The Hauser Center
for Nonprofit Organizations
Harvard University

79 John F. Kennedy Street
Cambridge, Massachusetts 02138
tel (617) 495-232 fax (617) 495-0996
marion_fremont-smith@harvard.edu

Marion R. Fremont-Smith
Senior Research Fellow

July 13, 2004

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Max Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: June 21, 2004 Senate Finance Committee Staff Discussion Draft

Gentlemen:

I am writing at the request of Mr. Dean Zerbe with comments on the proposals contained in the Discussion Draft prepared by your staff in conjunction with your efforts to correct abuses in the charitable sector highlighted in hearings you held in June. I concur that there is need for improved and expanded regulation of charities by the Internal Revenue Service and state attorneys general. I particularly applaud efforts to improve state regulation by enhancing the ability of state officials to work cooperatively with their federal counterparts and I believe that increased disclosure will improve accountability. I am honored to have been asked to assist in your efforts and in that context submit the following comments.

INTRODUCTION: THE OVERRIDING NEED FOR AN ADEQUATELY FUNDED INTERNAL REVENUE SERVICE

I believe that with adequate funding and personnel, the Internal Revenue Service would have been able to prevent most of the abuses you are addressing. It is not the Code provisions that

are inadequate, rather it has been the inability of the Service to adequately police the sector. Unfortunately, in such a situation, there are individuals and organizations who will take advantage of the failure and attempt to reap private profit and benefit at the expense of the public. Accordingly, it will be futile to increase the regulatory burden on the Service unless additional funds will be available to provide the personnel and resources necessary for effective enforcement.

Your report recognizes the need for funding, but also appears to concede that it will not be forthcoming from general revenues. Your suggested solution is a combination of "user fees" and additional prohibitions the sanction for which would be loss of tax exemption. User fees merely add to administrative expenses, costs for foundations that are already being criticized as excessive. I urge that they be imposed only as a last resort. As to the sanction of revocation of exemption, one hoped that passage of section 4958 reflected Congress' acknowledgement of the fact that it is an inappropriate and ineffective sanction, removing funds dedicated to public purposes and leaving wrongdoers in place. I strongly urge that penalties for violation of any new limitations be imposed on the managers who committed or approved the prohibited actions, rather than on the charities themselves. If that is not feasible, then provision should be made for abatement of penalty taxes on charities or revocation of exemption if federal or state judicial action is taken to correct the violations and assure they will not be repeated.

GENERAL COMMENTS ON THE PROPOSALS

Your proposals fall into three broad categories: *first*, proposals to amend the Internal Revenue Code to extend existing limits on private foundations and public charities and increase disclosure re

quirements; *second*, proposals to expand the role of the IRS from its traditional function of protecting the integrity of the tax system to policing the internal practices of exempt organizations, imposing a set of "best practice" requirements on their day to day activities, and establishing the Internal Revenue Service as a "certifying agency"; *third*, proposals to increase the enforcement powers of the federal and state governments, while extending some of them to individuals. I will address each of these categories separately and will also provide comments on a few specific proposals that I believe warrant additional consideration. I support the majority of the recommendations under Heading A. Exempt Status Reforms, the provisions expanding the definition of disqualified persons, increasing the taxes on individuals under sections 4941, 4944 and 4945, improving the quality and scope of forms 990 and financial statements, and increasing public disclosure. My failure to

address these proposals specifically reflects an attempt at brevity.

Proposals to amend Code provisions to correct abuses and increase accountability:

I believe that, with a few exceptions, the first category of proposals will improve the ability of the Service to correct abuses and at the same time will enhance the accountability of exempt organizations by expanding the scope of information that they must make available to the public. My principal objection is to the proposal to extend the private foundation prohibition against self-dealing to public charities. I believe it is premature to discard the intermediate sanctions provisions. The charitable community is, albeit slowly, accommodating to the intermediate sanctions regime. The provisions of section 4958 were well considered before being enacted and should not be jettisoned without additional time to assess their effectiveness, particularly if this will occur once the Service has adequate funds for enforcement. There were valid reasons for imposing less stringent limits on self dealing by public charities than on private foundations, and you do not provide evidence to refute those reasons. In particular, I think a flat prohibition will greatly disadvantage the many charities in small communities which do not have a large pool of volunteers from which to draw for their governance. There are many examples of the negative effect of such a prohibition. One example I have used over the years is a town with one community hospital and one oil dealership. The owner of the oil company is a community leader who would be a natural candidate to serve on the hospital board. He would be precluded from doing so, regardless of the fact that his prices are the same for the hospital as for any other business in the community. We should not be discouraging his ability to volunteer. You will find analogies in almost any field of endeavor.

There are, however, two aspects of the intermediate sanctions provisions that I do believe should be modified. First, in determining reasonable compensation, comparables should be drawn from the nonprofit sector, not the business world. The leniency in the existing provisions may already have led to excesses that cannot be corrected. We need not perpetuate this situation, however. Second, disqualified persons found to have violated the provisions of section 4958 should not be allowed to avoid payment of excise taxes through application of corporate indemnification provisions, or proceeds of insurance. To do so is to render the prohibitions meaningless. Finally, if it is concluded that additional regulation of self dealing is necessary, I suggest limited measures such as prohibition of loans, combined with expanding the scope of disclosure of compensation arrangements and related party transactions.

If the private foundation prohibitions against self-dealing are extended to public charities, the private foundation rule prohibiting any leases between disqualified persons and a foundation should be modified to permit leases at or below fair market value, a proposal that has generally been agreed to be advisable and should be considered in all events. (In this context, I recommend consideration of this and other proposals to refine the private foundation rules developed by the Exempt Organization Committee of the ABA Tax Section in 2003.)

Proposals relating to governance and best practices:

The second group of proposals, the majority of which are grouped under your Heading “G. Encouraging Strong Governance and Best Practices for Exempt Organizations”, would vastly change the role of the Internal Revenue Service. I do not support them for several reasons. First, I believe that the Service as currently constituted does not have the capacity to administer the provisions you are recommending, and I question the advisability of attempting to adopt the changes necessary to permit it to do so. Regulation of best practices is more appropriate to an SEC-type agency, not one whose principal charge is to protect the integrity of the tax system. However, I am not persuaded that the extent of wrongdoing in the sector is sufficiently extensive to warrant creation of a separate federal regulatory agency to police charitable best practices, although such a move would be preferable to attempting to transform the IRS into such an agency. Evidence of the unsuitability of the IRS to police standards relating to governance is to be found in the difficulty the Service has encountered in effectively enforcing the provisions of section 4944 of the Code which applies a prudent man rule to private foundation investments. I also query what sanctions are contemplated for their breach and whether it would be possible to frame suitable ones.

Among this group of proposals is one that would assign to the Service the role of supporting accreditation programs or, alternatively, initiating its own programs, with tax exemption conditioned on accreditation. In addition to my reservations about the ability of the Service to conduct such a program, I believe it to be a misguided concept. You note the benefits of accreditation to the public in regard to standards for operation of hospitals, administration of universities, conduct of social welfare agencies and governance of museums. However, these programs are designed to and directed toward maintaining standards for the field in which these organizations operate; they do not extend to maintaining standards that would be the basis for tax exemption or the broader general administration of charities. The various nonprofit organizations that accredit charities that solicit funds from the general public provide

immeasurable benefit to donors and at the same time have been effective in raising the standards of many of the organizations they monitor. It should be noted, however, that the Maryland accrediting program and its counterparts in other states affects only charities that volunteer to become accredited, not with all soliciting organizations. It is a model for such a program, but I am concerned as to whether it can be effectively extended to the universe of charities.

I would also note that several of the specific proposals under Heading G are duplicative of those in other sections, while others, such as the whistleblower requirements are already applicable to charities under the Sarbanes-Oxley Act.

Proposals to enhance enforcement of federal and state laws regulating charities:

The third category of proposals reflect attempts to enhance enforcement – at the federal and the state level. For more than thirty years I have urged amendment of the Code to permit the Service to disclose its enforcement activities to state attorneys general on a timely basis. This reform is long overdue and it will be meaningless to encourage federal state cooperation unless it is enacted. This is mentioned is the introduction to your category H. “Funding of Exempt Organizations and for State Enforcement and Education.” I hope it is not lost during consideration of the recommendations relating to appropriations.

Under Heading D, item 2, you recommend providing the states with authority to pursue certain Federal tax law violations by exempt organizations with approval of the IRS. I am not sure what exactly is contemplated, but do recommend consideration of a Code amendment that would impose a governing instrument requirement on public charities similar to that applicable to private foundations under section 508(e) that would make compliance with the excess benefit limits under section 4958 a condition for exemption. The effect, of course, would be to make violation of the federal rules a violation of state law, thereby providing specific grounds for judicial action by state attorneys general, grounds that are needed in many states where the standards for charitable fiduciaries are not well-developed.

Under Heading I, there are three proposals for extending enforcement efforts by granting equity powers to the Tax Court, and creating new federal rules of standing for directors and individuals. In a paper prepared for the Filer Commission in the early 1970s, Adam Yarmolinsky and I recommended granting equity powers to the federal courts similar to those available to the state courts so that abuses could be corrected directly, rather than through the inadequate sanction of revocation. This proposal was made when the only remedy available to the Service for

violation of the Code provisions relating to charities was revocation of exemption and those provisions limited only private benefit and private inurement. I am not persuaded that they are needed today, but if they are to be considered, I would not confine the provision to the Tax Court and, in fact, believe that the District Courts may be more appropriate venues for actions requiring remedial remedies under equity principles. Furthermore, we should be extremely cautious in moving toward the imposition of federal standards of behavior for charities, both in regard to the standards to be adopted, and the effect such provisions would have on state laws and state enforcement authorities. The aim should be to promote uniformity under both regimes, and this will require both time and greater consideration of the basic principles that would be adopted.

Under Heading G relating to Governance and Best Practices, you recommend granting the IRS “authority to require the removal” of fiduciaries and employees of charities in the event that they have been found to have violated “self-dealing rules, conflicts of interest, excess benefit transactions rules, private inurement rules, or charitable solicitation laws.” I am unclear as to how it is contemplated that this power would be exercised, particularly where the basis for action was violation of state law (e.g. charitable solicitation laws or limits on transactions involving conflicts of interest). Further, the sanction of loss of exemption is particularly inappropriate in these situations.

The Discussion Draft recognizes the futility of attempting to increase regulation without also increasing the funds necessary for enforcement. Under Heading H, it is proposed to provide $25 million to States for exempt organization oversight and enforcement pursuant to a formula that would provide “$100,000 for each State with matching federal dollars for each new dollar in State spending”. It is unclear to me how this would operate, specifically how it would be allocated among individual states, including whether it would be directed toward states with no current enforcement programs or to those with active, but underfunded charity regulation efforts. State regulation has two aspects, regulation of the behavior and operation of charities that falls in each state to the office of the attorney general, but is actively conducted in less than fifteen states, and regulation of charitable fundraising which is carried out in more than half of the states, with some programs such as in New York and Illinois conducted within the office of the attorney general and others such as in Pennsylvania by the secretary of state or other state official.

In a study of government regulation of foundations I conducted in the middle 1960s I suggested federal subsidies to support regulation of charities in states which enacted statutes and adopted programs that met certain federal minimum standards of behavior for charitable fiduciaries, while encouraging the IRS

to defer enforcement in cases in which a state attorney general initiated a complaint. The purpose was not only to provide incentives to the states to increase regulation, but to permit the application of state court equity powers to the correction of violations of the federal prohibitions against private benefit and private inurement as a substitute for revocation of exemption. The staff proposals appear to endorse such a concept, but it cannot work without adequate subsidy. I have serious doubts as to whether $25 million will be adequate for the task. I also question the adequacy of the amounts recommended for facilitating public access to Form 990, an effort that I strongly support.

Another aspect of enhanced federal regulation recommended in the proposals relates to conversions of corporations from tax exempt to taxable. I am sending to you under separate cover a copy of a study I made of state regulation of conversions that points out, first, the extent to which a majority of the states adopted measures to regulate conversions in the late 90s, and, second, the divergent interests of the states and the IRS in the process. Your proposal does not recognize adequately the role of and the interest of the states in this process and, I fear, will impede state regulatory efforts, particularly if no changes are made in the limits on the Service's ability to exchange information with state regulators. Please note in this context the objections I have raised to confiscation of charitable assets as a penalty.

On a more technical note, the proposal relating to conversions is described as applying to "exempt organizations". It is not clear whether it would apply to BlueCross BlueShield and similar insurers that are not exempt under section 501(c)(3) and even in many cases under (c)(4), but are nonetheless considered charities under state law. Conversions of these organizations have been as troublesome, if not more so, than conversion of tax exempt charities and there is no reason for there to be two sets of limits depending on the special considerations that led to denial of charitable status under the tax laws.

ADDITIONAL COMMENTS ON SPECIFIC PROPOSALS

1. *Heading A, Item 1 - Five-year Recertification of Exempt Status:* I wonder whether charities might comply as part of Form 990 filings, similar to the manner in which public charities establish compliance with the public support tests of sections 170(b)(1)(a)(iv) and 509(a)(2). Obviously, it will be necessary to stagger the five year cycles and it would be advisable to grandfather certain organizations – possibly those that are subject to certification such as hospitals, universities, and museums.

2. *Heading A, Item 2 - Donor Advised Funds:* I agree that additional regulation of donor advised funds is advisable and the proposals you suggest are reasonable with the exception of the proposed prohibition against foreign grants. A donor advised fund is in a better position to assure that all requirements for foreign grant-making are met, and it provides the most efficient and effective manner in which individual donors can funnel their contributions for exempt purposes abroad. In addition, the 10th limit appears to discourage, rather than encourage, responsible grant-making and I wonder if this was intended.

3. *Heading A, Item 3 – Supporting Organizations:* I would prefer revision of the regulations governing Section 509(a)(3) Type III suppporting organizations to close any loopholes, but if this is not agreeble, the category should be eliminated. However, transition rules that permit existing organizations to modify their organizational structure will be needed. There is precedent for this in the transition rules in the Tax Reform Act of 1969.

4. *Heading B, Item 1 - Prohibiting or Limiting Compensation of Private Foundation Trustees and Disqualified Persons:* In light of the excesses that have recently come to light, there may be merit to placing a limit on trustee compensation, but I believe we should retain flexibility rather than adopt an outright prohibition. In taking action on this matter, you will need to address the status of corporate and professional trustees, such as banks and trust companies. If they are to be prohibited from receiving compensation, or limited in the amount they may receive, as trustees, they should nonetheless be permitted to charge for services such as investment advice or account management currently covered under a trustee fee agreement. Section 4941 does permit disqualified persons to receive reasonable payments for services. This provision will need to be coordinated with a limit on or prohibition of payment of fees. The proposed limits on compensation to disqualified persons appears punitive and would adversely affect far too great a universe of individuals who serve foundations well than the evidence of impropriety appears to merit.

5. *Heading C, Item 1 – Treatment of Administration Expenses of Foundations*: I would prefer to see greater flexibility than you propose, particularly in order to avoid penalizing a foundation that incurred heavy administrative expenses, for example while exercising expenditure responsibility correcting a misspent grant or while it was modifying its grant program. Some time period in which expenses could be averaged might be the answer. I also question the legitimacy of imposing processing fees which will only serve to further increase expenses.

6. *Heading C, Item 2 – Encouraging Foundations to Make Large Grants by Eliminating the Section 4940 Excise Tax:* I believe that

government should not indirectly attempt to undermine the ability of charities to continue to benefit society in perpetuity. Accordingly, I believe this proposal is inappropriate.

7. *Heading C, Item 4 - Limiting Amounts Paid for Travel, Meals and Accommodation:* I would favor establishing a nonprofit rate for all charities, but cannot endorse the imposition of a penalty on the organization. I wonder, further how practical it will be for large public charities such as universities and hospitals to comply with the exception and why it is necessary.

8. *Heading E, Item 1 - CEO Certification of Financial Reports:* I would also like to see provisions that would assure that trustee/directors are provided with copies of Form 990 and audited financial reports, whether as a specific requirement, or with certification by the Board Chairman.

9. *Heading E, Item 5 - Establishing Standards for Filing Form 990:* There is a great need for appropriate standards for charities, but I am not sure whether the IRS is the appropriate entity to formulate them. It would be better if they were formulated by the exempt organization community, with input from members of FASB with special expertise in exempt organization issues (as opposed to its general membership,) and then possibly with “approval” by the IRS.

10. *Heading I, Item 4 – Valuation Resolution:* In the discussions of abuses in the valuation of contributions of land and tangible personal property, I have been struck by the absence of any references to the work of the IRS Art Advisory Panel that assists the IRS in regard to valuation of contributions to charities as well as for estate and gift tax purposes. It is my understanding that it has played an important role in assuring the integrity of the valuation process. If that is the case, I wonder whether it could be used as a model for valuation of the other types of property where there appear to be abuses.

CONCLUSION

I have been honored by your request to provide these comments and hope you and your staff will call on me if I can provide additional information or clarification.

Sincerely,

Marion R. Fremont-Smith