax forms and approved by the board.

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[45] A risk averse person would prefer no payment to a payment that represented a 50% chance of receiving $100 to a 50% chance of losing $100. For papers that discuss final offer arbitration see Richard Sansing, "Voluntary Binding Arbitration as an Alternative to Tax Court Litigation," *National Tax Journal*, vol. 50, June 1997, pp. 279-296 and Philip A. Miller, "A Theoretical and Empirical Comparison of Free Agent and Arbitration-Eligible Salaries Negotiated in Major League Baseball," *Southern Economic Journal*, vol. 67, July 2000, pp. 87-104.

Conversion from nonprofit to profit status would require IRS review and approval; without approval (or lack of disapproval within a year) the highest rate of tax would apply to unrealized gains. The proposal would also establish reporting requirements and modified self dealing rules for converted organizations.

States would be provided with authority to review tax exempt organizations.

Several proposals are made to improve scope and quality of tax and financial documents such as requiring the signature of the CEO, increased penalties for failure to file accurate and timely tax documents, perhaps requiring electronic filing, standards for filing, independent audits, enhanced disclosure of financial forms and certain tax data, and more disclosure of corporate charitable contributions on their tax returns.

Finally there are proposals to encourage strong governance and best practices, proposals for IRS accreditation, prudent investor rules, provision of funding, and additional powers for the tax courts.

Joint Committee on Taxation.

The Joint Committee on Taxation proposal also has a number of provisions other than the proposal discussed earlier to limit the deduction to basis for property contributed other than publicly traded securities.

The Joint Committee on Taxation study discusses some of the same or similar provisions as in the Senate draft: the five year review of status, extending some self-dealing restrictions to organizations converting to profit status, public disclosure and certification changes, and restrictions on credit counseling agencies.

It would also increase a range of excise taxes including some on private foundations, impose a termination tax on charitable assets converted to non-charitable uses, impose a series of additional (fairly technical) restrictions on foundations, impose an entity level tax and suspend some benefits for participation in tax shelter transactions, modify the rules on contributions of facade and conservation easements, limit deductions for clothing and household items to $500 per year, expand the base of the investment income of foundations (to conform the tax code with Treasury regulations and include capital gains), and allow tax exemption for fraternal beneficiary societies only if providing insurance is not a substantial part of their business.

RESPONSE TO A QUESTION FROM SENATOR ROCKEFELLER

Question: Anecdotal information and media reports indicate wrongdoing and questionable activities of a few organizations. How widespread do you believe these problems to be? Do you know of any credible studies assessing exempt organization compliance? How can Congress determine the size and scope of the noncompliance problem in this sector?

Answer: There are no data to my knowledge that could indicate how widespread are abuses, questionable activities, or lack of compliance. To fully measure the incidence of such behavior, in addition to defining it, one would wish to take a random sample of organizations and then audit them to determine the frequency of the activity in question. Such a study would need to be carried out by the Internal Revenue Service. The IRS has made such a compliance study in the past of individual returns.

Absent such a study, only data that are largely anecdotal, data on examinations reported by the IRS (as in Commissioner Everson's testimony), or data that have been gathered from returns are available. With respect to the issues I addressed in my testimony, I cited a study reported in the *Chronicle of Philanthropy* that searched a database to determine the number of supporting organizations with large loans to officers and directors. The Form 990 returns of tax-exempt organizations are public and have been put into a searchable database on the Internet by

GuideStar, at *www.guidestar.org*. The *Chronicle* article reported 18 cases of supporting organizations with loans above $100,000.[1]

Considering charitable organizations and loans more generally, another article in the same issue of the *Chronicle* indicated that 10,700 organizations showed loans of some size (out of a population of 264,000 organizations).[2] This is a rate of about 4 percent. Of the 10,700 organizations, 2,278 said they were owed at least $10,000; 4,756 did not report the amount of loans.

Making loans to officers and directors by charities is not prohibited by Federal law, so that this practice may be considered questionable but would not constitute non-compliance with Federal tax law. The article indicated that 19 States and the District of Columbia prohibit or limit these loans, but there were 221 organizations reporting loans in these jurisdictions. This finding suggests a higher rate of loans among those States that do not prohibit these loans than for those States that do prohibit such loans.

Note, however, that this type of analysis can detect practices by organizations that report the required information, but not by organizations that fail to report, and presumably organizations in States that prohibit lending are more likely to conceal such activities. Only a sample and audit approach can detect unreported activities, and even audits may not detect well-concealed behavior. Thus, it is reasonable to expect a greater rate than 4 percent, perhaps significantly greater, but it is difficult to say how much.

One can use other types of data to try to estimate the magnitude of a problem, as I discussed in my testimony. Tax return data on large supporting organizations did show that two-thirds distributed less than the minimum amounts required by private foundations, and if one considers delayed giving a problem, such data are suggestive. More limited evidence from a private survey seemed to suggest similar problems for donor-advised funds. As I discussed in my testimony, there are aggregate data from individual and estate tax returns that indicate a potentially significant problem with gifts of property that are difficult to value, but no way of knowing the extent of overvaluation.

As noted above, the best approach, the sample and audit approach, can only be done by IRS. For the 990 returns that are publicly available, analysis of the data could be made by any group. Other tax returns, such as individual returns, are confidential, and to analyze data on these returns, committees and agencies with access would need to do the analysis. Although certain congressional entities have access to confidential tax return data, IRS may still need to provide specialized samples.

PREPARED STATEMENT OF HON. MIKE HATCH

I. INTRODUCTION

Mr. Chairman, members of the committee, it is a privilege to appear before you to discuss the regulation of nonprofit and charitable organizations. I applaud the Senate Finance Committee for conducting these hearings and considering improvements to foster increased accountability of such organizations. I also applaud the many excellent suggestions for reform contained in the Senate Finance Committee staff discussion draft and the report prepared by the staff of the Joint Committee on Taxation.

Charitable organizations receive very generous local, State, and Federal tax exemptions in exchange for performing their charitable missions. Nonprofit and charitable organizations play an important role in our communities and in bettering the lives of our fellow citizens. Most are dedicated to fulfilling their charitable missions and perform a genuine public service worthy of the tax exemptions they receive. Unfortunately, a surprising number of charitable organizations encounter governance problems that threaten the proper stewardship of charitable assets. There are also bad actors within the sector who personally profit at the expense of the charitable organization and its mission.

The board of directors is responsible for the proper governance of a nonprofit organization. Unlike private corporations, nonprofit organizations do not have shareholders to serve as a check to ensure that the board of directors exercises proper stewardship. Nonprofit boards are essentially self-perpetuating. Strong State and Federal Government regulatory oversight of the nonprofit sector is imperative to

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[1] Harvey Lipman and Grant Williams, "Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts," *Chronicle of Philanthropy,* vol. 16, Issue 8.

[2] Harvey Lipman and Grant Williams, "Assets on Loan," *Chronicle of Philanthropy,* vol. 16, Issue 8.

protect charitable assets, preserve the public's trust, and ensure that tax exemptions are well-deserved.

II. NONPROFIT HEALTH SYSTEM COMPLIANCE REVIEWS

A. Introduction

In Minnesota, there are over 25,000 nonprofit organizations, 2,500 charitable trusts, 6,500 charitable soliciting organizations, and 250 professional fundraisers. The Minnesota Attorney General is responsible for regulating these organizations. This is a role attorneys general have played at common law dating back to 17-century England, where it was recognized that the community has an interest in the enforcement of charitable organizations, and the attorney general was responsible to represent this community interest. Today, our office exercises its regulatory oversight pursuant to both statutory and common law. Unfortunately, we only have a staff of eight engaged in such activity. We have no financial auditors. We have no compliance auditors. As with most States, we rely on the Internal Revenue Service ("IRS") to determine if a 501(c)(3) organization is engaging in charitable activity that meets the standards of the Internal Revenue Code.

We are frequently required to take action involving nonprofit and charitable organizations when the boards of directors make or allow the improvident use of charitable assets in a manner inconsistent with the mission of the organization and the tax exemptions those organizations enjoy. Today I would like to focus specifically on our findings involving nonprofit health care organizations, which amply make the case why self-regulation is not the right approach, and why strong government regulation of this sector is needed.

B. The Allina compliance review

In Minnesota, like the rest of the country, our health care system is in crisis. Health care premiums have increased at double-digit levels year after year. Employers are getting squeezed by these costs, making it increasingly difficult for them to offer health insurance to their employees. Health care also is prohibitively expensive for many self-employed, retired, and uninsured citizens. In this climate, nonprofit health care organizations owe a heightened duty to show proper stewardship over nonprofit assets.

In 2000, the Office of the Inspector General ("OIG") for the Health Care Financing Administration completed a review of the spending practices of nine managed-care organizations around the country that performed services for the Medicare program. The OIG concluded that a number of these organizations had incurred expenses for a variety of luxury items, such as Waterford crystal, season sporting tickets, and travel.

Medica Health Plans ("Medica") was one of the nine managed-care organizations whose expenditures were reviewed by the OIG. Medica is a large, Minnesota-based nonprofit health maintenance organization. The Medica president publicly announced that none of the expenditures uncovered by the OIG were billed to the Medicare program, but instead were purchased with "private," nonprofit, assets. Accordingly, members of the Minnesota State senate asked our office to commence an investigation to determine the extent to which nonprofit assets were wasted on such expenditures.

In 2000, we began a compliance review of Medica and its parent organization, Allina Health Systems ("Allina"). Allina is registered with our office as a charitable organization with tax-exempt status under section 501(c)(3) of the Internal Revenue Code. It solicits funds from donors and operates numerous hospitals and clinics in Minnesota. The purpose of the compliance review was to determine whether Allina was exercising proper stewardship over its charitable assets.

The Allina compliance review required the commitment of a tremendous amount of resources of the Attorney General's Office over a 1½-year period. Allina was a $2.6 billion organization which controlled over 50 separate legal entities. These entities included nonprofit tax-exempt organizations, taxable nonprofit organizations, for-profit organizations, joint ventures, trusts, partnerships, limited liability companies, and numerous operating units and divisions, both with and without separate boards of directors. Allina refused to cooperate with the compliance review, and we were forced to obtain a court order requiring it to produce records. The records it ultimately produced documented a serious breach of accountability on the part of both Allina executives and the board of directors.

Allina paid for employee travel to destinations such as Aruba, London, Paris, Venice, Grand Cayman, Athens, Cancun, Pago Pago, and Los Cabos. It paid for its president and his wife to travel to Grand Cayman Island, including four nights at

a 5-star oceanfront resort costing over $600 per night. It paid for over 30 trips to the Hawaiian Islands.

Allina paid $89,000 for its board members and executives, and their spouses, to travel to the Phoenician Inn in Arizona. The Phoenician Inn boasts a $25 million art collection, marble from the same Italian quarry that Michelangelo used for the Pieta, chocolate for "tuck in" service flown in from Belgium 3 times per week, and a 22,000 square-foot spa. Allina spent over $14,000 on food and alcohol and over $4,500 on golf, tennis, and spas. One dinner alone cost over $5,000. Executives charged the organization for $100 floral arrangements to decorate their $855 per night suites. When we asked Allina to explain its "business purpose" for the trip, it stated that the trip was designed to inspire discussions about "health care reform."

Allina similarly paid $42,500 to send executives and their spouses to the LaQuinta Resort in California, which promotes itself as "one of the most coveted golf resort destinations anywhere in the world." They spent over $16,000 on golf, including over $2,000 in golf lessons, $1,700 in spa charges, and $2,400 for a jeep tour.

On another occasion, Allina paid for its executives and spouses to take a 3-day wine tour of Napa Valley, complete with private limousines and hot air balloon rides. On yet another occasion, it sent executives to Monterey, California, where they traveled in limousines and expensed thousands of dollars in meals at the area's most exclusive restaurant. Allina stated that the trip was designed to teach executives how to run a health care system with a "moral center." The hospital administrator ordered an accounts payable clerk who questioned the propriety of the expenses to pay the bills, noting that he doubted there was a "high exposure" of the media learning about the junket.

Allina paid for private memberships for ten of its top executives in the Twin Cities' most prestigious golf clubs. It reimbursed one executive $1,400 to analyze his handicap, polish his golf clubs, and otherwise tend to similar needs.

Allina also spent thousands of dollars on executives' season and playoff tickets to the Minnesota Timberwolves, Minnesota Vikings, and Minnesota Twins.

Executives were reimbursed for lavish gifts to other executives and board members, including $3,000 bronze sculptures, $1,300 golf clubs, and $600 Waterford crystal.

Executives were handsomely paid. Allina offered executives approximately ten different incentive and bonus plans to augment 6-figure executive salaries by up to 150 percent. For instance, it compensated its executives with management incentive plans, defined benefit plans, 401(k) plans, long-term incentive plans, supplemental retirement plans, and mutual fund acquisition plans. The CEO in 1998 received compensation of over $900,000 per year.

Allina manipulated its bonus plans to guarantee that executives would qualify for bonuses. For instance, Allina's management incentive plan required that it reach 80 percent of its budgeted annual net income for bonuses to be paid. When it became clear that Allina would not meet that target as the end of the year approached, Allina simply lowered the figure to 60 percent and paid $2.6 million in bonuses for which executives were ineligible.

Allina paid long-time executives over $1 million as "retention bonuses" for simply remaining employees of Allina. The president, for instance, was promised a "signing bonus" of $100,000 when he moved from one Allina affiliate to another and an additional $200,000 if he remained an executive of Allina 2 years later. Allina then paid the executive the $200,000 1 year early.

Allina also spent tens of millions of dollars on consultants who failed to document their time or expenses.

Allina paid nearly $1 million per year for a part-time consultant to act as its chief operating officer. Allina also paid for her $855 per month luxury sport utility vehicle, luxury lakefront condominium, and first-class air travel. It paid for her incidentals of daily living, such as her cable TV bill, utility bills, valet parking, maid service, and even her shower curtains.

Allina paid $1.9 million to another consultant (who promoted herself as an "advisor" to movie stars) to serve as the personal confidant of the COO. The confidant billed $300,000 in expenses with no documentation. Another consultant was paid over $150,000 to help groom the image of top executives. Allina paid $15,000 for a sleepover retreat for senior executives in which they watched the movie *12 O'clock High*. It paid $37,000 to a consultant to organize the retreat. At these sleepover retreats, which occurred on a regular basis, executives were forced to sit in each other's laps to "build trust" and play "ring toss" to find their "inner selves."

Allina's "independent" auditor was paid over $35 million, mostly for acting as a consultant. No detail was provided to justify the accounting firm's professional fees,

nor was supporting detail provided for over $4 million in expenses. The auditor repeatedly issued unqualified audits.

The organization was rife with conflicts of interest.

The Allina board of directors not only failed to prevent the above abuses, but actively participated in them.

C. The HealthPartners compliance review

After completing the compliance review of Allina in 2001, we commenced a compliance review of HealthPartners, another large nonprofit HMO and hospital system in Minnesota. HealthPartners was registered with our office as a charitable trust. It has over $1 billion in revenue and operates over 19 nonprofit and for-profit subsidiaries. The HealthPartners compliance review also took about a year and a half to complete. As with Allina, the compliance review documented a lack of accountability and proper stewardship.

HealthPartners paid for over 100 flights to over 30 international destinations, including every continent but Antarctica. It paid over $17,000 for its CEO's "trade mission retreats" to Brazil, Chile, and Ireland, though the organization only operates in Minnesota and western Wisconsin. It paid $9,000 for its CEO to travel to Australia to find out: "Are we pricing consumers out of health care?"

HealthPartners paid over $30,000 per year for its CEO and board members to travel to 4-star Florida resorts, where they golfed, dined, and entertained themselves at the nonprofit's expense. HealthPartners paid almost $250,000 for its executives' membership in and use of country and golf clubs. It paid over $50,000 for its CEO's season tickets to the Minnesota Vikings.

HealthPartners paid for executives and board members to give each other expensive gifts, including golf clubs, kayaks, crystal, and spa services. It paid for its CEO's living expenses, which it attempted to conceal in expense reports. For instance, a Garrison Keillor satire and book on Harley Davidson motorcycles were billed as "business strategies research." Items such as the CEO's lean cuisine dinners were billed as "supplies."

Executives received generous savings and retirement plans, such as "split dollar" life insurance plans, retention bonuses, mutual fund option purchase plans, capital accumulation plans, and supplemental executive retirement plans. HealthPartners took steps to conceal the payments by mislabeling them, and it improperly omitted executives' deferred compensation from the IRS Form 990.

After HealthPartners began to pay for massages at board meetings, masseuses were implored to "bring more oil" to the next meeting. Ironically, the HMO refused to cover massage therapy for victims of Parkinson's Disease.

Once again, the HealthPartners board of directors not only failed to prevent these abuses, but actively participated in them.

III. NONPROFIT HOSPITAL CHARITY CARE AND DEBT COLLECTION PRACTICES

Another important area I would like to address is our experience concerning the billing, debt collection, and charity care practices of nonprofit hospitals. These issues relate to whether nonprofit hospitals are appropriately fulfilling their missions in a manner that justifies their tax-exempt status.

We should not in this country have a health care system that bankrupts patients because they get sick. The very poor typically have access to government programs such as Medicaid to help them with their medical bills. The middle class and working poor do not. With skyrocketing premiums, many employers are unable to offer health insurance coverage for their employees, and many individuals are unable to afford to pay for coverage. The reality is that even a short hospital stay can bankrupt a middle-class or low-income family who is uninsured or under-insured. Indeed, Harvard University recently reported that approximately 50 percent of all bankruptcies are caused in part by medical bills.

Medical providers are among the creditors most likely to refer debt to collection agencies. Patients subjected to aggressive medical debt collection practices are more likely to resort to financially unsound methods, such as credit cards and home equity loans, to pay off the debt. This sinks them even deeper into debt.

Medical debt also has serious health consequences. Over 50 percent of patients with medical debt reported in one study that they delayed getting necessary treatment because of their unpaid medical bills. These patients were uncomfortable seeking additional treatment because they owed money, they were asked to pay cash up front, or they were denied care because of the unpaid bills. Patients who postpone medical care often resort to seeking more expensive and less effective care later on, such as in the emergency room.

Many hospitals today are under pressure to absorb the cost of treating the uninsured. For instance, in my State, an additional 40,000 Minnesotans were recently

cut from MinnesotaCare to balance the State's budget. Since 1992, MinnesotaCare had offered modest health coverage benefits for the working poor in exchange for affordable premium payments. These cuts place increasing financial pressure on hospitals.

Nevertheless, until the health care system is changed, nonprofit hospitals must do their part not to bankrupt the uninsured. Nonprofit hospitals benefit from generous tax exemptions at the local, State, and Federal levels. As a result of these exemptions and their nonprofit status, they owe the community a duty to treat the uninsured in a fair and humane fashion. To do this, hospitals must take several actions.

First, hospitals must end brutal and inhumane debt collection practices. Some nonprofit hospitals hire debt collectors to sue impoverished patients, to garnish their meager bank accounts, hound them with harassing calls, or even to threaten them with arrest. One disabled woman in rural Minnesota was so hounded by a hospital's debt collectors after incurring $75,000 in cancer treatment that she wrote to us that she felt she had no options to satisfy her debt "short of killing myself." We have discovered debt collection lawyers who lie about serving summonses, who sue patients because hospitals bill insurers over a year late and are therefore barred from collecting from the insurers, and at least one female patient who received treatment for a fractured elbow and was billed for two penile implants. These types of debt collection practices are not consistent with a nonprofit mission and subject the hospital to litigation.

Second, hospitals and clinics charge substantially more to uninsured patients than they charge to HMOs, insurance companies, or the government *for the exact same treatment.* Third-party payors and the government use their market power to extract steep discounts from the retail, or "sticker" price, of hospital and clinic bills. As hospitals and clinics seek to generate more revenue, they raise their retail price for services, prompting insurers to demand even steeper discounts the next time both sides negotiate. The result is that uninsured patients are billed an artificial retail price that may be 50 percent or more than the cost an insurance company or the government pays for the same services. In other words, nobody pays the retail price but the hapless uninsured, who are usually poor.

The practice through which hospitals and clinics charge an inflated rate—which nobody else pays—to the uninsured must end. These pricing inequities are inconsistent with a nonprofit mission. They also constitute consumer fraud.

Last Friday, Fairview Health Services ("Fairview"), one of the largest hospital systems in Minnesota, took steps to give discounts of 40 to 100 percent to uninsured Minnesotans with household income of up to 450 percent of the Federal poverty level (*i.e.,* a single person with household income of $43,065 or a family of four with household income of $87,075). Persons with those incomes will also have their total liability capped at $5,981 and $12,095, respectively. Fairview also entered into an agreement with our office to improve the manner in which medical debt is collected from patients.

Fairview's leadership is a step in the right direction. One hospital, however, cannot act alone for long, lest it become a dumping ground for the uninsured by other hospitals. All hospitals must reform their retail prices so as not to gouge the uninsured with phony, artificially high rates that nobody else pays. For those Minnesota hospitals that do not, we intend to examine their charity care and billing practices and, where necessary, file lawsuits to correct them.

Third, hospitals must deliver a fair level of charity care. Many nonprofit hospitals deliver charity care at paltry levels, far less than the need of their patients or that their revenue, assets, or fundraising would allow. Hospitals also sometimes try to inflate their supposed charity care through numerous devices. They may label as "charity care" the fact that they treat Medicare and Medicaid patients at the discounted rates the government reimburses for treatment rendered to those patients. They may label as "charity care" bad debt they write off. Or they may label as "charity care" various "educational" expenses that appear designed less to deliver health care to the patient than to increase the hospital's market share.

Finally, many nonprofit hospitals tout their benevolent good works to donors when they solicit tax-deductible donations. A hospital that does this, while at the same time billing the uninsured a phony retail price, not providing fair levels of charity care, and hounding patients through unfair debt collection practices, engages in the fraudulent solicitation of charitable donations.

I call on Congress to exercise leadership in helping to reform nonprofit hospital billing, collection, and charity care practices. I also call on the IRS to crack down on nonprofit hospitals that do not reform their practices.

IV. NONPROFIT ORGANIZATIONS MUST BE REGULATED TO ACHIEVE ACCOUNTABILITY

Nonprofit organizations should establish internal standards for proper conduct and strive to hold themselves accountable. Self-regulation, however, is no replacement for strong government regulation. Nonprofit directors and executives sometimes suffer from a "halo effect" in which they believe that because their mission is pure, their actions are above reproach. Indeed, during our health care compliance reviews, executives expressed surprise that we would dare to question whether their trips or country club memberships constituted proper stewardship. of nonprofit assets, when "everyone else in the industry was doing it too." When the board and executives assume such an attitude, there are no shareholders to question their conduct; there is only the government to fulfill a role it has played for centuries.

Self-regulation alone also is not the answer because boards or trustees often actively participate in the abuses. We found this to be true in our health care compliance reviews. It happens in other areas as well. We recently discovered that the assets of an elderly woman's charitable trust had been depleted by her trustee, who was also her financial advisor. Through the purchase of annuities and life insurance that named him as the beneficiary, the trustee transferred millions of dollars to himself and his family, creating an estate tax liability that siphoned off the remainder of the trust's funds, leaving no money for the intended charitable beneficiaries.

I would like to offer several additional observations gleaned from our experiences with nonprofit health care organizations, as well as our experiences gained from regulatory oversight of other types of charities.

First, the board of directors of a nonprofit organization is responsible to set the tone and culture for the organization and ensure proper stewardship. Yet, we frequently encounter directors of nonprofits who take a subordinate role to the paid executives of the organization. Nonprofit boards are sometimes composed of good people who are well-meaning but, for one reason or another, may not fill their role in ensuring stewardship by the organization. This may occur because board members are volunteers who are not appropriately engaged in the governance of the organization or are on the board primarily to lend credibility or fundraising prowess. Our office is called upon on a regular basis to reform nonprofits which fail to follow sound governance principles. We would support legislative efforts, such as those contained in the committee staff paper, to prompt boards to follow prudent, basic governance standards—such as to establish, review and approve basic organizational policies and procedures.

Second, in some cases, nonprofit boards are too heavily comprised of directors who are compensated by the organization. This leads to a "tail wagging the dog" effect, where the board is led by the staff, rather than the other way around. In other cases, the CEO hand-picks directors who are then awarded lucrative legal, insurance, supplier, or other contracts by the organization. For example, we recently investigated a mental health organization with an important mission of serving certain hard-to-reach communities. Several "interested" board members were also employed by the organization, and they deadlocked with the independent directors on the board. During the ensuing power struggle, the organization's finances became imperiled. Congress should limit the number of board members who may be compensated by the organization and require conflict of interest policies to be adopted.

Third, far too many nonprofit organizations operate in this country for regulators to catch all abuses. Congress should pass legislation to help increase the likelihood that the most glaring abuses will be detected, including steps to ensure that bad actors cannot carry out their wrongdoing through inertia. These reforms should require independent auditing firms to be replaced on a regular basis and require nonprofit organizations to justify their tax-exempt status to the IRS on a periodic basis. I also understand that Congress is considering a proposal to target Federal dollars to States for their charitable regulatory enforcement efforts. Any efforts by Congress to provide funds to State agencies would be welcome, particularly in an era of strained State resources.

Fourth, the selection criteria for undertaking an investigation may differ widely among regulators. A case that is "too small" for the Federal Government may be taken by a State regulator because of its local impact. A case that is too spread out for any one State to take a parochial interest in may catch the attention of the Federal Government. A State may lack the resources to take a particular case. Other cases may simply escape detection by various regulators for unknown reasons. For instance, Minnesota was recently the first State in the country to take action against the National School Fitness Foundation ("NSFF"), a Utah nonprofit which operated on a national level and had tax-exempt status under section 501(c)(3) of the Internal Revenue Code. NSFF purported to offer free physical education equipment to school districts nationwide. It did this by getting school districts to pay its

for-profit affiliate for equipment on the promise that districts would later be repaid by NSFF with charitable donations it received. Instead, NSFF simply operated one of the largest ponzi schemes in history, in which school districts had their "free" equipment paid for by newer districts entering the program. Over 600 cash-strapped school districts entered into these arrangements at a cost of over $77 million. In July, 2004, the president of NSFF's affiliated for-profit company pled guilty to Federal criminal charges.

Congress should vest more regulators with more authority. The IRS should be permitted to share data with State attorneys general. State attorneys general are hampered in their enforcement efforts because the IRS cannot share data with them. In the case involving the NSFF ponzi scheme, for example, while we were able to provide information to the IRS, Federal law prohibited it from sharing information with us. Further, State attorneys general should be allowed in their charities oversight role to enforce Federal tax laws. This is an approach that has worked well between the Federal Trade Commission and State attorneys general, where attorneys general are permitted to enforce Federal laws such as the Telemarketing Sales Rule and Fair Credit Reporting Act. Similarly, the IRS and tax courts should have the authority that State attorneys general have to seek the removal of board members, officers, or employees who have engaged in improper conduct.

Fifth, executives and directors of nonprofits have no financial skin in the game. They do not place their own money at risk, nor is their own money being spent. We have frequently seen nonprofits spend money—particularly on travel and entertainment expenses—in a manner more copious than many private corporations. We certainly saw this in our health care compliance reviews. For example, we uncovered dozens of private country club memberships paid for by nonprofit health care organizations. Many for-profit corporations we interviewed noted that such expenses are not deductible under IRS regulations and stated that they would not pay for them in any event. Nonprofit organizations sometimes attempt to rationalize such expenses on the basis that the executives earn less than they would in the private sector. My response is that while this may be the case, those executives are free to go work in the private sector. Congress should limit the amount that nonprofits may spend for travel, meals, and accommodations to the rate the U.S. government would pay for those items. There is absolutely no reason that a nonprofit that receives tax breaks from the government needs to spend more than the government for travel and entertainment.

Sixth, particular reforms are also needed in the area of executive compensation. The compensation of executives in some nonprofits, particularly the health care organizations discussed above, is grossly excessive. The IRS intermediate sanction regulations created procedures (*i.e.,* board review, market comparability studies, etc.) designed to ensure a substantively appropriate result. The regulations further provided that, if these procedures were followed, there would be a rebuttable presumption that the compensation was reasonable. The thought was that if the proper procedural steps were followed, the proper result would be reached. This has not occurred. Indeed, the sanctions have had an opposite effect with Minnesota health care organizations. These organizations feel empowered to pay excessive salaries because they believe it will be difficult for regulators to question the substance of the transaction if the required procedural steps were taken. The problem is that it is far too easy to manipulate the procedural steps to obtain the desired result.

At the outset, executives of the health care companies we examined retained the compensation consultant hired to provide the market comparison figures. The consultant is then beholden to the executive who hired him and, wanting to please that executive so as to be retained again in the future, will help justify the executive's salary. Next, the market comparisons relied on to justify health care executives' compensation are those of other overly-paid health care executives. Then, because no board of directors wants to hire a "below average" executive, boards typically pay their executives a compensation package that is "above average" in the market to reflect the board's good judgment in hiring an above-average executive. This leads to a "Lake Wobegon" effect, in which all health care executives are above average. The problem is magnified during succeeding review periods.

For these reasons, I concur with the suggestion in the report by the staff of the Joint Committee on Taxation to repeal the "rebuttable presumption of reasonableness" under the intermediate sanctions test. Under that standard, a salary is presumed reasonable as long as the right procedural steps are followed. In this way, regulators would become more liberated to question the substance of the transaction for reasonableness, not just the procedures employed. Congress should also embrace the staff suggestion that compensation consultants be retained and supervised by the board so as to ensure a proper level of independence.

Seventh, we regularly advise donors to use the Form 990 as a tool to make informed decisions. Yet, Form 990s often are not particularly useful, especially where they are incomplete, inaccurate, or late. I agree with the recommendations in the Senate Finance Committee staff discussion paper that Form 990s should be signed by the CEO, that penalties be increased for failure to file a Form 990, and that the Form 990 more fully disclose the filing organization's relationships with affiliated tax-exempt and nonexempt organizations. The nonprofit health care organizations we have examined are enormously complex entities, and it is far too easy for them to masquerade their finances by steering money to other affiliates in the organization, including for-profit affiliates. Greater transparency is needed.

Eighth, Congress should tighten up the standards for nonprofit credit counseling organizations, particularly in the face of the mandatory credit counseling provisions of the Federal bankruptcy bill. I was one of the State attorneys general who filed a lawsuit against AmeriDebt, Inc., together with the Federal Trade Commission. AmeriDebt aggressively marketed Minnesotans, touting its status as a 501(c)(3) to bait vulnerable consumers into credit counseling. Instead of assisting consumers to pay down their debts, AmeriDebt exacerbated their situation, charging large monthly and up-front fees which it then siphoned off to for-profit companies. For example, one rural Minnesota consumer named in our complaint turned to AmeriDebt for help paying her bills in the face of health problems. She believed that AmeriDebt, as a nonprofit, would provide her free services. In fact, AmeriDebt took a $200 origination fee and $25 from each monthly payment that she thought would go to creditors. Because the creditors were not paid, they started assessing the consumer late charges. This woman, along with thousands of others, was in a far worse financial position after turning to AmeriDebt for help.

V. CONCLUSION

A solemn trust with the public is created when an organization receives tax-exempt status. That trust includes a duty to make provident use of the organization's assets to further the mission of the organization and better the community. When one organization engages in the types of abuses described above, confidence in the entire sector is degraded. Congress should take decisive action to promote more effective regulation of charitable organizations at both the State and Federal levels.

I thank you for the opportunity to appear before you today.

PREPARED STATEMENT OF RICHARD JOHNSON

WRITTEN STATEMENT OF
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BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARING ON TAX EXEMPT ORGANIZATION REFORMS
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Thank you, Mr. Chairman, Senator Baucus and distinguished members of this Committee, for the opportunity to comment on the legislative reforms for tax exempt organizations contained in this Committee's staff discussion draft. Our views on this contemplated legislation are influenced by the facts and circumstances of **STATE OF TENNESSEE, by and through VICTOR S. (TORRY) JOHNSON, III, District Attorney General, ex. rel. TOMMYE MADDOX WORKING, et al. v. ROBIN G. COSTA, et al.** which have been reported in the February 16, 2005 edition of the New York Times.

This written submission is intended to provide this Committee with an understanding of how we believe things went wrong with the Maddox Foundation and to assess how the reforms in oversight and governance of tax-exempt entities being considered by this Committee might have prevented the abuses which have been alleged and which the State of Tennessee now seeks to rectify.[1]

[1] The State of Tennessee lawsuit against the Foundation and its controlling director was filed on August 31, 2004 and is still pending. Although the Court has made certain interlocutory rulings – such a appointing a special fiduciary to conduct an accounting – no trial has been held. The facts set out in this testimony are contained in affidavits, depositions and documents on file in the Court record, as well as public disclosures made by the Maddox Foundation and other tax-exempt entities pursuant to the Internal Revenue Code. Footnotes herein refer the reader to such source documents, many of which are contained in a supplement to the Committee record submitted by the authors. This testimony also contains the opinions of the authors which are provided for the purpose of informing the Committee of the application of existing and contemplated law to the facts.

INTRODUCTION

In October 1997, Dan Maddox, a wealthy Nashville, Tennessee businessman, was putting the finishing touches on estate plans for himself and his wife, Margaret. He was being advised and assisted in this estate planning by Professor Jeffrey Schoenblum of Vanderbilt University Law School. Professor Schoenblum asked Mr. Maddox to prepare a written narrative explaining his reasons for the decisions he had made in his estate plan. Mr. Maddox did so in the form of a letter to Professor Schoenblum. In that letter, Mr. Maddox wrote about the charitable works he and Margaret had done through the years, and concluded:

> The charitable contributions have filled a highly productive and personally rewarding need in this wonderful Nashville community that has been so good to Margaret and to me. I am delighted to show my appreciation by leaving substantial funds **to help in Nashville's problems** and to make a big positive difference in a lot of youngsters lives. (Emphasis added.)

In his Last Will and Testament, Mr. Maddox left the residuary of his substantial estate to his wife. In her Will, Mrs. Maddox left the residuary to a charitable trust, the Maddox Foundation Trust, created years earlier. The Maddox Foundation Trust, in accordance with the language of the Trust Agreement, required a minimum of three trustees,[2] and had operated for many years as a tax-exempt private foundation. Through this trust, Mr. and Mrs. Maddox had established a laudatory track-record of support for charities in Middle Tennessee, predominantly the YMCA and Belmont University.

What neither Dan nor Margaret Maddox were able to foresee were their simultaneous deaths in a boating accident. Likewise, they could not have foreseen that within two years of their untimely deaths, the substantial wealth Mr. Maddox had built during his life would be hijacked from Tennessee to Mississippi, placed under the effective control of a single person,

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[2] *See* Maddox Foundation Trust Agreement ¶ 9, Appendix at Tab No. 1.

Ms. Robin G. Costa, used to purchase two ailing professional sports teams, squandered on lavish trips and high-living, and diminished by imprudent investments and excessive personal compensation paid to Ms. Costa all as alleged in a pending lawsuit.

On August 31, 2004, the State of Tennessee, through the office of the Hon. Victor S. ("Torry") Johnson, District Attorney General of the 20th Judicial District, filed a civil action in the Probate Court of Davidson County, under the authority of the Tennessee *quo warranto* statute.[3] That *quo warranto* action was made possible by the efforts of Tommye Maddox Working, Dan and Margaret Maddox's step-granddaughter. On November 22, 2004, following an extensive hearing, Judge Randy Kennedy entered a temporary injunction against the Maddox Foundation Corporation and Ms. Costa, and appointed a well-respected accounting firm, Frasier Dean & Howard, as special fiduciaries to conduct an accounting of the Maddox Foundation. This accounting is only a preliminary stage of a much longer process that, the State of Tennessee hopes, may lead to restoring transparency and accountability to the affairs of the Maddox Foundation and preserving Dan and Margaret Maddox's legacy for the people and charities of Middle Tennessee.

BACKGROUND FACTS

A. Dan Maddox

Dan Maddox, the youngest of five children, was born to a family of modest means in Easonville, Alabama, in 1909. He left college when his father died suddenly in 1929 and was required to liquidate his father's business to repay bank loans. He then took a job with CIT Corporation in New York, transferring to its Nashville office which, at the time, was the least

[3] Tenn. Code Ann. § 29-35-101, et seq.; *see also State of Tennessee, et al. v. Costa, et al.*, Seventh Circuit Court for Davidson County, Tennessee (Probate Division), Case No. 04P-1430.

profitable office in the company. By 1933, Dan Maddox had transformed the Nashville office to the most profitable in the company and he was promoted to Regional Manager.

In the mid-1940's Mr. Maddox founded an investment group focusing on consumer finance. This entity became known as Associates Capital Corp. and was later acquired by Gulf & Western Industries. Through his hard work, Dan Maddox established himself in the worlds of finance, oil and gas exploration and real estate development. His business success was matched by his and Margaret Maddox's philanthropic generosity. At the time of their deaths, the Maddox name was associated with a number of substantial charitable projects in Middle Tennessee, including the Margaret Maddox Family YMCA, the Maddox Hearing Aid Research Center at the Bill Wilkerson Center of Vanderbilt University, and Maddox Hall dormitory at Belmont University. They also supported numerous scholarship programs and other direct grant projects which over the years have contributed millions of dollars to educational and charitable endeavors.

B. The Maddoxes' Estate Plans

1. The Trust Agreement

The Maddox Foundation Trust is a Tennessee charitable foundation that was created pursuant to a Trust Agreement executed on October 10, 1968 (the "Trust Agreement").[4] Dan and Margaret Maddox donated the corpus of the Trust, which was established

> exclusively for charitable, religious, scientific, literary, and/or educational, purposes, either directly, or by contributions to organizations duly authorized to carry on charitable, religious, scientific, literary, or educational, activities.[5]

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[4] *See* Maddox Foundation Trust Agreement, Appendix at Tab No. 1

[5] *Id.* ¶ 2.

The Trust Agreement specifies that "no part of the assets of [the] Trust, either principal or interest, shall inure to the benefit of any private individual," and directs the trustees "to distribute from time to time for educational, religious, charitable, and scientific uses and purposes . . . such amounts of income or principal of this Trust fund as, in their discretion, they may appoint, order, or direct."[6] In addition, the Trust Agreement provides that "the number of TRUSTEES shall never be less than three (3)."[7] The Trust Agreement could be amended only "by the unanimous agreement of DONOR and the TRUSTEES, provided that there be not less than three (3) acting TRUSTEES . . . ."[8]

From the time the Trust was created up to the time of their deaths, Dan and Margaret Maddox executed ten additional written instruments related to the Trust (some being designated as Amendments and others as Actions on Written Consent of Trustees). The last of these, being an Action on Written Consent of Trustees dated May 9, 1996, provides:

> Following the death of Donor, Donor's wife, Margaret H. Maddox, shall be appointed Chairman of the Trustees, to serve for a one (1) year term and successive one (1) year terms until replaced by a successor. If Donor's wife, Margaret H. Maddox, is for any reason unable or unwilling to serve as Chairman, or having qualified shall resign or die, then Robin G. Costa and Tommye B. Maddox will serve as the Co-Chairmen of the Trustees for a term of one (1) year and successive one (1) year terms until their successor is designated by the Trustees. Following the death of Donor and the death of Donor's wife, the Board of Trustees will be comprised of Robin G. Costa and Tommye B. Maddox; they will have the right to jointly elect one or more persons to serve with them on the Board of Trustees.[9]

In addition, the Trust Agreement authorizes, but does not require, the Trustees to create a non-profit corporation to take the place of the Trustees and carry on the charitable purposes of

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[6] *Id.* ¶ 6.

[7] *Id.* ¶ 9.

[8] *Id.* ¶ 14.

[9] *See* Action on Written Consent of Trustees dated May 9, 1996, Appendix at Tab No. 2.

the Maddox Foundation Trust. Specifically, the Trust Agreement provides that the Trustees may "form and organize a corporation for the uses and purposes provided by [the Trust Agreement], such corporation to be organized under the laws of Tennessee, and such corporation, when organized, shall have the power to administer and control the affairs and properties of [the] Trust, and to carry out the uses, objects and purposes of [the] Trust."[10]

An Action on Written Consent of Trustees executed on September 5, 1986, allowed the corporation "to be organized under the laws of the State of Tennessee, and/or such other State, as deemed appropriate by the Trustees . . . ."[11] "Such corporation, if organized, shall be named 'Maddox Foundation.'"[12] The corporation, if formed, is to *take the place of the trustees of the Maddox Foundation Trust* and is to have the same powers and authority as were vested in the trustees of the Maddox Foundation Trust.[13]

2. The DWM Trust and the MHM Trust

On January 10, 1981, Dan Maddox, as settlor, created a revocable trust, which was amended, by a Notice and Full Text of Amendment and Restatement of the Trust Agreement dated November 19, 1997 (the "DWM Trust"). One of the co-trustees of the DWM Trust is Ms. Costa.[14] On May 10, 1981, Margaret Maddox, as settlor, created a revocable trust, which was amended by a Notice and Full Text of Amendment, and Restatement of the Trust Agreement

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[10] *See* Maddox Foundation Trust Agreement ¶ 12, Appendix at Tab No. 1.

[11] *See* Action on Written Consent of Trustees dated September 5, 1986, ¶5, Appendix at Tab No. 3.

[12] *See* Maddox Foundation Trust Agreement ¶ 12, Appendix at Tab No. 1.

[13] *Id.*

[14] *See* Notice and Full Text of Amendment and Restatement of the Trust Agreement dated November 19, 1997, Appendix at Tab No. 4.

dated December 17, 1997 (the "MHM Trust"). One of the co-trustees of the MHM Trust is Ms. Costa.[15]

Under the terms of both the DWM Trust and the MHM Trust (collectively, the "Maddox Revocable Trusts"), apart from certain, relatively small distributions to family members upon the death of the Maddoxes, all of the remaining assets in the trusts were to be distributed to the Maddox Foundation Trust. The assets of the DWM Trust and the MHM Trust are to be held for the benefit of the Maddox Foundation Trust.

3. The Maddoxes' Estates

On January 14, 1998, Dan and Margaret Maddox were killed in a boating accident while vacationing in Louisiana. It is estimated that the Maddoxes had in excess of $100 million in assets at the time of their deaths.

Shortly after the deaths of the Maddoxes, the separate estates of Dan and Margaret Maddox (the "DWM Estate" and "MHM Estate," respectively), were opened in the Seventh Circuit Court for Davidson County, Tennessee, Probate Division. In accordance with their Wills, Ms. Costa was named a Co-executor of the Maddoxes' estates. Ms. Costa, in her capacity as a Co-executor of the DWM Estate and the MHM Estate, has paid herself a "co-executor fee" of $525,000 from the DWM Estate together with a "co-executor fee" of $875,000 from the MHM Estate. Contrary to the rules and practice in the Tennessee Probate Court, Ms. Costa did not obtain judicial review and approval in advance of these payments.[16]

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[15] *See* Notice and Full Text of Amendment and Restatement of the Trust Agreement dated December 17, 1997, Appendix at Tab No. 5.

[16] Although the Court "conditionally" approved these fees on August 13, 2004, final review and approval has been withheld by the Probate Court pending further developments in the present litigation.

The Wills left all estate assets to the DWM Trust and the MHM Trust from which the assets are to pour over to the Maddox Foundation Trust. Ms. Costa, in her capacity as Co-trustee of both the MHM Trust and DWM Trust, paid herself $250,000 in compensation out of the trust assets.[17] Ms. Costa gave notice of her requests for fees only to herself and the co-executor. No notice of this request for fees was given to the representatives of the charitable beneficiaries.

C. Robin Costa Obtains Control of the Maddox Foundation

The untimely deaths of Dan and Margaret Maddox left only two trustees, Ms. Costa and Ms. Working, in control of the foundation. Although the Maddox Foundation Trust Agreement requires three trustees to oversee the affairs of the foundation, Ms. Costa persuaded Ms. Working that they, as two trustees, could lawfully operate the foundation.

1. The move to Mississippi

At Ms. Costa's insistence, Ms. Working agreed to move the Maddox Foundation Trust to Hernando, Mississippi, in 1999 in an effort to transfer the situs of the Trust to Mississippi. Ms. Costa told Ms. Working that the move was necessary to avoid Ms. Costa's avowed concerns that Maddox family members might engage the Trust in litigation, and because, according to Ms. Costa, Mississippi requires only one trustee instead of the three trustees that would be required in Tennessee. Ms. Working trusted Ms. Costa to make the right decision. Ms. Costa had been her supervisor before the Maddoxes' deaths, and Professor Schoenblum had told Ms. Working that Ms. Costa was to be her boss.[18]

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[17] See Defendants' Responses to Plaintiffs' First Set of Interrogatories ("Defendants' Responses") No. 4, Appendix at Tab. No. 6.

[18] *See* Deposition of Tommye Working ("Working Depo."), November 3, 2004 at 101-102, Appendix at Tab No. 7.

On June 14, 1999, Ms. Costa and Ms. Working, as Trustees to the Maddox Foundation Trust, executed an Action on Written Consent of the Trustees of the Maddox Foundation that purported to transfer situs of the Trust for administration and for all other purposes from Tennessee to Mississippi.[19] As alleged, this purported transfer of situs from Tennessee to Mississippi was ineffective, however, because neither Ms. Costa nor Ms. Working applied to the appropriate Tennessee Court for approval of a change of situs, as is required by Tennessee law.[20] Had Ms. Costa complied with the change of situs statute, the District Attorney General, as the statutory representative of the charitable beneficiaries, would have been given notice of the proposed relocation and could have acted to stop it. Moreover, Ms. Costa would have been required to file with the Court an accounting of her tenure as trustee.

The lawsuit states that the attempted transfer of situs from Tennessee to Mississippi was legally ineffective because at the time of the purported transfer only two trustees were serving notwithstanding the fact that the Trust Agreement as amended required a minimum of three trustees. Ms. Costa knew this to be the case because, prior to the execution of the June 14, 1999 document purporting to change the Trust situs, Ms. Costa and Ms. Working approached Wallace Rasmussen, the retired Chairman of Beatrice Foods and long-time friend of Dan Maddox, and asked him to serve as the third trustee.

Wallace Rasmussen met Dan and Margaret Maddox in 1974. In addition to being personal friends with each other over the years, he and Dan Maddox also served together on the Boards of Directors of Commerce Union Bank and of Shoney's Restaurants for approximately

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[19] *See* Action on Written Consent of the Trustees of the Maddox Foundation dated June 14, 1999, Appendix at Tab No. 8.

[20] *See* Tenn. Code Ann. § 35-1-122. **Note:** §122 was repealed by the UTC and replaced by Tenn. Code Ann. § 35-15-101 *et seq.*

fifteen years. During that time Mr. Rasmussen also was Chairman of Commerce Union Bank's trust and audit committees. Shortly before Dan Maddox died, he confided in Mr. Rasmussen that he intended to remove Ms. Costa as administrator of his estate and to replace her with Ms. Working.[21]

After Dan and Margaret's unexpected deaths, Ms. Costa called Mr. Rasmussen to see if he could meet her and Ms. Working for lunch, which was not unusual since he normally took them to lunch several times a month to review their problems of running an office for Dan Maddox. At the luncheon Ms. Costa asked Mr. Rasmussen if he would be the third trustee of the Maddox Foundation Trust. Mr. Rasmussen agreed, and said that he would prepare some guidelines similar to those that a bank trust committee would need to use in order to comply with applicable regulations. Ms. Costa asked Mr. Rasmussen to send her the guidelines as soon as possible. Shortly thereafter, Mr. Rasmussen sent a detailed compliance checklist to Ms. Costa, which was based on his years of experience as Chairman of Commerce Union Bank's trust and audit committees. The next thing he heard from Ms. Costa was that she was moving the Maddox Foundation Trust to Mississippi. When he asked why, Ms. Costa responded that it was easier to operate a foundation in Mississippi as it only required two trustees instead of the three required under Tennessee law.[22]

2. Robin Costa is given broad power over the Maddox Foundation Corporation

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[21] *See* Affidavit of Wallace N. Rasmussen ("Rasmussen Aff.") ¶ 4, September 16, 2004, Appendix at Tab No. 9; *see also* Deposition of Wallace Rasmussen ("Rasmussen Depo."), January 11, 2005, at 29-30, Appendix at Tab No. 10. Mr. Rasmussen concurred in Mr. Maddox's assessment. *Id.*

[22] *See* Rasmussen Aff. ¶ 7, Appendix at Tab No. 9. Notwithstanding Ms. Costa's statement to Mr. Rasmussen, the Mississippi not for profit corporation act allows for a single director. *See* Miss. Code Ann. § 79-11-231.

On September 13, 1999, the Maddox Foundation Corporation was incorporated as a Mississippi nonprofit corporation. Its only incorporators were Ms. Costa and Ms. Working, "as Trustee[s] of Maddox Foundation Trust."[23] Pursuant to its articles of incorporation,

> the Corporation shall only make contributions to organizations operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, the fostering of national or international amateur sports competition, or for the prevention of cruelty to children or animals.[24]

The corporate articles specified that "[u]nder no circumstances may any assets or income of the Corporation ever be used for the benefit of any individual or entity, other than in non-excessive payment of services rendered . . . ".[25]

Subject to these limits, the articles of incorporation provided Ms. Costa with extraordinary authority, including the ability to act unilaterally without the consent of the other member(s) of the board of directors. Until she is determined to "lack capacity by an appropriate court of the State of Mississippi," Ms. Costa has the power that would regularly be exercisable only by an entire board of directors.[26] Further, "[t]he Board of Directors shall have no authority with respect to Robin G. Costa to deprive her of, limit, or interfere with the exercise of the powers reserved to her by the incorporators."[27]

Likewise, the bylaws of the Maddox Foundation Corporation give Ms. Costa unlimited authority to exercise all of the powers which would otherwise be exercisable only by a board of

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[23] *See* Articles of Incorporation, Appendix at Tab No. 11.

[24] *Id.* ¶ 8a.

[25] *Id.* ¶ 8c.

[26] *Id.* ¶ 8f.

[27] *Id.* ¶ 8g.

directors to the exclusion of the other members of the board of directors.[28] According to the bylaws, "Costa is exclusively authorized to exercise all of the powers which would otherwise be exercisable by the Board of Directors, whether or not such powers are set forth in these Bylaws."

The bylaws authorize Ms. Costa to retain all such powers "until she is determined to lack capacity by an appropriate court of the state of Mississippi, resigns, or dies." . . . Thus, any provision in the law, bylaws, or otherwise, which authorizes or permits the Board of Directors to exercise any powers not enumerated . . . above, whether or not with reference to a prior vote of the Board of Directors, shall be exercisable instead **solely** by Robin G. Costa."[29]

At the time of the incorporation of the Maddox Foundation Corporation, Ms. Costa was appointed President, Treasurer, and Secretary, and Ms. Working was appointed Vice President. Pursuant to the bylaws, the officers of the corporation were entitled to compensation for their services.

According to the bylaws, the initial directors, Ms. Costa and Ms. Working, were to hold office on the Board of Directors for a term of five years, which was set to expire on or about September 7, 2004.[30] Thereafter, "[s]ince Robin G. Costa is acting in place of the Board . . . she shall have the power to appoint a new Director when a term of an acting Director has expired and can appoint herself, as well as any other Director, for a successive term or terms."[31]

On December 31, 2000, Ms. Working resigned as Vice President of the Maddox Foundation Corporation. However, pursuant to the temporary restraining order entered by Judge

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[28] *See* Bylaws of the Foundation at art. II § 1, Appendix at Tab No. 12.

[29] *Id.* (emphasis added.)

[30] *Id.* at art. II. § 2.

[31] *Id.*

Kennedy on September 1, 2004, and the Temporary Injunction entered November 29, 2004, Ms. Working remains a member of the Board of Directors.[32]

3. The transfer of assets from the Foundation to the Corporation

On July 27, 2001, Ms. Costa, as "managing trustee" of the Maddox Foundation Trust and as a director of the Maddox Foundation Corporation, and Ms. Working, as a director of the Maddox Foundation Corporation, executed an Agreement as to Reorganization of Maddox Foundation (the "Agreement").[33] The Agreement purported to authorize the Maddox Foundation Trust, pursuant to Section 12 of the Trust Agreement, to transfer to the Maddox Foundation Corporation "its legal and equitable title in any and every asset it presently has or shall be entitled to in the future."[34] Effective August 1, 2001, the Maddox Foundation Corporation purportedly accepted receipt of all of the assets transferred to it by the Maddox Foundation Trust.[35]

Also as alleged, the Maddox Foundation Trust's purported transfer to the Maddox Foundation Corporation of "its legal and equitable title in any and every asset it presently has or shall be entitled to in the future" was ineffective as alleged in the lawsuit, because, in addition to those reasons outlined above, Ms. Costa, a non-resident trustee, failed to comply with Tenn. Code Ann. § 35-50-107(b)(2),[36] and was therefore not lawfully able to act on behalf of the Maddox Foundation Trust.

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[32] *See* Temporary Restraining Order, September 1, 2004, Appendix at Tab No. 13, and Order Regarding Motion for Temporary Injunction, November 29, 2004, Appendix at Tab No. 14, in *State of Tennessee v. Costa.*

[33] *See* Agreement as to Reorganization dated July 27, 2001, Appendix at Tab No. 15.

[34] *Id.* ¶ 1.

[35] *Id.* ¶ 3.

[36] Tenn. Code Ann. § 35-50-107. **Limitations on appointment of nonresident fiduciary.**

The Maddox Foundation Trust's purported transfer to the Maddox Foundation Corporation of "its legal and equitable title in any and every asset it presently has or shall be entitled to in the future" was also ineffective because the Trust Agreement permits an out-of-state corporation to act as a trustee for and on behalf of the Maddox Foundation Trust, but does not authorize or permit an out-of-state corporation to act as the trust itself.[37] The transfer was therefore ineffective because the Maddox Foundation Corporation fails as a trustee since it is a non-resident trustee and it is not authorized by state or federal authorities to exercise fiduciary powers.

Thus, the correct situs for the Maddox Foundation Trust, including the "legal and equitable title in any and every asset it presently has or shall be entitled to in the future," has been, and always has remained in Davidson County, Tennessee.

D. Robin Costa's Management of the Foundation

Timothy J. Pagliara, Managing Partner of Capital Trust Wealth Management, who has been retained as an expert witness by the District Attorney General and Ms. Working in the Tennessee lawsuit, has determined in a preliminary report that Robin Costa, as the managing trustee of the Maddox Foundation and controlling director of the Maddox Foundation

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"(b)(2) Any nonresident person, bank or trust company shall not act in any such capacities, until it has appointed in writing the secretary of state as its agent for service of process, upon whom all process in any suit or proceeding against it may be served in any action or proceeding relating to any trust, estate or matter within this state in respect of which such person, bank or trust company is acting in any such fiduciary capacity, and in such writing shall agree that any process against it, which shall be served upon such secretary of state, shall be of the same legal force and validity as if served on such person, bank or trust company. ..."

[37] *See* Action on Written Consent of Trustees dated September 5, 1986, ¶5, Appendix at Tab No. 3; Maddox Foundation Trust Agreement ¶ 12, Appendix at Tab No. 1.

Corporation, breached the standard of care required of fiduciaries in a number of ways which have directly resulted in financial loss to the Foundation.[38]

Rhonda Sides, a Certified Public Accountant and Director with Crosslin Vaden & Associates, P.C., has reached similar conclusions about Ms. Costa's management of the Maddox Foundation Corporation. Based on her preliminary review of documents provided by the Corporation, Ms. Sides has concluded that:

- The financial statements of the Foundation and its related entities do not accurately reflect the true financial condition or value of the Foundation, its assets and its related entities;[39]
- Robin Costa has paid herself excessive compensation by taking compensation from the Foundation (premised upon an erroneously high valuation of assets) as well as from at least one of those related entity assets, Margaret Energy. She has also been paid fees as a co-executor of each of the Maddox Estates. As stated in Ms. Sides Affidavit, Robin Costa has been "triple dipping" her personal compensation[40]; and
- The financial records reflect expenditures of Foundation assets exceeding $6,000,000 for purposes that have no apparent relationship to the charitable purposes of this tax exempt entity.[41]

This paper will give a few examples from these reports which are illustrative of the lawsuit's allegations of how Ms. Costa has mismanaged the Foundation.

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[38] *See* Affidavit of Timothy J. Pagliara ("Pagliara Aff.") ¶ 5, October 18, 2004, Appendix at Tab No. 16.

[39] *See* Affidavit of Rhonda Sides ("Second Sides Aff.") ¶ 7.A., October 22, 2004, Appendix at Tab No. 17.

[40] *Id.* ¶ 7.B. (Ms. Costa's total personal compensation out of the Maddox assets is in excess of $3.5 million).

[41] *Id.* ¶ 7.C.

1. *Failure to adopt an investment policy*

For years, Ms. Costa operated the Maddox Foundation Trust and the Maddox Foundation Corporation without an established investment policy. Professor Schoenblum testified that he repeatedly and from the very beginning advised Ms. Costa to adopt an investment policy for the Foundation and that, as of late 2001 when he stopped representing the Foundation Ms. Costa still had not adopted an investment policy.[42] According to Professor Schoenblum,

> this goes to the whole concept of proper management of a charitable foundation and also Mr. Maddox's vision of what this foundation would be assuming that Mrs. Maddox would have followed through with his ideas, and that is that you were achieving a move from a relatively small foundation in terms of asset value that was very local in nature to what could have been a really influential foundation on a national or international level with 10 times, 15 times as many assets.
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> When you have that amounts of assets, you need an appropriate governance structure, and that was the idea of the corporate form. You need guidelines so that you institutionalize or bureaucratize your management. You have to have guidelines so that it transcends the individuals so that it isn't the personal fiefdom of any person but that whoever is there in that role follows expert specific rules of a long-term management of a foundation nonetheless.
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> It's not what an individual decides based on what the person feels on a particular day when they wake up in the morning or go to bed at night. It's routine, efficient and sensible management, so, for example, when you get to investments, you can't just come up with some hairbrain scheme ....[43]

As shown by the Foundation's tax returns, the Ms. Costa's failure to adopt or adhere to an appropriate and/or adequate investment policy has resulted in a significant churning of the investment portfolio and a continued and consistent pattern of investment losses.[44]

2. *Failure to divest from American Retirement Corporation*

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[42] Deposition of Jeffrey Schoenblum ("Schoenblum Depo."), January 6, 2005, at 182-184, Appendix at Tab No. 18.

[43] *Id.* at 184-185.

[44] *See* 2000 Form 990-PF, 2001 Form 990-PF, and 2002 Form 990-PF, Appendix at Tab Nos. 19, 20, and 21, respectively; *see also* Pagliara Aff. *supra.*

Several Nashville businessmen including Dan Maddox formed the American Retirement Corporation. DMAR, a limited partnership owned by Mr. and Mrs. Maddox at the time of their deaths, and one of the numerous entities related to the Maddox Foundation Corporation had significant holdings in American Retirement Corporation ("ARC"). Before the death of Mr. Maddox, Ms. Costa was elected to the ARC Board of Directors. Contrary to the advice of the attorney for the Foundation Trust (and later the Maddox Foundation Corporation), Ms. Costa maintained her position on the Board and audit committee of ARC.[45] At the same time, despite the actual and apparent conflict of interest, Ms. Costa exercised her authority as Executor/Trustee to retain a significant equity position in the corporation, even as the stock price plummeted. Ms. Costa made it clear to the Maddox Foundation Trust and Corporation's investment advisors that they were not permitted to sell ARC stock in order that Ms. Costa might be able to preserve her position as a member of the Board of Directors of ARC.[46]

Although Ms. Costa eventually did resign her position as a member of the Board of Directors of American Retirement Corporation, the assets of the Maddox Foundation have been significantly depleted as the ARC stock, which was valued at approximately $29 million at the time of the death of Mr. and Mrs. Maddox, has lost more than 85% of its value.[47]

3. *The purchase of professional sports teams*

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[45] *See* Affidavit of Tommye M. Working ("Working Aff.") ¶ 54, August 30, 2004, Appendix at Tab No. 22; Working Depo. at 63-64, Appendix at Tab No. 7.

[46] *See* Deposition of Sean T. Carey ("Carey Depo.") at 102-103, Appendix at Tab No. 23. In sworn court filings, Ms. Costa claims that it was her co-executor, Mr. Earl Bentz, who insisted on holding the ARC stock and that, in any event, the stock was thinly traded and the Estates could not have effectively divested their large concentration of shares. Ms. Costa's defenses are rebutted by the sworn affidavit testimony of Mr. Bentz (*see* Affidavit of Earl Bentz ("Bentz Aff.") ¶ 4, Appendix at Tab No. 24) and contradicted by publicly available data reflecting the actual trading volume of ARC stock during the relevant time period.

[47] *See* Affidavit of Rhonda Sides ("First Sides Aff.") ¶ 10, August 30, 2004, Appendix at Tab No. 25.

On July 19, 2002, Ms. Costa incorporated Maddox Hockey, Inc. and Maddox Football, Inc. as wholly owned subsidiaries of the Mississippi non-profit entity. [48] On September 1, 2002, Ms. Costa executed a "Grant Agreement" as a grantor on behalf of the Maddox Foundation Corporation.[49] Under the terms of the Grant Agreement, $1,500,000 of Foundation assets was given to Maddox Hockey and $601,000 was given to Maddox Football. Ms. Costa thereafter used these Foundation assets and others to purchase and operate the Memphis RiverKings professional hockey team, through Maddox Hockey, and purchase and operate the Memphis Xplorers professional arena football team, through Maddox Football.

Owning these sports teams has been an economic disaster for the Maddox Foundation. The purchase price was well above that recommended by Ms. Costa's financial and legal advisors. Both teams had significant annual losses in the years prior to their purchase. For example, the RiverKings sustained annual losses of approximately $1,000,000 prior to the purchase. In the first year following the purchase, the RiverKings lost $1.4 million and the Explorers lost over $883,000.[50] Nevertheless, Ms. Costa continued to use the Maddox Foundation's assets to fund the operating expenses of these failing professional athletic teams.[51]

According to the 2003 Form 990PF, the Maddox Foundation contributed over $4,000,000 directly to Maddox Hockey, Inc. and Maddox Football, Inc., and paid an additional $51,000 of expenses associated with the sports entities directly from Foundation assets, while characterizing such expenditures as charitable distributions By October 2004 the Maddox Foundation had

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[48] *Id.* ¶ 11.

[49] *See* Grant Agreement dated September 1, 2002, Appendix at Tab No. 26.

[50] *See* Maddox Hockey, Inc. 2002 Form 1120 and Maddox Football, Inc. 2002 Form 1120, Appendix Tab Nos. 27 and 28, respectively.

[51] *See* First Sides Aff. ¶ 14, Appendix at Tab No. 25.

incurred over $8,000,000 in debt through draws on a line of credit with Merrill Lynch, the proceeds of which have reportedly been used to fund the operations of these "for profit" sports teams.

A complete assessment of how trust assets have been poured into these professional sports teams must await completion of the court ordered accounting. However, the information disclosed in the Foundation tax returns and financial statements indicate that in two and a half years, more than $8 million, which otherwise would have been available to support charitable works and causes, has been spent on the business of minor league hockey and arena football.

Neither of the investments in professional athletic teams meets the Maddox Foundation's athletic purposes, which are restricted to the "fostering of national or international amateur sports competition."[52] Nor are they compatible with the purposes of the Maddox Foundation Trust. Likewise, the investments are not in the best interest of the beneficiaries of the Maddox Foundation Trust and would jeopardize the carrying out of any of the exempt purposes of the trust.

In fact, prior to the purchase of these sports teams, Ms. Costa was advised by legal counsel to obtain a private letter ruling from the IRS to determine whether or not the investment could meet a narrow exception so as to be classified as "program related," thereby avoiding significant tax penalties.[53] Ms. Costa has yet to obtain such a private letter ruling from the IRS and did not even request such a private letter ruling until more than a year after she purchased the

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[52] *See* Articles of Incorporation ¶8a, Appendix at Tab No. 11 (emphasis added).

[53] Carey Depo. at 66-68, Appendix at Tab No. 23.

two professional sports teams.[54] This is contrary to the position taken by Professor Schoenblum, who testified:

> A: . . . I would not ever advise using funds to invest in professional athletics without a private letter ruling.
>
> Q: Without obtaining a private letter ruling before making the investment or at any time?
>
> A: Well, the way I practice law, before making that kind of investment, because I believe that is so questionable and there is so little authority justifying it that I would be very hesitant to advise any client to do that first and then seek a ruling because of the consequences if you got an unfavorable ruling and had to unwind all of that.[55]

Although Professor Schoenblum did not advise Ms. Costa on the purchase of the hockey and football teams, based on his experience advising her concerning the Foundation for several years he testified that, "as a general matter, I would have looked at it with an extremely jaundiced eye. That's not to say that it's inconceivable, but I think it's highly unlikely that I would have ever said that that's an appropriate investment."[56]

Outside attorneys for the Maddox Foundation Corporation advised Ms. Costa against serving as a member of management for either professional sports teams.[57] However, Ms. Costa refused to follow their advice, and serves as the chief executive officer and president of the RiverKings and the operator of the Xplorers.[58]

Ms. Costa also holds herself out to the public as the owner of these professional athletic teams. According to a press release dated August 17, 2002, announcing the purchase of the

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[54] *Id.* at 69.

[55] Schoenblum Depo. at 113, Appendix at Tab No. 18.

[56] *Id.* at 120.

[57] *See* Polsinelli Shalton & Welte memorandum dated July 3, 2002, Appendix at Tab No. 29.

[58] *See* team management rosters, Appendix at Tab Nos. 30 and 31, respectively.

hockey team, Ms. Costa "fell in love with hockey and with the RiverKings," and, "[a]s a new owner, you'll see a lot of me."[59] Ms. Costa's "two children are major hockey fans."[60] Ironically, in emails written before she used the Foundation's assets to buy the hockey team, Ms. Costa wrote: "I do not like hockey. I've never been to a hockey game previously. I'm not a [R]iverkings fan. I don't know any of the players or the people involved."[61]

4. Robin Costa's excessive expenditures of Foundation assets

According to its Form 990-PF, the Maddox Foundation Corporation held assets totaling only $39,598,321 at the end of 2000.[62] The grants made by the Maddox Foundation Corporation in 2000 totaled $1,868,424, while its total operating expenses were $1,900,801-- $32,000 more than its charitable gifts. The Maddox Foundation Corporation's operating expenses in 2000 included $516,000 in compensation to its officers, $503,000 in compensation to its attorneys, and $244,000 in compensation to its accountants and financial advisors. Realized capital losses for 2000 were $212,885.

In 2002, Belmont University in Nashville, Tennessee received a $500 cash donation, but the Foundation also counted as a charitable distribution to Belmont $4,650 of chartered airplane expenses for two round trips to Nashville, one of which reportedly was to deliver the $500 check.[63]

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[59] *See* Press Release, August 17, 2002, Appendix at Tab No. 32.

[60] *Id.*

[61] *See* Schoenblum Depo., Exhibit 123, Appendix at Tab No. 18. Whether the statement in her e-mail was true at the time she wrote it, she quickly changed her position and became well acquainted with players and employees of the hockey team. So well acquainted in fact that one of her relationships with a hockey team employee has resulted in a sexual harassment lawsuit against her and the Foundation.

[62] *See* 2000 Form 990-PF, Joint Appendix at Tab No. 19.

[63] *See* 2001 and 2002 Forms 990-PF, Appendix at Tab No. 20 and 21, respectively.

A comparison of the Maddox Foundation Corporation's operations over time reveals the effect of Ms. Costa's management of the Foundation's assets:[64]

	2000	2001	2002	2003
Assets a Year End (Fair Market Value)	$39,598,321	$49,239,122	$40,869,475	$118,290,116[65]
Contributions Reported by Foundation	$1,868,424	$1,584,372	$2,841,310	$5,524,509[66]
Operating Expenses	$1,900,801	$1,463,751	$2,155,136	$2,092,869
Legal Fees	$503,859	$368,491	$412,690	$486,340
Officer Compensation (Costa)[67]	$305,981	$275,828	$276,346	$276,342
Accounting Fees	$79,680	$162,070	$169,900	$123,085
Financial Advisors/Other Professional Fees	$164,532	$150,677	$216,864	$177,126

Strikingly, in 2002, the value of the Maddox Foundation Corporation's assets dropped by more than $8,000,000, while its operating expenses increased by 47%. There is even more to see when one looks deeper into these numbers. One of the recipients of Ms. Costa's largesse in 2002 and 2003 was the Community Foundation of Northwest Mississippi, ("CFNM"). In 2002, the Maddox Foundation claimed a charitable distribution to CFNM in the amount of $98,206. According to CFNM's public filings, much of this support came by way of payments to "third parties." An examination of the Maddox Foundation's general ledger for 2002 reveals that $59,114 was spent to put on a lavish party – dubbed the "Crystal Ball" – that according to the

[64] *See* 2000, 2001, 2002, and 2003 Forms 990-PF, Appendix at Tab Nos. 19, 20, 21 and 33, respectively. The 2004 Form 990-PF is not yet available.

[65] This reflects the transfer of assets from the DWM and MHM Estates.

[66] It should be noted that over $4,000,000 of this amount was paid by the Foundation directly to Maddox Hockey, Inc. and Maddox Football, Inc. to cover the teams' operating losses, yet the Foundation claimed a charitable deduction for these payments on its 2003 Form 990-PF. *See* 2003 Form 990-PF, Appendix at Tab No. 33.

[67] *See* Defendants' Responses No. 4, Appendix at Tab No. 6. At the same time she was paying herself compensation to manage all of the Foundation assets, she was paying herself additional annual compensation ($125,000, $150,000, and $150,000 from 2001 to 2003) out of one of the investment holding companies owned by the Foundation, as well as paying herself executor and trustee fees.

CFNM's tax return only raised approximately $4,000 in disposable funds. The remaining $39,092 of the Foundation's distribution was supposedly to pay expenses directly on behalf of CFNM, however over $11,500 was incurred for charter plane trips and $9,300 was spent to produce a promotional film.

The year 2003 saw a repeat of this practice on a larger scale, with the Maddox Foundation claiming cash contributions of $50,000 and $124,442 in expenses for CFNM. According to CFNM's 2003 Form 990, that year's Crystal Ball cost $78,712 and did not raise any money.[68] Nevertheless, in 2002 and 2003 Ms. Costa characterizes these party extravaganzas as charitable contributions.

In 2003, the Maddox Foundation reported charitable contributions of $5.52 million, $124,442 of which was for CFNM's expenses and over $4.1 million consists of payments to cover the operating losses of the hockey and football teams. This leaves, at best, only $1.3 million in genuine charitable contributions – which is $700,000 less than the Foundation's reported operating expenses.

Compared to lavish parties, chartered plane trips, and the expenses of operating minor league sports teams, the amount of money the Foundation, under Ms. Costa's leadership, actually provides to charitable purposes is small indeed.

5. Robin Costa's compensation

In 2000, Ms. Costa asked Professor Schoenblum, in his role as an attorney for the Maddox Foundation, to conduct a survey to determine an appropriate salary for Ms. Costa. Professor Schoenblum retained an independent consulting firm which determined a range of compensation. He then determined that an appropriate annual salary for Ms. Costa was

[68] *See* 2003 Form 990, Community Foundation of Northwest Mississippi, Appendix at Tab No. 34.

$275,000, based on information provided to him by Ms. Costa that all of the Maddoxes' assets had been transferred to the Maddox Foundation, and that such assets would have had a value of approximately $180 million.[69] As Professor Schoenblum testified, while there are many factors that must be considered in determining Ms. Costa's compensation, he "believe[s] that asset value was a critical factor, the critical factor."[70]

However, as it became clear later, Professor Schoenblum had not been given all of the relevant or current information on the value of the assets in the Foundation. As he testified, he

> never saw any documents, in fact, at various points [I] basically was begging for that information, but I never really got that information. And that's why I had these caveats later on, because I had reached a conclusion that I personally could not make a determination in Nashville, Tennessee, what was going on, what they were doing, and so, therefore, I would give advice, but I would give advice with great caution telling them you really have to – I hope you're really doing this at this level because this is the number we're relying on, and if this is not the number then obviously the report isn't worth the paper it's written on.[71]

By the time he was asked to do a second compensation report for Ms. Costa, Professor Schoenblum had learned that the Maddox Foundation Corporation did not have assets valued at $180 million.[72] The Form 990-PF for 2000 shows compensation to Ms. Costa of $305,981, however, the Maddox Foundation had assets at the end of December 2000, of only approximately $38 million — more than $100 million less than the amount on which Ms. Costa's salary was based.[73] In fact, had Ms. Costa asked Professor Schoenblum to prepare a third compensation report he would have refused to do so "[b]ecause at the time it would have come

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[69] *See* Schoenblum Depo. at 40-51; Exhibit 110-B (compensation report), Appendix at Tab No. 18.

[70] *Id.* at 50.

[71] *Id.* at 53-54.

[72] *Id.* at 54, 158-159, 169-176, Exhibits 136, 137 (second compensation report).

[73] *Id.* at 163-164, Exhibit 135.

up, I had reached the conclusion that the representations that she was making [as to asset value] were just too unreliable for me to put my name to a formal compensation report."[74]

In addition, Ms. Costa paid herself salaries from numerous other sources, which she controls through her management control of the Maddox Foundation, including the Maddoxes' estates, the Maddox Revocable Trusts, and at least one subsidiary of the Revocable Trusts and the Maddox Foundation Corporation, Margaret Energy, Inc. For the period 1998 through 2003, Ms. Costa paid herself a total of $3,263,943 in compensation from all of the Maddox-related entities.[75] The Maddox Foundation owns or has a controlling interest in all of these various entities, which are supposed to be held for the benefit of charitable beneficiaries.

6. Travel and other personal expenses

In 2002, the Maddox Foundation Corporation provided a computer-training seminar to its 4-person staff in Cancun, Mexico. The training, which consisted of a 2-day course, could have been conducted at the Foundation's offices. One Foundation employee has testified that she was the only one who attended seriously and that Ms. Costa and the other employee-attendees arrived late and drank throughout the first day:

> And they continued this all day. Any break that we had, they would go to the bar and get drinks. At lunch they drank some more. So by the afternoon it was apparent that they were intoxicated, and they were slurring their speech, they were acting silly, they weren't following the instructor.
>
> ...
>
> And the next day we had class again, which this time they did not drink, but they were – you could tell they were hung over. And we had our class that day. And then the next day was a free day, so we did some touring in the area and then the next day we came home.[76]

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[74] *Id.* at 182.

[75] *See* Defendants' Responses No. 4, Appendix at Tab No. 6.

[76] *See* Deposition of Tara Hermansen ("Hermansen Depo."), at 35-37, Appendix at Tab No. 35.

The Foundation paid for the employees' and their families' airfare, the all-inclusive resort, and the transportation between the airport and the resort.[77]

Similarly at Ms. Costa's direction, the Foundation paid for Ms. Costa and the Foundation's accountant to attend a seminar in California in May of 2002. An employee has testified that Ms. Costa spent most of the "business trip" on shopping activities.[78] Ms. Costa has used funds from the Foundation to charter jets to Knoxville, Tennessee, to attend University of Tennessee football games in 2000 and 2001.[79]

Since purchasing the hockey team in 2002, Ms. Costa has chartered jets to fly to hockey games using funds directly or indirectly held for the Maddox Foundation. A former employee of Maddox Hockey testified in his deposition that it is highly unusual for team owners in that league and similar leagues to travel to away games with the team due to budgetary constraints. In addition, even though team members received a per diem, Ms. Costa would buy meals for the team using her Foundation credit card.[80]

Ms. Costa also chartered a private jet to attend President Bush's inauguration in January 2001, billing the cost of the trip to the Maddox Foundation.[81] According to Maddox Foundation Corporation 2002 accounting records, over $19,000 was expended on chartered air travel.

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[77] *Id.* at 38.

[78] *See* Working Aff. ¶ 77, Appendix at Tab No. 22.

[79] Hermansen Depo. at 23-25, Appendix at Tab No. 35.

[80] *Id.* at 62-63.

[81] *See* Second Sides Aff, Preliminary Report, Appendix at Tab No. 17. A recent news story suggests that Ms. Costa and her representatives have provided contradictory explanations for this trip. *See e.g.* Stephanie Strom, *After Donor Dies, Battle Erupts Over Fund's Vision and Venue,* N.Y. TIMES, February 16, 2005 at A1, Appendix at Tab No. 36.

According to credit card expense reports during 2003 and through April 2004, the Foundation incurred over $46,000 of airfare expenses.[82]

The Maddox Foundation Corporation has paid for Ms. Costa's cell phone charges, according to its credit card expense reports for 2003 and 2004.[83] Maddox Foundation Corporation credit card expense reports for employees for 2003 and through July 2004 reflect various medical expenses, gas charges, florist charges, and pet store and product charges.[84]

According to credit card expense reports of the Maddox Foundation Corporation:

- on a total of seven occasions between May 2003 and July 2003, officers and/or employees of the Maddox Foundation Corporation charged a total of almost $8,000 in expenses at the Gold Strike Casino in Tunica, Mississippi, to the Maddox Foundation Corporation.[85]
- in November 2003, officers and/or employees of the Maddox Foundation Corporation charged a total of over $4,000 in expenses at the La Costa Resort and Spa to the Maddox Foundation Corporation.[86]
- in May 2004, officers and/or employees of the Maddox Foundation Corporation used Foundation assets to purchase approximately $13,000 of bronze statuary at the Carlton Gallery, in La Jolla, California to decorate the Maddox Foundation Corporation

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[82] *Id.*

[83] *Id.* ¶ 25.

[84] *Id.*

[85] *Id.* ¶ 27. In sworn Court filings, Foundation employee Paul Morris claims this expense was incurred to provide lodging for players of visiting hockey teams. While this may be a legitimate business expense for the RiverKings hockey operation, it is *not*, as Ms. Costa reports on the Foundation's tax return, a charitable contribution.

[86] *Id.* ¶ 28.

headquarters.[87]

E. Tennessee charities suffer

The actions described above, which are part of the lawsuit, are not abuses for which there are no victims. Assets which Dan and Margaret Maddox intended to be used to alleviate need and promote beneficial social programs in Tennessee have been taken to another state and squandered. The amount of charitable donations claimed by the Foundation on its tax returns is misleadingly inflated by the inclusion of expenses such as charter plane trips, catering and party accessories as well as the multi-million dollar operating losses of the two sports teams. These excesses have had a direct negative impact on Tennessee charities that were the intended beneficiaries of the Maddox's legacy. All the while, Ms. Costa has paid herself millions in compensation out of assets that were intended by Mr. Maddox, the person who earned them to support charities in his "wonderful Nashville community."

During their lifetimes, Dan and Margaret Maddox were significant and generous supporters of Covenant Presbyterian Church in Nashville, having pledged $1,000,000 of their personal funds to the Church's building campaign.[88] Shortly after Dan and Margaret Maddox were killed, Ms. Costa and Ms. Working met with the Rev. James Bachmann and Mr. Clarence Southerland, a close friend of the Maddoxes.[89] At this meeting Ms. Costa and Ms. Working orally committed to make a contribution to the Church in memory of the Maddoxes in an amount "between two and four million dollars."[90] Time passed, Ms. Costa procured the relocation of the

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[87] *Id.* ¶ 29.

[88] *See* Affidavit of S. James Bachmann, Jr., September 27, 2004, Appendix at Tab No. 37.

[89] *Id.* ¶ 6, 7.

[90] *Id.*

Foundation to Mississippi, and no payment on the pledge was ever made.[91] Eventually, Rev. Bachmann wrote to Ms. Costa asking about the pledge only to be informed by Ms. Costa that the Foundation did not have the assets with which to satisfy the pledge.[92] After Ms. Costa had cemented her control over the Foundation, it made a single contribution of $5,000 to the church.[93] Ms. Costa referred to such contributions as "GAG Gifts"; her acronym meaning "go away gifts."[94]

The Second Harvest Food Bank is one of Nashville's most valuable charities. It provides food for hungry families and for many it is the difference between health and starvation. In August 2000, after the Maddoxes' assets were moved to Mississippi, William G. Coke, Jr., wrote to the Maddox Foundation requesting its assistance in Second Harvest's capital campaign to build a new warehouse in Nashville. Ms. Costa replied to Mr. Coke in January, 2001 refusing Second Harvest's request claiming that "it is the current mission of the foundation to significantly impact Mississippi as a positive catalyst for addressing community needs." An attorney for the Foundation also wrote to Mr. Coke stating "the focus of the foundation has significantly changed since it moved ..."[95] Eighteen months after denying the Second Harvest Food Bank's request for assistance in building a warehouse for its charitable food distribution program, Ms. Costa spent nearly $2,000,000 to purchase the sports teams.

Another object of Dan Maddox's generosity during his lifetime was the Lewis County Museum, a project of the Lewis County, Tennessee Historical Society. Before his untimely

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[91] *Id.* ¶¶ 8, 9.

[92] *Id.* ¶10.

[93] *Id.* ¶11.

[94] Hermansen Depo. at 22-23, Appendix at Tab No. 35.

[95] *See* Affidavit of William G. Coke, Jr., October 12, 2004, Appendix at Tab No. 38.

death, Mr. Maddox committed to donate $2,000,000 to the Historical Society for its capital campaign. Based on this pledge, the Historical Society made commitments to purchase land and undertake building improvements for the Museum. After Mr. and Mrs. Maddox were killed, Ms. Costa acknowledged the existence of this pledge to Tony L. Turnbow, Chairman of the Board of Trustees of the Lewis County Museum; however, she has not honored that pledge and has since informed Mr. Turnbow that Maddox Foundation gifts to charities in Middle Tennessee would be limited to the discretionary funds given to the Community Foundation of Middle Tennessee and further limited to $5,000. Because of these actions by Ms. Costa the Lewis County Museum has been unable to raise the funds necessary to construct the facility the Maddoxes supported during their lifetime.[96]

CORRECTIVE ACTION

In late 2000, Ms. Working resigned as Vice President of the Maddox Foundation Corporation and returned to Nashville. As she testified in her deposition, Ms. Working resigned because she did not believe that the Foundation was being run as her grandparents would have wished it to be run.[97]

Because of her concern over Ms. Costa's management of the Maddox Foundation Corporation, and because she remained a Director of the Corporation, Ms. Working continued to attempt to stay involved in running the Corporation. However, as she had while Ms. Working lived in Mississippi,[98] Ms. Costa actively frustrated Ms. Working's attempts to learn about the

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[96] *See* Affidavit of Tony L. Turnbow, October 13, 2004, Appendix at Tab No. 39.

[97] Working Depo. at 44-45, Appendix at Tab No. 7.

[98] Tara Hermansen testified that "Robin told me and the other girl that was there if Tommye Working called that we were not to give her any information, we were not to tell her where Robin was or what she was doing, that we would only take a message. I would sometimes put Tommye through to Robin's voice mail and then later on Robin told

Corporation's financial status or internal operations.[99] Finally, out of concern that her grandparents' legacies were being wasted by Ms. Costa, Ms. Working contacted District Attorney General Johnson in Nashville.

After investigating Ms. Working's concerns, District Attorney General Johnson authorized the filing of a lawsuit in the Probate Court in Nashville seeking to have the assets held by the Maddox Foundation returned to Tennessee, remove Ms. Costa as a fiduciary over those assets, have an accounting of the Foundation's assets, and other related remedies. Because of his office's resources and pressing responsibilities, General Johnson authorized our law firm, Waller Lansden Dortch & Davis, PLLC, to prosecute the Tennessee action on behalf of the State of Tennessee. While Ms. Working certainly does plan on petitioning the probate court for reimbursement of her legal fees out of the Maddox Foundation assets, to date Ms. Working has paid for Waller Lansden's services out of her own pocket.

It is important to keep in mind that Ms. Working's prosecution of this lawsuit is not being done for her personal gain. This lawsuit was filed to protect Maddox Foundation assets, which are currently held by a Mississippi non-profit corporation, for the benefit of the rightful beneficiaries, *i.e.*, the charities of Middle Tennessee. In fact, even if Ms. Working were to prevail in this matter on the claims advanced by her in the Complaint, she would not receive any monetary compensation. Ms. Working is not seeking monetary damages in her individual capacity. Nor is she seeking to insert herself in Ms. Costa's stead at the helm of the Maddox Foundation Corporation. She only wants what her grandparents wanted – to bring the

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me not to put her through to her voicemail, to just take a message." Hermansen Depo. at 47-48, Appendix at Tab No. 35.

[99] *See* Working Depo. at 225-228, Appendix at Tab No. 8.

Foundation back to Middle Tennessee and to have it properly managed "to help in Nashville's problems and to make a big positive difference in a lot of youngster's lives."

In attempting to reach that goal, Ms. Working and District Attorney General Johnson have been opposed at every corner by both Ms. Costa and the Maddox Foundation Corporation. Ms. Costa and the Maddox Foundation Corporation attempted, albeit unsuccessfully, to dismiss the Tennessee lawsuit on jurisdiction grounds.[100] They unsuccessfully opposed the State's motion seeking to require prior Court approval of the use of trust assets to pay attorney fees and litigation expenses. Most recently, Ms. Costa and the Maddox Foundation Corporation unsuccessfully opposed the Davidson County Probate Court's appointment of a special fiduciary to conduct an accounting. This accounting is currently ongoing.

The one forum where Ms. Costa has enjoyed any success is in the Chancery Court of DeSoto County, Mississippi, which is the same County that is home to Foundation Corporation headquarters. Although nominally designated as a defendant by the Mississippi Attorney General, Ms. Costa actively sought to be enjoined by the Mississippi State Court from complying with the orders of the Tennessee Probate Court. Ms. Working, who was also named a defendant in the Mississippi litigation, has removed the case to federal court in Jackson, Mississippi. As of the date this testimony was prepared, the State of Mississippi's motion to remand the case is still awaiting a ruling by the U.S. District Judge.

POLICY CONSIDERATIONS

We believe that many of the proposals discussed in the Senate Finance Committee staff discussion draft [108th Cong. (2004)] could have deterred or prevented the abuses that have

[100] The jurisdiction of the Davidson County, Tennessee Probate Court cannot be seriously questioned. Ms. Costa is an executrix of the Maddoxes' estates which are being administered in Davidson County and have never been closed.

occurred in the Maddox Foundation as alleged in the lawsuit. Our recommendations and observations in this written testimony are limited to the proposals as applied to the facts we have encountered in the Maddox Foundation case. Our firm represents several private non-operating foundations. The donors and trustee/board members of these family foundations take great pride in their ability to maximize the amount of funds distributed to publicly supported charities each year and to minimize expenses. Furthermore, these individuals are very careful not only to comply with the provisions of the Internal Revenue Code but also to fulfill their fiduciary duties and obligations to the class of charities that their foundations are intended to benefit.

We believe the following proposed reforms (listed in the order as presented in the staff discussion draft) could have mitigated, deterred or may have prevented the abuses seen in the Maddox Foundation. We do not reference the proposals that are inapplicable to our case.

1. 5-Year Review of Tax-Exempt Status: We recommend the Service review the tax-exempt status of private non-operating foundations every five (5) years. We believe that there are few citizens like Tommye Maddox Working, who have the interest, willingness and resources to pursue corrective action of foundation abuses. If Ms. Working had not brought the matter to the attention of the District Attorney and agreed to fund the litigation, we do not believe that the Maddox Foundation abuses would ever have been exposed. Adopting this proposal may increase the likelihood that abuses will be identified, corrected and stopped.

2. Increase in Taxes on Self-Dealer and Foundation Manager: This proposal, if enacted, might have a deterrent effect on others who find themselves in positions of control, like Ms. Costa, from entering into abusive self-dealing transactions.

3. Increase Taxes on Foundation Manager for Jeopardizing Investments: We believe that the facts suggest Ms. Costa caused the Foundation to purchase the two sports teams

primarily for her personal enjoyment rather than for any charitable purpose. The acquisition of the teams subjects the Foundation to penalties for jeopardy investment, excess business holdings and taxable expenditures and jeopardizes the Foundation's tax exempt status. Because she sought legal advice and such advice quantified the potential excise taxes, we believe that Ms. Costa might have been deterred if she, as a Foundation Manager, would have been subject to substantial penalties for investing Foundation funds in the sports teams. At the very least, she hopefully would have sought a private letter ruling prior to entering into the purchase of the sports teams, and at best, perhaps she would have dropped the idea entirely.

4. Compensation of Private Foundation Trustees/Directors: We believe compensation reform is necessary. Through 2003 Ms. Costa received $3.2 million in total compensation from the Foundation and affiliated entities. As stated above, Ms. Costa received $1,168,620 in compensation from the Maddox Foundation, in part, based on the value of assets not held by the Foundation but held by the Maddoxes' estates. In addition, Ms. Costa paid herself $1.3 million from the Maddoxes' estates which appear to have been calculated on the value of the estates' assets, and she paid herself a total of $425,000 from an Estate/Foundation for-profit subsidiary. We believe Ms. Costa's opportunity to pay herself such compensation would have been significantly reduced by adoption of this proposal. Under this proposal, Ms. Costa would not have been in the position to have determined her own compensation.

5. Compensation of Disqualified Persons: Given that Ms. Costa has been both a controlling director and officer (President, Treasurer and Secretary), this proposed reform would have required Ms. Costa to make a choice of either being a director/trustee or a foundation manager. If she chose to be the foundation manager, an independent board would have to

approve her compensation. The likelihood of "triple-dipping" and excessive compensation would be significantly reduced by this proposed reform.

6. Treatment of Administration Expenses of Non-Operating Foundations (*i.e.*, 10% and 35% Thresholds): We believe this proposal would have been very beneficial in the Maddox Foundation case as a deterrent to Ms. Costa incurring such high administrative expenses. If not a deterrent, we believe the proposal could have the utilitarian effect of spotting foundation abuses for remedial action by the Service.

7. Limit Amounts Paid for Travel, Meals and Accommodations: Like the immediately preceding reform, we believe this proposal would have curtailed and/or severely limited Ms. Costa's lavish spending.

8. Provide States the Authority to Pursue Federal Actions (with the Approval of the Internal Revenue Service): We recommend adoption of this reform. District Attorney General Johnson could have included claims of federal tax law violations in the Tennessee lawsuit if he had the authority this proposal would confer. Tennessee has enacted a statute adopting the prohibited transaction rules for private foundations although there has never been a Tennessee reported case enforcing such law.

9. Require Signature by Chief Executive Officer: This proposal would require a certification by the exempt organization CEO that processes and procedures have been put into place to ensure the accuracy of the organization's tax return. The effectiveness of this requirement depends upon the quality of third-party review of the organization's financial information. In this regard, this proposal will have greater effect if it is coupled with other proposed reforms such as those requiring periodic independent audits and disclosure of insider

transaction. Without these additional reforms, merely requiring the CEO's signature on the tax return will not be enough to effectuate genuine reform.

10. Electronic Filing (and Coordination with State Officials): We recommend this reform. It has been difficult to receive information from the Foundation. There is limited information about the Foundation's finances available on the Internet. Even though the Foundation is a private non-operating foundation, which does not carry on any unrelated trade or business activities, Ms. Costa required employees to sign confidentiality agreements. Furthermore, Ms. Working, as a director, was refused information she otherwise was entitled to receive under the law unless she signed a confidentiality agreement. Obtaining information through the discovery process in litigation is very expensive and time consuming.

11. Standards for Filing (990PF): We endorse this proposal. The financial standards and disclosures proposed in the discussion draft would promote uniformity in the presentation of financial information and would facilitate regulatory oversight.

12. Independent Audits or Reviews: This reform would have been extremely helpful in our case. The Maddox Foundation had never been audited. We have received financial statements through the discovery process which are not accurate. The Foundation has double booked certain assets, has over-stated the value of other assets, and has failed to account accurately for its liabilities. In one financial statement the outstanding balance of the Foundation's line of credit loan was understated by $3,000,000. Tax-exempt status is a public franchise. The public has a compelling interest in the accuracy and completeness of the financial reporting of entities which hold that franchise. Requiring periodic independent auditing is a reform that will go a long way towards assuring the public that this franchise is not being abused.

13. Enhanced Disclosure of Related Organizations and Insider Transactions: This proposal includes enhanced disclosure of related organizations; affiliated entity chart; reporting of taxable subsidiaries; reporting of transactions with subsidiaries; reporting of insider dealings; reporting of joint ventures; reporting of partnership interests and exempt entity's role in the partnership. All of these reforms would have been beneficial in the Maddox Foundation case. It is obvious to us that the Foundation has tried to operate in a climate of secrecy which allowed the abuses to continue for several years without detection. Requiring more disclosure, thus promoting transparency, could have helped avoid the Maddox Foundation abuses. The enhanced disclosure could also be a deterrent from entering into various abusive transactions.

14. Disclosure of Performance Goals: One of the themes that runs through the reforms proposed by this Committee's staff is greater transparency. The same public interest that justifies regular audits, governance standards and compensation reform also supports this and other measures calculated to enhance regulatory oversight.

(a) Disclosure of Material Changes in Activities or Structure: We believe this proposal would have been very beneficial in our case and we would suggest that such disclosure include advance notice of intent to change situs. Foundations also should be required to file the disclosure with state or local authorities. Moreover, exempt entities should be required to affirmatively warrant that they are in compliance with all applicable state laws. This reform, coupled with empowering state authorities to enforce federal tax law claims would provide state regulators with a powerful oversight tool.

15. Disclosure of Financial Statements. We absolutely endorse this proposed reform. The Maddox Foundation operated in a culture of secrecy until the State of Tennessee's lawsuit brought about a court-ordered accounting. The effectiveness of this proposed reform will be

enhanced if the IRS is empowered with the authority to impose uniform standards regarding the content and format by which exempt organizations present their financial statements to the public.

16. Encouraging Strong Governance and Best Practices for Exempt Organizations (Including Defining Board Duties, Board Composition, Board/Officer Removal, and Encouragement of Best Practices): The Maddox Foundation's facts and circumstances are the "Poster Child" for why these reforms should be enacted. We believe that a uniform requirement that the governing board be comprised of at least 3 members should be required. We believe the facts demonstrate that the primary purpose for the Foundation being hijacked to Mississippi was for Ms. Costa to have the sole control over the Foundation because Mississippi only required one governing board member. Ms. Costa was President, Treasurer, Secretary and has sole authority over the Foundation. These circumstances created an environment of no accountability allowing the Foundation, as a practical matter, to answer to no one.

Obviously, issues of federalism arise whenever national standards are contemplated in an area that has historically been the subject of regulation by the states. These reforms are no different. Indeed, the role of the states in oversight and enforcement will continue to be vitally important. Considerations of federalism should be respected and can be accommodated.

Individual states may make different policy choices in regards to the conditions they impose on the tax exempt franchise. For example, the people of Tennessee, through their elected representatives, have decided to require that not-for-profit corporations have no fewer than three directors. The people of Mississippi have decided only to require a single director. Each of these policy choices are equally valid and it is not the role of the federal government to impose a "one-size-fits-all" system.

Nevertheless, the federal government, like the individual states, has the right and obligation to place appropriate conditions on its grant of a tax-exempt franchise. These competing interests can be reconciled, however, by permitting private foundations and public charities the option of being exempt from state taxes but not exempt from federal taxes, if the governance and accountability regimes are different between the sovereigns. For example, a foundation may wish to organize as a not-for-profit corporation under Mississippi's current law, and be exempt from that state's property taxes, sales and use taxes, and franchise and excise taxes, but not be exempt from federal income taxes. Allowing such a result would promote federalism while still creating national standards.

17. Establish Prudent Investor Rules: We believe this reform should be adopted. The Foundation's former legal advisor, Professor Schoenblum, has testified that he repeatedly urged Ms. Costa to adopt an investment policy but as late as 2001 she had not done so. Timothy J. Pagliara, an expert retained by the plaintiffs in the Maddox lawsuit, has opined that the Foundation operated without an investment policy at all, then failed to follow the policy later adopted. Moreover, we believe the schedules to the Form 990PF show that investment accounts were excessively churned. In several years the entire value of the portfolio was traded with many transactions being only days apart. Tennessee's prudent investor rule applies to the Maddox Foundation Trust but not to the Mississippi corporation Ms. Costa created. With this proposed reform, however, regulators in every state would be able to address the abuse that arises from the absence of an investment policy.

18. Funding of Exempt Organizations and for State Enforcement and Education: We are very much in support of this proposal. Ms. Working brought information of the Maddox Foundation's abuses to the attention of authorities in Mississippi and Tennessee. However, like

substantially all of the other states, there are little or no public funds available to police private non-operating foundations. To date, Ms. Working has funded the costs of the litigation, benefiting the State of Tennessee and the Tennessee charities that are the intended beneficiaries of Dan and Margaret Maddox. The current system of bringing foundation abuses to light and correcting the abuses is very inefficient. We have found public officials in our state to be keenly interested in performing a regulatory function, but the resources necessary to achieve an appropriate level of oversight are scarce.

(a) Exempt Organization Hotline for Reporting Abuse and Complaints: We are in support of this proposal. We believe that this proposal would have given the former employees of the Maddox Foundation the opportunity to report the abuse if the hotline had been available, even though the employees were subject to confidentiality agreements.

(b) Information Sharing with State Attorney General: This initiative would have been helpful in obtaining information from the Maddox Foundation instead of having to obtain the information through costly discovery.

19. Tax Court Equity Authority and Private Actions; Private Relator Actions: We favor the proposal to expand the equitable powers of the Tax Court. Those contemplated remedies are, in many ways, duplicative of the remedies available under Tennessee's *quo warranto* statute. Nevertheless, this reform would create an alternative forum for private parties and relators. Moreover, the possibility of removal of an action from state court to the U.S. Tax Court may also be an efficacious reform, particularly where, as in the Maddox Foundation case, competing state court actions are pending.

Allowing private actions to be brought by directors/trustees as well as by private relators will also promote accountability and oversight of exempt entities and relieve the burden on finite state resources.

CONCLUSION

The Maddox Foundation litigation has provided a glimpse into practically every form of excess and abuse of the tax exempt status of private non-operating foundations identified in this Committee's staff report. Those excesses and abuses have highlighted the need for legislative reform.

Private foundations, public charities and other tax exempt entities perform vital services in our society and contribute to enhance the quality of life in communities all across the United States. The abuses occurring in the Maddox Foundation are news mainly because they are the exception and not the norm. Nevertheless, they are abuses that are as hard to correct as they are shocking.

Common sense reforms, such as those under consideration by this Committee, will make the job of state regulators easier and will add to the tools available to protect charitable beneficiaries.

Respectfully submitted,

Richard A. Johnson
Waller Lansden Dortch &
Davis, PLLC

Joseph A. Woodruff
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Davis, PLLC

PREPARED STATEMENT OF DAVID KUO

Chairman Grassley, Senator Baucus, and distinguished members of the committee, I am David Kuo, contributing editor to *Beliefnet.com,* the leading multi-faith religion and spirituality website. For 2½ years I was also Special Assistant to the President and Deputy Director of the Office of Faith-Based and Community Initiatives at the White House under President George W. Bush.

My perspective on the topics we discuss this morning is informed by various vantage points on the charitable sector I've had during the past 15 years. I've worked in senior positions here in the United States Senate, in advocacy organizations and in the White House. For 3 years I founded and tried to create a charitable organization to objectively determine the efficacy and efficiency of social service organizations. I was even recruited to a dot-com company with the promise that I'd be able to manage what promised to be a huge foundation—they were going to give away 1 percent of gross revenues to charity, and, since they'd be making hundreds of billions of dollars every year, that meant a lot of money for charitable giving. Suffice it to say that things didn't turn out quite as planned.

I also approach it from a certain philosophical perspective. I believe in government's inviolable duty to help serve the poor. This isn't just philosophy for me, it is also theology. I believe that Jesus's commands to care for the least among us mean that we have to bring to social problems every available resource and every best effort. I reject some conservative notions that suggest the government is the enemy and must step out of the way and let the private sector take over. I similarly reject some liberal notions that suggest the answer to every problem is another government program and more government money. Both of these noxious notions are born of either ignorance or indifference. It doesn't really matter which. My passion isn't for politics per se but for what politics can bring to bear on these matters. It is in that spirit that I want to speak to government, to the non-profit sector, and to us as individuals.

I believe in President Bush's compassionate conservative philosophy as articulated at the start of his 2000 campaign. "It is not enough for conservatives like me to praise [charitable efforts]. It is not enough to call for volunteerism. Without more support and resources, both private and public, we are asking them to make bricks without straw." His proposals for $8 billion per year in new spending and charitable tax incentives for non-itemizers and IRA rollovers were important policies, but they were something more—they were an unmistakable public signal that charity, compassion, and care for the poor were to be cornerstones of his domestic policy.

Four years later, these tax incentives and other spending programs haven't yet been enacted. The White House could certainly have done more. That's already been said. However, were it not for the President's interest in these issues, we wouldn't be here today. That brings me to Congress. Save for the tireless action of this committee that has repeatedly pushed for charitable tax incentives, I have been astonished by the lack of interest in these matters by your colleagues. The CARE Act is a perfect example. For the last few years, the CARE Act has had overwhelming bipartisan support, and has gone nowhere. Why? In large part it is because of widespread congressional apathy and a desire for political gamesmanship on all sides. I have been quoted as saying that the White House knows how to get what it really wants to get. That is true. But, just as certainly, Congress knows how to get what Congress wants. Why hasn't Congress been a passionate advocate on behalf of charities and the poor in the midst of economic crisis, a downturn in charitable giving and an upturn in social service needs?

As Members of the United States Senate, you are called and pulled in every different direction. Every problem, every constituency demands more from you and of you. But I can think of no other area in American politics so ignored by political leaders than matters of charity, of care for the poor, of substantive debate and discussion on matters of civil society. No, America's poor do not have a powerful voice. They aren't combined into the power of the AARP. They aren't likely to flood your office with calls, e-mails, or letters, and yet there are more poor Americans today than there were 4 years ago. It is always easy politics to blame either the other party or the White House, but I just wonder why these matters are such a low priority for the United States Congress?

It isn't just Congress that has ignored charities. Without any doubt, the charity abuse stories that we hear are the result of a lack of IRS enforcement of existing laws. Having had my own 501(c)(3) organization that looked into the efficacy and efficiency of other organizations, I saw firsthand cases of willful misuse of funds. That kind of stuff was hardly a secret. And yet where is IRS enforcement of these existing laws? It has been AWOL, and now we are to believe that *new* laws are the answer?

By themselves they are not. They may serve the appetite of a public that wants action, because nothing spells action more than a new law. But, without dramatic enforcement enhancements, we'll all be back having the same debate 5 years from now.

Make no mistake, however, I am not a shiny, happy charity cheerleader. If we don't face the facts that loopholes need to be closed, reforms made, and accountability had, we will have failed just as much as if we did nothing. The IRS cannot enforce laws that make no sense or that provide loopholes for the wealthy in the name of charity. Clearly, more stringent rules need to be put in place regarding the use of donor-advised funds. It hardly seems a stretch to require accounts to pay out a certain basement requirement annually. More publicly disclosed information about charities also seems to be a no-brainer. Charities are by their very definition here to serve the public interest. The public has a right to know a lot more than they currently do about how these organizations operate, how much money individuals are making, and how the money is being spent. Donors' private information should remain private, but charities need to see daylight.

I'd like to add one more thing. We need to begin looking at information in different ways. To date, charities tend to be judged by how well their accountants make their books look like all the money is going to serve targeted populations. Why? Because that is how "efficient" charities have been ranked by media like *U.S. News & World Report.* Unfortunately, this mindset has prevented us from asking a more important question. "How well?" Efficacy is a far more important and relevant gauge than efficiency. We need to begin asking charities to tangibly measure how well they are doing their jobs, not just how efficiently.

Charitable abuses are real and they are offensive. They must be eliminated, serious fines must be imposed, and violators need to be exposed. But we must be careful amidst these reports not to allow these abuses to create new laws that punish the overwhelming majority of donors or the recipients of non-profit services—the poor, the addicted, those seeking education, those in need of health care or those who simply love art. I am concerned about changes in non-cash deductions and clothing deductions; that may be using disproportionate force given the problems.

Finally, the United States faces record budget deficits, not because of abuses in the charitable sector but because of choices and priorities that our government has made. Much of the rhetoric around charity that I have been hearing lately seems to suggest that the charitable sector is a great target for raising more funds to ensure the continuity of our existing way of government waste. Doesn't that strike the committee as a bit odd, perhaps even a bit perverse?

Everything we're discussing today is about the culture of charity that we are creating. The culture of charity is hurt by a lack of enforcement. It is hurt by loopholes and exceptions and tricks that benefit the rich in the name of the poor. It is also hurt by laws that inadvertently discourage charitable giving. Nowhere is that clearer than in the estate tax. Congress will be revisiting this matter in the coming months. As it does so I hope that it, and this committee, will bear in mind the huge consequences that matter has on the charitable community. Conservative estimates show that a total repeal of the tax would cost the charitable sector more than $10 billion per year. That is a lot of money and discourages the culture of charity.

I want to close by again thanking Senator Grassley, Senator Baucus and their exceptional staffs. We are having a vigorous debate this morning about charity, about giving, and about helping others. Everyone here should be excited about the debate, because the debate will lead to important changes, new understanding, and a stronger charitable sector benefiting America.

STATEMENT OF THE ARKANSAS COMMUNITY FOUNDATION
SUBMITTED BY HON. BLANCHE LINCOLN

Monday, April 04, 2005

ARCF
ARKANSAS COMMUNITY FOUNDATION
For Good. For Arkansas. For Ever.

Senator Blanche L. Lincoln
U. S. Senator
359 Dirksen Senate Office Bldg
Washington, DC 20510-0404

RE: The Senate Finance Committee hearing on "Charities and Charitable Giving"

Dear Senator Lincoln:

On behalf of the Arkansas nonprofit sector, we would like to submit the following for the Senate Finance Committee hearing on April 5, 2005.

A. General

1. There has been abuse. Charities share Congress' concerns over unethical actions within the nonprofit sector, as such activity by a few threatens to undermine the good work of all charities.

    a. Charities recognize the need to be more active in encouraging, educating and assisting each other regarding compliance issues, as well as the development of conflict-of-interest and whistleblower policies and other "best practices" that are commensurate with each organization's resources and mission.

    b. Directors must have the independence to assess the most cost-effective methods for ensuring that the organization's financial resources are managed responsibly and effectively.

2. Independence. The effectiveness of charities depends on their continued independence.

    a. Charities must be free to develop new ideas, respond to needs without delay, hold government accountable and encourage both large and small efforts that contribute to the public good.

    b. Government should resist inappropriate intrusion into policy and program matters that are best determined by the charities themselves.

3. Transparency. The public must have access to accurate, clear, timely and adequate information about the programs, activities and finances of charities.

a. Government regulation should promote transparency while providing sufficient flexibility to accommodate the wide range of resources and capabilities of nonprofit organizations, particularly of small organizations.

4. Enforcement. Congress should appropriate sufficient resources to enable the IRS to implement the existing laws effectively.

   a. Current legal standards are generally adequate, if enforced.

   b. New regulation is needed only in those limited areas where current standards have proven inadequate to deal with those who deliberately exploit charities for personal gain.

5. Do no harm. Any new laws or regulations should not discourage legitimate charitable activity.

   a. Regulations that do not consider the diversity and complexity of the nonprofit sector may increase the administrative and financial burdens of compliance to a point where some charities will be forced to curtail or even cease their legitimate activities.

   b. Particular care should be given to any actions that might discourage donations, volunteer activities or the service of qualified individuals as employees, directors and trustees.

   c. Lawmakers must refrain from adopting regulations where the costs of demonstrating compliance outweigh the benefits gained.

B. Donor-Advised Funds (DAF)

1. Define "donor-advised funds" in the Code or regulations to ensure that they are used exclusively and appropriately to advance charitable purposes.

2. Prohibit public charities from making grants with DAF assets to private nonoperating foundations.

3. Require public charities holding DAFs to take steps to ensure a minimum of fund activity:

   a. contact the donors/advisors of those funds that have been inactive for a period of years to request advice; and

   b. make distributions or revoke advisory privileges if there has been no activity for a specified period.

4. Prohibit public charities from knowingly using DAF assets to (1) reimburse the donor/advisor or related parties for expenses incurred in the grantee selection process; (2) compensate the donor/advisor or related parties for services rendered; (3) make grants to the donor/advisor or related parties; or (4) satisfy a legally binding charitable pledge of the donor/advisor.

5. Require public charities with DAFs to obtain the donor/advisor's certification that a grant to a recommended grantee would not provide any substantial benefit to, or relieve any obligation of, the donor/advisor or any related party.

E. Donations of Property

Any changes to federal law regarding the valuation or deductibility of non-cash donations should not (1) discourage individuals or corporations from making such donations or (2) force charities to dispose of donated property in a manner that would diminish its financial value to the charity.

F. Enforcement

Enforce penalties to deter inappropriate actions, but do not unjustly punish individuals for inadvertent violations:

1. Increase first-tier excise taxes imposed on foundation managers and disqualified persons who knowingly participate in self-dealing transactions, and modify the standard for when such penalties will be imposed.

2. Impose penalties to eliminate the inappropriate use of Type III supporting organizations, but maintain their availability for legitimate charitable purposes.

3. Impose penalties to deter participation in listed tax shelter transactions.

4. Increase funding to the IRS for oversight and enforcement.

5. Encourage states to incorporate federal tax standards for charitable organizations into state law.

6. Allow state attorneys general and other state officials charged by law with overseeing charitable organizations the same access to IRS information currently available by law to state revenue officers, under the same terms and restrictions.

G. NOT RECOMMENDED

Avoid actions that would unnecessarily chill charitable activity, disproportionately burden small organizations or discourage qualified individuals from donating their time and talents to charity.

1. Mandatory rotation of auditors.

a. It can be difficult to find auditors with the appropriate expertise (particularly for smaller or rural organizations), who are willing to perform an audit on a cost-effective (or pro bono) basis.

2. Limits on board size

3. Federal involvement in traditional state law matters of charity oversight, governance, fiduciary duties, prudent investor standards, solicitation, etc.

4. Limits on deductibility of non-cash donations.

Thank you again, Senator Lincoln, for your interest and your work for the nonprofit sector. Please do not hesitate to contact me with any questions or concerns.

Sincerely,

Heather Larkin Eason
Executive Vice President

PREPARED STATEMENT OF LEON PANETTA

Mr. Chairman, members of the committee, I am pleased to be here in my capacity as a member of the Citizens Advisory Group to the Panel on the Nonprofit Sector. As most of you know, I have been in the public sector and the private sector and I now serve as the director of the Panetta Institute, a nonprofit, non-partisan center for the study of public policy located at California State University, Monterey Bay. When I was in government, I was privileged to serve as a Member in the House of Representatives, and as Director of the U.S. Office of Management and Budget, and as Chief of Staff in the White House.

From those different vantage points I learned a great deal about the role of charities and foundations in this country and came to appreciate, far more than I had before, how essential to our communities and our Nation these organizations are to serving the needs of a nation. Whether large or small, these organizations focus on a wide range of services from helping the homeless or bringing opera to the schools, cleaning the oceans or researching a cure for AIDS. Their ability to innovate, collaborate and tailor services to meet an immediate need, test a creative idea or build a museum for the arts is something government officials support and applaud. Their work in many ways represents the essence of our democracy.

The human as well as financial resources these organizations tap is inspirational. We saw it most recently and most overwhelmingly following the tsunami crisis, when the best of what we are capable of being came to the fore as millions of individuals and organizations contributed more than a billion dollars to help the victims of this immense tragedy.

Are there abuses in the nonprofit field? Yes, sadly, there are. In the midst of incomprehensible human suffering and need in southeast Asia, there were a few scam artists attempting to siphon off funds for their personal use, funds that would otherwise have gone to help rebuild the devastated communities in Sri Lanka, India and Thailand. There are a few charitable organizations that have not been good stewards of the public trust, that have spent charitable dollars for purposes other than those for which they were contributed.

I join you in saying that these abuses must end. I feel very strongly that charitable institutions must be above reproach, because they are so essential to every aspect of community life. The only way to guarantee their continuation is to ensure an even higher level of public confidence and trust in the way they do business. We cannot allow the small number of those who deliberately abuse the public trust to hurt the good name of thousands of organizations that operate in good faith and serve the public good with distinction.

Having spent some time lately reviewing current laws and IRS regulations as well as the Finance Committee's staff discussion paper and the Joint Committee on Taxation's Options paper, I believe that collectively you have done an excellent job of clearly identifying problem areas. I want to commend you for your vigilance and your commitment to protecting what is best about this magnificent voluntary sector. Already your attention to this area has stimulated many to look at their programs and practices with an eye towards improvement.

The fundamental issue you confront today is how do you balance the need for new laws and regulations with the need for stronger enforcement of existing laws with the need for tougher self-regulation?

There may be some new laws or clarifying rules needed in certain areas of charitable activity, but we also need greater attention paid to adequate enforcement of current law. Many of the stories I've seen describing excessive compensation and self-dealing (where insiders benefit not the charitable cause) appear to be violations of existing law. In those instances, the problems would not be solved by simply raising the bar, but by going after the violators.

The vast majority of abuses are already illegal, and the solution lies more in improving—greatly improving—enforcement of the laws and regulations already on the books than in creating more laws and regulations that increase the burdens on the IRS. I say this having served in the public sector and being keenly aware of the shortage of financial resources to achieve this important goal. I begin, therefore, by encouraging serious consideration of increased funding for the IRS to allow for additional audits, collection of fees, and development and installation of software that will enable mandatory electronic filing of all of the forms in the 990 series, including attachments, and Form 1023, the application for 501(c)(3) status.

I believe that a good blueprint for action is provided in the recommendations included in the Panel on the Nonprofit Sector's Interim Report. As a member of the Citizens Advisory Group, I had the opportunity to review the work of the Panel and the well-considered advice it received from so many fine experts and organizations. I believe it has achieved the important balance between adequate oversight and accountability and the ability of charitable organizations to fulfill their missions. Among the recommendations that I call to your attention are:

- Requiring audits for organizations with annual revenues over $2 million, and mandating an independent public accountant's review of financial statements for those with budgets of $500,000 to $2 million (p. 23).
- Defining and clarifying the rules for donor-advised funds (p. 36).
- Increasing penalties for violations of the self-dealing rules (p. 40).
- Allowing better cooperation between State and Federal regulators (p. 47).
- Encouraging the IRS to move forward with mandatory electronic filing for the Form 990 series (p. 21).

The Panel on the Nonprofit Sector is now preparing its recommendations on other critical issues, and will release a final report in late spring. I encourage you to hear the full scope of its recommendations before you take any formal action.

Even with improved regulations and the significant infusion of funds, there is a limit to what can be achieved through new legislation and improved enforcement. Without the collective will within the voluntary sector to uphold good standards of ethical practice, we will not achieve the outcome we all wish for.

I have had the opportunity to meet many leaders of charitable endeavors. Their purpose is to make life better in some way, and they try their best to live up to their obligations. Too many of them don't know as much as they would like about board governance, management of organizations, audit processes, self-dealing and so on. For them a good program of education would do wonders. I hope that this committee will favorably consider putting some meaningful resources behind a nationwide education system undertaken by the charitable sector itself. But I also encourage the sector itself to invest in this effort. A comprehensive education initiative will take both public and charitable sectors coming together to achieve these outcomes.

Let me offer some thoughts that go beyond where the panel is at this time. I fervently believe the best way to prevent abuse and raise the standards of the charitable sector is for the sector to demand of itself greater accountability. And I understand that this is beginning to happen. Numerous organizations have held conferences, workshops, seminars and other training sessions on the fiduciary responsibilities of boards of directors, chief executive officers and others. Many of the sector's leaders have begun to better educate themselves and their directors about the law and filing requirements. And there are a host of organizations—national, regional and local—devoted to standard setting and improving the practices of their affiliates and those associated with them. I am aware that some fields of practice require compliance and meeting of certain standards in order for the organization and professionals to operate. Other standards are entirely voluntary.

It is a good start, but it is far from sufficient. Self-regulation, to be credible and effective, must have a structure, must demand high standards, and must have the authority to investigate allegations of wrongdoing and enforce penalties. Without such a structure, self-regulation is just an aspiration.

It is my view that the charitable sector needs a formal structure, a National Council on Nonprofit Accreditation, that brings together all of the accrediting bodies of the sub-sectors under one umbrella. They ought to have common standards regarding governance, transparency and accountability, allowing for the diverse needs of small, intermediate and large organizations. Although the charitable purposes of public interest groups, family service agencies, health systems and research centers are significantly different, there are standards of operation that they must surely share.

A National Council of some sort could write clear guidelines requiring that any nonprofit institution seeking accreditation from any cooperating accrediting body must meet the guidelines for board composition, audits, public disclosure of financial information, and compliance with all laws and regulations governing exempt organizations. These guidelines would be in addition to the sub-sector requirements for curriculum development, physician certification or whatever is relevant in each subsector to obtain accreditation today. Violations of governance and ethical standards would be cause for suspension and finally revocation of accreditation, just as failure to meet academic, health or safety standards.

An additional function of a National Council on Nonprofit Accreditation would be education and training. I have been truly surprised to find that many, many people working in charitable organizations or serving on boards or as trustees do not know the laws and regulations that apply to their tax-exempt status, IRS filings, fiduciary responsibilities and public disclosure requirements. While not denying that there is abuse of tax laws that is knowing and purposeful, there are a great many errors of omission and commission that are due to ignorance of the law or its application to the specific organization. Examples are failure to file a Form 990, failure to receipt gifts over $250 or providing excess benefits to executives or trustees.

At the end of the day, relying on this type of self-regulation has three main advantages. It lightens the burden on the IRS and other regulatory agencies, all of whom are already struggling to meet their responsibilities with limited resources; it preserves the independence of the sector, which has been crucial to its ability to address the needs and aspirations of Americans; and it places the responsibility where it should be: on the organizations across the country that know that they will maintain the support of the public only if they operate according to the highest possible ethical standards.

The charitable sector is indispensable to American life as we know it. Americans value volunteer service to their communities, and they trust and rely on nonprofit institutions that serve them. We send our children to religious schools or community centers to learn the values in which we believe. People from all over the world come to the United States for higher educations in some of the finest colleges and universities ever established. It is impossible to enumerate the myriad services charitable organizations make available to families that would be unable to afford them in the private marketplace—from shelters for the homeless to job training, cancer screenings to literacy programs.

The charitable sector serves the public good. But it must do more. It must serve well, and to do that there must be more accountability and transparency. The trust placed in these organizations is more important than the dollars contributed to them. The good work needs funds; the donors need trust. They are inseparable.

So I urge you to please keep the pressure on. Demand better enforcement of current laws from the IRS and give them the means to do it. Demand passage of new laws and promulgation of new regulations to curb abuse and increase penalties, but do so cautiously and only where absolutely necessary.

And finally, demand that the charitable sector do a better job of self-regulation. Those of us involved in the sector will make demands on ourselves as well: for higher standards of ethics and governance, for better training of professionals and volunteers about their duties and responsibilities, and for holding organizations accountable for meeting those standards.

Together we have an obligation to give the public the trust they need to ensure that they give to the Nation.

PREPARED STATEMENT OF HON. RICK SANTORUM

Mr. Chairman and members of the committee, I want to take this opportunity to commend the efforts of charities throughout this country who work day-in and day-

out to transform the lives of individuals, families, and communities. I believe strongly that the philanthropic, generous nature of Americans is a big part of what makes America a great nation. Neighbors helping neighbors, those blessed with financial resources and talents walking alongside and learning from the least of these in our communities.

I recently introduced S. Con. Res. 15, which encourages Americans to increase their charitable giving. I have been working for several years with Senator Joe Lieberman and this committee on a broad package of incentives to encourage charitable giving through the Charity Aid, Recovery, and Empowerment Act (CARE Act). The CARE Act includes incentives for non-itemizers, IRA charitable rollovers, food donation incentives, and corporate giving incentives. The CARE Act passed the Senate on April 9, 2003, by a vote of 95–5. The House of Representatives passed companion legislation, the Charitable Giving Act, H.R. 7, on September 17, 2003, by a vote of 408–13. Tragically for those in need, the bill was chosen as the first bill to not be allowed to go to conference after passage by both chambers and thus prevented from becoming law in the last Congress.

The CARE Act is currently included in S. 6 in the 109th Congress. The recently passed Senate budget included an amendment which I offered to reflect our ongoing support for completing this important package. I look forward to passage of a similar bill by the House and its consideration by this committee again and by the full Senate.

Unfortunately, what brings us here today is not incentives for charitable giving but a series of proposals which would collectively require the charitable community and charitable donors to bear a significant burden for dubious public benefit. Of course we want to discourage inappropriate behavior by those who may seek to abuse the public's trust. Included in the CARE Act—with the help of the Chairman and this committee—are several key provisions which encourage transparency, disclosure, accountability, and better coordination between State and Federal authorities tasked with charitable oversight responsibilities. These proposals are the next logical step, combined with appropriate enforcement efforts of existing laws. I also appreciate the work of the Independent Sector in their interim report and the Alliance for Charitable Reform in developing proposals that meet the goals of the committee without unnecessarily burdening the important work of legitimate charities.

Some of the committee staff proposals and relevant Joint Committee on Taxation tax proposals target problem areas which are limited in scope and in nearly all cases inappropriate under current laws. As one illustration, in the initial hearing that the Finance Committee had last summer on June 22, 2004, concerning areas of abuse, one private group went through the transcript and found approximately 94 cited references to "abuses" in the charitable sector in the testimonies and written statements. All but two are addressed in current laws and regulations.

Troubling for all aspects of the charitable community from social service organizations to volunteer firefighting departments are prescriptive proposals of charitable governance. These include everything from the size of one's board to Sarbanes-Oxley corporate-style self-dealing rules. The reality is that a "one size fits all" approach is not appropriate for the vast and diverse charitable sector in this country. There are more than 1.2 million charities in this country. Most charities are small, focus primarily on their mission, struggle with resources, and would find these requirements a distraction and burden imposed from Washington, DC. Many do not know anything about these proposals and would not likely know much until after their adoption—they are too busy feeding the hungry, mentoring children, helping the disabled, restoring ex-felons, rehabilitating drug addicts, teaching kids how to read, and serving the elderly. Clearly we should be capable in collaboration with the Executive Branch of more artful responses to these areas of concern, if necessary, rather than proposing elimination of legitimate incentives altogether.

I recently asked Secretary Snow in a written question following a hearing whether it is necessary to consider sweeping changes in charitable governance, and what evidence we have that this is a problem area which cannot be adequately addressed by effective oversight and existing laws. In his response he mentioned the IRS's current review of compensation practices and procedures of 2000 charities and said, "Although the results of the IRS audit initiatives may indicate the need for particular governance reforms, it is simply too soon to tell."

Another problematic proposal is the elimination of fair market value deductions for the contribution of land to charities. The JCT report recommends that any donor receive only the basis for such a contribution. While I understand that their can be legitimate concern over excessive evaluations in some cases, clearly we don't have to effectively throw out this incentive altogether. This is no longer a reform but a tax increase and a barrier to charitable giving. We should instead be seeking nar-

rowly targeted solutions for clearly demonstrated problems once the government has established that enforcement of current law alone is inadequate.

Another proposal limits deductions of clothing and household items to an aggregate annual total of $500 per taxpayer. This appears to be an arbitrary number apparently intended to minimize inappropriate deductions. Yet the proposed solution would eliminate legitimate in-kind contributions without providing any assessment of its impact on charitable giving and its impact on organizations which do great work—like the Salvation Army and Goodwill—but receive many of these in-kind contributions.

As a final example, while a different category of charities—apparently because of a misunderstanding about the charitable nature of their activities and some limited abuses—I must add that I am deeply troubled by the Joint Tax Committee's proposal to impose taxes on fraternal benefit societies, reviving a proposal that was considered in the mid-1980s and rejected. These organizations are a major source for good in the United States, with 10 million members nationwide that devote themselves to fraternal, charitable, religious, and patriotic activities. The Joint Committee's proposal would extinguish these organizations and the good that they do at the very time that our society needs the private sector to step in and support our communities. As I mentioned recently in the *Congressional Record,* this is a proposal that clearly should be rejected once again.

I appreciate the Chairman's commitment to ensuring the public trust and protecting the charitable community from abuse, but we need to tread carefully before we would impose an added layer of burden on the social entrepreneurs helping those in need around the country. We also need to think twice before we send the message that those blessed with significant resources would be safer spending their money on yachts rather than helping improve their communities. Unintended consequences in this arena will have real world consequences in the lives of those in need.

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TRUST COALITION[1]

EXECUTIVE SUMMARY TO TABLE OF CITED ABUSES

1. Introduction. The testimonies presented at the June 22, 2004 hearing of the U.S. Senate Finance Committee entitled "Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities" and the accompanying written submissions to the hearing record (collectively, the "Hearing Record") cited a number of alleged abuses by nonprofit organizations. In our review of the 429-page Hearing Record, we identified 94 alleged abuses which are summarized in the attached TRUST Coalition Table of Cited Abuses.[2] The 94 cited alleged abuses range from general descriptions of perceived problems in the exempt organizations sector to specific incidents of abuse by identified charities. Of the 94 alleged abuses cited, we found that current laws, regulations, and reporting requirements already address all but 2.[3]

2. Overview of Laws, Regulations, and Reporting Requirements Addressing Alleged Abuses Cited in the Hearing Record. The following are some of the current laws, regulations, and reporting requirements that address the alleged cited abuses cited in the Hearing Record:[4]

- **Form 990: Information for Identification of Abuse Must be Reported On Form 990; Penalties for Failure to File Form 990, Under-Reporting, or False Reporting:** 67 of the 94 cited abuses.
- **Private Inurement and/or Private Benefit, Subject to Intermediate Sanctions and Self-Dealing Penalty Taxes and/or Revocation of Exempt Status:** 53 of the 94 cited abuses.
- **State Law Compliance Issue:** 12 of the 94 cited abuses.

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[1] TRUST (Tax Restraint Ultimately Serves Trust) provides research for several faith-based tax exempt organizations.

[2] While the Table attempts to list only once specific abuses referenced by more than one hearing participant or written contributor to the Hearing Record, it is possible that there is some duplication among the 94 alleged abuses cited given that the descriptions of many of the cited abuses were not comprehensive.

[3] Given the existence of over 1.8 million nonprofit organizations in the U.S., it is unclear that the 94 cited abuses represent any form of widespread or systematic pattern of abuses by exempt organizations. The examples of abuse cited certainly pale in comparison to the vast scope of legitimate and beneficial charitable activity undertaken by U.S. tax exempt organizations.

[4] This is not intended to be an exhaustive listing of all laws, regulations, and reporting requirements that may be applicable to the cited abuses, and primarily focuses on federal law requirements. An exhaustive listing would not be possible given that the descriptions of many of the cited abuses were not comprehensive.

- **Tax Shelters: Abuse Subject to IRC Section 6111 Reporting Requirements and Section 6700 Penalties:** 11 of the 94 cited abuses.
- **Form 1023: Information for Identification of Abuse Must be Reported On Form 1023:** 10 of the 94 cited abuses.
- **Form 8283/8282: Valuation of Property Contributions:** 4 of the 94 cited abuses.
- **IRC Section 170 Requiring Completed Gift Under Full Discretion and Control by Charity for Tax Deductible Treatment:** 4 of the 94 cited abuses.
- **IRC Section 4945 Expenditure Responsibility Requirements:** 3 of the 94 cited abuses.
- **IRC Section 4944 Jeopardizing Investment Prohibitions:** 3 of the 94 cited abuses.
- **Patriot Act:** 3 of the 94 cited abuses.
- **Penalties for Failure to Withhold and Remit Employment/Payroll Taxes:** 3 of the 94 cited abuses.
- **Below-Market Loans: IRC Section 7872 Requirements:** 2 of the 94 cited abuses.
- **IRC Section 4942 Mandatory Distribution Requirements:** 1 of the 94 cited abuses.
- **Form 1120-POL Political Activity Filing Requirement:** 1 of the 94 cited abuses.
- **Alleged Problem Not Addressed in Current Law:** 2 of the 94 cited abuses.[5]

3. Conclusion. Our review of the June 22, 2004 Hearing Record indicates that the vast majority of concerns and alleged abuses related to tax exempt organizations that were presented to the Senate Finance Committee can be remedied under existing law. Thus, the testimonies and written submissions in the Hearing Record not point to a need for new laws regulating the tax exempt sector. Rather, the Hearing Record indicates that there may be a need for additional financial resources for increased efficiency and assertiveness in enforcing existing laws. Government should continue to encourage transparency, full disclosure and accountability, but should not overburden the growth of the charitable community with new requirements where it has not been fully demonstrated that they are necessary.

[5] The two cited issues not addressed by current law are: (1) IRS employees are prohibited from sharing information with state charity regulators, leading to absurd communications re: anonymous charities; and (2) only 12% of the grant dollars given away by the 100 largest foundations (based on total giving) were for general/operating support. In the case of the latter, it is not altogether clear what is the perceived abuse.

TRUST COALITION TABLE OF CITED ABUSES

REVIEW OF CITED ABUSES INVOLVING NONPROFIT ORGANIZATIONS AND EXISTING LAWS, RULES, AND/OR PRACTICES ADDRESSING CITED ABUSES

IN CHRONOLOGICAL ORDER OF TESTIMONY OR STATEMENT AT THE HEARING BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE "CHARITY OVERSIGHT AND REFORM: KEEPING BAD THINGS FROM HAPPENING TO GOOD CHARITIES"

Abbreviations:
EF 1023 = Revised Form 1023 (effective October 2004) expanded the scope of inquiry and would facilitate detection of potential abuse.
Form 990 = Information to detect such abuse or potential abuse is required to be reported on Form 990 or Form 990-PF.
PI/PB/IS/SD = Private Inurement / Private Benefit / Intermediate Sanctions and Self-Dealing Penalty Taxes.
DAF = Donor-advised funds.
* State laws (not referenced) also address many of these cited abuses.

No.	Source Reporting Abuse	Page Citation from Hearing Transcript	Cited Abuse – Brief Description	Existing Law, Rule, Form, and/or Practice Addressing Abuse*
1	Sen. Max Baucus (D-GA)	pp. 3-4	Inflated salaries paid to trustees and charity executives.	1. EF 1023 2. Form 990 3. PI/PB/IS/SD
2	Sen. Max Baucus (D-GA)	pp. 3-4	Insider deals with insufficient transparency.	1. EF 1023 2. Form 990 3. PI/PB/IS/SD
3	Sen. Max Baucus (D-GA)	pp. 3-4	Charities engaging in abusive tax shelters.	1. EF 1023 2. Form 990 3. IRC Section 6111 Reporting Requirements 4. IRC Section 6700 penalties on tax shelter promoters
4	Sen. Max Baucus (D-GA)	pp. 3-4	Charities serving as conduits to fund terrorist activities and operations.	1. EF 1023 2. Form 990 3. Patriot Act
5	Mark Everson, IRS Commissioner	p. 5	Lavish compensation packages to executives.	1. Form 990 2. PI/PB/IS/SD
6	Mark Everson, IRS Commissioner	p. 5	Inappropriate related party transactions.	1. Form 990 2. PI/PB/IS/SD

7	Mark Everson, IRS Commissioner	p. 5	Profit-making entity in guise of charity to escape tax liability or regulatory oversight.	1. Form 990 2. EF 1023
8	Mark Everson, IRS Commissioner	p. 6	6 types of listed tax shelters that are specifically structured for EOs (details not enumerated).	1. EF 1023 2. Form 990 3. IRC Section 6111 Reporting Requirements 4. IRC Section 6700 penalties on tax shelter promoters
9	William Josephson, Asst AG, NY, Charities Bureau	pp. 7, 11	Private Foundation Abuse: Grand Marnier Foundation's board paid extremely high compensation and pension benefits, masterminded by a lawyer.	1. Form 990 2. PI/PB/IS/SD
10	William Josephson, Asst AG, NY, Charities Bureau	pp. 7, 11	25% of 990s are incomplete or inconsistent on their face.	1. Form 990- penalties for non-filing
11	William Josephson, Asst AG, NY, Charities Bureau	pp. 7, 11	Forms 4720 are rarely filed to disclose self-dealing.	1. Form 990
12	William Josephson, Asst AG, NY, Charities Bureau	pp. 7, 11	Political contribution by PF.	1. Form 1120-POL 2. Form 990
13	William Josephson, Asst AG, NY, Charities Bureau	p. 13	Charity that received in 1 year a helicopter, plane, boats, etc. and did not liquidate these assets, but assets had nothing to do with the charity's purposes. Suspicion that donors continued to use these assets for personal purposes.	1. Form 990 2. Forms 8283 and 8282 3. PI/PB/IS/SD
14	William Josephson, Asst AG, NY,Charities Bureau	p. 7, 57	The Urban League of Northeastern New York (i.e., Albany Urban League) Abuse: Catastrophic failure in 2001 due to mismanagement of organization by unsupervised executive director who failed to withhold payroll taxes, resulting in federal tax lien of $525,830 tax lien that could not be satisfied. Board was inattentive and ill-informed, "board paid very little, if any attention."	1. Penalties for failure to withhold (Not an EO specific issue)
15	William Josephson, Asst AG, NY, Charities Bureau	p. 11	Abuse: "lawyers who are executives of private foundations and members of law firms bill their charities for their work as their executives, inflating the law firm's bill, inflating their take in law firm, and depriving charity of money."	1. Form 990 2. PI/PB/IS/SD

16	William Josephson, Asst AG, NY, Charities Bureau	p. 24	10% of New York state charity registrations raise concerns (not enumerated).	1. State law issue
17	Mark Pacella, Pres., National Association of State Charity Officials (Harrisburg, PA)	p. 12	Hospital sale Abuse: board of hospital did not exercise due diligence in sale of hospital (did not offer to public sale, was going to sell it for $19 million, sold for $38 million when offered publicly).	1. PI/PB/IS/SD
18	Mark Pacella, Pres., National Association of State Charity Officials (Harrisburg, PA)	p. 12	Allegheny Health Education and Research Foundation Abuse: Foundation went bankrupt because "the board was not attentive to ongoing affairs of the organization.	1. State law issue: duty of care 2. Form 990
19	William Josephson, Asst AG, NY, Charities Bureau	p. 13	Professional fundraiser running a charity. Abuse: Professional fundraisers creating charities that they raise money for and give little to charity. Cites code § 6113 as ineffective.	1. PI/PB/IS/SD 2. Form 990
20	Sen, Craig Thomas (R-WY)	p. 15	Credit counseling industry Abuse: funneling debt service packages to related parties.	1. PI/PB/IS/SD
21	Mark Everson, IRS Commissioner	p. 18, 24, 26	Son of Boss tax shelter.	1. IRC Section 6111 Reporting Requirements 2. IRC Section 6700 penalties on tax shelter promoters
22	Sen. Jeff Bingaman (D-NM)	p. 18	Life Heritage Plan, LIFE Abuse: charity sets up a trust sells either fixed income shares or instruments to the insurance company, using money raised, the trust purchases life insurance policies from a different insurance company on the lives of charity donors, in the end institutional investors benefit substantially.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
23	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 27	Baptist Foundation of America Abuse: foundation went bankrupt because it was a pyramid scheme, owing $600 million to investors who were mostly elderly and retired who were promised high returns plus grants for Baptist causes.	1. Fraud 2. Form 990

24	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 28	National Heritage Foundation Abuse: donor-advised funds that allow donors to use tax-deductible donations to fund what may be personal expenses; six examples given [page 201]: (1) set up DAF for adoption expenses that would not ordinarily be 100% deductible; (2) set up DAF to pay yourself for charitable employment when you retire; (3) donations to DAF allow deduction for contributions intended for international charity; (4) avoid self-dealing rules by setting up a DAF rather than a traditional corporate foundation; (5) DAF makes payments for children's education; (6) run your insurance or other for-profit business through a DAF.	1. Form 990 2. Section 170; Rev. Rul. 62-113 re: control by charity for deductibility of contributions 3. PI/PB/IS/SD 4. EF 1023
25	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 28	Charities participating in complicated shelters, such as Life Heritage Plan.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
26	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 38	At least 10% of 990s he has reviewed have had many red flags on them.	1. Form 990
27	Jay D. Adkisson, Editor of Quatloos.com, and Director of Private Client Services Select Portfolio Management, Inc.	p. 30	Private foundations abuse: donations made to accommodating or controlled foreign charities and foundations, and donations funneled back to control of original donor.	1. Expenditure responsibility 2. Form 990
28	Jay D. Adkisson, Editor of Quatloos.com	p. 30	Abusive Tax Shelter: Parking of tax-producing assets in an accommodating EO through donation of a second class of S corporation stock.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
29	Jay D. Adkisson, Editor of Quatloos.com	p. 65	Harris Organization- promoting use of Panamanian foundations as offshore tax evasion schemes.	1. Form 990 2. Expenditure Responsibility

30	Mr. Car (confidential witness)	pp. 31, 35	Car donations fundraising abuse: the middleman is making a lot of money off the sale of donated cars and the charity makes pennies, charities aren't paying attention to options they have to get highest market value of car (examples given page 32 and 33).	1. PI/PB/IS/SD
31	Mr. House (confidential witness)	p. 33	AmeriDream, Inc., Synergistic Marketing, LLC, Valao Mortgage Abuse: two individuals Mr. Red and Mr. White were paid huge amounts by AmeriDream and Synergistic (did marketing for AmeriDream), decisions approved by "rubber stamp board", created Valao Mortgage (fake investment co.) to borrow millions for personal use [See pages 158-59 of written statement for elaboration on this scheme].	1. PI/PB/IS/SD 2. Form 990 3. Fraud
32	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 38	Public charity in Arizona Abuse: charity took in $53 million in donations of charitable gift annuities just before filing bankruptcy; had sent out financial statements showing $42 million in assets.	1. Fraud 2. CGA rules on state level re: investments, reserves, disclosures, etc.
33	Diana Aviv, President/CEO, Independent Sector	p. 76	Hundreds of reports of excessive compensation; self-dealing; fundraising practices; conflicts of interest; lavish expenditures.	1. Form 990 2. PI/PB/IS/SD
34	Diana Aviv, President/CEO, Independent Sector	p. 89	DAFs have permitted a few individuals to set up tax shelters.	1. Section 170; Rev. Rul. 62-113 2. EF 1023
35	Jay D. Adkisson, Editor of Quatloos.com	pp. 61-62	"Corporation sole" Abuse: converting yourself, your business, and your family into a "church" that lives tax free, a ticket for the average American to make his/her business tax free.	1. Prohibited under 501 (c)(3) and related regs. 2. PI/PB/IS/SD
36	Jay D. Adkisson, Editor of Quatloos.com	p. 62	"Pure trust" Abuse: "corporation sole" is "the successor-in-scam to the pure trust."	1. Prohibited under 501 (c)(3) and related regs. 2. PI/PB/IS/SD
37	Jay D. Adkisson, Editor of Quatloos.com	pp. 63-64	Private Foundations Abuse: foundations established with very little activity to benefit the public, but primarily benefit the donors, i.e. payment of management fees to family members, funding "charitable" vacations, etc.	1. PI/PB/IS/SD 2. Form 990

38	Jay D. Adkisson, Editor of Quatloos.com	pp. 64-66, 72	Foreign foundations used as abusive tax shelters, funneling funds back to the original donors.	1. Form 990 2. Expenditure responsibility
39	Jay D. Adkisson, Editor of Quatloos.com	p. 66	Donating illiquid assets to an EO in anticipation of the donor purchasing the asset back after a few years at a substantial discount.	1. PI/PB/IS/SD 2. Form 8282 and 8283
40	Jay D. Adkisson, Editor of Quatloos.com	pp. 66-67, 71	KPMG abuse: parking S-corporation stock in an EO; S-corporation would attribute a large sum of its income taxes to the donated stock, but EO would receive little cash distributions; after a few years stock would be purchased back by S-corporation owners at fair market value or at a discount.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
41	Jay D. Adkisson, Editor of Quatloos.com	pp. 68-69	Tax shelter opinion letters bolster taxpayers' confidence to enter into transactions that they otherwise would consider bogus.	1. IRC Section 6111 Reporting Requirements 2. IRC Section 6700 penalties on tax shelter promoters
42	National Committee for Responsive Philanthropy	p. 118	The Bielfeldt Foundation in Peoria, IL, paid nearly $3 million to 3 members of the Bielfeldt family for investment services. The foundation's assets were invested in risky futures trading, resulting in a 64% loss in value in just 2 years.	1. PI/PB/IS/SD 2. Form 990 3. Jeopardizing Investments Prohibitions
43	National Committee for Responsive Philanthropy	p. 121	Only 12% of the grant dollars given away by the 100 largest foundations (based on total giving) were for general/operating support. The next largest 900 foundations: 22% for general/operating support.	Not clear why a higher percentage of project or program restrictive grants than general purpose grants is particularly problematic.
44	National Committee for Responsive Philanthropy	p. 126	Non-diversified investments: David and Lucille Packard Foundation held majority of its investments in Hewlett-Packard company stock. Due to economic downturn in 2001, the foundation's assets shrank by $8.3 billion (down from $10 billion).	1. General business issue; not exclusive to EOs 2. Form 990
45	Mark Everson, IRS Commissioner	p. 137	Taxpayers donate offsetting foreign currency option contracts to a charitable organization to trigger a loss deduction while avoiding taxation on corresponding gain due to Section 1256 rules.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
46	Mark Everson, IRS Commissioner	p. 138	Purported transfer of S corporation nonvoting stock by taxpayer to a tax-exempt entity in an attempt to shield income from taxation while allowing the taxpayer to retain the economic benefits of ownership.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters

47	Mark Everson, IRS Commissioner	p. 141	Almost immediately after a purported charitable donation to a supporting organization, an unsecured loan was made of all or a significant portion of the funds back to the donor and creator. Several promoters are under investigation by the IRS in this area and the IRS is examining dozens of organizations.	1. Section 7872 re: loans with below market interest rates 2. Form 990 3. PI/PB/IS/SD 4. Many state laws prohibit loans to officers and directors
48	Mark Everson, IRS Commissioner	p. 142	Corporation sole- aware that some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under pretext of being a "bishop" of a religious organization or society, and claim exemption from federal income taxes as organization described in 501(c)(3). Individuals are told that income will not be reportable or taxable, that their assets cannot be reached by current or future creditors. IRS is conducting dozens of promoter investigations of corporations sole.	1. Prohibited under 501(c)(3) and related regulations 2. PI/PB/IS/SD
49	Mark Everson, IRS Commissioner	p. 142	Donor advised funds abuses: IRS is aware that some promoters encourage clients to donate funds and then use those funds to pay personal expenses, which might include school expenses for the donor's children, payments for the donor's own "volunteer work," and loans back to the donor. Over 100 individuals under audit in connection with such cases.	1. PI/PB/IS/SD 2. Section 170; Rev. Rul. 62-113 3. EF 1023
50	Mark Everson, IRS Commissioner	p. 143	Employee Stock Ownership Plans (ESOPs). IRS discovered an abuse through determination letter process that led to publication of Rev. Rul. 2003-6 in response to a promotion where a person set up a series of ESOPs in advance of the effective date of new requirements for the purpose of selling the plans as "grandfathered."	1. Determination letter process
51	Mark Everson, IRS Commissioner	p. 143	Overvaluation of in-kind donations to charities.	1. Section 170 2. Forms 8282, 8283, appraisal requirements
52	Mark Everson, IRS Commissioner	p.144	IRS has seen several abuses in area of conservation easements: easement donated is overvalued; the donor or donor's successor in interest takes an action inconsistent with easement without adverse consequences.	1. Section 170 2. Forms 8282, 8283, appraisal requirements

53	William Josephson, Asst AG, NY, Charities Bureau	p. 163	Texas jury found 2 former leaders of Carl B. and Florence E. King Foundation, including president and CEO, had committed fraud against charity and should repay $7.5 million in excessive salaries, personal credit-card charges, and attorneys' fees. Salaries had not been approved by the Foundation's board. Spent more on compensation and paying for legal defense than it gave to charities.	1. PI/PB/IS/SD 2. Form 990
54	William Josephson, Asst AG, NY, Charities Bureau	p. 165	7,964 entities that file Form 990 are not registered with the New York AG's Charities Bureau: 5,955 public charities and 2,009 private foundations (though some may be exempt from registering).	1. New York state law issue
55	William Josephson, Asst AG, NY, Charities Bureau	p. 166	In New York, 12,000 (nearly 25%) of 50,000 total registrants had failed to file an annual report for the last 2 years.	1. New York state law issue
56	William Josephson, Asst AG, NY, Charities Bureau	p. 166	Private foundation registered in NY had not met its IRS section 4942 distribution requirements since 1997. From 1997 through 2002, foundation paid excise taxes rather than distributing money to charity. Incurred excise taxes totaling $90,000, while the amount required to be distributed was $267,000.	1. Section 4942 mandatory distributions requirements and related excise taxes
57	William Josephson, Asst AG, NY, Charities Bureau	p. 166	IRS employees prohibited from sharing information with state charity regulators, leading to absurd communications re: anonymous charities.	1. Not addressed in current law or regulations
58	William Josephson, Asst AG, NY, Charities Bureau	p. 177	Private family foundation invested in a related company and paid incentive fees to its general partner, which is owned by a former trustee and his children, one of whom is a current trustee- $514,480 in 2002 and $614,360 in 2000.	1. PI/PB/IS/SD 2. Form 990
59	William Josephson, Asst AG, NY, Charities Bureau	p. 178	Foundation paid over $450,000 in legal fees to law firm of which foundation's president was former partner, including payment for trip to Vatican and $53,000 in premiums for life insurance policies of board's president.	1. PI/PB/IS/SD 2. Form 990
60	William Josephson, Asst AG, NY, Charities Bureau	p. 178	Foundation incurred loss of $1 million on sales of $2.4 million in securities and experienced 59% decline in assets (loss of $500,000) but paid officers compensation of $53,000 and interest of $56,000.	1. PI/PB/IS/SD 2. Jeopardizing investments prohibitions 3. Form 990

61	William Josephson, Asst AG, NY, Charities Bureau	p. 178	Foundation had heavy losses and entered into speculative investments after entering into investment management agreement with director/treasurer-husband of president.	1. PI/PB/IS/SD 2. Jeopardizing investments prohibitions 3. Form 990
62	William Josephson, Asst AG, NY Charities Bureau	p. 179	Board members husband and wife made unsecured loans totaling almost half of foundation's assets at below-market rates to family members and entities controlled by family members.	1. PI/PB/IS/SD 2. Section 7872 3. Form 990
63	William Josephson, Asst AG, NY, Charities Bureau	p. 179	Foundation's board was composed of directors and officers of the for-profit parent. The fairness of the consideration received by the foundation in a repurchase by the for-profit of its stock owned by the foundation was questionable.	1. PI/PB/IS/SD 2. Form 990
64	William Josephson, Asst AG, NY, Charities Bureau	p. 180	Public charity failed in 2001 due to repeated inability to meet payroll obligations, pay employment taxes, adopt annual budgets, maintain active committees, etc. CEO misinformed board.	1. Not an exclusively EO issue - general business problem 2. Employment tax penalties 3. State law duty of care/loyalty
65	William Josephson, Asst AG, NY, Charities Bureau	p. 180	Board members of public charity are friends of CEO, but none has any knowledge of fiduciary duties, some attend meetings only rarely, and some have profited personally from transactions with the charity. Multiple self-dealing transactions with companies controlled by the CEO.	1. PI/PB/IS/SD 2. Form 990 3. State law issue re: duty of care/loyalty
66	William Josephson, Asst AG, NY, Charities Bureau	p. 181	Martha Graham Center of Contemporary Dance - Directors did not challenge the control exercised and assertions made by the Artistic Director, leading to private inurement.	1. PI/PB/IS/SD 2. Form 990 3. State law issue re: duty of care/loyalty
67	William Josephson, Asst AG, NY, Charities Bureau	p. 181	Green Hills Cemetery Association- husband and wife directors of cemetery association improperly withdrew $128,000 from cemetery's trust funds and deposited funds into cemetery's checking account from which they drafted checks to themselves and corporation they control.	1. PI/PB/IS/SD 2. Form 990
68	William Josephson, Asst AG, NY, Charities Bureau	p. 182	Hudson Valley Hospital Center- hospital board chairman compensated handsomely by real estate developer for arranging for real estate developer to sell property to hospital at substantial mark-up.	1. PI/PB/IS/SD 2. Form 990

69	William Josephson, Asst AG, NY, Charities Bureau	p. 182	Directors allegedly refused to give one of the directors information re: finances, investments, and operations of foundation, thereby preventing director from taking active role in management of foundation, failed to file tax returns and financial reports with IRS and AG Charities Bureau, and authorized distributions to organizations other than the 2 supported charities directed by foundation's certificate of incorporation.	1. State NP law issues 2. Penalties for nonfiling
70	William Josephson, Asst AG, NY, Charities Bureau	p. 183	Hale House- public charity operated without functioning board of directors and solely under direction of executive director who wrongfully used thousands of dollars of charitable funds for personal and non-charitable expenses.	1. PI/PB/IS/SD 2. Form 990
71	William Josephson, Asst AG, NY, Charities Bureau	p. 183	Community Health Accreditation Program (CHAP)- CHAP's sole member National League for Nursing (NLN) unilaterally transferred $160,000 to purportedly satisfy debts owed by CHAP to NLN, despite objection of CHAP's board; NLN then sold its membership in CHAP to an individual, which then looted CHAP.	1. PI/PB/IS/SD 2. State NP law issues
72	William Josephson, Asst AG, NY, Charities Bureau	p. 184	Chairperson/CEO of public charity picked board members, set agenda, presided over meetings, prepared minutes, was in charge of all operations, and was paid consultant fee of over $200,000 per year for vaguely described purpose, and used organization's funds to pay $50,000 of personal expenses.	1. PI/PB/IS/SD 2. Form 990
73	William Josephson, Asst AG, NY, Charities Bueau	p. 184	Alleged mismanagement of funds, including improper use of restricted funds, use of corporate assets to pay personal expenses, and failure to pay payroll tax obligations; failure to follow legal advice and other professional studies re: oversight and management practices.	1. PI/PB/IS/SD 2. Form 990 3. State law issue re: duty of care 4. Penalties for payroll tax violations
74	William Josephson, Asst AG, NY, Charities Bureau	p. 185	Public charity announced that it was seriously in debt 3 years after receiving $4 million grant. Engaged in excessive spending and growth after receiving money. Board claims that it was misled by management about financial straits.	1. Form 990 2. State law issues re: duty of care
75	William Josephson, Asst AG, NY, Charities Bureau	p. 186	Foundation's vice-president executed a note with interest only payments to foundation, but note has no collateral provided, and no listed remedies for nonpayment.	1. PI/PB/IS/SD 2. Form 990

76	William Josephson, Asst AG, NY, Charities Bureau	p. 186	Severance agreement with executive director included forgiveness of $58,400 loan, retention of van as personal property, and availability of up to $51,000 of placement services.	1. PI/PB/IS/SD 2. Form 990
77	William Josephson, Asst AG, NY, Charities Bureau	p. 187	Private foundation's president decides on charitable events she wishes to attend, buys the tickets, and receives reimbursement from foundation for portion which is tax deductible Foundation does not write checks to charities nor does board decide which contributions to make.	1. PI/PB/IS/SD 2. Form 990
78	William Josephson, Asst AG, NY, Charities Bureau	p. 188	Foundation paid management fees of $1.2 million (2001) and $650,000 (2000) to company whose sole shareholder was director of foundation; and foundation paid salaries to its directors.	1. PI/PB/IS/SD 2. Form 990
79	William Josephson, Asst AG, NY, Charities Bureau	p. 189	Foundation incurred expenses of $83,000 (including compensation of $44,000 to president) but only made charitable grants totaling $71,000 (including $67,000 to one scholarship fund) in 2001-02. Foundation's president received $22,000 in compensation from the scholarship fund. Both foundation and scholarship fund have 2 directors only, 1 short of minimum required in NY.	1. Potential PI/PB/IS/SD 2. Form 990 3. State NP law issues
80	William Josephson, Asst AG, NY, Charities Bureau	p. 190	Private foundation paid investment management fee to its vice-president of 3 to 5% of market value of net assets, which is normatively high.	1. PI/PB/IS/SD 2. Form 990
81	William Josephson, Asst AG, NY, Charities Bureau	p. 191	More than $2.5 million of $3.1 million in expenses incurred for the benefit of Smith family, with $560,000 in compensation and $140,000 in employee benefits to Jane Smith the secretary and $963,000 in compensation and $185,000 in employee benefits to John Smith the president/treasurer, and $397,000 to Michael Smith the investment consultant who also is the vice-president.	1. PI/PB/IS/SD 2. Form 990
82	William Josephson, Asst AG, NY, Charities Bureau	p. 192	Private foundation is trust whose primary assets are $350,000 in notes receivable. Notes originate from loans made to corporate borrower, and a trustee is owner of 33 percent of voting shares of parent of affiliated group in which the borrower is a member. Interest rate is 12%. Interest has accrued without payment.	1. PI/PB/IS/SD 2. Form 990

83	William Josephson, Asst AG, NY, Charities Bureau	p. 192	Private foundation had total revenue of $708,000, incurred expenses of $1,619,000, and made grants of only $316,000 to charity. High compensation to its officers and directors.	1. PI/PB/IS/SD 2. Form 990
84	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 197	Francis of Assisi Foundation- Martin Frankel started foundation that purchased insurance companies, promising high rate of return to investors (most of them churches), but instead of paying promised returns, Frankel siphoned $215 million to personal account and fled to Europe.	1. PI/PB/IS/SD 2. Fraud
85	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 198	Robert Dillie formed Mid-America Foundation, offering charitable gift annuities and donor advised funds, raised $53 million, and reported $42 million in assets before Dillie disappeared. $20 million went to personal account, $10 million to gambling debt, then Dillie fled. No 990s were filed. Dillie indicted.	1. Form 990 non-filing penalties 2. PI/PB/IS/SD 3. EF 1023 4. Fraud
86	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 204	Inadvertent funding of terrorist groups because too difficult to perform due diligence.	1. Patriot Act 2. Form 990
87	J.J. McNab, CFP CLU QFP, Analyst, Insurance Barometer LLC (Bethesda, MD)	p. 210	Charity invests in life insurance dead pools, benefiting outside investors.	1. Form 990 2. IRC Section 6111 Reporting Requirements 3. IRC Section 6700 penalties on tax shelter promoters
88	Mark Pacella, Pres., National Association of State Charity Officials (Harrisburg, PA)	p. 224	Charity filed 990 reporting that 65% of its joint costs were allocated to program services, but audited financials indicated the same amount allocated to fundraising.	1. Penalties for incomplete/incorrect Form 990 returns
89	NY Times (Stephanie Strom, January 9, 2004)	p. 286	Cites criticism of University of Georgia for spending more than $30 million on business with companies linked to 37 of its 55 trustees.	1. PI/PB/IS/SD 2. Form 990

90	NY Times (Stephanie Strom, January 9, 2004)	p. 286	Cites judge ordering the Minnesota Partnership for Action Against Tobacco to overhaul its board after AG questioned its administration of the state's tobacco settlement funds because members of its board were representatives of organizations/agencies that were very likely to seek its money.	1. PI/PB/IS/SD 2. Form 990
91	NY Times (Stephanie Strom, January 9, 2004)	p. 286	Foundations linked to 2 of the nation's major stock exchanges, the NY Stock Exchange and Nasdaq, have come in for criticism for making donations to organizations with ties to their board members.	1. PI/PB/IS/SD 2. Form 990
92	Denman Kountze, President, Gilbert M. and Martha H. Hitchcock Foundation	p. 288	Significant self-dealing issues in private foundation.	1. PI/PB/IS/SD 2. Form 990
93	Roy Masters, Mark Masters (Gregory F.W. Todd) and Appendix with background information included	p. 303-378	"Church" entity involved in profit-making and political activities; runs radio station shows (Talk Radio Network) and websites (World Net Daily.com) promoting bigotry, racism, and sexism.	1. Prohibited under 501 (c)(3) and related regs. 2. PI/PB/IS/SD
94	Stephen Y. Ruden	pp. 424-426	Historic Seattle Preservation and Development Authority: Entrenched board operates organization more like a private club, including helping friends get publicly funded projects.	1. PI/PB/IS/SD 2. Form 990

Alliance for *Charitable* Reform
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Commonsense Charitable Reforms We Support

The Alliance for Charitable Reform's overarching goals and principles include:

- **Increase and Expand the Private Philanthropic Sector**
- **Expand Resources Available for Charitable Activities**
- **Value the Important Role of Family Charitable Commitments in America**
- **Improve Financial Transparency and Accountability of Charitable Sector**
- **Enforce and Simplify Existing Laws Before Adding New Laws or Outsourcing the IRS's Oversight and Enforcement Functions to Third Parties**
- **Impose Stricter Penalties on Wrongdoers without Punishing Inadvertent Violators**
- **Avoid a "One Size Fits All" Approach**

The following charitable reforms would further these goals:

Increase Philanthropy and Expand Resources Available for Charitable Activities

1. **Reduce the net investment income tax on foundations from 2 percent to 1 percent (*passed by the House as part of H.R. 7 – the House version of the CARE Act and in the President's FY'06 budget).***

Currently, private foundations pay as much as a 2% excise tax on their net investment income each year. Those proceeds, since 1969, were intended for IRS enforcement. In fact, only a very small fraction of those proceeds are used for that purpose while the remainder goes into the general Treasury.

The Alliance supports the House and the President in their calls to roll back the tax so that foundations can use the additional funds for grant-making.

2. **Enhance incentives that encourage foundations to exceed current targets for grant-making *(proposed in the SFC staff draft).***

Provide additional incentives to private foundations to make grants by eliminating the tax on net investment income for those entities whose grants levels exceed prescribed grant-making targets will expand the charitable sector – and remove a greater burden from the government for programs and services.

The incentives proposed in the SFC staff draft are a good start and we would encourage Congress to also consider graduated incentives that begin with a 6% payout rate.

3. **The Alliance supports restricting certain administrative expenses of private foundations** ***(passed by the House as part of H.R. 7 – the House version of the CARE Act).***

The Alliance supports the House-passed proposal that provides objective standards and limits to determine which administrative expenses are allowable for purposes of determining minimum annual payout by private foundations.

ACR supports treatment of the following expenses as allowable for purposes of minimum annual payout:

a. Administrative expenses directly attributable to direct charitable activities, grant selection activities, grant monitoring and administration activities, compliance with law, or furthering public accountability of the private foundation;
b. The portion of compensation paid by the foundation to certain individuals up to an annual rate of $100,000, adjusted for inflation;
c. Travel expenses – costs of ground travel and all regularly scheduled commercial, coach airfares.

4. **Improve valuations of – but do not eliminate -- in-kind property contributions** ***(proposed in the SFC staff draft).***

Improper valuation of assets, whether as a result of mistake or otherwise, is one of the most important challenges facing the administration of the Federal income tax system.

Given the importance of non-cash contributions to charities, the Alliance strongly supports these contributions. As a necessary corollary, the Alliance supports efforts to improve the valuation standards that apply to non-cash contributions and the imposition of stiff penalties on appraisers that overstate the value of in kind property.

Enhance and Enforce Existing Law

5. **Excise taxes paid by private foundations and fees and taxes collected from public charities should be dedicated exclusively to fund IRS enforcement of exempt organizations.**

When Congress first enacted these excise taxes in 1969, the intent was for the proceeds to be used to fund IRS oversight of the charitable sector. Since then only **a small fraction** of those proceeds are used for that purpose.

If inadequate funding of the IRS enforcement capability is the problem, then solve *that* problem by dedicating sufficient proceeds from the current tax to enforcement, as they were intended.

The best way to cure enforcement deficiencies is not to write more laws: but to **vigorously enforce existing laws and regulations.**

Moreover, vigorous IRS oversight is the best deterrent to future wrongdoers. The first step of any meaningful exempt organization reform effort must be to act to assure that adequate funding exists and is used to enforce present law and any enacted reforms.

Alternative funding mechanisms such as other user fees could also be explored *provided* the funds are used for enforcement, not general government operations.

6. **Increase Excise Taxes, Sanctions and Other Penalties for Wrongdoers *(proposed in the SFC draft and in the JCT Study).***

Enforce existing laws and, if necessary, strengthen penalties on those found to have violated the law. Penalties should be **increased, imposed and collected,** without punishing inadvertent violators.

Increase first-tier excise taxes and penalties on acts of self-dealing and non-charitable expenditures for wrongdoers.

The Alliance would support increased excise taxes in other areas, such as jeopardy investments, as long as the enhanced penalties are accompanied by clear, "bright-line" tests and definitions.

7. **Modify and Simplify the Form 990 series to improve financial reporting *(proposed in the SFC staff draft).***

Efforts are already underway to improve financial reporting through improvements in the Form 990 series. Instead of creating new forms and complex and burdensome new reports, the IRS can and should reform and improve the financial reporting aspects of Form 990/990-PF.

Use the time-honored form 990 series but *simplify* and *improve* it, to give the IRS and donors a clearer picture of funds being received and how they are being expended by charities and foundations.

For example, the Alliance supports improved descriptions of activities being conducted by the organization such as direct charitable programs and activities by private foundations, to permit the IRS and the public to assess the types of program services and activities or unrelated trade or business activities being conducted by the organization.

8. **Expand electronic filing of Form 990/990-PF by all charities and foundations and penalties for failure to correctly file *(proposed in the SFC staff draft).***

The IRS recently estimated that under the electronic filing regulations promulgated in January 2005, approximately 10,000 tax-exempt entities would be subject to electronic filing requirements by 2007.

ACR generally supports the initial extension of the electronic filing requirements to the largest of the tax-exempt entities: those with total assets of at least $100 million for 2005 returns, and of at least $10 million for 2006 returns.

However, ACR also expresses its concerns about electronic filing and offers these cautionary notes:

- Be certain to establish mitigating provisions for inadvertent errors by smaller organizations if / when electronic filing is extended to *all* filers;
- Be careful that the electronic filing doesn't run counter to the principles of simplification and greater transparency;
- Be certain the IRS is prepared to properly handle and process electronic filing such that the automated systems function as promised.

9. **The IRS should utilize its current reviewing capabilities during the five-year advance ruling period before establishing some <u>new</u> or additional 'initial review' system.**

The IRS already has the tools at its disposal to review the sources of support for broadly supported public charities during the initial five-year advance ruling period;

The IRS already has the capability for reviewing the Form 990s of charitable organizations to ascertain whether the annual expenditures are in keeping with the stated purposes of the organization as described to the IRS by the charity in its Form 1023.

<u>The IRS can and should enforce the existing laws and utilize the tools and information already being provided to the IRS every year to ascertain whether charities are performing in accordance with the law and their mission for which exempt status was granted.</u>

Adding more and more layers of reporting and regulation isn't going to address a problem of review and enforcement when the information filed with the IRS currently is either being ignored or is not being utilized for its purposes under existing law because of lack of resources.

10. **Make tax-exempt entities and their managers subject to penalties for facilitating tax shelter transactions *(proposed in the JCT study and SFC staff draft).***

Charitable and other exempt organizations should not assist others in transactions that serve no purpose other than to avoid federal income taxes. The Alliance supports efforts to require disgorgement of the fee or other income an exempt organization derives from helping others avoid their proper income tax liability, and the imposition of penalties on organization managers who are responsible for authorizing the organization to participate in such transactions.

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The Alliance for Charitable Reform is a project of the Philanthropy Roundtable, a 501(c) (3) tax-exempt organization. The Alliance is proud to represent charitable organizations, including private foundations, and specifically family foundations, as well as public charities.

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COMMENTARY

Death by Bureaucracy

By HEATHER R. HIGGINS
April 4, 2005; Page A15

With the spirit of Sarbanes-Oxley ever in the air, the Senate Finance Committee will hold a hearing tomorrow on the issue of financial abuses by nonprofits, and will consider draft proposals that would inflict broad new reporting and regulatory requirements on every charity operating in the U.S. This action -- which can only be described as overkill -- is in response to purported abuses discovered in the tax returns of a handful of philanthropic bodies, mainly involving self-dealing and excessive compensation.

The committee's own proposal would impose burdens that are well beyond the capabilities of most nonprofits. Of 65,000 foundations, only 46, or 0.06%, have assets over $1 billion. Most have assets under $50 million. And of the roughly 1.4 million public charities, about 94% have annual revenue of $1 million or less; 98% have revenue of less than $5 million. Most are run with small staffs and tight budgets.

These smaller nonprofits are where people with problems often find help, where research and funding begins for everything from AIDS to charter schools, where local communities organize to keep their streets beautiful, protect the environment, return the homeless to productive society and support civic institutions. This is the sector that most often preserves the texture and strength of our communities -- and that would be most hurt by many of the current proposals.

There is so little hard data on charitable abuses that it would indeed be appropriate for Congress to call for studies on the scope of the alleged abuse before imposing a new punitive regulatory regime. The few systematic analyses performed to date indicate that while there are, of course, bad actors, the incidence of abuse seems to be relatively low. And where abuses exist, they are already covered by existing laws.

Despite concerns that the IRS and state attorneys general haven't the wherewithal to adequately examine current filings, the proposals include myriad new filings at a stricter and more severe liability standard, similar to those enacted for publicly held business corporations. These additional compliance dollars will be a millstone for charities that are local and non-bureaucratic. Indeed, one of the first things donors ask about charities is how much is spent for overhead and

administration; these proposals will force even more donor dollars into non-core costs for dubious public benefit.

Under these proposals, virtually anyone could see a charity's filed documents, public or private and, most ominous of all, will have standing to file a complaint -- effectively transferring a policing function to any individual with an axe to grind. Failure by a charity to file certain documents could result in immediate revocation of its tax exemption, essentially a death penalty for a charity. Boards of trustees would face new federal liability standards and expanded legal exposure. Trustees of public charities would be subject to draconian self-dealing rules which would violate common sense, e.g. a trustee couldn't offer even below-market rent to a charity on whose board he serves.

The added costs are easily absorbed by the huge charities that already employ large bureaucracies, but they will devastate small shops with limited budgets and largely volunteer non-professional staff. New rules would limit board size -- another blow to fund-raising -- and prescribe governance policies, duties and composition.

The proposals would require the IRS to grade each charity against its definition of "Best Practices." The IRS already receives annual "Form 990s" from most nonprofits (detailing officers, revenues and expenditures), and can audit any nonprofit at any time. These proposals may clarify that process, and if so that's all to the good. But some now propose an expanded process that could put most, if not all, charities through an extensive review as frequently as every five years. This would involve submission of massive documentation to the IRS justifying the charity's compliance, restating its charitable goals and offering detailed narratives about its policies and operations, all to be made public.

Moreover, the IRS could require accreditation for the maintenance of tax-exempt status, and could contract out some of these powers to private accrediting entities. There is already deep concern on both sides of the political aisle that the IRS, despite denials, has had its auditing powers used for political purposes. Accreditation is an area where Congress must proceed with great caution. Accreditation by private organizations can be an excellent idea if voluntary and competitive, but mandatory and monolithic accreditation as a substitute for IRS oversight could stifle diversity while doing nothing to alleviate fears of misuse.

Of deep concern to many nonprofits is the proposal to scrap treating many non-cash donations at fair-market value and instead only count them at cost, which could drastically affect receipts. Perhaps most alarming is that the proposals actively discriminate against family foundations and many family members involved in such philanthropies. The proposals are hostile to meaningful family control, proposing severe limits on family-member compensation and dictating board composition. All of this would adversely affect the operation of many family foundations, important sources of charitable works, innovative funding and independent thought.

Families are also particularly critical to the creation of new engines of charitable giving: Donors either trust members of their family to share their vision and implement it, or see their family foundation as a vehicle for inculcating in their heirs a binding charitable ethic. Yet the Senate

proposals prefer "professional" control of foundations, further diluting the notion of original donor intent. How does this create incentives for donors to establish new philanthropies?

Private philanthropy is the organized expression of the highest of American ideals: the belief that Americans can create wealth, and then use it generously to establish organizations that act in good faith and have the wisdom, compassion and initiative to help others, without undue reliance on government. Naturally, all wrongdoers should be punished. But surely the enforcement of existing laws against self-dealing and abuse is a far better solution than the imposition of potentially prohibitive costs on every struggling nonprofit in America.

Ms. Higgins is a co-founder of the Alliance for Charitable Reform (www.ACreform.com[1]), a project of the Philanthropy Roundtable.

April 5, 2005

The Honorable Rick Santorum
511 Dirksen Senate Office Building
Washington, DC 20510-3804

Dear Senator Santorum:

The National Volunteer Fire Council (NVFC) is a non-profit membership association representing the interests of the more than 800,000 members of America's volunteer fire, EMS, and rescue services. On behalf of our membership, I am writing in reference to possible Senate action to increase federal government oversight and regulation of the non-profit sector.

As you know, of the nation's more than 30,000 fire departments, 88% are mostly volunteer or all volunteer. Most of these organizations have non-profit status and will be affected by any legislation you consider that would overhaul regulations on charitable organizations.

While we strongly condemn any organization, non-profit or otherwise, that tries to skirt the law, we urge the Congress and the Internal Revenue Service to show restraint in dealing with this issue. We are concerned that too large of an increase in IRS regulations may overburden small volunteer fire departments and the rest of the 80% of non-profits who have annual expenditures of less than $1 million. Congress needs to strike a balance that will weed out criminals without creating new bureaucratic regulations that have no clear public benefit.

In addition, many volunteer fire departments lack any members who have expertise on tax issues as well as the funds to hire a tax professional. We believe that instead of increasing fines on these small organizations, the federal government should look at ways to provide assistance to non-profits to help them comply with existing law.

We thank you for your continued leadership and support of America's volunteer fire and emergency services. If you or your staff have any questions please feel free to contact Craig Sharman, NVFC Director of Government Relations at (202) 887-5700.

Sincerely,

Philip C. Stittleburg
Chairman

PREPARED STATEMENT OF GEORGE K. YIN

Mr. Chairman, Ranking Member Baucus, members of the committee, I am pleased to testify today about the exempt organization proposals in the recent Joint Committee on Taxation staff report on "Options to Improve Tax Compliance and Reform Tax Expenditures."[1] As you know, the report was in response to a request of the Chairman and Ranking Member.

In the report, the staff offered a range of proposals to address many potential causes of noncompliance in the tax system. In my testimony today, I will describe only the proposals involving the tax-exempt sector, particularly the charitable sector. I will first discuss proposals dealing with charitable contributions and then turn to those concerning the operation of exempt organizations.

[1] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS–02–05), January 27, 2005.

NONCOMPLIANCE IN CHARITABLE CONTRIBUTIONS

In the case of charitable contributions, the report focuses on the most significant area of potential noncompliance, namely the valuation of noncash charitable contributions.

Under present law, taxpayers are entitled to deduct the fair market value of most charitable contributions of capital gain property to a public charity. When property value is uncertain, this rule presents compliance burdens for the taxpayer, noncompliance opportunities, and law enforcement difficulties. Challenging taxpayer valuations is a very resource-intensive task for the IRS. Even a preliminary determination that the amount of a deduction may be questionable requires an up-front commitment of resources. If a serious challenge is to be made, more resources are needed to secure alternate appraisals and expert opinions. The less likely the threat of enforcement, the more likely is the possibility of overvaluation and noncompliance. Adding to the problem is the fact that the interests of the donor and donee are generally aligned because each wants to see the gift completed. Thus, each party has a reason to give the value claimed by the donor the benefit of the doubt.

The staff report contains several options intended to improve compliance for charitable contributions of property. The report does not propose changing the current law rules with respect to cash gifts or gifts of publicly traded securities, which do not present valuation concerns.

General treatment of contributions of appreciated property

First, in general, for contributions of appreciated property, the report proposes that the charitable deduction be equal to the taxpayer's basis in the property. This is the present-law rule for contributions to most private foundations as well as contributions of certain property to public charities. In most cases, basis is a more certain amount than fair market value and subject to easier proof by the taxpayer and verification by the IRS. Thus, this option could be expected to improve compliance, reduce burdens and disputes, and lessen the amount of IRS enforcement effort. It would also eliminate the greater tax preference under current law provided to these types of property gifts than to contributions of cash.

As an alternative, the report suggests that a basis deduction might apply only to taxpayers contributing property unrelated to the charity's exempt function. Under this alternative, for example, a taxpayer could still deduct the fair market value of an appreciated gemstone given to a natural history museum, but could deduct only the basis of appreciated closely held company stock or real estate contributed to the museum.

Used clothing and household items

The general treatment of gifts of property just discussed would not be helpful for gifts that have depreciated in value, such as used clothing and household items. In such cases, the deduction is limited to the value of the property. Thus, a determination of value is still necessary.

Congress faced this same challenge last year in adopting rules for the donation of vehicles. Before the new rules, vehicles, like clothing and household items, were deductible at their fair market value at the time of the gift. Under the new rules, a taxpayer generally is not allowed any deduction for a contribution of a vehicle until the item is sold by the charity, at which point the sales price provides an indication of the proper amount of deduction. However, this solution obviously would not be feasible for the many thousands of items of used clothing and other household goods given to charities each year.

The relatively small value of any item of clothing or household goods makes it unlikely that the IRS challenges many of these deductions, leaving taxpayers with significant flexibility in valuing such gifts. Moreover, taxpayers may have a natural tendency to overvalue such items due to the attachment they have to the item.

Because this situation is vulnerable to error and noncompliance, the report proposes that at a minimum, the potential amount of error should be capped. Thus, the report suggests limiting the deduction for gifts of clothing and household goods to $500. This option has sometimes been mischaracterized as granting taxpayers an automatic $500 deduction with no questions asked. In fact, all of the current-law substantiation requirements would continue to apply in order for the deduction to be available; the proposal simply limits the deduction to no more than $500 each year.

Conservation easements

Unlike clothing and household items, the value of a conservation easement generally exceeds the taxpayer's basis in the easement. Yet a rule limiting the charitable deduction to the taxpayer's basis in the easement is of no help in easing the

potential noncompliance problem because in most cases, the taxpayer's basis in the easement will depend upon a determination of the fair market value of the property interest. Thus, if a deduction is to be allowed for conservation easements, a determination of value is again necessary.

For several reasons, determining the value of conservation easements may be even more difficult than in the general case. First, the value of the interest given away is a function of the contract terms crafted by the donor, and will vary from case to case. There may be few, if any, comparables to help determine value. Second, conservation easements constitute only a partial interest in the property rights held by the taxpayer. As difficult as it may be to determine if I have correctly valued the old shirt I give to a charity, at least the charity owns it and I do not. How much more difficult would the value determination be if I retained substantial rights to the shirt after contributing it to the charity? Third, in many cases, taxpayers who make these contributions are already subject to significant State and local restrictions on the use of their property. Such restrictions vary considerably from jurisdiction to jurisdiction and would have to be taken into account in valuing the easement.

Because these valuation difficulties present the greatest challenge in the case of conservation easements placed on property used by the taxpayer as a personal residence, the report proposes that no deduction be allowed for such contributions. For gifts of easements placed on other historic structures, the report proposes a deduction equal to the lesser of 5 percent of the fair market value of the structure or 33 percent of the value of the easement. For all other gifts of conservation easements, the deduction would be limited to 33 percent of the value of the easement. Moreover, the gift must be pursuant to some clearly articulated Federal, State, or local government policy in favor of the conservation objective. The report also proposes heightened appraisal standards and requirements in the case of these contributions.

NONCOMPLIANCE IN EXEMPT ORGANIZATION OPERATIONS

The second broad category of noncompliance in the exempt organization area is in the operation of the organization. An organization that is granted exemption from Federal income tax warrants exemption not as a matter of right but as one of privilege. To maintain exemption on an ongoing basis, organizations are required always to conduct their operations in a manner that is consistent with the basis for exemption. To the extent an organization deviates from its mission, there is noncompliance.

Five-year review

Under present law, charitable organizations are required to obtain a determination from the IRS that they are tax-exempt as a charitable organization, and thus eligible to receive deductible contributions. Typically, organizations apply for charitable status shortly after they are formed, and the IRS generally must make its determination of such status based on statements of intent by the organization. However, once charitable status is granted, it rarely is revoked. Yet organizations may change and grow significantly over time, sometimes in ways inconsistent with their exemption. There is no mechanism in present law requiring a periodic review of the basis for an organization's charitable status.

The report proposes that, every 5 years, charitable organizations (other than churches) file with the IRS information that would enable the IRS to determine whether the organization continues to be organized and operated exclusively for exempt purposes. The proposal applies to new organizations and organizations receiving charitable status within 10 years of enactment of the proposal. The filing would be done electronically, perhaps as a schedule to the current information return, and be made publicly available to encourage improved oversight of the sector by both the public and by State officials. The IRS would not be required to take action or make any determination with respect to a 5-year review filing, but would have the discretion to review any filing and could revoke tax-exempt status retroactively or prospectively, as warranted by the facts and circumstances.

As described in more detail in the report, the information to be filed as part of a 5-year review filing would include a narrative about the organization's prior, current, and contemplated operations and practices; a description of the prior, current, and contemplated trade or business activities of the organization and whether and how such activities are related to the organization's exempt purposes; a summary of the organization's compensation of management and senior employees for the previous 5-year period; a description of related-party transactions over the previous 5-year period; a description of the organization's material changes during the prior 5-year period; and such additional information as the IRS may require. Private nonop-

erating foundations would be required to show how much of the foundation's required payout was made up of administrative expenses.

Termination tax on public charities

Related to the issue of an organization's ongoing basis for tax exemption is the effect of a public charity's dissolution, acquisition by a for-profit company, and other change of ownership or control. Federal tax law requires that, upon dissolution, the charitable assets of the organization continue to be dedicated to charitable purposes. Yet there is no Federal enforcement mechanism of this requirement in the case of public charities. In contrast, upon their termination, private foundations generally are subject to a tax equal to the amount of the aggregate tax benefit received by the foundation over time (not to exceed the net asset value of the foundation), unless their assets are dedicated to charitable purposes.

As an example of this issue, a charitable nonprofit hospital may be acquired by a for-profit hospital, thus terminating the nonprofit hospital's charitable status. In this case, the "dedication to charity" requirement of present law means that the Federal Government has an interest in ensuring that a fair price is paid for the nonprofit hospital, and that the proceeds from the transaction be dedicated to charitable purposes.

In order to provide the Federal Government with a means to enforce the "dedication to charity" requirement, the report proposes a termination tax on liquidations or conversions of a public charity. The tax would also apply to private foundation terminations, and differs from the present-law termination tax principally in that the tax would be based on the net asset value of the charity and not on the aggregate tax benefit. The tax could not be recovered against assets held by the charity for charitable purposes. The proposal also would impose the present-law excess benefit transaction rules to conversions of a public charity if, after the conversion, insiders of the public charity are also insiders of the newly converted entity. This is intended to ensure that, when insiders are involved in the acquisition of a charitable organization, the acquisition is subject to the present-law rules that tax abusive insider transactions.

Exempt organization involvement in tax shelters

One of the primary compliance concerns in tax law today is abusive tax shelters. The increasing involvement of exempt organizations as accommodation parties in tax shelter transactions is a growing concern. Such transactions contribute to the erosion of the tax base by improperly extending the benefit of tax exemption to nonexempt persons. Tax shelters involving exempt organizations also raise questions about whether the facilitation of tax avoidance by an exempt organization can be consistent with the basis for tax exemption. Although recent legislation addressed many tax shelter abuses, such legislation does not prevent certain abuses that might be perpetrated using exempt organizations.

The report provides for an excise tax on the participation by any exempt organization (not just charitable organizations) in a transaction that the Treasury Department determines is a listed transaction, or a reportable transaction that is a confidential transaction or one with contractual protection. Under the proposal, if an exempt organization participates in such a transaction, knowing or with reason to know that the transaction is "prohibited," the entity is subject to a tax of 100 percent of the entity's net income attributable to the transaction. If the exempt entity is eligible to receive deductible contributions, the Treasury Department may suspend eligibility for 1 year. The entity-level tax does not apply to certain pension plans and similar tax-favored accounts. An excise tax would also apply to the entity managers that approved the entity's participation in the transaction.

The proposal also addresses the case in which an exempt organization participates in a transaction that is later determined by the Treasury Department to be a prohibited tax shelter transaction. Because the exempt entity did not know at the time it entered into the transaction that it would later be prohibited, taxing all of the entity's net income attributable to the transaction may not be appropriate. However, the proposal would impose an excise tax at the UBIT rate on the exempt organization's net income from the transaction after it has learned that the transaction is prohibited. There also are obligations to disclose involvement in such transactions.

OTHER PROPOSALS

I will briefly touch on the other exempt organization proposals in the report.

Private foundation excise tax rates.—As you know, private foundations are subject to a special set of restrictions and excise taxes that do not apply to public charities. The excise taxes apply to acts of self-dealing, failure to meet the mandated payout, excess business holdings, jeopardizing business investments, and taxable expendi-

tures. The tax rates on the initial taxes have not been revisited since their enactment in 1969. The report proposes a doubling of the present law initial rates of tax.

Intermediate sanctions.—Public charities are subject to excise taxes on so-called "excess benefit transactions" between the organization and an insider of the organization. This regime was enacted to provide a sanction short of revocation of exemption for abusive self-dealing transactions by public charities. The report concludes that the sanction would be more effective if certain changes are made. For example, present law provides organization insiders with a presumption that a transaction is reasonable if certain steps are taken. The report recommends eliminating the presumption of reasonableness because it unnecessarily gives the taxpayer a procedural advantage on a matter that already is difficult to enforce. The report also suggests modifying the "initial contract exception" so that the sanctions apply to a contract by an organization with a person who is contracting for a position of substantial influence within the organization.

Form 990–T.—The report suggests that the Form 990–T, which exempt organizations file to report unrelated business taxable income, be made public, so as to provide the public with a better picture of an organization's business activities. The report also proposes that large exempt organizations obtain a certification from an independent auditor or counsel regarding the organization's reporting of the unrelated business income tax.

Other proposals.—The report contains proposals that (1) require small charitable organizations to file short annual returns, (2) expand the base of the tax on the net investment income of private foundations, (3) limit the tax-exempt status of fraternal beneficiary societies that provide commercial type insurance, and (4) establish additional exemption standards for credit counseling organizations.

We will continue to examine compliance issues in the exempt organizations area and give consideration to possible additional proposals beyond those contained in the report.

Thank you very much for this opportunity to testify.

RESPONSE TO A QUESTION FROM SENATOR LINCOLN

Question: Mr. Yin, to the extent that abuse in the charitable world is leading to this tax gap in terms of missed revenue, which baseline is the abuse affecting the most? Are most of the people seeking to avoid estate taxes through trust arrangements or are they seeking more income tax evasion? Do you have any estimates as to where we are losing the money and the breakdown of how much we are losing to each of those baselines?

Answer: The "tax gap," *i.e.,* the difference between what taxpayers owe and what taxpayers voluntarily pay on a timely basis, is comprised of three components: (1) underreporting of taxes; (2) underpayment of taxes; and (3) non-filing of returns. Underreporting of taxes is the largest component of the tax gap, accounting for more than 80 percent of the total. Underreporting of income by individuals is the largest subcomponent of underreporting, representing approximately half of the total tax gap. Such understatement by individuals results not only from excluding income from a return or underreporting income on a return, but also from taking improper deductions (including charitable deductions), overstating business expenses, and erroneously claiming credits.

In my testimony, I stated that valuation of contributed assets is the most significant area of potential noncompliance in charitable contributions. I believe that misstatements of value in claiming income tax charitable deductions have a far greater effect on the tax gap than misstatements of value in claiming estate tax charitable deductions. Where a taxpayer overstates the value of a donated asset in claiming an income tax charitable deduction, such overstatement generally results in an understatement of the taxpayer's tax liability by reducing the taxable income reported on the taxpayer's return. An overstatement of the income tax charitable deduction could occur, for example, in the context of an outright transfer of an asset (other than cash) to charity or through a transfer of such an asset to a split-interest trust. In contrast, if the value of an asset is misstated for purposes of claiming an estate tax charitable deduction, the misstatement generally will not affect the estate tax liability. This is because the effect of the estate tax charitable deduction generally is to offset the entire value of the contributed asset, thereby removing the asset from the taxable estate. However, where an estate tax charitable deduction is claimed improperly, the improper deduction could increase the tax gap. For example, in the case of a transfer to a defective charitable trust, an estate might claim a charitable deduction to which it is not entitled, resulting in an understatement of estate tax liability.

IRS estimates of the tax gap support a conclusion that abuse in claiming estate tax charitable deductions accounts for only a small portion of the total tax gap. Indeed, such estimates show that all underreporting of estate taxes—not limited to underreporting relating to charitable contributions—accounts for less than 1 percent of the total tax gap.

Although we believe that abuses in claiming income tax charitable deductions account for a greater portion of the tax gap than abuses in claiming estate tax charitable deductions, we do not have estimates of the portion of the total tax gap attributable to such abuses. The IRS estimates that the portion of the tax gap attributable to individual income tax deductions is between $15 billion and $18 billion. Commissioner Everson testified that income tax charitable deductions account for a portion of this $15 billion to $18 billion estimate, but he stated that more specific figures will not be available until the IRS conducts additional statistical analysis.

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: Anecdotal information and media reports indicate wrongdoing and questionable activities of a few organizations. How widespread do you believe these problems to be?

Answer: In general, the proposals in the Joint Committee on Taxation staff report are directed toward two types of noncompliance in the exempt organization area: noncompliance with exempt status rules and noncompliance with charitable contribution deduction rules.

With respect to the first type, noncompliance occurs when an exempt organization acts in a manner that is inconsistent with the basis for the organization's exemption from Federal income tax. This type of noncompliance can occur in a variety of ways, and may implicate rules regarding revocation of tax-exempt status (due, for example, to operation for a nonexempt purpose, private inurement, private benefit, substantial lobbying activity, or political activity), the unrelated business income tax, intermediate sanctions, or any of the specific rules applicable to private foundations. The second type of noncompliance occurs in the context of a charitable contribution of property for which a fair market value deduction is available, if the amount of deduction claimed by the taxpayer is not in fact the fair market value. Several recent investigations and reports have identified both types of compliance problems associated with certain activities and organizations (*see* answer to next question for references).

The Joint Committee staff has not conducted an independent assessment of how widespread particular forms of noncompliance in the exempt organization sector may be. Rather, the staff proposals in this area primarily derived from an analysis of the noncompliance opportunities created by present law. It general, noncompliance is exacerbated by legal tests that rely upon difficult factual determinations. Thus, for example, ensuring compliance in the context of charitable contributions of certain types of property is difficult because enforcing the law requires the Internl Revenue Service ("IRS") to make a factual determination about the value of a specific item of property. Whenever enforcement of the law depends upon such determinations, there are significant opportunities for noncompliance.

The staff proposals also took account of the limited amount of enforcement resources available to the IRS. For example, the staff concluded that the current annual information return does not provide information sufficient for the IRS to make a determination that a charitable organization continues to be operated exclusively for a charitable purpose, and that a procedure should exist that requires organizations to file every 5 years information with the IRS that is explicitly directed to the organization's continuing basis for tax exemption. By providing more useful and current information to the IRS, the proposals should improve compliance levels even without any change in IRS resources committed to that effort.

Question: Do you know of any credible studies assessing exempt organization compliance?

Answer: We have not found a comprehensive study assessing compliance by all types of exempt organizations There are a number of reports on particular abuses or practices within the sector. *See, for example,* Marion R. Fremont-Smith and Andras Kosaras, "Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002," The Exempt Organization Tax Review 25 (October 2003); Marion R. Fremont-Smith, "Pillaging of Charitable Assets: Embezzlement and Fraud," 2004 Tax Notes Today, 247–29 (December 23, 2004); Christine Ahn, Pablo Eisenberg and Channapha Khamvongsa, "Foundation Trustee Fees: Use and Abuse, The Center for Public and Nonprofit Leadership," Georgetown Public Policy Institute (September 2003). In April 2002, the General Accounting Office prepared a report: "Tax Exempt Organizations: Improvements Possible in Public, IRS, and State

Oversight of Charities," (GAO–02–526), which provides a helpful overview of some compliance issues. The Exempt Organization ("EO") function within the IRS established in 2004 an EO Compliance Unit that you may want to contact about compliance information within the sector. The Treasury Inspector General for Tax Administration released an audit report in December 2004 titled "The Exempt Organizations Function's Market Segement Approach Needs Further Development" (2005–10–020), which may provide some insight to how the IRS is addressing compliance issues.

Question: How can Congress determine the size and scope of the noncompliance problem in this sector?

Answer: In general, a systematic audit program for exempt organizations would be the best means of assessing the extent of compliance within the sector, provided results of the audits are maintained in a centralized database. To assess compliance with respect to donations for charitable giving, this effort would ideally include the linking of data on property received and sold by exempt organizations to the corresponding individual donor's tax return. The EO compliance unit established in 2004 is a crucial first step in such a study. Providing for additional funding to include a research component for this initiative within the IRS, and a significant increase in audits, could result in a better overall assessment of compliance within the exempt organization sector.

Measures that foster and impove disclosure of information about exempt organizations would aid Congress, the States, and the general public in assessing the amount of noncompliance, and improve enforcement of the law. For example, encouraging increased electronic filing of information returns and substantial revisions to the principal information return (Form 990) should result in more accurate and accessible information about exempt organizations. In addition, the Joint Committee staff report proposed the public disclosure of the tax return filed by exempt organizations to report their unrelated business income (Form 990–T) , which would provide the public with a clearer picture of an organization's business activities that are not related to exempt purposes. The staff report also proposed that certain small organizations not currently required to file information returns with the IRS file each year a short form that confirms the organization's existence and provides contact information, so that the IRS and the public have updated information about small organizations. The staff proposal (mentioned above) to require section 501(c)(3) organizations to disclose additional information every 5 years with the IRS also is directed to improving the quality of information about charitable organizations for compliance purposes.

COMMUNICATIONS

American Bankers Association
1120 Connecticut Ave., NW
Washington, DC 20036

We thank the Committee for this opportunity to express the views of the American Bankers Association (ABA) regarding the proposed abolition of Section 509 (a) supporting organizations. We would like to share the experiences of our member banks who serve as trustees for these types of trusts.

The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country. Nearly 2000 banking institutions offer trust and investment services to clients.

Type III Supporting Organizations, for which many of our members serve as trustees, perform many legitimate and valuable functions in support of public charities. Any legislation designed to address abuses in this area should be targeted to deal directly with identified abuses, and not impair or eliminate the valuable benefits these organizations provide.

Supporting organizations function in a complementary capacity to that of the supported organization insofar as supporting organizations allow donors an opportunity to provide measured and continuing support and guidance of a public charity. For example, one of our members - a typical large Midwest financial institution, which acts as corporate trustee for approximately 350 Type III Supporting Organizations - reports that 95% of these trusts made substantial annual contributions to local charities in 6 Midwestern states. (The other 5% was for large public charities.) The types of cultural, educational and religious organizations that benefited include children's homes, old age homes, hospitals, local hunger programs, food banks, Christmas gifts to needy children, shoes for children, churches, programs sponsored by YMCAs and

YWCAs and other types of family services programs. In 2004, these 350 supporting organizations distributed over $24 million to local charities to provide for programs and services that might not otherwise have been available to the communities.

Supporting organizations are part of an existing regime of checks and balances that permits a donor to support a charitable enterprise in a responsible way. There are multiple levels of reporting and oversight in place to regulate Type III Supporting Organizations. An extensive and longstanding body of trust law imposes strict fiduciary responsibility on trustees with respect to management, investments and distributions of trusts. Trusts are overseen by the Courts.

Another layer of oversight is current tax law. Type III Supporting Organizations are currently required to file a Form 990 annually. This requirement ensures transparency in that certain important information is provided to the government and is made available to the public.

As a further level of oversight, various state and federal regulatory agencies are in place when banks serve as trustee. To serve as trustee, banks must be chartered under state trust law or section 92(a) of the National Banking Act to provide trust services. As such, trustee banks are subject to federal and state fiduciary laws.

In addition, bank trust departments and trust companies are regularly examined by the banking regulators (The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, as well as the state supervisory agencies) for compliance with fiduciary standards and principles. These examinations occur every 12-18 months, or more often if deemed necessary. When examining a bank, the examiners look for compliance with banking laws and manuals, fiduciary standards and principles, and any other guidance, including compliance with tax laws.

With this type of oversight, the Committee should consider a targeted approach to any abuses that might be found. Our concern is that without the ability to provide support to public charities through the mediating influence of a supporting organization, many donors would reduce their support for important public charities.

For these reasons, we support a targeted approach to dealing with any abuses and oppose an outright abolition of supporting organizations. We offer the committee our assistance and cooperation in putting an end to any abusive practices identified in Type III Supporting Organizations.

April 6, 2005

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

To Whom It May Concern:

Please consider the suggestion to offer a tax deduction for community service work hours as we now have a tax deduction for charitable donations.

Sincerely,

Lois A. Bader , Executive Director Capital Area Literacy Coalition

Attachment: article

Capital Area Literacy Coalition
1028 E. Saginaw, Lansing, Michigan 48906-5518
(517) 485-4949 • Fax (517) 485-1924
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BOOK REVIEW

The End of Work by Jeremy Rifkin

G.P. Putnam Sons, NY 1995

By Lois Bader

Downsizing and re-engineering are terms we see with increasing frequency in the media. Almost daily we read that a company; city, state, or local government; hospital or other institution will be dismissing employees. In *The End of Work*, economist Jeremy Rifkin analyzes factors contributing to the decline of the labor force in the United States and throughout the world. While his belief that most displaced workers will have little hope for meaningful employment in our increasingly technological world is deeply disturbing, he does suggest that we can develop a new and better society in which we can share the benefits of increased productivity and leisure.

Current technological advances in computers and communication are affecting the middle, professional class. According to Rifkin, tens of millions of jobs will be threatened by the development of these technologies alone. Some argue that new technologies spawn new jobs. However, Rifkin counters, the new industries require far fewer people to operate them. We may have more engineers and computer scientists, but the total number will be quite small in comparison with the millions of clerical, retail, and wholesale workers being replaced. Minimum wages in the service fields are so low that workers need more than one of these jobs to support a family.

Streamlining the work force while increasing production has resulted in huge business profits. Not only has the stock market been yielding substantial gains for investors, but CEOs also have been awarded staggering sums. In April 1996, the *Wall Street Journal* published a special insert describing the salaries and perks of million dollar executives. Throughout his text, Jeremy Rifkin cites historical attempts to balance social and economic factors. When labor unions were strong, they demanded to share in company profits. By reducing the size of their work force through automation and moving their factories to developing nations, employers have been able to reduce employment costs. CEOs are being rewarded by their boards for using these strategies to be competitive and increase profits.

Marshall Loeb (Fortune, March 18, 1996) states that a big payoff from public service is the acquisition of valuable career skills.

Except for a small elite, the world Rifkin describes will be bleak and perhaps even can be described as evil and dangerous. Countries where the rich live in walled communities with armed guards while the poor barely survive are not safe or stable. However, Rifkin does offer hope in what he describes as the third sector (the other two sectors being business and government). By reducing the work week to 20 or 30 hours, more people can have meaningful employment and have more time to care for vulnerable individuals, as well as volunteer to improve the quality of life in their communities. Certainly, the United States has a history of entering into voluntary organizations that Alexis de Tocqueville found remarkable and perhaps essential in a democratic society.

A new social contract is needed if the civil sector is to make a better world through volunteering in their communities. Volunteers can find community work satisfying and creative. Marshall Loeb (*Fortune*, March 18, 1996) states that a big payoff from public service is the acquisition of valuable career skills. However, we need to improve funding for this sector. Rifkin suggests offering a tax deduction for civil sector work hours just as we now have a tax deduction for charitable donations. He adds that the business community must be challenged for more equitable distribution of productivity gains.

Jeremy Rifkin presents a convincing argument for all of us to become informed and involved in improving our communities and our world.■

Lois Bader is a professor at Michigan State University and executive director of the Capital Area Literacy Coalition.

Capital Region
community foundation℠
The Center for Charitable Giving

April 12, 2005

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

Re: April 5, 2005 Hearing on "Charities and Charitable Giving: Proposals for Reform"

Dear Committee Members:

I am writing to comment on one section of the Panel on the Nonprofit Sector's Interim Report, which lists the Panel's initial recommendations for strengthening the accountability of nonprofit organizations. Specifically, I am concerned about one recommendation concerning donor advised funds, which were mentioned during the hearing.

I strongly disagree with the rationale given in the Interim Report for prohibiting grants from a donor advised fund from satisfying a charitable pledge of the donor. The rationale given is that the funds belong to the charity that owns and administers the funds, and that permitting such grants would allow the use of charitable funds for private benefit.

First, I don't believe that such grants in any way interfere with the administering charity's ownership of the funds. The charity can still refuse to follow the donor's recommendation, especially if it believes that the grant would not be in the public's best interest. The donor is informed that this is the case when the fund is established. Furthermore, it is clear that the donor cannot legally bind the administering charity by making a pledge. If the donor makes a pledge, the donor is the only one bound by it, and if the administering charity decides not to follow the donor's recommendation, the donor is the only one obligated to fulfill the pledge.

Second, donor advised grants that happen to satisfy pledges the donor has personally made do not result in the type of "personal benefit" that we are worried about. The only personal benefit the donor receives is convenience in the manner of giving, not some type of wrongful enrichment. By prohibiting such grants, you will merely take away some flexibility in how a donor can make charitable gifts, which will have the effect of reducing charitable giving.

6035 Executive Drive • Suite 104 • Lansing, MI 48911
517-272-2870 • Fax 517-272-2871 • www.crcfoundation.org

Third, other proposed rules – such as the prohibition on using donor advised funds to reimburse or make grants to donors/advisors, or prohibiting such funds from paying for tickets to charitable events (where the donor/attendee receives an actual benefit) – will address the "personal benefit" problem. Thus, as a practical matter, this proposed rule is unnecessary, and would simply discourage donors from using donor advised funds. Donors will instead either give gifts directly to the designated charities, or not give at all. I fail to see why we should deny a donor the flexibility of giving via a donor advised fund that offers him/her an easier way to distribute gifts to several charities as a result of a transfer of stock or other property, or to distribute the proceeds of a large gift over time, etc. The money is still coming from the donor and will end up in the same place. The other proposed rules – with which I agree – will take care of potential abuses.

I have one final comment. Whichever way this issue is decided, it would be helpful to have the matter clarified through statute or regulation. Although many community foundations state that the IRS prohibits donor advised grants that satisfy personal pledges, I am unaware of any actual rule or regulation to that effect, and I have had donors challenge the alleged prohibition because of that lack of clear authority on the subject. Also, if donor advised grants are permitted to satisfy personal pledges, it would be important to have the tax laws state that the amount of such a grant will not constitute income to the donor (as satisfaction of a debt). Such a rule is justified because, in reality, the money originates with the donor, and is not coming from some unrelated source.

I agree with the Committee staff's proposal to permit donor-advised funds to satisfy a donor's charitable pledge. Such an approach is eminently reasonable. Thank you for your consideration of my views.

Sincerely,

Dennis W. Fliehman
President

center for nonprofit
advancement

STRENGTHENING NONPROFITS IN GREATER WASHINGTON 1666 K Street, NW, Suite 440, Washington, DC 20006 T 202 457 0540 F 202 457 0549
nonprofitadvancement.org EDUCATION • NETWORKING • ADVOCACY • BUYING POWER

Nonprofit Oversight and Accountability: Supporting the Critical Work of the Charitable Sector

The Center for Nonprofit Advancement represents a network of over 1100 nonprofits serving the entire metropolitan region of Washington area residents. This is the largest and most experienced organization in the Washington Metropolitan area providing education, networking, advocacy and buying power to nonprofits. As such, the Center for Nonprofit Advancement *supports accountability and smart regulation that promotes the effectiveness of nonprofits, and opposes inappropriate regulation that hinders the ability of nonprofits to serve their constituents.*

We encourage Congress to promote the following:

1. Support for Capacity Building

The Center for Nonprofit Advancement strongly supports the authorization of $10 million towards nonprofit capacity building proposed in the Senate Finance Committee's 2004 white paper. Nonprofit organizations deliver government programs and provide services in government's absence. As such, government is rightly concerned with nonprofit accountability and effectiveness. Nonprofit capacity is a natural area for nonprofit and government partnership. Many nonprofit infrastructure and support organizations have answered the call for accountability and capacity building by developing best practices, training, and certification programs. Government support in this area is much needed, and could help to increase the development and reach of such programs. Current government support for nonprofit effectiveness is miniscule when compared with spending for the development of the private sector or the efficiency of government-run programs. We believe that the Small Business Administration provides an effective model for how government can support the development and capacity of the nonprofit sector.

2. Reporting Reform and Simplification

- The Center for Nonprofit Advancement welcomes a comprehensive discussion of the goals and procedures of the IRS Form 990. Specifically, the Center for Nonprofit Advancement supports; a requirement that the CEO sign an organization's Form 990; the phasing in of electronic filing procedures, *as long as efforts do not cause undo hardship to small nonprofit organizations and support and training is provided to them to comply*; the development and distribution of comprehensive directions and adequate training for filing Form 990 that are consistent with uniform charts of accounts and financial reporting requirements. Directions for filing Form 990 are critical as many filing irregularities are due to a lack of education and understanding.
- The Center for Nonprofit Advancement supports the "H" election and the elimination of the distinctions between grassroots and direct lobbying. Currently, organizations may elect an "expenditure test" that clarifies lobbying limits, but organizations must distinguish between direct and grassroots lobbying. This distinction is arbitrary and confusing for nonprofits. The Joint Committee on Taxation has stated that there is no reason for the distinction.
- The Center for Nonprofit Advancement recommends full disclosure and transparency of all financial transactions involving voting board members or other disqualified persons such as family members of board or staff, trustees, and major donors. Details of board members or other disqualified persons involved with transactions $1,000 or more should be reported in full on the Form 990. In addition, The Center for Nonprofit Advancement strongly recommends that all charities establish and enforce conflict of interest policies.
- The Center for Nonprofit Advancement supports an annual audit requirement for organizations with annual revenue of more than $500,000, with revenue indexed for inflation. Audit threshold requirements are currently set at the state level and vary widely. A national standard will help to ensure ethical financial practices, improve accounting and reporting methods, and present a more accurate picture of an organization than the Form 990 alone.
- The Center for Nonprofit Advancement supports a non-onerous five-year review for nonprofit organizations that do not meet the revenue threshold of $25,000 required to file IRS Form 990. Such a review would allow these groups to be accountable to the public, provide a more accurate count of existing nonprofits, and discourage non-reporting organizations from expanding operations to include programs that are not appropriate for tax-exempt organizations. Such a review would be duplicative for those organizations that already file the IRS Form 990.
- The Center for Nonprofit Advancement supports placing hospitals, colleges, universities and research institutions in a designation separate from general charitable organizations, that more closely reflects their make up and operating budgets.

3. Effective Enforcement

The Center for Nonprofit Advancement supports appropriate authority and funding for the enforcement of regulations and laws governing nonprofits in order to ensure effective and efficient enforcement. Specifically, The Center for Nonprofit Advancement recommends granting state regulators and the IRS the ability to share information across jurisdictions and adequately funding the IRS and state regulators. The Center for Nonprofit Advancement recommends that the private foundation excise tax be used to fund the enforcement of regulations on the nonprofit sector. Attention to and adequate funding of enforcement would go much farther toward ensuring nonprofit compliance with existing laws and regulations. Solicitation by the nonprofit sector is already regulated by the states, standard enforcement would help but new laws are not needed.

Issues that do not warrant bureaucratic intrusion:

1. Inappropriate Regulations on Best Practices and Governance

- The Center for Nonprofit Advancement opposes legislating best practices or accreditation because such legislation would stifle innovation and would be impossible to implement fairly, cost efficiently, and reasonably. Experience has shown meaningful best practices and accreditation programs to be time consuming and expensive. Many small organizations do not have access to such programs due to lack of resources or proximity; penalizing such groups for lack of access raises serious fairness concerns. Nonprofits like businesses are licensed by their home states
- The Center for Nonprofit Advancement also opposes regulation of board duties and size as it could hamper productivity, efficiency, and innovation. Well-managed organizations are diverse in their management structure and often rely on board involvement in program and administrative committees. Board duties, like best practices, require education not legislation.

2. Burdensome and Inappropriate Use of Fees

- The Center for Nonprofit Advancement opposes punitive federal fees on small nonprofits with annual revenues of less than $500,000. Complying with accountability regulations is costly. While small nonprofits should comply with regulations, such as a requirement that an organization's CEO sign the IRS Form 990, small and grassroots organizations should have options other than fines and federal fees as remedy for infractions.
- The Center for Nonprofit Advancement opposes allocating penalties and fees imposed on nonprofits to fund the enforcement of the nonprofit sector because of potential conflict of interests. We would warn against a situation where enforcers have incentive to impose additional penalties on nonprofits in order to increase the enforcement budget.

3. Meaningless and Damaging Reporting

- The Center for Nonprofit Advancement opposes reporting rendered meaningless by subjectivity, such as the proposed reporting of performance goals in Form 990. Necessary information is currently reported in the Form 990 and such subjective language would not increase transparency.
- The Center for Nonprofit Advancement opposes public disclosure of the IRS Form 990-T. Many nonprofits legally and ethically engage in social enterprise ventures in order to sustain operations. For-profits are not required to share their tax documents with anyone other than the IRS.

For further information contact Lee Mason, Director of Public Policy and Community Relations at 202.57.0540. leem@nonprofitadvancement.org

Chapman Charitable Trusts

Written Testimony on

"Charities and Charitable Giving: Proposals for Reform"

Submitted to

United States Senate
Committee on Finance

by

Chapman Trustees
Sharon J. Bell and Bank of Oklahoma, N.A.,

April 4, 2005

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The Chapman Trust Complex: "A Type III Success Story"

Introduction

This testimony is submitted by Sharon J. Bell and Bank of Oklahoma, N.A. in their capacities as trustees of twelve trusts (collectively referred to as the "Chapman trusts") organized and operated as Type III supporting organizations under IRC §509(a)(3) and the corresponding regulations thereto. This testimony is intended to dispel the myth heralded by a zealous minority that Type III supporting organizations are deceitfully devised tax avoidance vehicles devoid of any legitimate purposes, which should be indiscriminately eliminated. This testimony provides a review of a successful Type III with over 55 years of history, highlights a myriad of legitimate purposes for which Type IIIs were originally created, and offers targeted reform alternatives which specifically address each of the Committee's concerns. It should be noted from the outset that none of the twelve trusts within the Chapman trust complex have ever participated in or served as accommodating parties for any of the abuses targeted by the Committee. Further, the Chapman trustees acknowledge that there have been instances of abuse involving Type IIIs which should be eliminated and applaud the committee's efforts toward achieving that end.

Background

The Chapman trusts were established by the J. A. and Leta Chapman Family over a 30 year period beginning in 1949. Each trust was created to provide perpetual financial support to the named beneficiaries. The trusts serve sixteen charitable beneficiaries located in Oklahoma, Texas, and Arkansas including:

- The University of Tulsa– Tulsa, Oklahoma;
- Trinity University– San Antonio, Texas;
- Southern Methodist University– Dallas, Texas;
- John Brown University– Siloam Springs, Arkansas;
- St. Mary' Hall– San Antonio, Texas;
- Holland Hall School– Tulsa, Oklahoma;
- St. John Medical Center– Tulsa, Oklahoma;
- * Hillcrest Medical Center– Tulsa, Oklahoma;
- * Children's Medical Center– Tulsa, Oklahoma;
- Oklahoma Medical Research Foundation– Oklahoma City, Oklahoma;
- Southwest Biomedical Research Foundation– San Antonio, Texas;
- Tulsa Psychiatric Center--Tulsa, Oklahoma;
- Presbyterian Children's Homes & Services– Austin, Texas;
- Tulsa Area United Way– Tulsa, Oklahoma;
- Episcopal Diocese of Oklahoma– Oklahoma City, Oklahoma; and
- St. Simeon's Episcopal Home– Tulsa, Oklahoma.

(*The assets of Hillcrest Medical Center and its subsidiaries which includes Children's Medical Center were sold to Ardent Health Services a for-profit healthcare management company. As a result of the sale, Hillcrest Medical Center

and Children's Medical Center no longer qualify as trust beneficiaries.)

The approximate fair market value of trust assets as of March 2005 is $1.6 Billion. Over 93% of the trust assets consist of publicly traded securities. The remaining 6 to7% consists of residual real estate holdings leased to unaffiliated third-parties subject to triple net lease agreements, and both producing and non-producing oil and gas interests subject to royalty and non-operating working interest agreements. In 2004 the trust complex distributed in excess of $62 million. Motivated by changed dynamics of investment markets and facilitated by recent legislation, the trust complex currently distributes annually 4.5% of the average market value of trust assets during the preceding three year period without any reduction for operating costs. The trust complex has never paid out less than 100% of trust net income. Annual trustee fees for all administration and investment services are "38/100ths of 1%" of trust assets, substantially less than the "25/100ths of 1%" for administrative costs plus the "25-50/100ths of 1%" for investment services currently charged by most community foundations. Chapman trustees' fees have never been higher than 38 bases points.

Legitimate Purposes For Which Type IIIs Were Created

The Type III classification is preferred by some charitable donors for both tax and non-tax reasons. Classification as a supporting organization allows a trust or non-profit corporation to operate under the Internal Revenue Code provisions applicable to public charities. "Type III" is an industry term used to identify supporting organizations qualifying as public charities under the "operated in connection with" language of IRC §509(a)(3)(B) and corresponding Treas. Reg. §1.509(a)-(4)(i).

A. Tax Reasons: The easiest method of highlighting the tax reasons for organizing as Type III is to compare the tax treatment of public charities to the tax treatment of private foundations.

- Cash contributions to a public charity may be deducted up to 50% of the donor's adjusted gross income (AGI). Cash contributions to private foundations may deducted up to 30% of donor's AGI.

- Contributions of appreciated property, such as real estate or securities, to a public charity may be deducted up to 30% of the donor's AGI. The deduction is calculated using the fair market value of the appreciated property. Contributions of appreciated publicly traded securities to private foundations may be deducted up to 20% of donor's AGI. Contributions of appreciated closely-held securities to private foundations are valued using the donor's basis in the securities.

- Private foundations are subject to a 2% excise tax on net investment income (which includes realized capital gains). Public charities do not pay an excise tax which frees up additional money for distribution to the beneficiaries.

- The minimum annual payout requirement for public charities is 85% of net income. The

minimum annual payout for private foundations is 5% of trust assets. Currently operating costs of a private foundation are included in the 5% payout amount.

- The provisions governing private foundations are much more complex than provisions governing public charities, significantly increasing compliance/administrative costs for private foundations.

B. Non-tax Reasons: When properly enforced, the treasury regulations governing Type III supporting organizations create a relationship of mutual accountability between the "supporting" and the "supported" organizations. This relationship of mutual accountability, unique to Type IIIs, is attractive to many potential donors who want to safeguard against beneficiary abuse.

- Type IIIs are required to name each supported beneficiary in the trust document. This means each trust beneficiary has an equitable right in the trust assets as long as the trust and/or the beneficiary is in existence. Type IIIs can only support the named public charities. Private foundations are not required to name the beneficiaries in the trust document and may merely specify a broad purpose or mission to guide support decisions. Private foundations can support any organization they choose. Thus, it is often easier for trustees of a private foundation to deviate from the donor's original intent to support liberal/conservative causes that the donor might not have endorsed. Type IIIs are preferred over Type Is and Type IIs because Type IIIs can support multiple beneficiaries. Type Is and Type IIs can only support one named beneficiary.

- In order to ensure that the Type III is responsive to the needs and demands of the supported beneficiary, the Type III supporting organization must satisfy a "responsiveness" test. That test is typically satisfied by meeting the following requirements (a) to be organized as a charitable trust under State law; (b) to name each supported beneficiary in the trust instrument; and (c) the beneficiary must be able to enforce the trust instrument and to compel an accounting under state law.

- While Type IIIs are not required to make distributions to every named beneficiary every year, they are required to distribute an amount sufficient to ensure the "attentiveness" of at least one beneficiary to the operations of the Type III. The "attentiveness" requirement is satisfied by distributing an amount equal to or greater than 10% of one or more of the beneficiary's total support from all sources. Often it is difficult or impossible for a Type III that supports a large charity to satisfy this requirement. As a result the treasury regulations provide an alternative method of satisfying the "attentiveness" requirement. If the Type III provides the support necessary to fund a significant project or program to one or more of the named beneficiaries that the beneficiary would not otherwise be able to fund, then the attentiveness requirement is satisfied.

- In addition, the amount distributed by the Type III to an "attentive beneficiary" must be a "substantial amount" of the total support generated by the Type III. The IRS has defined "substantial amount" to equal or exceed 33-1/3% of the total support generated by the Type

III. Therefore 33-1/3% of total distributions from a Type III must be paid to at least one beneficiary every year to ensure attentiveness.

- Donors often desire perpetual financial support to their charities of choice. In other words, donors want to provide amounts of support that are both indexed for inflation and capable of growing as the scope of the charity's mission expands. Donors recognize that a perpetual stream of support indexed for inflation will provide the beneficiary with the long-term financial security and stability necessary for institutional success and longevity. Baseline financial support and security allow and encourage the supported organizations to develop long-term programs and funding strategies rather than continually fund-raising to meet immediate operating expenses. Thus, supported organizations are allowed to focus scarce time and resources toward a long-term institutional mission of service to the community without having to exist "hand to mouth." The fact that Type IIIs are not subject to a high minimum payout requirement increases the probability that the trust corpus will grow at a rate at least equal to inflation. The vast majority of distributions from the Chapman trusts are to organizations providing medical and educational services. The inflation rate within both industries far exceeds the Consumer Price Index. Providing perpetual support is also attractive to philanthropic donors who desire to stimulate positive public sentiment toward the family name indefinitely.

C. *Type IIIs allow donors to segregate management of the financial endowment from the operational management of the supported organization.*

- Many donors are understandably reluctant to give any organization complete control over a large charitable endowment which represents a lifetime of hard work and good decision-making. Donors of such gifts recognize that most charities, while worthy of support, lack the financial and investment skills necessary to oversee and administer large endowments. In such cases the donors select trusted professionals with the legal and investment skills necessary for effective and efficient management. Segregating the operational management of the Type III from the operational management of the beneficiary allows the donor to shield the endowment from beneficiary mismanagement and fiscal irresponsibility. Type Is require the supporting organization to be controlled by the supported organization. Type IIs require the supporting organizations to be operated by the supported organization. Thus, both Type Is and Type IIs are inadequate substitutes for Type IIIs.

- In a similar vein, many donors realize that the current success and achievement that makes a particular charity an attractive candidate for support results largely from the specialized skill or unique qualities of that charity's existing management team. Sophisticated donors recognize that a charity's management and even its mission will change over time. The Type III structure fosters an ongoing environment of mutual accountability and participation between the donor's representatives and the named beneficiary essential for a successful long-term partnership.

- Similarly, potential donors desire a means to protect against beneficiary disregard of donor intent. Frequently, a donor wants to direct or restrict an endowment to fund a specific

program or project. The donor's requests are typically followed during the donor's life and/or the tenure of existing management. But when the donor dies and/or beneficiary management changes, the donor's intent is often disregarded to fund a variety of causes that the donor would not have otherwise supported. Donors are aware that most fiduciaries stake their professional reputation on the exactitude with which they conduct the affairs of the client/donor. Prudent fiduciaries will not deviate from the donor's intent without prior court approval. Donors appreciate and often seek out this type of assurance. Moreover, if the donor's charitable objective is accomplished or becomes impractical, most donors prefer a disinterested advisor to identify alternative objectives that best reflect the donor's original purpose rather than officials from the benefitted charity.

Historic Partnership

Built upon a foundation of mutual respect and accountability, the Chapman trustees and the Chapman beneficiaries have forged a historic and successful partnership, providing essential services to the communities, and individuals of Oklahoma, Arkansas, and Texas. Representatives of the trustees actively serve on fourteen of the sixteen boards of the named beneficiaries. Active involvement by the trustees on the boards of the named beneficiaries enables the trustees to monitor and influence the beneficiary's use of the trust distributions to ensure the distributions are used for the donor's intended purposes. Board service also enables the trustee to assure effective use of the distributions and to respond immediately to address the pressing needs and concerns of the beneficiary.

For example, the trustees often work with the beneficiaries to launch capital campaigns, to fund capital projects, to create challenge grants, and to endow professional positions and student scholarships. The Chapman trusts' distributions have generated numerous faculty, scientific, and medical endowments at several of the beneficiary institutions. The Chapman trusts' distributions have also successfully funded numerous capital projects and improvements. The endowments, and successful capital campaigns have propelled the beneficiary institutions to national prominence.

The beneficiaries receive quarterly detailed investment and transaction statements as well as copies of the Form 990– Return of Organization Exempt from Tax. The trustees and beneficiaries meet regularly to review the trust performance, trustee fees, and trust distributions. These meetings afford the beneficiaries with the opportunity to apprise the trustees of their long-range objectives and allows both parties the opportunity to align those objectives to the trust's investment strategy. No financial information is withheld from the beneficiaries. No other public charity classification fosters this type of ongoing relationship with multiple beneficiaries.

During their collective existence the Chapman trusts have distributed in excess of $1.5 billion to the named beneficiaries. Achieving this remarkable milestone would have been virtually impossible if the trusts had been subject to the private foundation rules. One of the primary objectives of the Chapman family was to increase the level of support at a rate at least equal to the rate of inflation in order to protect the real purchasing power of those distributions to minimize beneficiary dependence on fluctuating government subsidies. This objective has been achieved, resulting in increased distributions to the beneficiaries. The size and quality of virtually all the

educational, medical and other institutions supported by the Chapman trusts have grown dramatically as a direct result of this partnership.

The single exception to the success of the trusts' beneficiaries validates an important non-tax purpose for the Type III structure. Recently, one of the beneficiary hospitals lost its financial struggle to survive and was sold to an out-of-state for-profit hospital management company. The hospital had traditionally been the single largest provider of indigent healthcare in one of the nation's largest metropolitan communities without a public hospital. Its conversion to a for-profit hospital reduced access to indigent healthcare, and shifted the financial burden to the remaining private hospitals in the community.

If the Chapman family had supported the hospital directly or through a Type I or Type II supporting organization, approximately $134 million of the Chapman endowment, much of which funded indigent healthcare, would have disappeared. Instead, the money was shielded from the beneficiary's fiscal problems by the Type III operating structure. The $134 million is currently being redirected to fund new healthcare initiatives and to serve as a catalyst for a comprehensive community-wide healthcare planning process. The new healthcare initiatives include underwriting the start-up costs of a 2-1-1 non-emergency call system; funding for cancer treatment and medication for indigent patients; funding for the purchase of advance radiology equipment for diagnosis of indigent outpatients; funding for bilingual training of healthcare professionals; funding for a new physician's assistant training program; and funding for an after hours indigent family healthcare clinic. These initiatives conform to the Chapman family objective of improving access to healthcare for the underprivileged. For a large metropolitan area without a public hospital, $134 million is an indispensable source of healthcare funding.

Targeted Reform Alternatives

Paramount to any consideration of logical reform is recognition by the Committee members that government regulation and oversight should focus on eliminating or minimizing specific opportunities for abuse rather than indiscriminately abolishing one particular tax classification. Reform and oversight should be directed at strengthening the financial and ethical integrity of non-profit organizations while minimizing government intrusion into the establishment and the organizational objectives of public charities. The following reform alternatives prohibit the abuses involving Type IIIs highlighted by the Committee and/or publicized by the media. However, without dedicated enforcement and oversight no reform can be expected to be effective.

A. Self-Dealing–

The Committee's staff discussion draft dated June 22, 2004, included a recommendation to eliminate all Type III supporting organizations. As sole support for this recommendation, the drafters cite an article in *The Chronicle of Philanthropy*, "Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts," February 5, 2004, which exposes an opportunity for abuse involving insider loans between donors and Type III supporting organizations. The donor receives a valuable charitable deduction for his contribution to the supporting organization, but, as a result of a loan back

from the supporting organization to the donor, the named beneficiary receives little or no support.

This type of abuse, as well as abuses involving lease-backs, sales or other exchanges between the supporting organization and insiders, can be eliminated by simply imposing the same strict prohibitions against self-dealing currently applicable to private foundations under IRC §4941(d), to all supporting organizations. The penalties should be increased for intentional violations and statutory protection provided for whistle blowers who report violations.

B. Minimum Payout/ Parking of Assets–

Nearly every instance of abuse involving Type IIIs has exploited the absence of a minimum payout requirement calculated as a percentage of trust assets. Presently, Type IIIs are required to payout "substantially all" of their income. The courts have defined "substantially all" to mean at least 85% of income. Type IIIs with assets such as car collections, artwork, closely-held stock, etc., which generate little or no income, distribute either a de minimis amount or nothing at all to the named beneficiaries. This glaring deficiency is an invitation for abuse. However this vulnerability can be negated by imposing a unitrust distribution requirement on Type IIIs.

The new minimum distribution requirement should resemble the following:

> *A Type III supporting organization shall distribute to the named beneficiaries annually from the net income and principal an amount exclusive of operating costs (the "minimum distribution amount") not less than the greater of the (i) net income as determined for accounting purposes or (ii) four percent (4%) of the average fair market value of trust assets as of year-end of the three (3) years preceding the year of the distribution.*

The minimum distribution requirement prevents the parking of assets. Fiduciaries charged with oversight of Type IIIs will be forced to either sell non-productive assets, diversify into productive assets and invest for total return to sustain the minimum distribution amount, or risk spend down. Either way the beneficiary is assured a reasonable distribution amount.

A minority in philanthropy believe supporting organizations and private foundations should be spent out of existence after a period of time. However, this philosophy is fatally flawed in two regards. First, it is contrary to the intent of donors that their endowments be used for perpetual financial support providing long-term financial security and stability to the named beneficiaries. Second, it ignores the reality of beneficiary mismanagement which is a legitimate concern of many donors. The overwhelming majority view the former as a noble intention, and the latter as a prudent concern, both of which should be considered by all charitable donors. Undeterred the minority often attempts to stir-up the beneficiary against the supporting organization by arguing that the distribution amount is insufficient, playing up the beneficiary's need for immediate support while disregarding the impact on its long-term financial security and stability. Thus, those in the minority will attempt to rachet-up the minimum distribution amount beyond a sustainable level.

In order for a public charity to provide perpetual financial support the corpus must be

protected from the erosive affects of inflation. Otherwise the real purchasing power of current dollars distributed cannot be preserved, and thus true trust perpetualness cannot be achieved. This problem can be avoided by adopting a reasonable minimum distribution rate such as the 4% rate proposed above, which maximizes the amount paid out currently while providing some assurance that the corpus will be allowed to grow at the rate of inflation.

Prior to 1994 the Chapman trusts generally distributed in excess of 5% of trust assets as a result of the trust's requirement to distribute annually 100% of trust net income. With the decline in interest rates and the shift in stock market from paying dividends to rewarding shareholders through stock appreciation, it became increasingly difficult for the trusts to maintain trust distributions. In order to adapt to both the changes in the market and in investment strategies, the Chapman trusts adopted a 4.5% payout rate calculated by averaging trust fair market value for the three year period starting with the current year end. Using a three year average smooths out the affects of market volatility.

Most objective studies based on reviews of actual historical market performance over a twenty-five year or longer period have concluded that payout rates in excess of 4 to 5% significantly decrease the probability of maintaining the purchasing power of current distributions. *Cambridge Associates, Inc.*, "Sustainable Payout of Foundations," Council of Michigan Foundations, April 2000; *DeMarche Associates*, "Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix," Prepared by Donald W. Trotter (1990) updated by Carter R. Harrison (1999), Washington D.C. Council on Foundations, (1999). At a 5% payout rate there is a 46% probability that the real value of current distributions can not be maintained. A well-reasoned distribution rate should provide a cushion to account for market volatility and thereby moderate year-to-year variance in distributions to beneficiaries. The Chapman trustees recommend a 4% minimum distribution rate.

C. Beneficiary Notification and Enhanced Reporting–

Many of the problems involving Type IIIs go undiscovered because the named beneficiary is unaware that it has been designated a beneficiary of the supporting organization. Thus the charity is unable to enforce is rights under State law or to insure responsive and prudent management by the Type III. This deficiency can be remedied by simply requiring beneficiary notification.

Acknowledgments signed by each of the named beneficiaries should be required as an attachment to every Form 1023 Application for Exemption submitted to the IRS and made available for public inspection. An application filed without such acknowledgments should be automatically rejected by the IRS.

A similar acknowledgment by each named beneficiary of receipt of the prior year Form 990 should be required as an attachment to the current Form 990 filed with IRS. This will ensure that every beneficiary is aware of its beneficiary status and ensure that is has been provided with basic financial information for the prior tax year.

The Form 990 should be enhanced to provide meaningful and useful information to both the

beneficiaries and to the IRS. The first page of the Form 990 should contain a "check the box" requirement for each charitable classification: Type I, Type II, Type III etc., enabling the IRS to quickly identify the entity type. This enhancement will allow the IRS to efficiently focus its audit resources and enforcement initiatives on areas of substantial abuse. In addition, the designation allows the named beneficiaries the opportunity to evaluate whether or not the supporting organization has satisfied the requirements for public charity status. In some instances beneficiaries may want to prompt an IRS audit of an organization involved in an abusive transaction.

At a minimum the following should be clearly stated on every Form 990:

1. *Fair Market Value of Trust Assets*
2. *Trust Earnings* (categorized as follows):
   - *(1) Interest and Dividends*
   - *(2) Rents and Royalties*
   - *(3) Realized Capital Gains and Losses*
   - *(4) Unrealized Gains and Losses*
   - *(5) Other Items of Income*
   - *(6) Total Realized Earnings*
3. *A Schedule of Fees and Expenses* (including but not limited to the following categories):
   - *(1) Trustee Fees by Trustee*
   - *(2) Salaries and Compensation in Excess of $100,000 Listed by Recipient*
   - *(3) Salaries and Compensation Paid to Members of Donor's Family by Recipient*
   - *(3) Total of all other Salaries and Compensation*
4. *Total Distributions*
   (Each category of earnings and expense and total distributions should be expressed both in terms of real dollars and as a percentage of total assets.)
5. *Investment Mix* (expressed both in real dollars and as a percentage of total assets)
6. *A List of all Non-Publicly Traded Securities*
7. *A List of all Alternative Investments*
   (The requirement to list every investment individually should be eliminated with exception of the 6 and 7 above.)

Conclusion

The trustees and beneficiaries of the Chapman trusts encourage the Senate Finance Committee to carefully consider the recommendations of the Independent Sector, American Bar Association's Tax Section, The Council of Foundations, the Philanthropy Roundtable and others who have unanimously opposed eliminating Type IIIs. In lieu of elimination, the Committee should propose legislation targeting actual abuses by Type IIIs and other exempt organizations. Each instance of abuse publicized by the media can be eliminated or significantly curbed through targeted reforms without penalizing Type IIIs, like Chapman trusts, operating within the original legislative intent underlying the creation of the Type IIIs.

If the private sector is to be increasingly relied upon to address the nation's social agenda, it is critical that any legislation balance the need to strengthen the integrity of the tax exempt sector with the need to encourage charitable giving by permitting organizational structures which provide donors with the assurance of objective and independent management. Finally, elimination of Type IIIs should not be promoted under the rhetoric of reform if in reality they are being targeted as a source of additional federal revenue.

United States Senate Committee on Finance
April 5, 2005 Hearing on
Charities and Charitable Giving: Proposals for Reform

Presented by:
Robert A. Compton
2847 Keasler Circle W.
Germantown, TN 38139

Chairman Grassley, Senator Baucus and distinguished members of the Committee, thank you for the opportunity to add to the public record of the Senate Finance Committee's hearings on Charities and Charitable Giving: Proposals for Reform.

I am a staunch supporter of your Committee's leadership in creating greater visibility and accountability in the Non-Profit sector in America. Without a doubt, the Senate Finance Committee has provided a much needed impetus for positive change in the field.

My Background

Although my career has been spent in business, I have been active in the non-profit sector for nearly 25 years – as a donor, foundation board member and charity board member.

As a donor, I have been a contributor to non-profit organizations active in medical research -- juvenile diabetes, orthopedics, and cancer primarily. I have also been a donor to the Boy Scouts, Girl Scouts, United Way, Junior Achievement, my church and a variety of educational not-for-profits.

My service as a Trustee has included the following non-profits: The Ewing Marion Kauffman Foundation (Kansas City; assets: $1.8 billion), the Abe Plough Foundation (Memphis; assets: $160 million), the Rose-Hulman Institute of Technology (Indiana engineering college), Junior Achievement of Memphis, The Campbell Orthopedic Research Foundation (Memphis), and The Interactive Academy (Indiana private school).

The bulk of my board experience, however, has been in the private sector. I have served on 24 corporate boards of directors, including five public company boards, both NASDAQ and NYSE, both pre and post Sarbanes-Oxley. I have served also as President and Chief Operating Officer of a New York Stock Exchange-listed company.

All of these experiences combine to inform my recommendations to the Committee.

Basic Premise

Much like investors in public companies, donors to non-profit organizations are making "investment" decisions for their charitable dollars. Unlike the self-interest of a stock

market investment, however, donors are contributing their money in the desire to achieve something positive for the greater good of society.

Intelligently "investing" charitable dollars requires donors to research a non-profit organization as thoroughly as they would a public company before buying its stock. Is the organization financially sound? Do they have clear objectives? Is there a reliable Board and is it free from conflicts of interest?

To make informed judgments, donors should have relevant information that is consistent and available:

- Accurate historical financial information,
- Assurance of proper Board governance, free of conflicts of interest,
- An understanding of how the organization compensates it officers.

Recommendations

1- Accurate financial information

Finding a non-profit's current financial information is not very easy. It requires knowledge of IRS rules for financial disclosure, an understanding of where IRS 990 reports might be found, and more than a little effort to access and interpret those filings.

My strong recommendation is to allow donors to have easy access to timely, accurate and consistent financial information with this simple requirement – **if a non-profit organization has a web site, it should be required to post the most recent three years IRS 990 reports in PDF format on its Home Page and accessible with one-click.**

The cost for a non-profit to comply with this requirement would be negligible, but it would be invaluable to potential donors. What more logical place to look for a non-profit's IRS reported financials than on their web site?

2- Assurance of proper governance

Sarbanes-Oxley regulations hold public company Boards of Directors accountable for proper governance of publicly traded companies. While the non-profit sector would be crushed by the weight and cost of similar regulations, many of the same benefits can be achieved by simple public disclosures, again accessible on the non-profit's web site Home Page:

- **Post Articles of Incorporation and By-Laws** – surprisingly few volunteer board members have read their organization's By-Laws or Articles. Posting them in the public domain adds impetus for directors to review these documents – as they know the public will be reviewing them.

- **Post Conflicts of Interest Policy** – a non-profit's policy on Conflicts of Interest should be signed by each officer and director and the signed document should be posted on the non-profit's web site. Any conflicts of interest that directors or officers might have should be clearly disclosed on that web site posting as well.

3- Officer Compensation

Just as with public companies, non-profit officer compensation is a legitimate topic of inquiry for charitable donors. Unfortunately, this information is not contained in a single location within the body of the IRS Form 990.

Since officer compensation it is often the largest single line item in the budget and can vary significantly between charities of the same size and similar missions, donors should be able to access this information so they can understand an organization's compensation structure.

My recommendation is for a non-profit to post its officer's compensation from the IRS Form 990 onto a link from it web site's Home Page in a format similar to the example shown below:

Organization Name:	**United Way of America**	
Fiscal Year Ended:	December 31, 2003	
Organization Revenue:		$28,597,444
Expenses:		$43,993,877
Net Income or (Loss):		($15,396,433)
Officer Compensation:		
Brian A. Gallagher	Chief Executive Officer	$629,950
Michael Brennan	Executive Vice President	307,394
Deborah Foster	Executive Vice President	282,869
Michael Schreiber	Executive Vice President	265,767
Cynthia Round	Executive Vice President	223,614
Edward Christie	Chief Financial Officer	180,716
Elizabeth Noble	Vice President	179,415
Patricia Turner	Secretary/General Counsel	159,918
TOTAL		$ 2,229,643

Officer Compensation as a Percent of Revenue – 7.8%

Summary

The Independent Sector's *Panel on the Nonprofit Sector* has provided your Committee with many thoughtful and appropriate recommendations in both their written report and testimony. I hope my three simple, low-cost recommendations add to your Committee's work on behalf of the public interest.

Thank you again for the Senate Finance Committee's leadership in improving the visibility and accountability of America's non-profit sector.

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April 8, 2005

Senate Committee of Finance
Attention: Editorial and Document Section
Room SD-203
Dirkson Senate Office Building
Washington, D. C. 20510-6200

Re: Senate Finance Committee Hearing on
Charities and Charitable Giving: Proposals
For Reform – April 5, 2005

Gentlemen:

We appreciate the efforts of the committee in its continuing effort to provide oversight to the nonprofit sector. The vast majority of charitable organizations is responsible, ethical, honest, and carry out their exempt purposes faithfully. However, we realize that there are some bad apples in the basket that undermine the good works for the rest of us. We must deal with these abuses, but in a way that does not penalize or discourage the good works of the majority.

The William A. Cooke Foundation is a small foundation organized by the late William A. Cooke for the purpose of awarding college scholarships and other grants in our local community. We have no paid staff at the present time. Our Board of Directors includes representatives from our supported organizations. I do not believe that we have any "disqualified people" on our board. Our founder is dead and none of his family is associated with the Foundation.

Our main area of concern is the committee's proposal to eliminate Type III supporting organizations. We are a Type III supporting organization and to be denied Type III status would be devastating to our organization.

We believe the Internal Revenue Service has the tools needed to address abuses in this area as demonstrated by the challenge of several egregious cases. The elimination of all Type III supporting organizations would adversely affect legitimate organizations that support public charities.

We advocate using targeted anti-abuse rules to eliminate inappropriate use of Type III supporting organizations while keeping such organizations available for legitimate purposes.

We agree with the following recommendations made by the Council of Foundations concerning Type III supporting organizations:

- Do not abolish Type III supporting organizations
- Require new Type III supporting organizations to obtain a statement from the supported organization attesting that the supported organization has consented to be named as such and describing the support each named organization will receive
- Require Type III supporting organizations to obtain a statement from the supported organization attesting to the level of support each year and include that statement with the supporting organization's Form 990
- Require the IRS to issue a revenue procedure that sets forth guidance on how Type III supporting organizations can substantiate their relationship with the supported entity or, in the alternative, that an annual accounting of support or the reasons for no support be provided to the supported organization and to the Internal Revenue Service as part of the Form 990
- Require the IRS to issue a revenue procedure delineating the process by which a supported organization may notify the Internal Revenue Service of its withdrawal of consent to be named as a supported organization
- Bar loans from a Type III supporting organization to the founder or any other "disqualified person"

The National Panel on the Nonprofit Sector will include specific recommendations in its final report. We urge the Committee to wait for this report before finalizing its recommendations.

We hope these comments are helpful to you. However, if you have any questions or need additional information concerning this matter, please feel free to call me.

Respectfully,

WILLIAM A. COOKE FOUNDATION

Wallace Tingler

Wallace L. Tingler
Chairman of the Board
and President

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Hearing on Charities and Charitable Giving:
Proposals for Reform

U.S. Senate Committee on Finance

Written Statement for the Record
Dorothy S. Ridings
President and CEO
Council on Foundations
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Washington, DC 20036

April 5, 2005

The Council on Foundations is a membership association of more than 2,000 grantmaking foundations and corporations worldwide. For 55 years, the Council has served the public good by promoting and enhancing responsible and effective philanthropy. The Council is home to all kinds of grantmakers, from the largest private foundations to those with less than $1 million in assets. Family foundations, independent foundations, operating foundations, corporate foundations and giving departments, community foundations and public charities that focus on grantmaking all have a place in the Council. Marshalling private resources for the public good, Council members have helped create stronger societies in the United States and in the world. Foundations are truly an American success story.

Tax exemption and the ability to receive tax-deductible charitable contributions are tremendous and important privileges that this country accords foundations. The Council shares the Senate Finance Committee's concerns about charitable sector abuse and we are committed to doing our part to put an end to illegal and unethical behavior on the part of those who are charged with the governance of the country's foundations. The Council has called for numerous reforms, increased transparency and open communications between the Internal Revenue Service and state charity officials about pending matters involving tax-exempt organizations.

In addition to identifying ways the government can improve the charitable sector, the Council on Foundations has undertaken several initiatives aimed at promoting strong governance and stewardship, including "*Building Strong and Ethical Foundations: Doing It Right,*" a multi-faceted program designed to provide intensified professional development and outreach about strong legal and ethical practices to grantmakers, their advisors, foundation executives and trustees across the country.

Council members have also led the way in demonstrating commitment to the highest standards of ethical practice by developing standards and principles to which adherence is strongly encouraged. Several years ago the Council's community foundation members drafted definitional standards to promote effectiveness and the highest levels of integrity, as well as to distinguish themselves among all those offering donor-advised funds. Last year, our family and corporate grantmaking members told us they wanted more guidance, and they have drafted sets of aspirational Stewardship Principles and Practices. Currently, the Council is drafting Stewardship Principles for independent foundations.

While the Council supports strong efforts to eliminate abuse in the charitable sector, many of the proposals in the committee's staff discussion draft and the Joint Committee on Taxation's report[1] are far reaching and will require thoughtful consideration and dialogue between charitable organizations and Members of Congress before they are enacted into law. It is important that any legislative remedies do no harm to the overwhelming majority of foundations and charities that are following the rules. The Panel on the Nonprofit Sector, formed at the encouragement of Chairman Charles Grassley (R-IA) and Ranking Member Max Baucus (D-MT), is currently examining these issues and will release its final report and recommendations later this Spring. Through this process, the charitable sector is undertaking a thoughtful and careful review of important issues and practices. We encourage Congress and the committee to wait until the Panel on the Nonprofit Sector finishes its work before considering legislation.

I have attached a document outlining the Council's positions on proposals affecting foundations, but want to focus the remainder of my statement on three issues of particular concern to the philanthropic community – donor-advised funds, supporting organizations and proposed limitations to charitable gifts of property. These issues were also the focus of April 5 testimony by Dr. Jane Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service. Since Dr. Gravelle relied on data from studies commissioned by the Council, I wanted to share information regarding those studies.

Donor-advised funds

Donor-advised funds serve as a critical way to attract donors and resources that further the charitable missions of our nation's 700 community foundations. Many donor-advised funds help endow the future of U.S. communities because they become unrestricted assets that help meet changing local needs after the deaths of donors or successor advisors. Others equip younger donors with sharpened understanding of community needs and the tools to make a difference as serious philanthropists.

Overall, donor-advised assets represent about 25 percent of total assets held by community foundations. The Council supports a number of the committee staff's recommendations, including clarifying the definition, prohibiting grants for the benefit of donors or advisors and shoring up other areas of potential abuse. However, proposals to reform the rules governing donor-advised funds require careful and thoughtful

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[1] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures,* January 27, 2005.

deliberation, especially given data that shows donor-advised funds distribute, in the aggregate, a high percentage of their assets to charities.

The Council is concerned that data included in a study prepared for the Council by the Foundation Strategy Group LLC may have been relied on mistakenly for Dr. Gravelle's conclusion that donor-advised fund assets are insufficiently benefiting charity. While acknowledging the lack of complete data, Dr. Gravelle concludes that the data justifies concerns that assets in donor-advised funds are not being paid out rapidly enough. [2] Her conclusion is based on survey results from a study prepared for the Council by the Foundation Strategy Group LLC. In a subsequent communication to the Council on Foundations, Mark Kramer, Managing Director of the Foundation Strategy Group, LLC, noted that Dr. Gravelle's reliance on this survey data is problematic on a number of fronts:

- While Dr. Gravelle mentions that there are three types of donor-advised funds, she cites survey data that was drawn primarily from donor advisors with endowed funds – funds that are intended to provide regular income for charitable purposes over time. Many other donor-advised funds pay out both income and principal and show much higher aggregate payout rates than endowed funds.
- The survey data cited by Dr. Gravelle reflects a single year and does not look at payout patterns over time. It is not unusual for a community foundation to make a large distribution in one year and then no distribution the next year to allow the income to build up again. This type of giving is particularly characteristic of endowed funds.
- We also do not know when during this single year the funds were established. For example, a fund may have been opened during the last quarter of the year and, while not making a distribution within that calendar year, might well make distributions within 12 months of being opened.
- While the purpose of the Foundation Strategy Group survey was to look at the administrative requirements of donor-advised funds based on the number of transactions processed, Dr. Gravelle instead uses these findings to characterize donor payout practices. Dr. Gravelle uses Graph 1 on page 5 to show that 42% of the respondents made less than five distributions, 31% made between 6 and 20 distributions and only 7% made more than 20 distributions. The number of distributions a donor-advised fund makes in a single year is irrelevant – the size or percent of the assets given out in the distribution(s) over time is what is important. For example, a donor-advised fund may have made one distribution during that year, but that distribution could have been 25% of the fund's assets. This data sheds no light on the claim that donor-advised funds are distributing insufficient funds.

Are the claims that donor-advised funds are not paying out sufficient funds for charitable purposes justified? The data suggest otherwise. The question the committee should consider is not whether every donor-advised fund makes payments every year, but whether, in the aggregate, the funds going into donor-advised funds are being distributed

[2] From "Statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service Before the Committee on Finance, United States Senate," April 5, 2005, pp. 2.

to charity. And all available data suggests that donor-advised funds have a high payout rate. Even Dr. Gravelle, on page 4 of her analysis, concedes that donor-advised funds, in the aggregate, pay out around 19% of their assets each year. This number is well above the 5% mandated annual payout rate for private foundations.

In her analysis, Dr. Gravelle does not address the fact that donor-advised funds increase philanthropy by creating an alternative for smaller donors who cannot afford to set up a foundation. While Dr. Gravelle does note that donor-advised funds tend to be significantly smaller than private foundations, she does not point out the savings in administrative costs that come from the shared management of these funds. Administrative costs would be substantially higher if these donors started a foundation instead of a donor-advised fund. Moreover, scrutiny provided by community foundation boards of directors is far preferable to placing tens of thousands of additional entities under IRS oversight.

Dr. Gravelle's analysis of donor-advised funds and supporting organizations also relies heavily on econometric studies that suggest these vehicles allow individuals to delay the transfer of their contribution to charity, to the ultimate detriment of the charity. But delaying a distribution to charity is not necessarily detrimental to the charity. In an article that appeared in the Spring 2003 edition of the *Stanford Social Innovation Review*, Michael Klausner argues that deferred contributions and immediate ones share equal social benefit.[3] While a charity may not receive an immediate payout from a donor-advised fund, the assets in the fund will appreciate and the charity will receive a larger contribution in the future.[4]

Supporting Organizations

Supporting organizations have unique characteristics that make them more effective and efficient than other options in certain circumstances. Community foundations, universities, public jurisdictions and other charities rely on gifts made possible through supporting organizations to carry out their charitable work.

The Council, like the committee, is concerned about abusive transactions involving some Type III supporting organizations. Rather than elimination, there are several courses of action that could be taken. The first priority should be to enforce existing law. The Council has encouraged the IRS to more clearly define mechanisms through which a Type III supporting organization would demonstrate the consent of each named supported organizations in its application and annually, as part of its Form 990. Ensuring that the supported organization truly participates in the governance of the charities, and requiring both parties to sign an annual reporting document with the IRS could go a long way toward shining light on instances of abuse.

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[3] Michael Klausner, "When Time Isn't Money: Foundation Payout Rates and the Time Value of Money," *Stanford Social Innovation* Review, Spring 2003, pp. 50-59.

[4] In the article, Michael Klausner makes a compelling argument that the discounted cash flow approach that McKinsey & Company consultants Paul J. Jansen and David M. Katz use in their 2003 study, cited by Dr. Gravelle, is inapplicable to the foundation payout issue.

There are a variety of legitimate reasons why a Type III supporting organization may be created, and may in certain circumstances be preferable to a Type I or II. Abolition of Type III supporting organizations, as proposed in the committee's staff discussion draft, will undermine the ability of charities and their donors to accomplish their charitable goals. A Type III supporting organization is sometimes the most appropriate vehicle for use as a separate stand-alone entity to hold and manage endowment assets for the benefit of one or more publicly supported charities whose programs entail material risks. In prior statements to the committee, the Council has outlined several other situations in which a Type III is preferable in contexts involving public universities, non-profit health entities and charitable trusts.

During the hearing, Dr. Gravelle cited a recent study that found 10 cases where loans from supporting organizations back to the donor were greater than half of each organization's assets. But, as Dr. Gravelle noted, eight of the ten cases involve a single individual breaking current law. Instead of eliminating Type III supporting organizations, the committee should encourage greater enforcement of existing law through a meaningful audit presence.

Proposed Limitations on Charitable Gifts of Property

Both the Senate Finance Committee discussion draft and the Joint Committee on Taxation report propose changing the rules related to donations of property, including closely held stock, real property, oil, gas and mineral rights and personal property. In 2001, 15% of the $2.15 billion gifts to community foundations, alone, were made up of "qualified appraisal property." The ability to donate this property to public charities and deduct fair market value has been critical to participation in philanthropy by family businesses, entrepreneurs and many middle-class people with small real estate investments. Any reforms must be carefully drafted to avoid discouraging donors who have substantial wealth in non-cash and non-stock assets from contributing to community foundations and other public charities.

Unfortunately, there is no data on the percentage of property gifts to donor-advised funds that fall in this realm of qualified appraisal property. The Council is currently gathering this data from our community foundation members. Dr. Gravelle's estimate of 45%, based on estate tax returns, is almost certainly too high. And, Dr. Gravelle does not mention the fiduciary duty of the receiving organization not to overstate the value of the assets it accepts. A community foundation that did so would violate its duty to the community and would risk providing false information on its financial statements. The public embarrassment of later restating the gift value also functions as a disincentive to overvaluation.

The Panel on the Nonprofit Sector is considering and will recommend actions on donor-advised funds, supporting organizations and gifts of appreciated property in its final report due out later this spring. Once again, we urge the committee to wait until the Panel completes its work before considering legislation.

We thank Chairman Grassley, Ranking Member Baucus and the members of the Senate Finance Committee for their ongoing concern about the health of this country's charitable sector. We applaud your commitment to a future that is as innovative, independent and vital to American democracy as it has been in the past. We have appreciated the opportunity to work with the Senate Finance Committee to find solutions to the abuses that harm us all and that erode the public confidence in our sector. We look forward to continuing that strong relationship.

The attached document highlights the Council's positions on many of the important charitable sector reforms being considered by the Committee and the Panel on the Nonprofit Sector.

The Council on Foundations
Overview of Selected Charitable Sector Reform Proposals

Proposed Limitations on Charitable Gifts of Property

Both the Senate Finance Committee staff discussion draft and the Joint Committee on Taxation's January 2005 report propose changing the rules related to donations of property, including closely-held stock, real property, oil, gas and mineral rights and personal property. The ability to donate this property to public charities and deduct fair market value has been critical to participation in philanthropy by family businesses, entrepreneurs and many middle-class people with small real estate investments.

We Support:

- Reform that prevents donors from claiming deductions that greatly exceed the actual value that the gift represents to the charitable community but that are drafted to avoid discouraging donors who have substantial wealth in non-cash and non-stock assets from contributing to charity.

We Oppose:

- Limiting the deduction of charitable gifts of property to the donor's basis.
- Proposals that discriminate against donors whose wealth takes the form of real property and other non-cash assets.
- Proposals that discriminate against donors who are small business owners, farmers and ranchers, denying them the same deduction that owners of large businesses will continue to receive.

Donor-Advised Funds

Nearly all community foundations offer donor-advised funds as a giving option, amounting to approximately 25 percent of total assets held by community foundations.

We Support:

- Prohibition of grants from donor-advised funds to private non-operating foundations.
- Prohibition of grants to or for the benefit of donors or advisors, their family members and businesses they control.
- Standards and enforcement to ensure that donor-advised funds can continue to be a building block for legitimate charity and philanthropy and not a focus of abuse.

We Oppose:

- Prohibitions on all grants to individuals, including scholarships, disaster relief and emergency hardship grants.
- Prohibitions on private foundation grants to donor-advised funds.
- Banning grants to nondomestic organizations since donor-advised funds provide a simple, low-cost mechanism through which donors can safely support a far wider range of foreign charitable organizations.

Supporting Organizations:
Supporting organizations are among the many charitable vehicles that donors can utilize to achieve their specific philanthropic goals. As with all charitable vehicles, supporting organizations have unique characteristics that make them more effective and efficient that other options in certain circumstances.

We Support:
- Continued availability of Types I, II and III for community foundations, universities, non-profit healthcare organizations and numerous other charities that rely on gifts made possible by supporting organizations.
- Specific IRS technical requirements to ensure that supporting organizations are properly organized and operated and that the charities they support have sufficient oversight of and involvement with the affairs of the supporting organization.
- Additional oversight and procedures to address concerns about Type III abuse.

We Oppose:
- Elimination of Type III supporting organizations.

Administrative Expenses
Questions about administrative expenses have been at the forefront of discussion of problems affecting tax-exempt organizations. The issues range from what constitutes administrative expenses, to how they are reported, and finally to how much is too much. Improvements should be made that identify those foundations that have unusually high administrative expenses in comparison with other foundations that are like them.

We Support:
- Uniform standards for reporting foundation administrative expenses with common definitions.
- Enhanced reporting of administrative expenses that exceed a threshold percentage of 20 to 25 percent of total expenses, based on the average of these costs over a five year period.
- A modest fee to the IRS for processing the additional information.
- Excluding administrative expenses that exceed 35 percent of total expenses from qualifying distributions in calculating a foundation's payout.

We Oppose:
- Limitations on administrative expenses that discourage direct service to the community.
- IRS filing fees that are punitive or intended to generate a significant amount of revenue to pay for other activities in the legislation.
- Reporting requirements that fail to recognize differences among foundations including their size, whether they have paid staff, the scope and scale of their grant-making, the kinds of grantees they fund, and the extent to which they directly carry on charitable programs in comparison to the scope of their grant-making.

- Reporting requirements that are triggered by expenditures in a single year given that the ratio may vary from year to year due to circumstances beyond the foundation's control.

Compensation

The law limits compensation to that which is reasonable in amount and necessary to accomplish the foundation's charitable purposes. Private foundations may not pay compensation that is excessive and must disclose compensation paid to board members and officers on Form 990-PF. Compensation is judged by what similar organizations pay for similar services in the same geographic area.

We Support:

- Strict enforcement of current legal requirements that compensation be both reasonable **and** necessary.
- Increased penalties on both the recipient and foundation managers who approve excessive compensation.
- Improvements to laws that govern how trustee compensation is determined and disclosed.
- Improvements to the 990-PF that provide more consistent reporting of compensation and better identification of outliers.
- Targeted follow-up, including audits and the imposition of penalties as appropriate, that discourages the kind of outrageous compensation reported recently in the media.

We Oppose:

- Any prohibition against paying trustees or limiting compensation to an artificial amount that has been judged to be "*de minimis.*"
- The use of a specific dollar amount to trigger additional reporting.
- Treating family members who are disqualified persons differently from non-family members who are disqualified persons.
- Using federal rates as benchmarks for compensation.

Increased Philanthropy

Foundations have a rich history of funding some of our country's greatest achievements: the discovery of the polio vaccine, protease inhibitors, the 911 emergency response system and Sesame Street. Foundations' entrepreneurial, independent and visionary strategies are ones that should be supported and encouraged by Congress. Foundations are an American success story – they do vital work in the communities you represent.

We Support:

- The President's plan to reduce the excise tax on the net investment income of private non-operating foundations from 2 percent to 1 percent will encourage additional funding for grants, as well as reduce major administrative burdens.
- Reforms that prevent donors from claiming deductions that greatly exceed the actual value of non-cash and non-stock assets.

We Oppose:

- Changing the valuation standard for non-cash charitable gifts. Much of America's wealth - as much as 60% - is in property other than cash and publicly-traded securities. Since non-cash charitable gifts are so vital, valuation reforms must be carefully drafted to avoid discouraging donors from contributing to charity.

Improved Financial Reporting

We Support:

- Modifications and simplification of Forms 990 and 990-PF, and of financial statements that will improve public disclosure and transparency.
- E-filing of these forms as soon as can reasonably be done.
- Amendments to the Internal Revenue Code to the permit the IRS to share audit and investigation information with state charity regulators.

Written Statement

Dr. Steven Specker

President and Chief Executive Officer

Electric Power Research Institute (EPRI)

3412 Hillview Avenue; Palo Alto, CA 94304

Before the

United States Senate

Committee on Finance

Hearing on "Charities and Charitable Giving: Proposals for Reform"

April 5, 2005

The Electric Power Research Institute, Inc. (EPRI), a 501(c)(3) scientific research organization, was founded in 1973 to manage a national, public/private collaborative research program on behalf of its electric utility industry members, their customers and society. EPRI's founders included the leadership of the National Association of Regulatory Utility Commissioners, the Federal Energy Commission (now DOE) and leading electrical utility companies.

Today, EPRI has over 1,000 members, including government-owned utilities (both federal and non-federal), rural electric cooperative associations, investor-owned utilities, independent and affiliated transmission companies, independent system operators (ISOs), regional transmission operators (RTOs), independent power producers, state and Federal agencies engaged in funding electricity-related research and development, and international utilities. EPRI's mission statement – "Together . . . shaping the future of electricity" – expresses the essence of its business model: collaboration. EPRI convenes groups of stakeholders in the electricity enterprise, pools their funding, their knowledge and their needs, and as a result of this leverage, conducts research, development and deployment (RD&D) that a single utility or government agency could not afford.

EPRI supports the Committee's pursuit of high governance practices across the nonprofit sector. Some of the draft proposals, however, suggest a "one size fits all" approach that will not serve the legislative objective, and will likely undermine the ability of nonprofits to meet their public interest mission.

Of particular concern is the proposal to limit the size of a nonprofit Board to 15 (or any arbitrary number). Nonprofits function, by and large, because of the commitment of their funders to the organization's mission. EPRI, for example, receives more than 90% of its annual funding from a widely-diverse set of members, spanning the public and private sectors. EPRI's Board reflects that diversity; while our members broadly share the goal of producing reliable, economical and environmentally friendly power, they have very different RD&D needs, depending on their organization type, service territory, access to different fuel types, roles in the industry (generation, transmission, distribution), to call out just a few of the variables.

Accordingly, EPRI has chosen to be governed by a fairly large board, reflecting the diverse interests of its constituent members, as well as the public, represented on the Board by 6 directors from outside the utility industry.

An arbitrary restriction on the size of the charitable organization's governing board would not, in and of itself, improve governance practices. It would, however, almost certainly impair the ability of a nonprofit like EPRI to form a board. whose diversity reflects that of both its membership and its public interest mission.

While detailed discussion of issues like audit and compensation may be cumbersome in a large board setting, a far better solution than restricting the board size would be to require the formation of smaller committees, populated by qualified directors (e.g., directors with "financial expertise") and empowered to manage these technical but critical issues. The board as a whole would continue to address the organization's public interest mission. Legislation could further such a committee approach, while leaving it to the individual entity to find the right size for its board and committees.

We urge the Committee as its moves forward with its examination of charitable organizations to allow appropriate latitude for individual entities to develop the right size, structure and composition for its board to best serve its public interest mission.

Evangelical Council for Financial Accountability
440 West Jubal Early Drive, Suite 130 • Winchester, VA 22601

A higher standard.
A higher purpose.

April 19, 2005

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

Re: Charities and Charitable Giving: Proposals for Reform, April 5, 2005

Staff Discussion Draft (June 21, 2004) and "Options Report" of the Joint Committee on Taxation (January 27, 2005)

Dear Senators:

The Evangelical Council for Financial Accountability (ECFA) was formed in the late 70s in a Congressional climate very similar to what exists today. It was a time when the evangelical Christian community was being cited for abusive transactions, which as it turned out, were caused by a relatively small number of organizations. Nevertheless, the community became very serious about integrity and accountability and ECFA was formed from a grassroots initiative. Its formation forestalled legislation.

The organization has grown steadily in the 26 years since its inception. Its 1,150 members now receive nearly $13 billion annually. ECFA remains very serious about its mission of accreditation and monitoring its members for compliance with its "Seven Standards of Responsible Stewardship." This is ECFA's only business – not just a sideline. The ECFA seal is granted on an annual basis and has been augmented in recent years by 900 onsite reviews. The ECFA model has been emulated or studied by charity regulators around the world.

1. Introduction.

This letter addresses proposed legislation which, under the twin banners of revenue enhancement and curtailing the bad actions of a few, could destroy thousands of charitable organizations, substantially impair the effectiveness of those which survive, and deprive millions of our neediest citizens in America and the world of the help they desperately need. Having been denied the opportunity to testify, ECFA, representing 1,150 religious charities, submits this letter.

In the past ten months, two separate legislative proposals have been issued under the aegis of the United States Senate Finance Committee ("the Committee") bearing on charities, their governance, and the tax treatment of those wishing to donate to them. On June 21, 2004, the staff of the Committee issued a "Discussion Draft," which proposed an extensive revision of the laws and regulations

concerning the governance of charities. On January 27, 2005, the staff of the Congressional Joint Committee on Taxation issued a 430-page report titled "Options to Improve Tax Compliance and Reform Tax Expenditures" ("the Report"). This came in response to a letter dated February 26, 2004, from Chairman Charles Grassley of the Senate Finance Committee and Ranking Member Max Baucus ("the February Letter"). Section VIII of the Report is directed toward exempt organizations.[1]

Both of these proposals include substantial regimes for the imposition of new and burdensome regulatory and governance regulations and unwarranted revisions of the Internal Revenue Code which would operate, intentionally and otherwise, to reduce the amount of money a donor may or will donate to a charity. We respectfully submit that these proposals are misguided and represent a policy initiative directly opposite to that of the current Administration in its promotion of the work of faith-based charities. If enacted, these proposals will impose enormous compliance costs on all charities and deprive many of them of needed revenue. Inescapably this will take resources away from millions of charitable beneficiaries.

Wise policy making weighs competing values and legislates in a manner which does the least amount of damage possible, or none at all, to an established policy which continues to represent the values and goals of the people. In contrast, the proposals of the Joint Committee's Report and the Discussion Draft would create a catastrophic collision between the general goal of revenue raising and the indispensable resources provided to the neediest members of the public by the charitable, nonprofit world. Stunningly, the Joint Committee's Report is oblivious to the fact that raising revenue on the backs of charities violates the most deeply-held values of the American people.

This Memorandum addresses, separately, the Report and the Discussion Draft and the features of each which represent significant threats to charities. There is some overlap in the two proposals, though the Report is directed more explicitly to revenue raising while the Discussion Draft proposes changing governance and reporting rules and regulations.

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[1] A cursory review of the Report makes it clear that the primary goal of the Report was to identify potential sources of income to the government. The Senators sought proposals both to reduce noncompliance and to reform so-called tax expenditures—Congress' phrase for money left in taxpayers' pockets by virtue of exclusions, deductions, and credits. (The dubious premise of the phrase is that tax relief should be justified on the same basis as if the government collected the tax and then spent it.) Hence, the first sentence of the Report: "This report...presents various options to improve tax compliance and reform tax expenditures." The reformation of "tax expenditures" requires one to accept the tax-subsidy theory of taxation which holds that any deduction or credit allowed is, in essence, a subsidy provided by the benevolence of the government. We believe most Americans reject this theory. The stated goals of the Joint Committee were to (a) increase taxpayer compliance, (b) simplify the Code, and (c) reduce the number and /or effect of the Code provisions that create inequities among similarly-situated taxpayers. It seems clear that when the Joint Committee located any provision in the Code which it deemed either inequitable or a non-sequitur, it resolved the issue in favor of taxation for the purpose of simplification and increased revenue. Where tax-exempt organizations were involved, the Joint Committee followed a general rule of taxation, juxtaposed with a "special" rule for tax-exempt organizations, and concluded that the special rule was inequitable (which merely begs the question) or inefficient, or both.

2. The Discussion Draft. Following are proposals from the Discussion Draft which represent significant intrusion into the governance and regulation of charities. The National Charities' Regulatory Agency. The Discussion Draft proposes that the Internal Revenue Service supplant state authority over charities and become in effect a national charities' regulatory agency, to which charities would be directly accountable for all significant internal and external activities. *At issue is not merely the content of the particular proposed requirements but, more fundamentally, who will control the nation's charities.* This directly challenges long-established principles of federalism and the interests of the several states in governing charities located within their borders. No obvious reason exists to substitute a federal form of nonprofit governance for the state-regulated procedures which have served heretofore. There is also nothing in the record to suggest that the Internal Revenue Service possesses any expertise to suit as the agency to govern and control the corporate and business operations of nonprofit entities. The Discussion Draft includes a laundry list of intrusive proposals to regulate the governance of charitable organizations, substituting a federal nonprofit corporations code for those of the states. These proposals wander far afield from the expertise of federal agencies, particularly taxing agencies.

2.1. An eight-item list of *initial* assignments for nonprofit boards of directors to undertake, including, among others, the establishment of policies and procedures, standards for performance reviews, the development of conflict of interest policies, and the creation of whistleblower protection, all to be confirmed on Form 990. ("Relaxation of certain of these rules *might* be appropriate for smaller tax exempt organizations.").

2.2. Establishing federal duties and liabilities for charities' boards of directors in a number of highly subjective areas: good faith, ordinary care, reasonably-believed best interests, duty to use ones special skills or expertise (which would effectively deter professionals from volunteering for service).

2.3. Regulating very specifically the charities' compensation procedures, and requiring public disclosure.

2.4. Requiring disclosure in Form 990 of material changes in activities, operations, or structure.

2.5. Requiring a charity to report to the IRS how often its board has met, with and without the CEO being present.

2.6. Requiring review of Form 990 by an independent auditor, audited financials for charities with more than $250,000 of gross receipts, and CPA review for those receiving between $100,000 and $250,000.

2.7. Mandating that a new auditor be retained (and newly oriented to the charity, at its substantial expense) at least every five years.

2.8. Requiring charities to submit for review every five years their management policies regarding so-called "best practices," their conflicts-of-interest policies, and a detailed narrative about their organizational practices.

2.9. Establishing best practices in fundraising and grant making. (Though the Discussion Draft includes no such specific proposals, the Senators' letter recites these in its list of concerns to be addressed.)

2.10. Developing a federal prudent-investor rule applicable to the investment activities of charities.

2.11. Limiting boards to between three and fifteen members, and establishing minimum numbers of independent board members.[2]

2.12. Disallowing compensation to more than one member of the board.

2.13. Prohibiting membership on any charity's board by individuals meeting any of a number of descriptions, many of which arise from policy realms very different from governance of nonprofit organizations.

2.14. IRS authority to force removal of any director, officer, or employee found (presumably by the IRS) to have violated any of several categories of rules (presumably established and interpreted by the IRS) or charitable solicitation laws and to prohibit the person from serving on any other exempt organization "for a period of years." As described in the Discussion Draft, then, the IRS could determine that a founder, leader, or key employee of a charity had violated the IRS' conflicts-of-interest rules or perhaps a local charitable solicitation law and, on the IRS' own say-so, without judicial action, ban him or her from all participation in the entity he or she created or otherwise serves, or any other exempt organization, for some unspecified number of years.

2.15. Authority for the IRS to seek removal of any director or officer by the Tax Court for fraudulent or dishonest conduct, gross abuse of authority or discretion, or failure to perform duties in good faith or with ordinary care or in a manner reasonably believed to be in the best interests of the corporation; the court could bar the individual from serving on any board for a period set by the court.

2.16. Maintenance and publication by the IRS of an official blacklist of persons determined not qualified to serve. Any charity which knowingly retained such a person to serve—apparently in any capacity, paid or not—could lose its tax exempt status.

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[2] The Discussion Draft proposes that boards be limited to fifteen (15) members. No explanation for the limit is given. Further, under the provisions of the Discussion Draft no more than one member may be directly or indirectly compensated by the organization. No explanation for that restriction was offered by the Discussion Draft.

2.17. Establishment by the IRS of a nationwide system for accreditation of charities, by the IRS and by organizations with which it contracts, establishing "best practices" and accrediting organizations that meet them. Charitable status and authority to accept charitable contributions could be conditioned upon such accreditation.

2.18. Other federal agencies required to give favorable consideration to accredited organizations (and thus inescapably to give unfavorable consideration to unaccredited organizations) in determining recipients of federal grants and contracts.

2.19. $25 million funneled through the IRS to organizations that educate on best practices and inform the public of charities judged to engage in best practices—by holding these purse strings the IRS would be able to influence significantly even these ostensibly independent determinations of best practices.

2.20. Imposing an excise tax on "self-dealing transactions" (such as a property sale or lease, loan, or furnishing of goods or services) with a disqualified person (including persons with "substantial influence" over the organization or an affiliate). Many charities depend upon close, synergistic relationships which, even if beneficial to the charity, would be threatened or eliminated under these proposals.[3]

2.21. Limiting payments for travel, meals, and accommodation to the U.S. government rate or perhaps some other rate (unless *each* expense is approved by the Board and disclosed in the Form 990)—with disgorgement by the individual *and* a 10% bounty assessed by the IRS against the charity.[4]

2.22. Imposing upon the states federal standards for reviewing conversions of charities to for-profit organizations, requiring notice to and opportunity for participation by the IRS, designating the IRS as "a protector of charitable trust assets," and conditioning conversion upon IRS approval.

2.23. Requiring IRS approval for state prosecution of certain federal violations.

2.24. Giving the Tax Court broad equity powers including but not limited to rescinding transactions, surcharging trustees, ordering accountings, substituting trustees, divesting assets, enjoining activities, and appointing receivers, to remedy detriment resulting from violation of rules

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[3] This proposal will ban all dealings between charities and their directors or major supporters, regardless of whether such dealings are beneficial to the charity or not. This will deprive charities of the "good deal" business transaction with a director or major donor.

[4] Setting aside the intrusion into the operation of the charities, the proposal is completely unrealistic in that it presupposes that charities will be able to obtain the same rates, discounts, and other benefits available to the federal government through its buying power and general influence. That is, of course, naïve and will result in the imposition of substantial costs on individuals (employees and directors) traveling on behalf of charities. That, in turn, will unquestionably negatively influence the willingness of employees as well as directors to travel on behalf of the charities.

and "to *ensure* that the organization's assets are *preserved* for *philanthropic purposes* and that violations of the substantive rules *will not occur* in the future." What measures are justified to "ensure" and what constitutes preservation and how the philanthropic purposes are determined and what is justified to assure non-occurrence of future violations remain to be seen.

2.25. Allowing the Tax Court to consider state enforcement actions adequate or provide further equitable relief—double jeopardy for the accused.

Collectively, these proposals of the Discussion Draft represent an unprecedented usurpation of private governance authority by the federal government.

What is the urgency for these proposals? Is this all prompted by anecdotal media reports of scattered atypical ethical lapses? Surely such a regulatory erosion of the charities' precious resources should be supported by a serious scientific study of all corners which the legislation would reach, quantifying both the problems and the cost of the proposed solutions, and establishing whether the former clearly justify the latter—but no such study has occurred.

Indeed, the Discussion Draft and its recommendations are a legislative solution in search of a problem. The paucity of evidence substantiating any need for the proposals makes them difficult to defend or support.[5]

On April 5, 2005, during a public hearing conducted by this Committee, Senator Santorum noted that, of the roughly 100 examples of charitable misconduct cited in testimony before the Committee at its hearings during the summer of 2004, *all but 4 or 5 were already adequately covered by existing law!*

Though they are presented in the name of preventing abuse of tax exempt status, these proposals go far afield. It is up to the donors, not the IRS, to determine the effectiveness of charities in pursuing their mission. Accordingly, the IRS defines its own mission (on its website) as follows:

> "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law

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[5] The Internal Revenue Service has posted to its website a list of what it considers to be "abusive" tax avoidance schemes practiced by exempt organizations (http://www.irs.gov/charities/article/0,,id=128722,00.html). It should be clear that the Service, as the federal agency charged with monitoring compliance with the Internal Revenue Code, is in far better position to identify those practices which abuse the system, violate the law, or mislead the public than theoreticians and academicians who have set themselves the task of finding problems without regard to whether they are real or imaginary. The IRS website offers to the reader a review of the forms of abusive conduct. Adequate remedies already exist to address those abuses. Nevertheless, a principled approach to these abusive problems might be for the Senate Finance Committee to aim the force of the Discussion Draft at those organizations engaged in the practices already identified as abusive, rather than targeting all charities indiscriminately. Inasmuch as the remainder of the charities are not broken, they ought not be subjected to a federal fix.

> with integrity and fairness to all." "The Internal Revenue Service is the nation's tax collection agency and administers the Internal Revenue Code enacted by Congress."

Even if national control of charities as proposed by the Discussion Draft were appropriate as a matter of federalism and constitutional law, one might reasonably ask, why should it be administered by the IRS? When one considers the local, state, or federal authorities most likely to be attuned to the missions of charities and the needs of their beneficiaries and donors, few would place the Internal Revenue Service anywhere on the list.

Charities are regulated by the states and, most fundamentally, by the contribution decisions of their donors. The Discussion Draft proposals would usurp the power of donors by threatening to deprive them of their tax deductions, of their leaders, and even of the existence of their chosen charities. If the donating public is dissatisfied with the management or practices or information disclosure of a charity, it will give elsewhere; tax exempt status is no monopoly! If the behavior of an exempt entity is determined by the relevant state or local authorities to be inappropriate, they can inform the IRS, which in turn can take steps to review or revoke the exemption.

Are donors clamoring for this protection? Do they want their donations and the delivery of charitable benefits to be diluted by the cost of these proposals? Is this the least-cost alternative? Should the misdeeds of a few serve as the pretext for a massive federal power grab which undermines the effectiveness of the vast majority of charities? A recent opinion poll conducted by the Edelman public relations company found that public confidence in charities was on the rise in America. Those surveyed rated the likelihood that charities would "do what is right" substantially higher than government agencies or the news media.

The heart and soul and lifeblood of America's successful charitable movement is its independence. The charitable community as a whole has proven itself significantly more effective than government agencies at delivering resources to beneficiaries. Yet, the federal government now would presume to impose its own notions of governance upon charities of every sort, without regard to their missions and special circumstances.

Bottom line, while they may curb some isolated abuses, these proposals will certainly diminish rather than increase the total delivery of benefits by charities, both by directly diverting hundreds of millions of dollars in resources away from the charitable missions and by driving away many of the volunteer leaders upon whom they depend.

3. The Report of the Joint Committee on Taxation. Following is a discussion of the proposals contained in the Report, Section VII.

Most fundamentally, the Report seeks to generate revenue on the backs of the neediest members of society. Every dollar raised by the Treasury will come from the resources now used to serve the beneficiaries of America's charities.

3.1 Require Five-Year Review of Exempt Status of Public Charities and Private Foundations and Annual Notice by Organizations Not Required to File Information Returns

3.1.1. 501(c)(3) organizations will be required every five years to file "such information as would enable the Secretary to determine whether the organization continues to be organized and operated exclusively for exempt purposes," including without limitation governing instruments, related-party transactions, detailed narrative of operations and practices, trade or business activities, senior compensation, financial statements, and material changes.

3.1.2. The proposal exempts churches, but not integrated auxiliaries and conventions or associations of churches. Also exempt, at least initially, are those organizations that received exempt status more than ten years prior to enactment of this five-year review.

3.1.3. The filing will be made publicly available.

3.1.4. Filing one day late (with a possible exception for reasonable cause without willful neglect) will result in loss of tax-exempt status, effective on the first day of the next taxable period. Such an automatic revocation (here and under item 10 below) cannot be challenged by declaratory judgment procedures.

3.1.5. The Secretary will not be required to review or take any action on or make any determination with respect to any filing. He or she need not advise the organization of a favorable determination. No statute of limitation is suggested.

3.1.6. Upon completion of the review, tax exempt status may be revoked retroactively.

3.1.7. The review will also extend to taxation of unrelated business activity.

3.1.8. Organizations below the gross receipts threshold for filing information returns must annually furnish a notice with their legal name, any fictitious name, address and Web site address, taxpayer identification number, name and address of a principal officer, and support for continued exemption from the information return requirement. Notice of an exempt organization's termination will also be required. This proposal does not apply to churches and other organizations exempted from the filing requirement on other grounds.

3.1.9. Failure for three consecutive years to file the new annual notice or the Form 990 will result in automatic revocation of tax-exempt status, retroactive to the deadline for the third notice or return.

3.1.10. The five-year review will begin with 2007 filings. The annual notice will start for the periods beginning after the date of enactment.

3.1.11. Predicted total revenue gain in fiscal years 2005-2014: less than $50 million.

3.1.12. Comparison To Discussion Draft: The five-year review is the lead suggestion of the Discussion Draft (section A1). The Discussion Draft's sliding-scale processing fee is absent from the Report; the annual notice by smaller organizations is not mentioned in the White Paper.

3.1.13. Comments: As expressed in the Report (p. 223), the foundational premises supporting periodic review of exempt status are that (i) the benefits of tax exemption and tax-deductible contributions are substantial, (ii) exemption is often granted based upon aspirations rather than actual operations, and (iii) organizations change over time (p. 223).

The Report misconceives the *purpose* of charity. It is manifestly *not* to provide tax relief to donors, but rather to encourage donations. The benefit of exempt status should be seen from the perspective not of the organizations but of their beneficiaries. This proposal (a) is unnecessary in light of existing remedies which lack only funding for enforcement, (b) will be ineffective and enormously wasteful if, as expected, most reports are not reviewed by the IRS, and (c) in any event will impose costs far exceeding any theoretical benefits.

The Report's proposal is equivalent to telling every taxpayer in America to submit, every five years, enough information to answer every issue that could possibly be raised in an audit of any of the five years, just in case the IRS decides to take a look at it (which the taxpayer may never know), except that for the beneficiaries of exempt organizations it is even worse: the very lives of the organizations upon which they depend are at stake. After the filing, the vast majority of organizations will be left wondering, perhaps forever, whether their status is being or has been reviewed, unless and until an adverse determination is made, which could result in retroactive loss of exempt status. The Report offers no guarantee of, or concern for, due process, or even notice of jeopardy—one must just submit the filing and hope that everything comes out all right. Whatever its intentions, the primary effect of this proposal will be to terrorize charities and those who rely upon them for help. How will this lead to better governance of charities?

Making the filings public exacerbates their deleterious effect. The public's interest in disclosure must be balanced with both the organization's privacy rights and the danger of vexatious activity by those opposed to the charity's goals. Indeed, the Report notes that public disclosure will enable state officials *and the public* to oversee whether an organization meets its exempt purposes, contributions are being spent appropriately, and laws are being obeyed. If more-effective state enforcement is desirable, the Service can share the information with duly authorized state officials without leaving it out in the open to draw gadflies. Thus, the five-year filing becomes not merely an opportunity for the IRS to reevaluate exempt status but a chance for all members of the public—particularly those motivated by a contrary agenda—to get into the act. The Report says as much, admitting that "the Secretary does not have the resources . . . even necessarily to review a high percentage of five-year filings," and it goes on to observe, "However, the five-year review filing will be a public document subject to public scrutiny and oversight . . . " (p. 227). Again, "Because the filings are publicly available, it will be easier for nongovernmental oversight organizations...to collect, analyze, and disseminate data about charitable organizations" (p. 228). Do not worry, says

the Joint Committee staff, that the tons of paper prepared at great cost under threat of organizational death will never be seen by those entrusted with knowledgeable and wise enforcement of the law; we have millions of self-appointed scrutinizers and overseers who will be more than happy to do the job.

The Report's only discussion of compliance cost appears on page 228. The highlights: "The five-year review need not be overly burdensome. . . . [S]uch a filing is infrequent and the information required should be readily available. . . . Small organizations [exempt from filing Form 990] . . . would have to provide additional information of a nature not currently provided. However, in general, the smaller the organization the easier the form should be to complete. . . . Some might argue that the Secretary and the public have the right to know such information and that a five-year filing is a reasonable burden to impose for the privilege of tax exemption as a charity."

The cost of complying with these proposals will be paid by the weakest and least fortunate, the beneficiaries of charitable organizations. The Report fails to mention the effect upon, or even any awareness of, these unseen burden-bearers. Unlike the cost of other perceived public benefits, this cannot be added to the price of widgets, since no widgets are being sold. It cannot come out of the pockets of the shareholders, since there are none. Nothing in these proposals will produce an offsetting reduction in a charity's administrative costs; indeed, it is certain those costs will rise. Short of printing money, a charity will have no choice but to reduce the benefits otherwise delivered to the needy to pay the cost of compiling reports which will probably never be read, except by the enemies of their mission.

All of this is projected to raise less than fifty million dollars of revenue over the next ten years ($5 million per year). Significantly, the authors did not see fit to estimate the cost of compliance by the 1.8 million entities in the charitable world! If compliance costs averaged no more than $500 per year (clearly a low estimate), the aggregate cost to American charities would be Nine Hundred Million Dollars ($900,000,000) *per year*! This represents a net loss of Eight Hundred Ninety-five Million Dollars ($895,000,000) *every year* to provide for this review, the benefit of which has yet to be established.[6]

3.2 Reform Intermediate Sanctions and Extend Certain Reforms to Private Foundations.

Under the Report's proposals, the intermediate sanctions regime, which addresses excess benefit transactions between charitable organizations and disqualified persons, will be changed as follows:

3.2.1. Compliance with the prescribed approval procedures will no longer yield a presumption of reasonableness; instead, these procedures will be deemed minimum due diligence, and any deviation from these procedures must be justified. These procedures will also be expected of private foundations.

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[6] To put this into perspective, the cost of this single proposal would be the equivalent of wiping out a charity of the size and reach of World Vision. The loss to the needy and those who depend on other charities would be incalculable.

3.2.2. The entity is subject to tax equal to 10% of the excess benefit (2.5% for a private foundation), even after the transaction is corrected, unless the entity had adhered to the minimum due diligence standards.

3.2.3. Neither the authorized body's satisfaction of the minimum due diligence standards nor reliance upon professional advice will any longer necessarily shield the organization's managers from being considered knowing participants for purposes of the intermediate sanctions and self-dealing excise taxes.

3.2.4. The initial contract exception to the intermediate sanction rules will not apply to individuals who will become disqualified within two years.

3.2.5. Predicted Total Revenue Gain In Fiscal 2005-2014: $200 million

3.2.6. Comparison to Discussion Draft: The Discussion Draft proposes going further, applying the private foundation self-dealing prohibitions to public charities.

3.2.7. Comments: The proposal, as written, is very problematic. The chilling effect will further undermine the ability of charities to attract talented personnel and to engage in transactions which are justified by intangible benefit to the organization. Charities will need to divert their attention to assuring the objective reasonableness of transactions with disqualified persons and following the letter the minimum due diligence standards. Managers will be at risk even though the board has duly considered and approved the transaction and an appropriate professional has given a reasoned opinion that it is permissible. No reasonable explanation has been provided as to why the current intermediate sanctions are inadequate to prevent or reduce prohibited transactions.[7]

3.3. Increase the Amount of Excise Taxes Imposed on Public Charities, Social Welfare Organizations, and Private Foundations Punitive excise taxes are increased as follows:

3.3.1. private foundation self-dealing other than compensation, from 5% to 10%

3.3.2. private foundation compensation self-dealing, from 5% to 25% (of which 15% is subject to abatement)

3.3.3. private foundation managers, from 2.5%to 5% and from $10,000 to $20,000

3.3.4. public charity and social welfare managers, from $10,000 to $20,000

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[7] This proposal may illustrate most clearly the revenue raising driver behind the Report of the Joint Committee. One has only to recall the reason the intermediate sanctions were created in the first place to appreciate the irony of the Report: they were devised as an alternative to termination of tax-exemption for those charities which engaged in excessive self-dealing or private inurement. The goal was *not* revenue enhancement, but the elimination of conduct which was seen as inconsistent with exempt status.

3.3.5. private foundation failure to distribute income, from 15% to 30%

3.3.6. private foundation excess business holdings, from 5% to 10%

3.3.7. private foundation jeopardizing investments, from 5% to 10%, from $5,000 to $10,000, and from $10,000 to $20,000

3.3.8. private foundation taxable expenditures from 10% to 20%, from 2.5% to 5%, from $5,000 to $10,000, and from $10,000 to $20,000

3.3.9. Predicted total revenue gain during fiscal years 2005-2014: less than $50 million

3.3.10. Comparison to Discussion Draft: Unspecified increases in these excise taxes are recommended in the Discussion Draft (B3).

3.3.11. Comments: The Report justifies the increased excise taxes as a substitute for audits, in light of the Service's greatly reduced enforcement presence in this sector. However, the increases underscore the revenue-raising nature of the entire Report. In the end, the Report is not about promoting compliance with the law or enhancing charitable transparency; it is about money raising.

3.4. Limit Charitable Deduction for Contributions of Clothing and Household Items.

3.4.1. Deductions for contributions of clothing and household items are limited to a total of $500 per year per taxpayer, regardless of filing status.

3.4.2. The limitation applies to donations of both used and new items.

3.4.3. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items.

3.4.4. Not included in the limitation are food, paintings, antiques, other objects of art, jewelry and gems, and collections.

3.4.5. Corporate donors, other than closely held and personal service corporations, are exempt.

3.4.6. Predicted Total Revenue Gain In Fiscal 2005-2014: $1.9 billion.[8]

3.4.7. Comparison to Discussion Draft: This is not discussed in the Discussion Draft.

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[8] As with the 5-year report proposal, if the average annual cost to charities is no more than $500 to comply with this specific proposal, the total cost to charities over the ten years projected in the report will be $9.0 billion in order to collect $1.9 billion.

3.4.8. Comments: This broad-brush, no-exceptions (for clothing and household goods) approach appears to be an expansion of the recent change in the law concerning the donation of cars and other vehicles and may have a significant detrimental effect upon a large number of special cases: the gift of valuable kitchen equipment to a homeless shelter, the vintage clothing donated to a community theater costume department, the store owner's in-kind donation of a new big-screen television to the Boys and Girls Club. Including new items in the limit is indefensible, as the valuation issue animating the concern over used items simply does not apply. As with the other proposals of the Report, no effort has been made by the draftsmen to quantify the injury to charities this proposal will impose.

3.5. Reform Rules for Charitable Contributions of Property.

3.5.1. Option 1.

3.5.1.1. The deduction for charitable contributions of property, including capital gain property, is not the fair market value of the property but, instead, is the lesser of the donor's basis or the fair market value.

3.5.1.2. This does not apply to publicly traded securities, for which the fair market value deduction continues to be available.

3.5.1.3. The donee information return upon disposition of the property within two years is no longer required.

3.5.2. Option 2.

3.5.2.1. This is like option 1, except that fair market value deduction is permitted for contributions of exempt use capital gain property, with a recapture tax if the property is disposed of by the organization within three years.

3.5.2.2. For exempt use property the donee's disposition information return requirement is retained and expanded.

3.5.2.3. The recapture tax may be avoided if an officer of the organization states in writing under penalty of perjury that the property was used for a significant intervening exempt use, explaining the use and how it substantially furthered the organization's purpose.

3.5.2.4. A false statement in support of exempt use carries a penalty of $1,000 (reason to know) or $10,000 (knowledge).

3.5.3. Predicted total revenue gain in fiscal 2005-2014: $2.5 billion (for Option 1)

3.5.4. Comparison to Discussion Draft: This topic is not discussed in the Discussion Draft.

3.5.5. Under current law, the prospective donor has the choice of (a) donating the property and deducting his basis plus appreciation or (b) selling the property and receiving in cash his basis plus the after-tax appreciation. Though the latter course will deliver more economic benefit to the donor, he may be persuaded to accept less in exchange for the satisfaction of conferring upon the charity the full value of the property. Under the Report's proposal, though, the donor's return from contributing the property will be reduced by the value of deducting the appreciation; certainly in many cases this will tip the balance away from the contribution.

The Report offers as justification (1) the expense to the IRS of evaluating and challenging appraisals of donated property, which leads to under-enforcement, and (2) the administrative burden to charities of disposing of such gifts, as opposed to cash and publicly traded securities, calling into question whether such gifts should be treated on an equal footing (p. 296).

The proposed change would not nearly relieve the Service of the burden of evaluating and challenging property appraisals. They are simply an unavoidable fact of financial life, from casualty deductions to estate valuations. The Report admits (at page 296) that this is a low-yield enforcement area. So, as a substitute for antifraud enforcement which the Service considers not worth the effort, the Report proposes directly depriving charities of billions of dollars of contributed property.

As to the Report's second justification, we note that the proposal would certainly have the effect of favoring securities investments over real estate and, like the sudden imposition of at-risk rules in the 1980s, would to some extent depress real property values.

More to the central point, (pages 296 and 300):

> A primary goal of the charitable deduction, however, should be to encourage gifts that are most useful to a charitable organization, and should not be to encourage gifts that entail significant diversion of resources from the charitable mission or that require the charity to incur substantial transaction costs. Cash, publicly traded securities, and arguably property that can be used directly in substantial furtherance of exempt purposes meet this standard. Other gifts of property generally do not and so need not be as favored. . . . Elimination of the value-based deduction is preferable to either approach because it eliminates the need for estimates of value, is easy to enforce, and by disfavoring property contributions generally, promotes contributions that a charitable organization needs most. . . .

The gift that is most useful to a charitable organization, that is, the contribution that it needs most, is the one that it actually receives. Arguing that such a monumental reversal of incentives for donation of property somehow serves the best interest of charities is astounding. It would be one thing to suggest that the deduction for gifts of appreciated property be reduced by the costs of sale, thereby accounting fully for any disadvantage to the charities as compared with gifts of cash or publicly traded securities. It is another thing altogether, and wholly unjustified by the cited considerations, to limit the deduction to the donor's basis, which has no bearing upon the value of the gift to the recipient charity.

Are we to believe that Elizabeth Dole had to set aside her other duties at the American Red Cross whenever the deed to another "disfavored" piece of contributed property showed up? Are these Joint Committee staff members, who urge the significant diversion of resources from the charitable mission to re-document every five years the case for exempt status, now suggesting that accepting and selling valuable contributed property is not worth the charities' time? The Joint Committee can rest assured that every charity will gladly accept the administrative burden of selling even "disfavored" property where the alternative is no contribution or one that is greatly reduced.

The goals of the Joint Committee staff are apparently satisfied by the observation on page 300 that "the proposal is a simple and effective solution to overvaluation of property. The rule is easy to apply. . . ." Their simple and effective and easy solution to overvaluation of property is to disallow any valuation of the property; never mind what effect this may have upon charities.

The discussion in pages 300 through 307 wanders into other troubling territory, such as charging donors a fee for the IRS' review appraisal, taxing the donee organization on the gain realized upon disposition of the property, and eliminating *entirely* the charitable contribution deduction for property.

This paragraph on page 301 is stunning:

> The proposal is likely to reduce the amount of contributions of hard-to-value property. In general, donors would be better off selling the property instead of contributing it, paying tax at long term capital gain rates, and contributing (and deducting) all or a portion of the after-tax proceeds to charity. In such a case, the charity might receive less from a donor, but such a shortfall is at least partially offset because the charity would not have any transaction costs associated with disposing of the property. A larger question, however, is whether any loss in fundraising outweighs the loss to the Treasury from excess deductions based on overvalued property, the cost to enforce correct valuations, and the damage to the tax system from generally tolerating taxpayers that claim deductions to which they are not entitled.

The answer to the staff's "larger question" is obvious. For every tax dollar that is raised by preventing donors from contributing appreciated property, the charities and their beneficiaries will lose one dollar. To collect $2.5 billion in additional revenue, the Joint Committee staff will deprive charities and their beneficiaries of *exactly* the same $2.5 billion, since the donors will have that much less after payment of taxes to contribute.[9] That is the very real damage to the beneficiaries of the charitable sector.

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[9] This analysis does not attempt to consider the additional adverse consequences to charities resulting from the potential for further erosion of charitable gifts through the imposition of some of the special provisions of the Code, including, among others, the alternate minimum tax, to say nothing of the general inconvenience to the donor who wishes to avoid the effort of a sale and merely make a bona fide gift. The Joint Committee Report seems also to assume that many donors of appreciated property will make the gift, claiming only a contribution amount equal to the donor's basis. That is an unsupportable assumption.

3.6. Require Public Disclosure of Form 990-T and Related Certification Requirements.

3.6.1. Current public inspection and disclosure requirements and penalties which apply to Form 990 will be extended to the Form 990-T, the annual return for unrelated business income tax.

3.6.2. Similar to Form 990 and applications for tax exemption, certain information may be withheld from public disclosure if *the Secretary* determines that public availability would adversely affect the organization—*e.g.*, trade secrets.

3.6.3. Organizations with gross annual revenues or gross assets of $10 million or more must include with the annual filings a certification by an independent auditor or independent counsel, supported by a number of detailed representations, that the filings accurately reflect the unrelated business income tax liability.

3.6.4. Predicted Total Revenue Gain In Fiscal 2005-2014: less than $50 million

3.6.5. Comparison To Discussion Draft: Public disclosure of Form 990-T is recommended in section F4 of the Discussion Draft.

3.6.6. Comments: The added work by and risk to auditors and attorneys will undoubtedly add administrative expense and reduce the resources flowing to charitable beneficiaries.

3.7. Expand the Base of the Tax on Private Foundation Net Investment Income.

3.7.1. For purposes of the excise tax on private foundation net investment income, the definition of gross investment income is amended to include certain items not enumerated in the Code but identified in the regulations: income from national principal contracts, annuities, and other substantially similar income from ordinary and routine investments.

3.7.2. Capital gains and losses subject to tax are modified to include capital gains from appreciation, including capital gains and losses from disposition of assets used to further an exempt purpose.

3.7.3. No carrybacks of losses from dispositions of property are allowed.

3.7.4. Predicted Total Revenue Gain In Fiscal 2005-2014: $200 million

3.7.5. Comparison To Discussion Draft: This is not discussed in the Discussion Draft.

3.7.6. Comments: The Report at pages 313-314 provides a bit of history on the excise tax and its intended use to fund IRS oversight of exempt organizations. However, none of the excise tax from the last go-around on this issue has been made available for enforcement activities, and it is questionable whether any from this proposal would be either. Further, if the underlying

purpose of the Report was to locate new sources of revenue with which to cover existing shortfalls, it seems axiomatic that any funds raised under this proposal will go to that shortfall—*not* to fund new enforcement initiatives.

4. *In terrorem* effect.

The proposals of the Discussion Draft and the Report will have a severe chilling effect upon the activities of charities and their ability to attract and retain qualified executives and directors. As written, they will cause every charity in America to expend substantial funds in defensive activities; will necessitate the expenditure of charitable resources to produce extensive reports of information already generally available to anyone with a legitimate need to know it; and will discourage volunteer leadership or those willing to work for generally substandard compensation within the charitable world from becoming engaged. The proponents have made no attempt to address or quantify the loss to America's charities from this "fear factor," but it will be enormous and far out of proportion to any benefit to the public.

4.1. Every charity will be faced with the challenge every five years of justifying its exemption anew, and the very real possibility that it will lose its exempt status.

4.2. The charity's Chief Executive Officer will be required to sign a declaration under penalty of perjury that he has put in place processes and procedures ***to ensure*** that the returns comply with the Internal Revenue Code and has received "reasonable assurance" of the return's accuracy and completeness. Penalties could be brought against a CEO ***and*** an internal or external paid preparer for failure to include required information. This is an unreasonable burden to place upon many charitable leaders and will diminish the pool of individuals willing to serve.

4.3. Directors will be subject to the new federal duties and penalties discussed above, and the Tax Court's power to surcharge them, yet only one can receive compensation for serving.

4.4. Directors, officers, and other employees will be allowed only inadequate compensation for their expenses.[10]

These proposals seem designed expressly to discourage participation in nonprofit organizations by imposing potential personal liability on those who serve, while unreasonably limiting reimbursement of travel and lodging expenses.

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[10] The Discussion Draft will eliminate the rebuttable presumption that compensation paid to leaders of the organizations is reasonable and the ability of the organization to rely upon the opinion of experts as to reasonableness. It is clear that the charity would be burdened with greater proof of reasonableness or the compensation would be deemed unreasonable, subjecting the controlling persons within the organization to the imposition of excise tax. This is another substantial burden which is not justified by current practice among charities.

5. Empowering the Enemies of Every Charity.

The Discussion Draft calls for public disclosure of the five-year review information noted above. Further, it would add to the publicly-available Form 990 the auditor's report, an affiliations chart, reports of insider deals and ancillary joint ventures, and—invading the attorney-client relationship—certain legal opinions received by the charity.

The Form 990 would also require a detailed description of the charity's annual performance goals and measurements for meeting the goals. We are assured that this is "to assist donors . . . and not as a point of review by the IRS" (yet). While no IRS establishment of standards for the descriptions and measurements is suggested, that could surely follow, and he who establishes the metrics in large part sets the values that drive the organization.

The proposals would require exempt organizations to disclose to the public their financial statements—including posting this and other information on the organization's website—and unredacted audit results, and would require charities (other than "smaller" charities) to make their investments publicly available. Public disclosure of compensation arrangements—presumably including pastors' salaries—would also be mandated.

The only certain use of this information will be by those bent upon harassing or destroying the charity, who will no doubt take full advantage of this free access to sensitive internal information on an organization in which they have no legitimate interest.

The Discussion Draft also proposes establishment of a hotline for reporting abuses and lodging complaints, making harassment as easy as a presumably-toll-free call.

Since the IRS lacks the resources to evaluate meaningfully all or even most of the information to be submitted for the five-year reviews, some criteria will emerge to focus its review in a way which will justify the process to some meaningful constituency. This may provide a dangerous opportunity for opponents of a particular charity, openly or surreptitiously, to press for review of that charity. It may also motivate the IRS itself to shoot first and ask questions later, stirring up enough activity to justify its requests for more funding.

The Discussion Draft promises a new cottage industry for litigation. The proposals would authorize private actions by unhappy directors, with possible attorneys' fees and costs to the plaintiff if he prevailed in whole or in part, but to the defendant only if the action were frivolous or in bad faith.

Any individual could submit a complaint in a proceeding to be brought derivatively in the right of the charity, subject only to verification by the IRS (which would retain control of the suit). Again, attorneys' fees and costs could be awarded to the complainant if he prevailed in whole or in part but to the defendant only if the action were frivolous or in bad faith (in which case a $10,000 fine could also apply).

6. Fee For Services Rendered. To fund all of this and more, the Discussion Draft proposes sliding-scale filing fees for the Form 990 and the five-year reviews based upon the charity's gross receipts or assets. This would be nothing less than a graduated gross income tax or property tax upon the charities! It is interesting that the authors of these proposals have not had the courage to admit what they are proposing. A rose by any other name is just as thorny.

If these fees are a good idea, why not charge individuals and corporations a filing fee for processing their tax returns? Or does some public policy support taking federal operating costs only out of the hands of charitable beneficiaries?

7. Church and Religious Institution Status. The Discussion Draft and Report fail to acknowledge the peculiar status of religious entities and churches and the traditional deference the government has accorded them—or that churches and other religious institutions may be Constitutionally exempt from the reach of the proposals. Similarly, there is no proposal to exempt charitable hospitals, colleges, and universities, entities which are commonly excluded from some of the more onerous regulations.

8. Some Other Intended and Unintended Consequences. By imposing onerous rules and regulations, carrying potentially severe personal liability to officers and directors of charities, the proposals of the Discussion Draft will certainly discourage participation in charitable enterprise.

As small businesses are the leaders in innovation and job creation, new charities fueled by the fresh vision of emerging leaders may find innovative and more-cost-effective ways to deliver benefits—but these proposals will erect barriers to entry which will prove insurmountable to many.

If charitable delivery of benefits is increasingly burdened by bureaucratic regulation and expense, the role of charities as a lesser-cost alternative to government-supplied services will be threatened.

One thing is absolutely certain: enactment of these proposals will result in millions fewer donated dollars being deployed for the intended charitable missions, having been diverted to support the enormous administrative burden both upon the charities and upon the IRS, all borne by the charities as administrative expense and filing fees.

We respectfully urge that the Report of the Joint Committee and the Discussion Draft be rejected. They both significantly overlook the imperative for charitable enterprise: service to the poor and disadvantaged. They assume that the costs implicit in their proposals and the loss of revenue which will certainly result from the proposals are insignificant to the charities, will not be missed, or can be made up by other means. In fact, each of these costs and losses will go directly to the bottom line of America's charities, resulting in dollar-for-dollar reduction in the funds available for the delivery of services to the beneficiaries, who are by definition the neediest

among us. If the Committee sincerely believes that the federal government does a better job of delivering services to the poor and disadvantaged, then perhaps the proposals of the Report and the Discussion Draft make some sort of sense. On the other hand, if the Committee acknowledges what every other person who has ever considered the issue realizes, that America's charities are much more efficient than government in the delivery of services, the Committee must reject most of these proposals and direct that the entire matter be reconsidered in light of the costs to charities and the impact upon those they serve.

Respectfully submitted,

Paul D. Nelson
President

Statement for the Record

Submitted by

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Regarding the April 5, 2005 U.S. Senate Committee on Finance Hearing

Charities and Charitable Giving: Proposals for Reform

April 19, 2005

INTRODUCTION

Chairman Grassley, Ranking Democratic Member Senator Baucus and members of the Committee, my name is Aubrey Harwell. I am writing to you on behalf of the Maddox Foundation, for which I am counsel of record in Tennessee. I have served as legal counsel for the Estates and Trusts of Dan and Margaret Maddox and as an advisor and counsel for the Maddox Foundation for approximately seven years. I was a personal friend and attorney for Dan and Margaret Maddox prior to their tragic deaths in 1998.

At the Committee's hearing on April 5, 2005, Richard Johnson, a Nashville attorney whose firm represents Tommye Maddox Working and the Nashville District Attorney General in ongoing litigation against the Maddox Foundation, presented testimony that was, in essence, a restatement of allegations made in this litigation. Written testimony presented by Mr. Johnson in support of his appearance before the Committee is little more than a restatement of the complaint filed on behalf of his clients in the pending civil litigation. Both Mr. Johnson's oral and written testimonies contain only one side of the story.

While my purpose in presenting this statement is not to engage the Committee in the merits of the litigation between Mr. Johnson's clients and the Maddox Foundation, I believe that some rebuttal is in order to illustrate several issues faced by philanthropy and the nonprofit sector now before the Committee. The Maddox Foundation, like you, has a strong interest in ensuring that the nonprofit community and charities act with the utmost integrity and within the parameters of the law. The Maddox Foundation supports the Interim Report of the Independent Sector's Panel on the Nonprofit Sector and its recommendations to strengthen charitable organizations and their operations.

As the Committee is well aware, we are at an important juncture regarding proposed reforms for charities and charitable giving. We commend the Committee on holding this hearing at this time. We believe that our charitable giving peers and more importantly, the communities we serve, will benefit from a close self-examination of current laws and practices. In addition, we embrace and encourage all reasonable measures to help make our philanthropic sector and the communities we serve even stronger. We thank you for this opportunity to address those issues that have been raised in connection with the Maddox Foundation.

I. Background

The Maddox Foundation is a Mississippi nonprofit corporation that is classified for tax purposes as a private foundation. The Maddox Foundation has been funded entirely by contributions from Mr. and Mrs. Dan Maddox.

The Maddox Foundation has a long history of serving numerous charitable organizations in the fields of education, human services, health care, religion, and conservation. The Foundation is committed to building philanthropic assets within the communities it serves through the establishment and support, at multi-million dollar levels, of community foundations in Middle Tennessee (Nashville) and Northwest Mississippi (Hernando). The Foundation also supports the building of capacity in nonprofits to effectively serve local communities by assisting nonprofit management support agencies.

Unfortunately, in the past year, the Foundation has been dragged into costly litigation and a public smear campaign. The Foundation is extremely disappointed that this litigation has led to personal attacks and the spreading of false allegations and misinformation through news coverage of this litigation, and now through testimony before this Committee.

Richard Johnson's testimony at your April 5 hearing unfairly maligned the Maddox Foundation and its president, Robin Costa, without providing the entire story. Much of the testimony did not bear on the Committee proceedings but merely amounted to arguing his clients' case before the Committee. He is using this forum to continue his clients' attack upon the Foundation and Ms. Costa.

This litigation is currently working its way through the courts of law in two separate jurisdictions, Tennessee and Mississippi.

The presiding judge in Tennessee has asked for an independent audit, which is currently being conducted. The Maddox Foundation is cooperating fully with that audit. We look forward to the final report, because we believe it will help to show that the plaintiffs' claims are unfounded.

In November 2004, the Attorney General of Mississippi filed suit to preserve and protect the assets of the Maddox Foundation, a Mississippi nonprofit corporation. An injunction has been entered protecting the Foundation's assets from the Tennessee litigation and is still in effect.

II. About The Maddox Foundation

Dan Maddox established the Maddox Foundation in 1968. He and his wife, Margaret, shared their 29 years together with a passion for business, the outdoors and philanthropy. The couple died in a tragic boating accident on January 14, 1998. Dan left his entire estate for the benefit of Margaret, with a gift over to the Maddox Foundation if she predeceased him. Margaret followed Dan's philanthropic example by leaving her entire estate to the Maddox Foundation.

Dan and Margaret combined keen business acumen with generous hearts. A sampling of their legacy includes the donation of RCA's famous Studio B to the Country Music Foundation, the Margaret Maddox East Family YMCA in Nashville, and Belmont University's Maddox Residence Hall and Maddox Scholars program.

The Maddox Foundation serves as a catalyst for building strong and viable communities that meet the needs of their citizens through collaborative action and service. The Maddox Foundation currently focuses its grant making activity in **both** Northwest Mississippi **and** Middle Tennessee, which are defined as the counties served by the Community Foundations in Hernando, Mississippi and Nashville, Tennessee, respectively.

Most grants by the Maddox Foundation are to organizations within these geographic areas or to organizations whose programs have a significant impact within these areas. The Foundation does consider funding for statewide initiatives that also have a significant impact in these communities.

III. About Robin Costa

Robin Costa is the President and Managing Director of the Maddox Foundation. Many vile personal attacks and false accusations have been made about Ms. Costa by Ms. Working and her attorneys. We thought that, in fairness, you would like to know more about Ms. Costa and her credentials.

In 1985, Ms. Costa began her career with the Maddox Companies, which included more than 40 entities involved in oil and gas exploration, real estate development, and various investment activities. She served as Secretary and Treasurer of the Companies from 1992 to 1994, and Chief Operating Officer from 1994 to 1998. In these increasingly responsible positions, Ms. Costa was involved in the day-to-day operations of the Maddox Companies. Following the untimely deaths of the Maddoxes in 1998, Ms. Costa became President of the Maddox Foundation, as well as President of Atlas Investment

Corporation, Maddox Petroleum, Inc., and Margaret Energy, Inc. She also holds a law degree, which she attained while working for the Maddox Companies.

In 1999, Ms. Costa initiated a pilot program to establish an online computer in every public school classroom in DeSoto County. Her success in attracting financial support for this effort from community leaders and other state and national partners was noted by Mississippi's Governor at the time, Ronnie Musgrove, who adopted the project as a statewide initiative. As a member of Governor Musgrove's Task Force on Classroom Technology, Ms. Costa was instrumental in raising significant support for a $28 million public-private partnership that made Mississippi the first state in the country to have online computers in every public school classroom.

Ms. Costa's commitment to nonprofit development and volunteer service has led to her selection as a member of the Board of Directors of the Mississippi Commission for Volunteer Service. She served on the Board of Directors of the Mississippi Center for Nonprofits from 2001-2004. Ms. Costa also serves on Belmont University's Board of Regents and the Board of Directors of the YMCA of Middle Tennessee.

A licensed attorney, Ms. Costa was inducted in 1997 as a member of Who's Who in Executives and Business in America. She is also a graduate of Leadership DeSoto, a training program for community leaders in business, educational and nonprofit agencies, operated by the DeSoto County Economic Development Council.

IV. Allegations Versus Facts

A. Change of Situs to Mississippi

Mr. Johnson opened his testimony by claiming that the Foundation was removed from its "intended home" in Tennessee, and implied in further testimony that the Foundation was in some way "hijacked" by Ms. Costa. In fact, it is the plaintiffs in the Tennessee litigation, Ms. Tommye Maddox Working and the District Attorney General in Nashville, who are attempting, five years after the fact, to remove the Foundation from Mississippi, contrary to the intention of Mr. Maddox and the actions previously approved by and taken by Ms. Working and Ms. Costa.

The assertion that Dan and Margaret Maddox would not have wanted the Foundation moved out of Tennessee is demonstrably incorrect, as are the assertions that the move was illegal or some kind of power play by Ms. Costa. During their lifetimes, Dan and Margaret Maddox made charitable donations to other states and countries, and did not limit their contributions to only Tennessee.

Dan Maddox did in fact anticipate a possible move for the Maddox Foundation, and provided approval for such a move to another state in an amendment he sponsored to the Maddox Foundation Trust Agreement. This amendment clearly states that the Foundation can be moved outside of Tennessee and be governed by the laws of another state -- which does not exclude Mississippi in any way. The intent of Mr. and Mrs. Maddox to permit

trustees to change situs is also manifested in amendments made to their respective revocable trusts shortly before their deaths.

Ms. Working and her lawyers claim that a subsequently repealed Tennessee statute required the approval of a Tennessee court before the Foundation could relocate to Mississippi. They are wrong. The statute in question was a venue statute that applied only to trusts that had actually been involved in judicial proceedings in Tennessee. Such had never been the case with the Maddox Foundation before it moved to Mississippi in 1999.

Professor Jeffrey Schoenblum of Vanderbilt Law School is an expert who had advised Mr. and Mrs. Maddox on various estate planning matters. After the deaths of Mr. and Mrs. Maddox, Professor Schoenblum concluded that the Tennessee statute was not applicable and that the trust was free to relocate to Mississippi. Furthermore, Professor Schoenblum has stated in an affidavit that, "[u]nder applicable Tennessee and Mississippi law as it then existed, no judicial approval or approval of the State's Attorney General's Office in the State of Tennessee or Mississippi was required to change the situs of the Maddox Foundation Trust to Mississippi."

Ms. Working and Ms. Costa made the decision together to move to Mississippi. In addition, Ms. Working played an active role in the move. There was, in fact, pressure placed upon her to allow family members of Dan Maddox who were then and are now domiciled in Tennessee, to get involved in the affairs of the Maddox Foundation Trust. In accordance with the expressed wishes of Dan Maddox, however, both trustees decided not to let his children directly or indirectly get involved in the Foundation. As reflected in a letter that Professor Schoenblum wrote, dated May 26, 1999, Ms. Working also told Professor Schoenblum about her desire to move out of Tennessee in an attempt to reduce the meddling of Dan Maddox's children with the Foundation's affairs. Ms. Working was actively involved in searching for a new location and spoke with multiple lawyers regarding the relocation. In fact, the ultimate selection of Hernando, Mississippi reflected her own personal preference.

Ms. Working's newfound complaints about the relocation and subsequent incorporation of the trust are especially outrageous, since she approved the relocation of the Maddox Foundation Trust to Mississippi; approved the Foundation's incorporation into a non-profit corporation; agreed that the Foundation would be governed by Mississippi law; agreed that the Mississippi courts would have exclusive jurisdiction over the Foundation; and approved the distribution of all assets of the Maddox Foundation Trust to the Maddox Foundation. Under the circumstances, Ms. Working's grievances about what were, in fact, her own decisions and actions ring hollow.

B. Program-Related Investments

Next, Mr. Johnson talked about the Foundation's purchase of two local sports teams -- teams that benefit the community and were at risk of being sold and moved to another town. Mr. Johnson characterized this purchase as a "jeopardy investment" that Dan Maddox would not have made.

Conveniently, Mr. Johnson confuses the issue of what kind of investment the purchase is and ignores the fact that expert legal advice guided the process for the purchase. He also completely ignores the benefits that the purchase created for the community - benefits that Dan Maddox would have fully endorsed.

In May 2002, the Maddox Foundation engaged attorney Bruce Hopkins to advise the Foundation concerning the feasibility and process for purchasing the Memphis RiverKings (minor league hockey team) and the Xplorers (arena football team). Mr. Hopkins specializes in the law pertaining to nonprofit, tax-exempt organizations. As a lawyer, he represents a substantial number of diverse tax-exempt organizations, both as to their operations and administrative matters before federal agencies, principally the IRS.

In his affidavit filed in the pending litigation, Mr. Hopkins describes how the purchase of the sports teams qualified as a "program-related investment" and what this means. He also specifically addresses the plaintiffs' claim and offers his expert opinion.

The sports teams were not a "portfolio investment," but rather an essential investment in the community. As a program-related investment, the acquisition and cost of operating the teams qualify as charitable donations under the federal tax laws because they were purchased to accomplish charitable purposes. The total economic impact for 2004 from both franchises on Memphis region business volume equals $6,252,631 and supports a total of 119 full-and part-time jobs. The teams generated personal income for their employees in excess of $3 million. Acknowledgement and approval of the acquisition of the teams is a matter that is presently pending before the Internal Revenue Service based on a private letter ruling request submitted by the Foundation's counsel long before this litigation arose.

The teams are generating losses, like a program related investment is usually expected to do. **As Mr. Hopkins points out in his affidavit, the sports teams, as program-related investments, were not expected to be profitable.** When the economic impact of the teams is considered, however, the Foundation is generating at least a 3:1 return on its investment in the community.

DeSoto County, Mississippi has reaped significant benefits from the presence of the teams, in accordance with the purpose and principles of the Maddox Foundation. Had the sports teams not been purchased by a local owner, they would have moved out of DeSoto County, leaving the DeSoto Civic Center without its single greatest revenue source for this government-funded facility. Without these tenants, it is likely that the Civic Center would be a significant financial burden for the County.

The Maddox Foundation's purchase and continued operation of the teams as program-related investments have kept the DeSoto Civic Center more viable as a community institution, stabilized income streams from concession stands and parking going to the local government, provided a forum and spotlight facility for additional nonprofit organizations, and acted as a springboard for many charitable activities.

The charitable activities and contributions of the sports teams are abundant and include:

- Newspapers in Education
- "Kings in the Classroom"
- The Jr. StreetKings youth roller hockey and Jr. RiverKings ice hockey leagues, initiated and staffed by professional hockey players
- "Face Off Field Trip," an annual field trip that introduces thousands of county students to professional sports and the Civic Center
- Working with area nonprofit organizations to showcase their work during sporting events and support fund raising efforts (Example: Fans brought 1,006 pounds of canned goods and non-perishable food to benefit the local Food Bank.)

Without the presence of a viable institution such as the DeSoto Civic Center, the community would not have been able to host a visit and address by President George W. Bush during 2003. The DeSoto Civic Center has hosted events in which Mississippi's national legislators, including its Congressman, Rep. Roger Wicker, have participated. Last year at a RiverKings hockey game, the DeSoto Civic Center hosted most members of the Mississippi legislature, and the Civic Center recently hosted the Board of Directors of the Mississippi Commission for Volunteer Services. All of these activities help build and support community and economic development strategies in DeSoto County.

C. Compensation

Mr. Johnson also attacked Ms. Costa's compensation and implied that she has overpaid herself in her various duties for the Foundation and the Maddox businesses.

It is important to note that Ms. Costa has never established her own compensation. Her compensation as Managing Director and President of the Foundation as well as a Co-Executor and Co-Trustee of Mr. and Mrs. Maddox's estates and trusts was based on the advice of outside professionals and recommendations of counsel. Her compensation as a Co-Executor and Co-Trustee of the estates and trusts was based on a substantial discount from what a corporate fiduciary would be entitled to for the same services and time required. Both estates were extremely complicated, involved the management and operation of multiple closely-held business enterprises, and were involved with extensive litigation. The estates were open for approximately six years before the remaining assets were transferred to the Foundation. Ms. Costa's compensation as a fiduciary was based on recommendations of outside professionals and approved by the other co-fiduciary.

D. Expenses

In a lengthy discourse about the Foundation's expenses, Mr. Johnson again told only one side of the story. Simply put, the allegations of misuse of funds are unfounded. The fact of the matter is that the IRS has qualified the Maddox Foundation for exemption from Federal income tax and approved the merger of the trust into the nonprofit corporation. The IRS recently examined all of the Foundation's records and expenditures for the 2001

calendar year in an extensive audit (initiated by the allegations referenced in the plaintiffs' complaint) that resulted in no changes or assessments against the Foundation or its key executives.

In his oral testimony, Mr. Johnson implied that in 2002, the Foundation made charitable contributions of only $5,150 to Belmont University, a favorite charity of the Maddoxes. In fact, in addition to the $5,150 cited by Mr. Johnson, the Foundation made, through its donor advised fund at the Community Foundation of Middle Tennessee, payments to Belmont University that year of $375,000 toward the Foundation's pledge on the construction of the Maddox Atrium in the University's Student Life Center; $100,000 to support the University's Presidential Scholars program; and $10,000 to support the Rasmussen Studies program.

Mr. Johnson's allegation that somehow the charities of Tennessee are victims here is even more misleading. Since the deaths of the Maddoxes in 1998, the Maddox Foundation, through the end of 2004, has made more than $7.7 million in grants to nonprofit organizations in Tennessee, representing more than 75% of all Foundation giving. In addition, the Foundation has more than $12 million in outstanding pledges for projects and organizations in Tennessee. The completion of these pledges will support a permanently endowed fund at the Community Foundation of Middle Tennessee that will support organizations favored by the Maddoxes during their lifetimes.

We would also note that the Maddox Foundation has contributed or pledged in excess of $10 million to charitable organizations located in the State of Mississippi.

Mr. Johnson's testimony regarding Foundation administrative expenses is equally misleading. An "$8,000 charge to a casino" is actually an expense for lodging costs for visiting football teams -- and is required by the league. No part of this expense benefits the Foundation or its staff. A "$4,000 charge to the La Costa Resort and Spa" relates to expenses incurred by the Foundation's staff while attending, along with foundation leaders from across the country, one of the most respected annual tax seminars for private foundations -- which is conducted by the Salk Institute.

V. Legislative Efforts

The Maddox Foundation supports the Interim Report of the Independent Sector's Panel on the Nonprofit Sector and its recommendations to strengthen charitable organizations and their operations. Nevertheless, we remain disappointed that unfounded personal attacks and misinformation played a role in this Committee's important hearing.

Thank you, Mr. Chairman and members of the Committee for your time and attention.

If you have any questions, I would be pleased to respond to them.

Testimony by The Humane Society of the United States

United States Senate Committee on Finance

Charities and Charitable Giving: Proposals for Reform

April 5, 2005

Chairman Grassley, Senator Baucus and distinguished members of the Committee, The Humane Society of the United States, on behalf of its nearly nine million members and constituents, urges Congress to eliminate tax loopholes with regard to non-cash charitable contributions that let wealthy trophy hunters write off the costs associated with killing big game animals. We would also like to thank Senator Grassley for his impassioned statements earlier this month drawing the attention of this Committee to the tax shelter involving the donations of trophy hunting mounts.

The Humane Society of the United States (HSUS) is the nation's largest animal protection organization and is a mainstream voice for animals, with active programs in companion animals and equine protection, wildlife and habitat protection, animals in research and farm animals and sustainable agriculture. The HSUS protects all animals through education, investigation, litigation, legislation, advocacy, and field work.

Introduction

During the course of a nearly two year investigation into the trophy hunting industry, HSUS undercover investigators learned that it was common knowledge in trophy hunting circles that certain trophy appraisers inflate the appraisal of big game hunters' mounts for donation purposes, factoring in everything from the cost of the hunting safari, to the taxidermy and skinning fees, to licensing fees so that the hunter can claim a significant tax write-off. A hunting outfitter in Texas who informed HSUS investigators that his hunting clients frequently take advantage of this scheme, aptly stated "... it's a license to steal."

The three main parties involved in this particular tax shelter are: big game hunters with trophies to donate; trophy appraisers willing to overvalue appraisals of mounts so that the donor gets a large tax deduction; and pseudo-museums willing to accept an endless flow of donations of stuffed animals regardless of their quality.

Who Gets a Tax Break?

> **"Why not let your past hunts pay for your future hunts! Why not have today's exorbitant hunt costs work for you. Donate your duplicate, less prestigious, smaller and unmounted trophies at today's replacement value. Use the tax savings to go on another hunt. Why not phone us, and we can determine how much each donated animal will put back in your pocket and even advise how many you have to donate to get a FREE hunt using tax savings."[1]**

This paragraph is from a publication by a promoter of hunting trophy donations to museums for tax write-off purposes. It is clear that this particular tax shelter is addressed to one very small segment of society – big game trophy hunters. By donating their over-valued trophy mounts to museums or other nonprofit organizations, big game hunters can

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[1] Chicago Appraisers Association, "Game Mounts for Museum Donation"

receive considerable income tax deductions. This form of charitable giving has, therefore, allowed wealthy hunters to go on big game hunting expeditions essentially at taxpayers' expense.

There is no data on the numbers of hunters who have received tax breaks by donating trophy mounts to nonprofit institutions, or how much tax revenue is being lost to these deductions. What is known, however, is how many trophy animals are imported into the U.S. Based upon data obtained from the U.S. Fish and Wildlife Service and analyzed by The HSUS, during a five year period from 1998-2003, 359,462 trophies of big game animals were imported into the U.S.[2] These hundreds of thousands of imported trophies are all potential tax breaks waiting to happen.

There is no question that big game hunters are exploiting tax loopholes to take inflated deductions for trophy mount donations. In a recent dispute with the IRS, David Liniger, an avid hunter and founder of the Re/Max real estate franchise, claims that the value of his 174 trophy mounts, which he donated to his own nonprofit museum, is $1.4 million. The IRS, however, claims that the collection is worth $370,665, forcing Liniger to pay an additional $660,215 in taxes. This dispute is continuing as Liniger filed a lawsuit against the IRS in federal court in Denver on March 1, 2005 demanding the money back.[3]

Liniger is not the only trophy hunter manipulating the tax code to finance his thirst for killing exotic animals. HSUS estimates that hundreds of hunters annually write off hundreds of thousands of dollars in taxes.

Inflated Trophy Appraisals

Hunters looking for tax write-offs for donating their trophy mounts often end up procuring the services of the Chicago Appraisers Association (CAA), a company that touts itself as a "liaison between museums and hunters since 1966." It is likely that big game trophy hunters find out about CAA and the tax write-off through organizations such as Safari Club International (SCI) which is one of the most influential organizations protecting the interests of trophy hunters. CAA's President, R. Bruce Duncan, is himself a big game hunter and has gone on numerous hunting expeditions around the world, and has several of his trophies listed in SCI's *Record Book of Trophy Animals*. Mr. Duncan also claims to have been a Vice President of SCI, and he has in the past given a workshop on taxidermy appraisal at an SCI Convention. He has also advertised his appraisal services in SCI publications for a number of years. One such ad in the *Safari Times* reads: "Game Mount Donations – Let us help offset recent stock market reversals."[4] SCI has in the past even recommended Mr. Duncan and CAA to hunters who have wished to have their collection of animal mounts appraised.[5]

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[2] Trophy imports into the U.S. during 1998-2003 based on U.S. Fish and Wildlife Service LEMIS data and analyzed by The HSUS

[3] Al Lewis, *Denver Post,* 3/13/2005

[4] Safari Club International, *Safari Times*, March 2003, p. 46

[5] Part of the findings of fact in *George H. Engel v. Commissioner of Internal Revenue,* 1993 WL 316212 (U.S. Tax Ct.)

The promotional material received from CAA by HSUS investigators include brazen statements such as: "This is the best time in history to donate game mounts for tax advantages, IRS audits are at an all time low, IRS donation review staff have been drastically cut, emphasis today is on corporate audits, not individual."[6]

In order to get to the bottom of this scheme, an HSUS undercover investigator traveled to Highland Park, IL to discuss with R. Bruce Duncan, the founder and President of CAA, the process for appraising and donating two trophy mounts. In a meeting that lasted all of five minutes, the investigator showed Mr. Duncan amateur snapshots of the two mounts he wished to donate as a tax write-off, and stated that all he knew about them was that they were taken in Texas a couple years ago. Within a matter of a few days, the HSUS investigator received from CAA a packet of material that included the appraisal, information for the trucking company that was to be used to ship them to the museum, and a letter from the museum that had agreed to accept the mounts.

The appraisals provided by CAA for the two mounts were about double what had actually been paid for them. A pedestal mount of a scimitar-horned oryx was given the appraised value of $8,500 and a blue wildebeest shoulder mount was given an appraised value of $8,000. The taxidermist and provenance for both mounts had been fabricated by Mr. Duncan. This is significant because CAA puts a lot of emphasis on provenance, i.e. details about when and where the specimen was collected, as well as the name of the taxidermist artist, in order to justify his use of replacement cost rather than fair market value to determine the appraised value. In fact, in a letter attached to the appraisal, Mr. Duncan states: "Therefore, mounted animals with provenance become a crucial – and often the only – source or reliable genetic data for museum scientists throughout the world."[7]

CAA claims to have isolated 23 variables that determine game mount value, which include objective variables and subjective variables.[8] From this, a scientific mathematical formula was derived, which is supposedly known in the appraisal industry as "Duncan's Equation." There are several problems with CAA's use of this formula, not the least of which is that the IRS does not recommend the use of formulas to determine the value of donated property. IRS Publication 561 states: "Determining the value of donated property would be a simple matter if you could rely only on fixed formulas, rules, or methods. Usually it is not that simple. Using such formulas, etc. seldom results in an acceptable determination of FMV (fair market value). There is no single formula that always applies when determining the value of property."

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[6] Promotional post card received from Chicago Appraisers Association

[7] Letter from Chicago Appraisers Association dated 12/1/2004, "Financial Appraisal Methodology"

[8] The 23 variables used by CAA are: cost of replacement; IRS engineer value; minimum insurance value; comparable retail sales; federal matching grants; federal court decisions; taxidermist reputation; taxidermist quality; rarity; condition; record book listing; mount style; country of origin; present day availability; blue book value; museum desirability; auction (distress sale); intangibles; comprehensiveness; blockage; years since collected; maturity of specimen; and sex of animal.

The main problem however with CAA's appraisal is that it inflates the value of what the trophy mounts are actually worth. The way this is accomplished is by relying on replacement cost to determine the value of the mounts. CAA in fact admits that this is the valuation method it uses: "Game mounts are unique. Because the most valuable animals are on the 'Endangered Species' list and cannot be sold on the open market, game mount values must be derived mainly using the 'Cost of Replacement' method. We have done this wherever applicable."[9] In the appraisal received from CAA by HSUS investigators, the replacement cost is computed by adding up the taxidermy and skinning fee, prorated cost of the hunt, estimated shipping cost, and estimated tags and licenses. Since the investigator did not provide CAA with any documentation to support any of these costs, CAA used its discretion to inflate these costs as much as possible. For example, the estimated tags and license fees were listed as $1,000 for the oryx and $750 for the wildebeest, while the provenance for both was listed as Texas. The Texas Parks and Wildlife Department issues a "Non-resident 5-Day Special Hunting License", the most commonly used by out-of-state hunters who come to Texas to hunt exotics, for $45. This demonstrates the blatant over-valuation of the trophy mounts by CAA.

CAA refuses to take into consideration fair market value of trophy mounts if the animal is described as "rare." For example, in the appraisal received by the HSUS investigator the rarity factor for the scimitar-horned oryx is listed as "unobtainable" and "almost all specimens are in museums." Consequently, due to rarity, no financial comparables were factored into the appraisal value. Indeed scimitar-horned oryx are considered to be extinct in the wild, but since the provenance in this particular case was listed as Texas, a look at SCI's *Record Book of Trophy Animals* reveals a listing of 285 top-ranking scimitar-horned oryx taken by hunters almost exclusively in Texas. Oryx and other exotic antelope species are raised in captivity in Texas and in other places around the U.S. and can thus hardly be considered "unobtainable."

CAA's President, R. Bruce Duncan, has a checkered past and in 1991 was sentenced to 10 months in prison for his guilty plea to a charge of conspiracy to import endangered animals. He entered into an agreement with the IRS to provide testimony in a case against a big game hunter who had donated his over-valued trophy mounts to a museum in North Carolina in exchange for refraining from bringing an abusive tax shelter case against him. Throughout the 1990s Mr. Duncan's method of appraisal for trophy mounts was called into question several times by the IRS in cases against big game hunters who had used CAA to appraise their mounts and then donate them to museums or nonprofit organizations.[10] In each of these cases the court decided that the trophy mounts had been over-valued and adjusted the figures downward. In one of the cases, the court determined that the valuation claimed by the hunter on the return was more than 150% of the correct valuation.[11]

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[9] Letter from Chicago Appraisers Association dated 12/1/2004, "Financial Appraisal Methodology"
[10] *George H. Engel v. Commissioner of Internal Revenue,* 1993 WL 316212 (U.S. Tax Ct.); *Lawrence T. Epping v. Commissioner of Internal Revenue*, 1992 WL 101153 (U.S. Tax Ct.);. *Robson v. Commissioner of Internal Revenue* and *Trnavsky v. Commissioner of Internal Revenue* 1997 WL 167382 (U.S. Tax Ct.)
[11] *George H. Engel v. Commissioner of Internal Revenue,* 1993 WL 316212 (U.S. Tax Ct.)

It is impossible to know how many trophy appraisals and museum donations have been arranged by CAA so that big game hunters can underwrite their hunting expeditions at taxpayers' expense. By Mr. Duncan's own admission, however, he has been exceptionally prolific in the trophy appraisal department. For example, a CAA newsletter proclaims: "...the company reached the milestone of having appraised and placed their 25,000th specimen. It is estimated over 63% of the animals now in natural history museums have been evaluated by the company."[12] The number of inflated tax appraisals carried out by CAA for wealthy big game hunters is certainly in the thousands. In a scam that was uncovered in the early 1990s where trophy hunters were having their mounts appraised by Mr. Duncan and then "donating" them to the North Carolina State Museum of Natural History, where they were found to be rotting in a damp warehouse by federal authorities, it was estimated that of the 2,000 game mounts shipped to the museum by contributors, Mr. Duncan had prepared the appraisals for about 95% of those mounts. The Wyobraska Museum of Natural History in Nebraska, the museum currently used by CAA for accepting donated trophy mounts, estimates that about 99% of their 3,000 specimen inventory came via CAA.

Though HSUS investigators focused their research on Chicago Appraisers Association, this is by no means the only company appraising trophy mounts. There are several other individuals and businesses throughout the U.S. who advertise their trophy appraisal services in SCI trade publications. As none of these were contacted by HSUS investigators it is not clear whether the appraisals they offer are also inflated to increase the hunter's tax deduction. However, the high-profile tax battle that is now going on between the IRS and David Liniger indicates that CAA is not the only company exploiting the tax code to benefit big game hunters. The trophy appraiser used by Liniger was Jack Jonas of Aurora, Colorado, and he, like Bruce Duncan, justified his inflated appraisal based on the "replacement value" of the trophy mounts which takes into consideration the cost of hunting the animals, licensing fees and taxidermy costs.[13]

Questionable Museum Donations

In order for big game hunters to get a tax write-off, the trophy has to be physically transferred to a museum or other suitable nonprofit organization that is willing to accept it as a donation. HSUS investigators discovered that one such willing museum is the Wyobraska Natural History Museum in Gering, Nebraska. Since Chicago Appraisers Association not only appraises mounts, but also arranges for their donation, it was arranged that the two mounts that had been appraised by CAA from photographs for the HSUS investigator would be sent to the Wyobraska Museum.

Posing as resort lodge owners interested in buying mounts, HSUS investigators traveled to Gering, Nebraska in early 2005 to visit the Museum and meet its curator, Mike Boone. Investigators were overwhelmed by the hundreds of trophy mounts stuffed into two railroad cars and one semi-tractor trailer behind the museum that had been adapted for

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[12] *Chicago Appraisers Association News*, Vol. 1, No. 1
[13] John Accola, *Denver Rocky Mountain News*, 3/2/2005

storage and were not open to the general public for viewing. The stuffed heads of lions, leopards, kudus, and other exotic species from all around the world were packed into the storage units along with bears, moose and other North American species. The curator estimated that he had received about 800 items just this past year, and that there were close to 3,000 game mounts, skins, and other animal parts in storage, the vast majority of them not museum-worthy.

The curator of the Wyobraska Museum admitted that some of the mounts he receives are "in really, really, really bad shape when they ship them off and they know they're bad, but they still get a big tax write-off – so you know I still take them and we keep them for two years." As Mr. Boone showed investigators the interior of one of the storage trailers, he pointed to one unfortunate creature and referred to it as "junk," stating: "Something like him – he should have been just thrown in the dumpster....But he gets a $5,000 tax write-off, so what the hell." He told investigators that out of all the mounts he gets each year, at most 5% can be considered museum quality mounts.

The Wyobraska Museum curator acknowledged that people just donate for the tax write-off since they are one of the few museums in the country that accepts animal mounts. He said that the busiest time of year is year's end (tax deduction deadline time) when shipments of donated mounts to the museum increase.

Mr. Boone revealed that the majority of donated mounts that the Museum receives are never going to be put on display. He holds on to them for two years, and then tries to sell them at auction, on site, or through the website. In a price list of animals for sale that he gave HSUS investigators, the sales price for an oryx shoulder mount is $700, while the price of a wildebeest shoulder mount is $500. These prices are in stark contrast to the $8,500 and $8,000 respectively for which an oryx mount and a wildebeest mount were appraised by CAA.

Mr. Boone stated that he also trucks over a hundred donated mounts to the Lolli Brothers taxidermy auction in Macon, Missouri several times a year. According to auctioneer Jim Lolli, the mounts have become something of a commodity, and winning bids are generally 10-20% of the appraised values. In fact in 2003, the Wyobraska Museum sold trophy mounts with an appraised value of $4.2 million for about $67,000 according to its yearly tax report.

Stressing that he was following the law, Mr. Boone repeatedly told HSUS investigators that he holds onto donated trophy mounts for two years before selling them. According to IRS publications, however, the two year rule refers to a reporting requirement. An organization that receives charitable deduction property affirms that in the event that it sells, exchanges or otherwise disposes of the property within two years after the date of receipt, it will file this information with the IRS and also inform the donor thereof. By not selling the mounts for two years, the museum does not have to report the sales price to the donor, and thus preserves the tax break for the hunter.

The Wyobraska Museum in Nebraska is only one of the museums that accepts donations of trophy mounts, and it is likely that there are other museum and nonprofit organizations that do as well. For example, Safari Club International Foundation's Sensory Safari program, which allows blind children to experience animals through mobile touch displays, is always looking for donated animals, and the curator of SCI's International Wildlife Museum handles the inventory of mounts.[14] Chicago Appraisers Association claims to have created the "sensory safari" concept used by SCI as a result of hunters with poor quality game mounts not being able to find a museum that would take them.[15]

Promoting Needless Killing of Animals for Tax Write-Offs

It is imperative that Congress act quickly to close the tax loophole that enables big game hunters to receive unwarranted tax breaks not only because it bilks the federal Treasury of untold millions of dollars, but also because it encourages more killing of wildlife around the world, including rare species.

The main promoter of the trophy mount donation for tax write-off purposes scheme, Chicago Appraisers Association (CAA), not only encourages hunters to donate the trophies they already have in their collection, but also to take "extra" animals on their hunting expeditions for the sole purpose of donating them for tax deductions. For example, one such promotional piece states: "This year we offer a special plan for clients going on future hunts. If you write and tell us where you are going, we'll suggest what extra animals to take and donate for tax savings."[16] Suggestions for "extra" animals are given in other material HSUS investigators received from CAA – "crippled females" and "sickly young" are recommended to be killed by hunters because the appraisal values are higher and the trophy fees are less.[17] Though it is impossible to know whether hunters in fact heed these preposterous suggestions, CAA claims: "In 1997, 27 hunters used our free consulting service, collected 63 extra animals for a total tax donation of $315,000. That is approximately $100,000 of tax credits to use on future trips."[18]

It is also likely that this trophy mount donation scheme encourages the needless killing of threatened or endangered species. A CAA publication entitled *Game Mounts for Museum Donation*, rightly notes that it is illegal to buy or sell endangered animal mounts. However, it goes on to state: "Thus, museum donation is your only legal option for realizing the financial value of animals like polar bears, tigers, leopards, jaguars, and elephants." Indeed, HSUS investigators observed the donated mounts of endangered and threatened species packed into Wyobraska Museum's storage trailers along with more common species of animals. The museum curator, for example, said that he could not sell a group of leopard mounts stuffed into one of the trailer cars because it is illegal to take

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[14] Email communication with J. Allyson Garcia, Humanitarian Services Coordinator, SCI Foundation, Tucson, AZ
[15] *Chicago Appraisers Association News*, Vol. 1, No. 1
[16] Promotional material received from Chicago Appraisers Association entitled "Hunt for Free"
[17] *Chicago Appraisers Association News*, Vol. 1, No. 1
[18] *Chicago Appraisers Association News*, Vol. 1, No. 1

them across state lines, but noted that it is legal for people to have them shipped to him for donation purposes.

Conclusion

"Congress certainly did not intend for the valuations of such donations of game mounts to encompass a write-off of a recreational big game hunter's vacation."[19]

This is a quote by the U.S. Tax Court in a 1993 case involving the inflated appraisals of trophy mounts that were donated by a big game hunter to a museum. In order to make its intention clear, we ask that Congress eliminate the loopholes that have made it possible up until now for trophy hunters, trophy appraisers, and questionable museums to exploit the tax code in order to give wealthy hunters a tax break.

Just as Congress and the IRS have recently addressed tax abuses involving vehicle donations with legislation, they should go after abuses of the tax code involving trophy mount donations.

[19] *George H. Engel v. Commissioner of Internal Revenue,* 1993 WL 316212 (U.S. Tax Ct.)

Statement of Steve McCormick
On behalf of The Nature Conservancy
Committee on Finance, United States Senate
Hearing on Charities and Charitable Giving
April 5, 2005

Mr. Chairman, thank you for the opportunity to present the views of The Nature Conservancy at this hearing on the governance of charities and the federal tax incentives for charitable giving. The Nature Conservancy shares your concern that the revenues committed to the charitable tax deduction achieve the important public purposes intended by Congress and not be squandered by taxpayer abuses designed for purely private gains.

The Nature Conservancy is an international, nonprofit organization dedicated to the conservation of biological diversity. Our mission is to preserve the plants, animals and natural communities that represent the diversity of life on Earth by protecting the lands and waters they need to survive. The Conservancy has approximately one million individual members and 1,900 corporate associates. We conduct on-the-ground conservation work that benefits nature and local communities in all 50 states and in 28 foreign countries. We have protected nearly 15 million acres of land in the United States and Canada and more than 102 million acres with local partner organizations globally. The Conservancy owns and manages approximately 1,400 preserves throughout the United States—the largest private system of nature sanctuaries in the world.

The Conservancy's programs are characterized by sound science and strong partnerships with public and private landowners to achieve tangible and long-lasting results. Our headquarters are located at 4245 Fairfax Drive, Arlington, Virgnia.

America's charitable sector is entering a new era of increased accountability, a transition that is no less consequential to the nation's nonprofit organizations than the corporate sector's recent and ongoing reforms are to public and private businesses. Concepts such as governance, accountability and transparency are gaining as much currency among the nonprofit community as fundraising, service and mission. Attention to these issues has been a long time in coming.

Nonprofit organizations—which range from hospitals and schools to soup kitchens and religious organizations—represent 7.5 percent of our economy with operating expenditures of more than $548 billion. They employ nearly 10 million workers, roughly as many as the 50 largest U.S. corporations, yet despite the sector's size and importance, nonprofits are subject to highly variable standards of oversight and internal governance.

The growing size and influence of the charitable sector has caught the eye of watchdogs, from Congress and state attorneys general to the Internal Revenue Service and the mainstream media. As a result, nonprofit oversight and governance practices, how charities use the tax code and whether all their actions are contributing to the public good are coming under new levels of scrutiny. This development promises to bring new pressure to bear on nonprofits and their boards, forcing them to take extra care to ensure all their organizations' actions contribute to the public good and are done in such a way as to protect their most important asset: the public's trust.

In May 2003, The Nature Conservancy suffered its own spate of negative media. That coverage prompted this Committee to begin an inquiry into some of the Conservancy's conservation transactions and led to an on-going IRS audit of our financial records. I want to commend the Committee and its staff for the very professional inquiry you have conducted. We look forward to the conclusion of your inquiry and a

hearing on your report about the Conservancy's transactions that may occur at the end of this month. We understand that your inquiry may lead to proposed changes in the tax code with respect to conservation easements and we look forward to working with you to get those changes enacted into law.

In addition to these public reviews, the Conservancy also created a review panel of outside experts headed by Ira Millstein, a well-regarded expert in corporate governance, to review our policies and practices and to produce a set of recommendations to help strengthen our governance and oversight. Their report was presented to the Conservancy in March of 2004, a year ago now. Since that time, the Conservancy has acted on nearly all of the panel's recommendations. The Conservancy's dozens of changes to improve its governance, policies and procedures are described in a short paper that I am attaching to this statement and that I would ask be printed with the record of this hearing.

As the Conservancy has responded to this public scrutiny and set about to strengthen its internal governance, we have learned some lessons that may be valuable for others in the charitable sector to consider:

- Governance must keep pace with growth. Every charity must have an active, engaged board committed to continuously reviewing, adapting and strengthening its oversight to meet the changing needs of the organization.

- Charities need individuals on their boards that bring specific professional skills and expertise beyond the traditional and almost exclusive roles of door-opening and fundraising. In today's world, board expertise in areas such as the law, public relations, accounting and management are not a luxury—they are a necessity.

- Because charities trade on their reputations, rigorous compliance with state and federal laws and conflict of interest policies should be an organization's default position. It's not enough to simply meet minimal levels of compliance. For charities, perception is everything, and charities can't afford even the appearance of impropriety.

- Openness and transparency must be organizational priorities for nonprofits. Since the performance of charities can't be judged on quarterly earnings statements, the public must have access to information to help them make judgements about the effectiveness of the charities they may support.

- Senior leadership and boards at nonprofits must be attentive to the full range of potential risks with policies and procedures in place to assure that we thoroughly manage our funds and respond promptly to challenges before they become crises that undermine public trust.

The charitable sector is at a critical juncture in its long, rich history of serving the public good. The final arbiters of how successful nonprofits are in meeting heightened standards and expectations is the public who, like a for-profit company's shareholders, are now rightfully asking tough questions of their charities' board members and executive staff.

In place of stock, however, charities trade in good will—which is not easily secured or maintained. The most successful nonprofits of the future will be those willing to step back, learn the lessons of the for-profit sector and implement best practices for governance, accountability and transparency, meeting the highest professional and ethical standards.

A sector-wide commitment to this approach will ensure that charitable institutions remain among the most trusted elements of our society.

Mr. Chairman, The Nature Conservancy has made such a commitment. I firmly believe the changes we have implemented over the last 20 months have made the Conservancy a far stronger institution and brought our organization into full alignment with the expectations befitting a major nonprofit institution.

Further, we have made a concerted effort to share with the broader charitable sector the changes we have made and what we have learned throughout our review processes, in the hope that our experience may be valuable or instructive to others.

I, and all of my colleagues at The Nature Conservancy, look forward to working further with the Committee on issues of nonprofit governance and oversight and expanding the important tax incentives designed to encourage charitable giving.

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The Nature Conservancy
Strengthened Governance, Policies and Procedures

The mission of The Nature Conservancy is to preserve the plants, animals and natural communities that represent the diversity of life on Earth by protecting the lands and waters they need to survive. This mission is pursued through a science-based planning process called "Conservation by Design", which enables the Conservancy to identify lands and waters for inclusion in its conservation programs and then design site-specific strategies for the protection of those lands and waters while preserving compatible human uses.

The Conservancy has been and remains committed to carrying out this mission in accordance with the letter and spirit of all applicable laws and its organizational values, which speak to "integrity beyond reproach." In recent years, the Conservancy has grown substantially, both in absolute size and in the number and complexity of the transactions it undertakes to carry out its conservation mission. The Conservancy has also become increasingly decentralized, operating with professional staff in every state in the U.S., and in twenty-eight other countries. During this same period, policymakers and others have properly focused increased attention on the governance and activities of nonprofit organizations, including the Conservancy.

In June 2003, the Conservancy initiated a comprehensive effort to strengthen its general governance and its specific policies and procedures, including those applicable to its various conservation programs. The principal changes adopted by the Conservancy in the past year are summarized in this memorandum. These changes are intended to achieve the following goals: (1) enable the Conservancy's Board of Governors to provide increased strategic guidance and undertake more active oversight; (2) incorporate many of the governance principles contained in the Sarbanes-Oxley Act; (3) promote tax law compliance by all parties to conservation transactions in which the Conservancy is a participant; (4) address on a comprehensive and consistent basis issues involving actual or potential conflicts of interest; (5) provide more specific rules guiding key conservation programs such as easements, conservation buyer transactions and sales to governments; and (6) ensure high-level advance review of transactions that may present financial, legal, ethical or other reputational risk to the Conservancy as a whole.

Board of Governors

With the assistance of an independent panel with broad experience in governance issues, called the Governance Advisory Panel, the Board of Governors has been restructured to enable it to provide increased strategic guidance, assume a more active oversight role and define and manage the important

relationships among the Conservancy and its Chapters and their trustees. To accomplish these goals, the Board of Governors has created an Executive Committee, which now meets a minimum of seven times a year, and restructured its other committees. Comprehensive charters have been developed for each committee. Areas of increased Board oversight include, but are not limited to:

- governance, including responsibility for the performance evaluation and compensation of the Conservancy's President, as well as oversight of all matters relating to the compensation of senior managers;
- additional review of conservation strategies and projects beyond financial commitments for land acquisitions;
- additional review processes so that Board can more effectively assess and manage organizational and reputational risks; and
- additional review of more transactions under a strengthened conflicts of interest policy.

Non-employee members of the Board chair the committees and Board members serve on only once committee so that they can focus their time and be more deeply involved in oversight and management. All members of the Board are apprised regularly of the work of each committee.

Sarbanes-Oxley Principles

The Sarbanes-Oxley Act generally does not apply to nonprofit organizations such as the Conservancy. Nevertheless, the Board of Governors concluded that certain core principles of governance and accountability embodied in that legislation should be incorporated into the Conservancy's policies and procedures.

The Conservancy has agreed to strengthen its *internal audit function*. Under the supervision of the Audit Committee of the Board, the scope of internal audits will be expanded and internal auditors will be authorized to perform internal investigatory functions similar to those performed by Inspectors General in federal governmental agencies. Managers will be required to provide written reports on the manner in which they have implemented the findings and recommendations of the internal audit staff. Procedures will be established to identify and take appropriate remedial action with respect to internal audit findings that have systemic implications. The *external auditor* will be selected by the Board of Governors annually upon the recommendation of the Audit Committee. At least every five years, the Audit Committee will recommend to the Board whether a new external audit firm should be selected. If the then current audit firm is retained, a *new lead partner* will be selected.

The Conservancy has created, and now has, a senior level position of *chief compliance officer*, who will have organization-wide responsibilities for the ongoing training of all staff and establishing systems to promote compliance with all applicable laws and the highest ethical standards. The Chief Compliance Officer has created an ethics and compliance program. All key manager attend training and execute an *annual certification* saying that they and their staff have complied with the Conservancy's policies and procedures and certifying that any conflicts of interest have been disclosed.

In addition, a written *"whistleblower" policy and procedure* and hotline are in place to ensure that any employee who wishes to report a potential violation of law, policy or procedure may do so without fear of retaliation. The Conservancy has previously adopted policies prohibiting the use of Conservancy funds for *loans to employees* and members of the Board of Governors.

The Conservancy adopted a policy requiring Board approval for *the formation and operation of any related organizations* to ensure that the related entities are consistent with the Conservancy's goals and objectives and that related risks are identified and appropriately managed. (Related entities where the

Conservancy has a significant business interest, i.e. $100,000+ investment, but not a controlling interest must be approved by the President.)

The Conservancy has taken important steps *to improve the transparency and public understanding of its Form 990* filings. Guided by recommendations from the Governance Advisory Panel, the Conservancy's Form 990 for Fiscal Year 2003 included more information about the Conservancy's governance and its direct charitable programs and accomplishments.

Key examples of increased transparency include: a complete list of every grant the Conservancy awarded; expanded reporting of executive compensation; extensive information about the Conservancy's performance including its approach to projects, the work performed, and conservation results; and information about the Conservancy's governance structure and new policies and procedures that were put in place over the last year.

Much of the information reported on the Form 990 is derived from the contents of its Web site, www.nature.org, which is regularly updated and the public is encouraged to visit. The 990 Form for fiscal year 2003 and past 990 Forms are available on the Conservancy's Web site. On an ongoing basis, the Conservancy will continue to seek additional ways to improve the quality if its Form 990 filings. The Nature Conservancy regards its return on Form 990 as an essential document demonstrating its commitment to enhanced public accountability.

Assessing and Managing Risk

As the preceding discussion illustrates, the Conservancy has a broad range of policies and procedures and many of these have been strengthened over the past year. No set of policies and procedures can identify in advance all possible instances that may present financial, legal, ethical or reputational risks to an organization such as the Conservancy as a whole. Moreover, there are many instances where established policies and procedures would, if literally applied, prohibit the accomplishment of important conservation goals and it therefore may be appropriate in certain specific situations to permit those goals to be accomplished in an alternative manner consistent with the intent and purposes of the applicable policies and procedures.

To address these issues, the restructured Board has a Projects and Activities Review Committee that reviews conservation projects and strategies in addition to land acquisitions. The Board created a new Risk Assessment Committee in early 2004 to supplement the Board's review process and specific policies and procedures applicable to programs and operations. The Risk Assessment Committee reports directly and regularly to the Projects and Activities Review Committee of the Board. The staff committee's activities are modeled on the committee review process increasingly used by decentralized firms, in the financial services sector and elsewhere, for risk review. The committee conducts advance reviews of those projects, transactions, and issues that meet its criteria for review (e.g., transactions that are new, novel or particularly complex, and transactions that comply with applicable legal and tax requirements and Conservancy policies, but nevertheless involve potentially substantial financial, ethical or reputational risk to the Conservancy). Particular attention is given to ensuring consistency of projects with the Conservancy's stated values.

The committee's members consist of experienced Conservancy personnel representing all relevant disciplines necessary to evaluate critically the organizational risks associated with the types of projects, transactions, and issues to be reviewed. The committee endeavors to promote intelligent and prudent entrepreneurship by helping innovative conservation projects succeed wherever feasible. Thus, the committee has the ability not simply to approve or disapprove a proposed project or transaction, but to grant approval conditioned on restructuring the project or transaction in ways that will address

organizational risks effectively and ensure full compliance with all applicable laws and relevant ethical considerations.

Conflicts of Interest

The Conservancy has for many years had a formal conflicts of interest policy intended to ensure proper advance review of transactions involving employees, members of the Board of Governors, state chapter trustees, and other related parties. This policy has been administered by the Conservancy's Legal Department and the review process has focused primarily on the potential misuse of proprietary or inside knowledge and on whether the terms of all such transactions meet the arm's length standards of applicable law.

The Conservancy has strengthened its conflicts of interest policies in several respects that go well beyond legal requirements. First, the Conservancy *expanded its definition of "related parties"* to include major donors and immediate families of Board of Governor members, trustees, and staff.

Second, *purchases and sales of land (including interests in land, such as easements) involving related parties have been prohibited* even though they are permitted under applicable tax laws if structured in accordance with arm's length standards. For this purpose, a "related party" means any person who, within the 12-month period preceding a proposed purchase or sale, was a member of the Board of Governors, a Chapter trustee or an employee. In addition, the prohibition applies to close relatives of any such individual and entities in which the individual and/or a close relative owns more than five percent equity interest.

Third, *other transactions with related parties* (i.e., those that do not involve the purchase and sale of land) will be subject to advance review under the Conservancy's *expanded conflicts procedures*. Under the expanded procedures, a new interdisciplinary committee of experienced Conservancy staff will supplement legal review of all proposed transactions. Actual or potential conflicts involving members of the Board of Governors or major donors will be referred to the Audit Committee of the Board.

Third, *purchases and sales of conservation lands and other transactions involving major donors* will be subject to advance scrutiny under the expanded conflicts of interest policy. For this purpose, a "major donor" means any individual, corporation, foundation or other entity that has made gifts or pledges of at least $100,000 (in cash or in kind) on a cumulative basis within the five-year period preceding the proposed transaction.

Fourth, special rules will apply in the case of *gifts of land (including easements) by related parties and major donors.* In these cases, such gifts will be accepted only if the Conservancy receives a written certification from the appraiser used by the donor to value the land for tax purposes that the appraiser is aware of the relationship between the related party or major donor and the Conservancy and that the relationship did not influence the appraiser's conclusion as to value. In addition, all such gifts would be subject to advance review under the Conservancy's expanded conflicts of interest procedures.

Fifth, while financial supporters of the Conservancy can be elected to the Board of Governors, *if a member of the Board or a company with which he or she is affiliated intends to claim a tax deduction for a gift of land (or an interest in land, such as a conservation easement) to the Conservancy, the transaction will be subject to strict scrutiny by the Conservancy and must be approved by the disinterested members of the Board.* Among other things, this new policy requires *independent assessments by unrelated and qualified persons* of both the conservation value of the land to the Conservancy's mission and of the tax valuations of the gift to be used by the donor.

Sixth, Board members and their companies *cannot engage in cause related marketing* agreements with the Conservancy.

Seventh, *training programs* have been initiated to enable staff to identify and address cases that involve even the appearance of a conflict.

Promoting Tax Compliance

The Conservancy is committed to the principle that conservation transactions in which it participates must be structured and implemented in a manner that promotes compliance by *all* parties to those transactions with the letter and spirit of all applicable laws, including federal, state, and local tax laws. To promote tax compliance, the Conservancy is implementing two new procedures.

IRS Form 8283 Review

To promote compliance with rules governing the *valuation of gifts of land (including interests in land such as conservation easements)*, the Conservancy announced in 2003 it will execute an *IRS Form 8283* for a donor (as required under IRS regulations to substantiate receipt of the gift) only if:

(a) the form contains all information required to be provided by the donor to the IRS;

(b) the donor provides to the Conservancy a copy of the appraisal to be used by the donor to establish the tax value of the gift shown on the form;

(c) the donor's appraiser provides the Conservancy with a written certification that he or she (i) is State-certified; (ii) has used generally accepted appraisal standards in making the appraisal; (iii) has the requisite expertise and experience to make appraisals of conservation lands and conservation easements; (iv) is not barred from practice before the IRS, the Department of the Treasury or other administrative bodies; (v) has taken into account any value enhancements to other property of the donor or parties related to the donor; and (vi) has otherwise satisfied all of the requirements for a "qualified appraisal" prescribed by the IRS; and

(d) if the donor is a related party or a major donor (as defined) with respect to the Conservancy, the appraiser must also certify that he or she is aware of this fact and that it did not influence the appraiser's valuation.

Existing tax law requires only that the Conservancy certify receipt of the gift.

Additional Tax Compliance Procedures

Consistent with the practices of many tax-exempt organizations, the Conservancy provides general information to third parties with respect to the potential tax consequences of contributions to and conservation transactions with the Conservancy, but it has long had a written procedure prohibiting the providing of legal and tax advice to third parties. The Conservancy adopted a more comprehensive procedure to promote tax compliance. Among other things, this new procedure places explicit limits on the types of conservation transactions in which the Conservancy will participate. Specifically, the Conservancy will not enter into any *conservation land transaction that provides tax benefits to a third party* unless the transaction enhances, directly or indirectly, the ability of the Conservancy to carry out its conservation mission; *and* the Conservancy determines that the transaction: (a) is not a "reportable transaction" within the meaning of section 6011 of the U.S. Internal Revenue Code, relating to tax shelters; (b) has not been structured to enhance the ability of any person to avoid a tax reporting or

substantiation obligation under any federal, state or local tax law; and (c) is substantially similar to the types of transactions previously approved by the Conservancy.

In general, a type of transaction will be approved by the Conservancy only if an independent and qualified tax counsel could reasonably render an opinion that, upon audit by the IRS or other appropriate tax authority, the anticipated tax benefits "should" be upheld by the tax authority or a court, as opposed to opinions that merely say it is "more likely than not" that the tax benefits claimed would be allowed, or that there is a "reasonable basis" for such a claim.

Procedures for Specific Conservation Programs

Conservation Easements

Conservation easements are one of the most powerful, effective tools available for the permanent conservation of private lands in the United States. Conservation easements are used in the United States by more than 1,200 organizations and many governmental agencies and have been used by the Conservancy for more than four decades for a broad range of purposes (e.g., providing buffers for core conservation areas, including national parks and other public lands; preserving critical habitats; and conserving watersheds and aquifers to protect aquatic biodiversity and help ensure clean drinking water). Their use has successfully protected millions of acres of wildlife habitat and open space, keeping it in private hands and generating significant public benefits.

For many years, the Conservancy has had specific procedures governing when conservation easements will be accepted or purchased; requiring preparation of a detailed "baseline" report at the time of acquisition to facilitate future monitoring and enforcement; and mandating the establishment of stewardship funds for finance monitoring and enforcement. In 2001, following consultations with the IRS, the Conservancy established comprehensive procedures governing proposed modifications to easements. These procedures were further strengthened in 2003. The Conservancy will not agree to a substantive modification of an easement unless the original conservation purpose of the easement is not compromised, the General Counsel's office determines that the modification does not result in a net private economic benefit, and approval is granted from the relevant state authority.

In June 2003, the Conservancy established a Conservation Easement Working Group to conduct a comprehensive review of the processes by which the Conservancy acquires, uses, monitors, and enforces conservation easements. Based on the Working Group's recommendations, the Conservancy adopted strengthened procedures requiring, among other things (a) that, consistent with prior practices, prospective donors of easements be informed of the Conservancy's policies and practices to ensure a clear understanding of mutual expectations and obligations with respect to easements; (b) standardized decision-making on the appropriate location, terms and conditions of easements; and (c) consistent monitoring and enforcement of the terms of the Conservancy's easements. Now as part of routine audits, the Conservancy's internal audit staff checks to see if easements are being monitored and that monitoring site reports are being filed.

As stated above, proposed modifications to easements have always been subject to advance review by the Legal Department. In addition, proposed modifications involving related parties or major donors now will be subject to advance review and approval under the Conservancy's strengthened conflicts of interest policies and, as appropriate, by the newly formed Risk Assessment Committee. Particularly large, risky or potentially controversial easement donations will also be referred to the Risk Committee.

The Working Group's final report was presented to and accepted by the Board of Governors in June 2004. At that time, the Board directed the Conservancy's staff to implement the Working Group's

recommendations through seven specific actions. One of these actions is the establishment of a new centralized easement management electronic database that will include all easements held by the Conservancy and the terms and conditions of each easement. When fully operational, the protocol will (a) notify Conservancy field offices of appropriate monitoring dates for each easement; (b) provide a standardized monitoring checklist; and (c) require that all records of monitoring, property transfer notices, regular owner cultivation, periodic verification of the baseline, and enforcement actions be entered into the system.

Conservation Land Sales to Governments

The Conservancy has for many years had a "no net profit" policy for transfers of land (and interests in land, such as easements) to governmental agencies for conservation purposes. This policy is intended to ensure that the Conservancy only recovers its costs upon such a transfer. Recovery of such costs is also generally limited by the fact that governmental units may only pay fair value for property.

In March 2004, the Conservancy strengthened its "no net profit" policy to provide more specific guidance with respect to inclusion of direct and indirect costs in the Conservancy's sales prices to governmental entities. In addition, the strengthened policy requires that certain amounts be deducted from the otherwise permissible purchase price. These required reductions include: (1) the value of gifts (including private grants) received and restricted to the conservation lands involved; (2) any government funding received for acquisition or other costs (including costs of capital improvements) relating to the conservation lands involved; and (3) net income received by the Conservancy from any activities (e.g., a significant timber harvest) that have a material effect on the value of the conservation lands involved.

Conservation Buyer Transactions

Conservation buyer transactions typically involve the purchase of land by the Conservancy at its fair market value followed by the sale of the land to an individual or organization (other than a governmental unit or another conservation organization) subject to a conservation easement permanently limiting the uses to which the land may be put. As a result, the restricted value of the land acquired by the conservation buyer is less than the value of the unrestricted land purchased by the Conservancy. In some instances, the Conservancy may seek a contribution from the buyer or a third party to offset its costs, including the cost of acquiring the property. All of the Conservancy's conservation buyer transactions served important conservation purposes and applied with all applicable laws.

These transactions permit important conservation objectives to be achieved while the property remains in private hands, on the local tax rolls, and in most cases allowing some compatible economic activity to occur. Of the approximately 10,000 land transactions in which the Conservancy was involved in the last 10 years, 169 were conservation buyer transactions. Of those 169, only 19 were with trustees or employees of The Nature Conservancy. All of these properties were sold for fair market value and subjected to conflicts of interest review.

As noted previously, conservation buyer transactions may no longer be undertaken with related parties and, in the case of major donors, they may be undertaken only following advance review under the Conservancy's strengthened conflicts of interest procedures. In the case of those conservation buyer transactions that are permitted, additional special policies and procedures are now applicable. Specifically:

(a) to ensure that there is a conservation benefit to the public, the land must fall within a priority conservation site established by Conservancy scientists (which frequently involves consultation with appropriate governmental entities, outside scientists, and other knowledgeable

sources), and the terms of the easement (and the plan to monitor compliance with those terms) must be structured to achieve the desired conservation result on a permanent basis;

(b) to provide an open and equitable purchase opportunity to all potentially interested parties, the land must be offered for sale in a manner that allows for broad exposure and fair competition among interested buyers;

(c) to ensure that the Conservancy receives fair value for the land, the Conservancy must obtain its own independent appraisal documenting the value of the land both before and after the imposition of the conservation easement;

(d) to ensure compliance with all applicable tax law requirements, if a contribution is solicited in connection with a conservation buyer transaction (i) the Conservancy must document that fact and provide the buyer with a statement of the link between the gift and the sale, and (ii) the transaction must be structured by the Conservancy so as not to relieve the buyer from substantiating the amount of the contribution for tax purposes; and

(e) to ensure that such projects are consistent with local community standards, the Conservancy will obtain community input regarding future uses of the land.

Compatible Human Uses

The Conservancy has long recognized that people are an integral part of the landscape and that a reasonable amount of human use of conservation lands must be allowed. To ensure that such uses on property owned by the Conservancy are compatible with basic conservation objectives, the Conservancy has taken the following steps: (a) to improve its decision-making, the Conservancy initiated, in cooperation with the United States Fish and Wildlife Service, a review of scientific studies and other literature related to compatible human use; (b) to improve its understanding of risk and inform future decisions, the Conservancy initiated a broad survey, based on recommendations of independent scientists, of existing uses of the Conservancy's preserves; and(c) innovative, large scale, or untested proposed human uses will be subject to advance review by the Risk Assessment Committee.

In addition, in June 2003, the Board of Governors adopted a policy prohibiting any new oil, gas or hard rock mineral activities on the Conservancy's preserves, except where required by pre-existing contracts or other legal requirements.

Legislative Advocacy

To accomplish its conservation mission, the Conservancy often takes a leadership role on ballot funding referenda and other public policy issues. The Board of Governors has clarified that the Conservancy will take positions regarding legislation, rule-making, adjudicatory and other policy matters only if (a) there is a substantial and direct impact on the Conservancy's ability to accomplish its mission, and (b) the Conservancy's position is essential to achieve the desired outcome of the matter in question.

To ensure continued compliance with the tax law requirement that "no substantial part" of its activities consist of attempts to influence legislation, etc., the Conservancy, the Board of Governors has approved an expenditure cap of up to two percent of the Conservancy's budget for such activities. In addition, the Conservancy has provided increased training to its staff.

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