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Senate Finance Committee
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Submission Of Comments on Staff Discussion Draft
Re: Charitable Oversight

These comments are submitted to the Senate Finance Committee Roundtable by invitation of the staff. Thank you for the invitation.

The comments herein are not offered on behalf of an entity or a particular interest, they may made aid, perhaps only slightly, in illuminating some of the issues the general public encounters in charitable oversight. The comments are offered, principally, to provide "case study" perspective on charitable oversight. Accordingly, the perspective(s) offered here are based on practical experience in working with Form 990's and discerning actual meanings of disclosures in them. The suggestions made here emanate, in some measure, from particular (private) examination of an charitable entity with a mission of education in the State of New Hampshire. That State has, among other things, what is commonly known as the first, modern statute for the regulation of charities by a state. Consequently, and practically, the comments made here will discuss some limited aspects of state and federal joint regulation: again, from the perspective of the public.

Additionally, attached is a portion of a letter drafted in 2003 and presented to the Technical Division of Exempt Organizations at the IRS last year. It contains some 22 numbered items that may be of some interest to the Committee members, staff and others. That list was derived from practical issues and problems that arose in trying to interpret or get additional information on Form 990 disclosure.

These comments will generally follow the discussion items and sections for in the Staff Discussion Draft. Other comments will be offered where applicable and as noted. Before engaging the draft itself, I will observe that these comments do arise in the context of a charity that is educational in mission, has been around for over 100 years, receives more than $1M in funds per year, and has an endowment in excess of $100M. To an extent, the comments here need to be calibrated to the size of the charity (and its educational mission) that give rise to the comments. Smaller charities that provide different services (e.g., different from education) might arouse concerns and comments other than those provided here.

A. Exempt Status Reforms

1. Five-Year review of tax-exempts

Some persons might observe that many of the essential features of "five year review" of tax

exempt status can or will occur if the existing functions of reporting are enhanced. One the other hand, charities that do not continue to report or file annual returns through the years pose different issues. But and still, on another hand, causing tax exempt charities to review tax exempt status every 5 years might indeed (for all charities, even conscientious reporters) be a salutary, free-standing mission for tax exempts to undertake.

In part, the benefit would be to cause entities to consider, at regular intervals, the specifics of tax exemption as applied. Failure to understand what a tax exemption is or what it means is at the core of some, but certainly not all, of the troubles in the charitable sector. Further, this would ensure that through reasonable periods (i.e., 5 years) through the life of the charity, changing leadership (or unchanged leadership) would be compelled to face the mission, the financing, the purposes and the sustained goals of the charity. Limited experience has shown that it is not safe to assume that these things happen "automatically;" even if, for example, Form 990's are filed annually.

In any event, whether happening in the context of 5 year reviews, or, in the context of revised and supplemented Form 990 filing, charities should file: articles of incorporation, current bylaws, conflicts of interest policy along with annual results of conflicts decisions and implementation, lists of trustees, directors, and other entities and charities served by the trustees and directors, evidence of accreditation, bond disclosures and covenants and filings of material changes (or other disclosure), financial statements and audits, amounts of settlements or enforcement actions, and, for charities of any size audit reports and independent audits of endowment funds, detailed records concerning how donations are received and processed, detailed description of board committee structure membership and practices of the Board and the organization, and, copies of disclosures and or solicitations or reports made to donors (or alumni, or other interested persons or the public).

Additionally, consideration should be given to requiring the charity to disclose on Form 990's, or, in five year review of tax exemptions, or both, any enforcement action taken as to the entity, its Board, its executive director(s) or other and all "disqualified persons" entities or affiliates. (Enhancement of penalties for failure to file corrections, amendments, emendations, or changes should be considered. The word "material" should be defined independently of GAAP definitions when assessing what needs to be reported. I.e., in the context of compensation, consultant fees in schedules, investment management fees, etc., "material"– in need correcting to reflect what is true and accurate" -- can be defined as "any amount in excess of $10,000 or which amount or mistaken amount, as reported, would have the effect of materially misleading the public in understanding how monies were actually spent by the charity, whichever is less.")

B. Insider and Disqualified Person Reforms

Whatever changes are made in this area of concern, express consideration should be given to matters involving not only compensation of Board members and "key" persons, etc., as to the charity's lease, compensation, exchange, lending, etc., interests, but also compensation flowing from referral or direction of the charity's endowment and investments. Irrespective of anything else that is filed as to conflict of interest disclosures or resolutions, all fees or benefits received by Trustees, officers, directors, executive directors, family (all disqualified persons however defined broadly) in conjunction with investments of the charity must be disclosed. For example, all limited partnership investments should be disclosed along with costs and fees and charges and duration of investment. Any person(s) however affiliated with the charity (i.e., as a disqualified person of any description) who invest in any investment or partnership, etc., that the entity is invested in as well must be disclosed. This should be done in conjunction with expansive definition of "control" over the charity by persons, affiliates or supporting entities.

C. 4. Limit Amounts Paid for Travel, Meals, and accommodation

This comment is in addition to the suggestion of government rates for charities – or other rate as

may be set by the IRS. Charities should disclose the rate at which travel, meals and accommodations are actually paid (or reimbursed) and the total amount spent on the same by the charity. Any amounts spent on "first class" (or "higher") travel or accommodation, should be listed and explained separately, and, as to each item explain necessity. Any actual expenses (including dues) for travel club memberships, or other memberships, should be disclosed as to item description, location, cost and necessity. The Board must approve both the policy of reimbursement and the expenses incurred up to a minimum. Any amounts penalized (as excess or otherwise) must be subject to detailed disclosure on the organization's Form 990 whether paid by the organization, its Board, a member or other individual, augmenting lines 89a through d of the existing Form 990. A year in which an excess benefit transaction(s) is reported is not a year in which an entity may apply for an extension in filing a Form 990; or, must pay a penalty for so filing.

D. 2. Provide States the Authority to pursue federal actions

Whatever "authority" is provided here, it ought to be considered in conjunction with the realities of existing state enforcement apparatus and infrastructure for charitable regulation and enforcement of state charities laws. In an extreme scenario, that may not be at issues these days, States (perhaps in addition to charities) could be penalized, in some fashion, for enabling charities (and or violations) to occur in an environment of lax (or non-existent) state enforcement. If charities exist in a state and state fees are collected, it is to be assumed that the state can adequately enforce appertaining laws and tax exemptions. Some thought might be given, expressly in this context of state/federal jurisdiction as to how private relators should function in this context of shared (or not) state/federal authority.

E. Improve Quality and Scope of Form 990 and financial statements

Comments as to this are attached in the letter dated March 3, 2003, to the Technical Division of IRS TE/GE (Exempt Organizations). There are 22 comments made there. Some additional emphasis is added here.

Chief Executives, Chief Financial Officers, the Treasurer, Finance Committee and the Audit Committee members or equivalent of the same of tax exempt charities, should sign the Form 990, or, at a minimum, sign a certification page stating that the Form 990 is true and correct and accurate to the best of their knowledge and that they have read the Form 990 and the disclosures made therein, and all attachments and schedules, and understand all of the same. The purpose is to get people on the Boards or in leadership of charities to read and to understand the filing and disclosures made.

Penalties for failure to file "true and accurate" or "timely" Form 990's should be not only be enhanced but enforced. Experience has shown several things. One observation is that entities feel no "need" to correct Form 990's with errors in them. The proffered excuse is "materiality" (bolstered, in some instances, by professional advice). Indeed, experience has shown that some entities may choose to fail to file a correction or amendment, and instead, will hire consultants, accountants, and lawyers to defend that choice – rather than file the correction at relatively nominal cost to the charity and the public. Another observation concerns how to follow up on corrections and accurate disclosures: When a "correction" is filed it should be made available and made "as public" as the original Form 990 was when it was filed. This would obviate any need for persons to hunt around to see what was or was not done in the face of error in disclosure to the public.

When penalties are paid the entity involved shall report the same by attachment or in a space provided in the Form 990 as revised. If "excess benefits" penalties or other payments or excises are involved, these too shall be noted and reported on the entity's Form 990 filing (e.g., lines 89a, et seq., and in detailed attachments).

Standards for filing Form 990's should not only be enhanced in order to promote uniformity in the charity sector, they should be enhanced in order to promote depth and breadth of disclosure to the public. Details of breakouts on compensation, pecuniary benefits, other benefits should be required. Charities could solve some of the problems in some areas by requiring that executive directors file their compensation agreements, contracts, retirement contracts, severance agreements, etc., as part of the disclosure on a Form 990. Additionally, Form 990 standards should be augmented so that every consultant, professional, lawyer, accountant, advisor, etc., is reported on the schedules with full amounts billed and full amounts paid shown for the year in question. Lists for compensation disclosure purposes in the schedules should not be limited merely to the top five highest paid (by the entity) consultants, but rather, all consultants should be listed by category of professional or other service and all fees and amounts shown. All "deferred" or other time delayed compensation must be shown.

Investments, investment policy, and procedures should be included and listed on Form 990 disclosure for charitable tax exempt entities.

Compensation consultants and fees should have a separate space for disclosure and description of services on the Form 990. A compensation consultant's reporting requirement is triggered by service to an employee, executive director, (disqualified person, etc.), officer of a tax exempt charity, rather than by the mechanical means by which the consultant may be paid.

All bond debt obligations should be listed and described with copies of reports as filed to bond trustees, holders or others. All contingent liabilities (e.g., calls on capital or capital due in limited partnerships, etc.) shall be listed and described in detail on a charity's Form 990.

Independent audits should occur as to Form 990's; but, more importantly, for some charities, independent and perhaps separate endowment (including of fees or managers and consultants and affiliates) audits should be a requirement for endowments receiving or holding more than $XXX (e.g., charities with an endowment and which charity receives more than $1,000,000 in a year).

Enhanced disclosure of related organizations and insider transactions has been partly described above (as to limited partnership interests, etc.). Show all taxable events and subsidiaries and explain, in detail, the purpose of each and the charity's relationship to the entity or event. Require public disclosure of all tax opinions, of any kind, provided to the charity, not simply as to insiders or conflicts of interest, but also as to any feature or facet of the tax exempt status and compliance.

In addition to listing partnerships (e.g., limited partnerships) in investment disclosure, the charity should list the partnership's purposes, its investments or investment vehicles if any, general partners, and other purposes. Any officer or director or employee or family member of the same involved in any way in any investment of any charity shall be listed, including in limited partnerships.

Disclosure of investments has been discussed variously in these comments. The Form 990 should include a section where each investment interest, including partnerships, is listed. As noted, alternative investments should be described completely as to purpose, the charity's stake (or investment role in the purpose), investment policy purposes as met by the investment. For charities of a certain size (e.g., receipts over $1M) audits of the endowment investment should be included (or, a detailed explanation of availability or unavailability provided). All materials on investments of charities shall be public as consistent with the granting of a tax exemption by the public.

F. Public Availability of Documents

All Form 990's, amendments, corrections, attachments, schedules, and financial statements shall

be public. All audits of endowments, endowment investments, or separate audits of investments or Form 990 disclosures shall also be public.

All audits and closing agreements between a charity and the IRS shall be public and shall be posted.

All state enforcement agreements shall be timely filed with the IRS and attached to Form 990's in the year when entered into and in any year that the enforcement agreement (consent agreement or settlement) is in effect. Certification that all other necessary and proper filings have been made with state or federal agencies shall be required (e.g., to a state bond authority, the SEC or any other agency, bureau, or department of state, local, or federal government). All fees incurred by a charity in conjunction with any enforcement action whatsoever, shall be reported as a separate category of fee in a separate portion of a Form 990 or schedule. All funds received by the charity upon return or disgorging unto it in conjunction with any settlement (voluntary or otherwise) shall be reported.

G. Encourage Strong Governance and Best Practices

Strong governance and understanding the nature of tax exempt entities and mission are related. For a Board to govern properly, it members must understand the nature of the entity in addition to its stated mission. In addition, Board members must understand the nature of the duties that attach to Board members of tax exempts, including the duties of care and undivided loyalty. Statements to this effect and modified in detail as to tax exempt entities with different missions, should accompany registration filings, exemption applications, proposed 5 year renewal applications, and Form 990 filings and signed by Board members.

Boards shall be required, over time, to demonstrate that Board selection processes instill good governance by, among other things, appropriate regard for independence of Board members. Boards shall select and be able to demonstrate selection of Boards that understand the duty of loyalty, the duty of care, and the need for independence. Board members must be able to articulate that their duties are performed in spite of, distinct from, and in many instances in contra-poise to their own interests. The duty of a tax exempt trustee is to perform for another set of interests completely (or as completely as is practicable) divorced from one's own interests.

Charitable boards should define "conflicts" broadly and avoid them scrupulously. Boards of charities with a mission of education, for example, should avoid not just financial conflicts with board members in compensation areas and investments, but also in the area of donations, gifts, tuition remission, admission of children, or, service on a Board while a child is enrolled in the charity.

Compensation consultants, as noted above, must be disclosed, must disclose their fees, must disclose how the fees were earned and calculated, and, what the fruit of the fee(s) is or are by disclosing not only their own agreements but those they bargained for on behalf of others (e.g., executive directors'). All compensation must be justified. All compensation consultants must be able to justify the fees they bargain for, whether for themselves or executive directors, etc. Any disputes or settlements with compensation consultants for public charities must be reported and publicly disclosed, including on Form 990 disclosure and schedules.

Auditors, consultants, and in some instances counsel, should be changed no less than every five years. In a case where counsel is openly serving compliance and disclosure and otherwise serving as an appropriate fiduciary for a charity in compliance, counsel might be retained on. When a charity falls woefully out of compliance, new counsel should be sought, or existing counsel should explain publicly the default(s) of the charity. Counsel, charities, consultants, Board members, directors, officers, and executive directors, etc., should avoid conflicts and divided interests.

Conflicts of interest policies should not only exist and be disclosed, they must be enforced and compliance processes and measures shown. Failure should result in removal.

Boards, executive directors, consultants, and all persons and entities acting in any capacity as a fiduciary or in the preparation of public disclosures should be removed for noncompliance and penalized for willful noncompliance with the duties of care, competence, and undivided loyalty.

Board Composition

The Board of tax exempt charities should be made up of people who are all substantially independent, where "independent" means free from fetter or even appearance of fetter on independent judgments in the exercise of the duty of care and undivided loyalty. In larger charities, particularly with emphasis on education or with a mission of education, no less that 90% of the Board shall be independent as broadly defined (and, the remaining 10%, for example, shall not have "all the power to act for the Board at anytime," on their own or in combination with others, or in any other way whatsoever).

Boards shall turn over at intervals and cycles of no less, generally, than six years, and shall select Board members openly.

Any Board of any of any tax exempt charity in the United States that is sanctioned by a state or the federal government in any way shall not be allowed or further enabled to select Board members exclusively for a period of not less than years after the lapse of the sanction period.

States and the IRS shall have broad authority to remove Board members of tax exempt charities not only for violations of securities laws, or convictions, but also for violations of the standards applicable to fiduciaries entrusted with the care of a (public) charities sustained by tax exemptions.

3. Board/Officer Removal

In addition to or to augment and underscore the comments in the Discussion Draft, it is observed here, that participation in an "excess benefits" transaction that results in a tax or penalty should arouse a presumption of removal of the officer, board member or director. Additionally, auditors, counsel, or consultants, that approve any such transaction or "audit it" without comment should also arouse the presumption of removal from the service of the public charity. State enforcement of state charities laws could provide the vehicle to perfect these matters upon referral from the IRS.

Board members who have not been forced to cease and desist from practice by the SEC, for example, nor convicted of any crime or fraud, etc., should still be required to report any litigation they are involved in (in any capacity) that involves claims of breach of fiduciary duty, fraud, failure of disclosure, investment fraud(s), or like claims. This should be mandated as to investment committee members, audit committee members, and Treasurers, in particular.

6. Establish prudent investor rule

A prudent investor rule for investment of a charity's assets in endowment should expressly be conditioned or modified to include the notion that a "prudent investor" that is a tax exempt charity is a different investor than non-tax exempt entity. The rule could be styled "prudent investor that is a tax exempt charity rule." The rule, however drafted or considered, should pay heed to the actual state of charitable oversight (lacking or not by degree) and tighten accordingly. Consideration should be given to how much or in what ways charities should be limited in asset allocations in classes of investment, particularly those were oversight of the investment itself is

slack or functionally non-existent. Additionally, standards for assessing and evaluating risk should be part of any charity "prudence" or "prudent charitable investor" rule. Best practices in "prudence" should be considered in the "prudent charity investor rule" area. These should, minimally include guidelines on how to structure Board oversight of investment policy, investment committees, investment decision and evaluation, evaluation of proper managers, consultants, periodicity of review of investment decisions and managers, conflicts in investments, and so forth. Minimum standards should be set high.

Rules applicable to charities and investment should be distinct in emphasis from rules that pply to investment brokers and investment houses generally. They should be tighter and emphasize investment purpose as coordinated with charitable mission. Schedules of fees (investment managers and consultants) and ceiling might be a valuable area of continued analysis.

H. Funding for Education

In addition to funding "education" this commentator emphatically recommends increasing the funding for enforcement and oversight by the IRS itself.

Any monies once appropriated for enforcement and now held due to change or lapse in law should be released. The charitable sector should be policed by itself in conjunction with adequate enforcement by IRS including funding mechanism to enhance timely filing and data analysis of Form 990's and attachments and schedules. The viability of a charitable sector that actually serves the public in a variety of missions depends on public confidence and public understanding. These things are safeguarded by public oversight and enforcement of the public's bestowal of tax exemptions upon charities.

While many or most charities, apparently, perform their tax exempt missions well, some do not, and these erode overall confidence. In addition, when, for example, charities with a mission of education fail to live up to the standards applicable to tax exempts, they axiomatically erode confidence in facets of the value of education and related functions. A system of tax exempt education (charities with a mission of education) ought to be free from breach, or fraud or failure trusteeship and entrustment, of any kind, as much as is practicable particularly as to exemptions.

Thus, my recommendation is that the IRS be appropriated more money than ever to enhance oversight and enforcement in the charity sector. States should be allocated monies in conjunction with an analysis of methods of state enforcement and efficacies.

Further, education as to duties and best practices in the area of charities and enforcement should be enhanced together at the direction (first of Congress then) of the IRS. But if, for example, tax exempts are going to make their mission into "a mission of educating other tax exempts on best practices," these "teaching" efforts should be closely overseen and monitored by and at the direction of the IRS. Essentially, except in the case of the smallest charities perhaps, the duty of education on best practices is an internal one to modulate with the public – not to be, strictly speaking, modulated by interference with interests or intermediaries that are not the public's interests or agents. Best practices, in this area, are practices that assist in delivering the substance of charitable mission (including the dollars) to the mission. Virtually all dollars should be allocated to the IRS itself to structure enforcement and direct education.

I. Tax Court, etc.

3. Private Relator provisions

If resort is made to private relator provisions to enforce laws and duties appertaining to charities, some time should be devoted to consideration of what these provisions can accomplish and for whom. Are these provisions really disguised discussions about underfunded enforcement at IRS? Are these provisions about trying to put out wider nets to detect abuses or needs? Are

these provisions about actually aiding in detection and cure of troubles in the charitable sector or are they offered as an alternative or palliative to an underfunded public enforcement entity? And, if the public (through the device of a private relator) is going to be encouraged to filed enforcement actions or notice actions to and for the IRS then it is likely to be counter-productive to that goal if the private relator provision emphasizes the threat to the relator of sanctions or fees.

Some thought ought to be given to the difference between what is frivolous use of a private relator statute and what is going to be a battle of substance where "frivolity" is asserted as a defense. A private relator statute should be crafted around the notion of duties to serve the public and the integrity of the tax exempt system of charities. It should be drafted as with an eye toward being a useful tool, not a threat, either to charities or to relators. (Leave it to state and federal courts to enforce the equivalent of Rule 11 and other litigation sanctions.) The model of a federal qui tam action might be resorted to in this context.

An alternative and different suggestion is that the IRS have its powers enhanced to police the amount of fees that a charity can spend to meet or defend investigations into the amount of money that the charity is spending. A way to do this is to cause charities and their counsel and consultants and experts to file quarterly reports, separate from Form 990's with the IRS and state regulators, upon "notice" of commencement or other activity of an investigation into the charity (e.g., excess benefits, self-dealing, private inurement, conflicts, breach of fiduciary duty), that reveals fees expended on lawyers and consultants to meet investigations or formal compliance matters with states or the IRS. Fees spent on meeting compliance standards or investigations should be reported separately and in detail from other legal expenses as reported on line 32 of the Form 990; and should be filed with the state of registration as part of registration requirements with the Form 990.

Postscript comments: July 22, 2004 at the hearing.

As noted at the Roundtable discussion, concern or focus on "a few" "bad apples" coloring the charity sector is an error in focus. The question is: how do so many "good eggs" become "bad apples?" (Does it happen over night? Could it happen to good people in a good charity? Experience shows that bad things can happen to good charities – and good people can be or become involved. Experience also shows that part of the remedy is vigilance, part of the remedy is education, a significant part of the remedy (in a variety of ways) can be public disclosure.

A knowledge of governance, a knowledge of public disclosure and its demands, a knowledge of the meaning and duties that attach to tax exemptions and the purposes of the same, are all things that aid in keeping charities closer to mission and more distant from troubles. Troubles do not just come or manifest in "outliers" (charities which are or behave at the margins). Troubles can come from within any charity.

Charities involve a profound level of entrustment and fundamentally require that persons exercise and demonstrate the ability to think in the interest of others. Put very broadly – anytime the thinking devoted to charity devolves into interests that are not of the entrustment (e.g., in the interest of say a school that is a charity, or, a local association or club, or, a health care entity) then the "charity" is developing a conflict and its agents, officers and directors must heighten their own vigilance, beginning with their own conduct. This is hard to do if people do not understand the duties that attach when acting in the interests of "another" in a disinterested way. This is also hard to do without investing a lot work, beyond money, in what is "charity."

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