Recommendations for the Reform of the Nonprofit Sector

A statement by Pablo Eisenberg, Senior Fellow, Georgetown Public Policy Institute, to the U.S. Senate Committee on Finance, July 22, 2004

Overview

Nonprofit abuses, malpractices and scandals that have been so graphically depicted in the media during the past couple of years are not a recent phenomenon. They have existed for many years. The rapid expansion of the sector, the heightened focus on charities after September 11 and the investigative reporting of the New York Times, Boston Globe and other major newspapers have turned the spotlight on what was before a well hidden facet of nonprofit life.

In defense of the sector's good works and integrity, many foundation and nonprofit representatives claim that the abuses and poor practices of their colleagues are the work of a very few "bad apples". It is a comforting perspective, but, unfortunately, it is not accurate. There are many more "bad apples" than most of us believe exist. Last month William Josephson, Assistant Attorney General for New York state, testified before this Committee that fully one-tenth of all foundation 990PF forms that his office had reviewed raised a red flag. Every day, newspapers are coming up with additional stories that shed a poor light on our charitable institutions. And there are plenty more of these tales to come.

It is precisely because the problems are much more widely spread than a few egregious offenders that both government and charities must take corrective action… and without delay. Public confidence in our charitable organizations has decreased, according to numerous observers of the field. There is a growing perception that the nonprofit sector lacks accountability. We cannot maintain strong and vibrant foundations and nonprofits without public trust. Restoring that trust must be the objective of any attempts to reform what is wrong with the system and to strengthen those practices that have been effective.

While acknowledging some of the past abuses and malpractices, many charities – both nonprofits and foundations -- tend to stress self-regulation by the sector as the primary

strategy for reform. Yes, they say, the federal government and state regulators have an important role to play, but current regulations are sufficient if only they can be enforced more effectively. Moreover, these observers note, there is a real danger in too much intervention by government.

While the latter observation has some merit, it is also true that self-reform is not a realistic alternative to the government's primary responsibility for overseeing and policing the nonprofit sector. Over the past forty years a few nonprofit associations have successfully promoted accountability standards among their members, and some accrediting bodies have maintained a reasonable level of practice among their professions. But, by and large, self regulation and reform have rarely occurred or been successful. Government regulations and enforcement are the key to reforming the nonprofit sector; self reform can be only a supplementary, albeit important strategy.

The Government's Role: IRS and State Attorneys General

The Internal Revenue Service has been ineffectual in overseeing and policing the nonprofit sector. Probably the major reason for its mediocre performance has been a lack of resources: staff, modern technology and limited capacity to work with nonprofit organizations and State Attorneys General.

Poor or inadequate regulations have also hurt IRS's ability to ensure the accountability of the sector. It has also failed in some cases to set clear standards that would differentiate between the activities of corporate America and nonprofit entities. Questions of excessive compensation is a case in point.

And at times the agency has not appeared to have the interest or political will to pursue nonprofit offenders in an aggressive manner. This indifference may have been caused, at least in part, by the failure of Congress to send a clear message to the IRS that it expects the agency to exercise strong supervision and enforcement measures. Charities can no longer remain the stepchild of Congressional oversight.

State regulators have been even more constrained than IRS by limited resources. Some states have no capacity to oversee the operations of nonprofits and foundations. Some thirty states don't have more than a handful of lawyers and investigators to carry out these responsibilities. Even those states like New York and California that have the most resources find themselves overwhelmed by the potential cases at hand.

Clearly, Congress must provide the IRS with the resources it and the State Attorneys General need to do their jobs effectively. The 1969 Tax Reform Act authorized that the revenue derived from the excise tax on the net investment income of private foundations should be allocated to the oversight and enforcement of the nonprofit sector. This money has never been used for that purpose. It should.

At least $300 million annually from this pot of money should go to the IRS for the expansion of oversight and enforcement activities. Seventy-five to $100 million of this amount should be distributed to the 50 State Attorneys General to build their capacity to regulate charities in their states. $25 million could be allocated to national and state nonprofits for conducting research and maintaining information on line about charities, including Form 990 reports to IRS.

The Discussion Draft prepared by the Senate Finance Committee staff recommended that $100,000 be allocated to each State Attorney General's office to expand its oversight activities. This small amount would provide little assistance. State regulators are in need of much more substantial help.

Beefing up the resources of both the IRS and the State Attorneys General offices is the heart of any strategy to ensure nonprofit accountability. Adequate funds to accomplish this task must be made available.

Trustee Compensation

A large number of foundations of all sizes pay their trustees a fee for their activities as a board member. Every year, several hundred million dollars are spent for this purpose, money that should be targeted to nonprofit organizations and their programs.
With few exceptions, members of nonprofit boards, many of them low income and working class people, are not paid for their charitable services. Why, then, should wealthy and highly paid professionals who sit on private foundation boards be compensated for their charitable activities? The answer is: they should not.

Some foundation representatives claim that trustee fees are essential in recruiting board members with specific skills needed by their foundations. That is nonsense. There are thousands of talented, capable people with the skills required by foundations who would be happy to serve as foundation board members with no pay. They are some of the same kind of persons who currently sit on the boards of museums, universities, social service organizations and community based groups.

For this reason, Congress should put a limit of $8,000 a year on trustee compensation. This amount would permit people who cannot afford to take time off from work to join foundation boards, thereby providing an opportunity for increased diversity among trustees. The $8,000 limit should include both payments for trustee fees and for other services provided to the foundation.

Prohibitions against Self-Dealing

Current law prohibits self dealing on the part of disqualified persons, yet a major loophole in the regulations permits such persons to receive payment for personal services to their foundations that are deemed "reasonable and necessary to carrying out the exempt purpose of the trust… and is not excessive." Tens, if not hundreds, of millions of dollars are spent on such payments every year to trustees and foundation managers who provide investment, legal, accounting, technical assistance and other services…paid services that could be provided by outside professionals.

To make matters worse, the IRS has not provided any clear standards or criteria for what is reasonable, necessary and not excessive. Generally, the agency does not make any distinction between exempt and non-exempt compensation. It applies the same standards to both foundation trustees and corporate board members.

If the intention of the law is to prevent self-dealing, then the loophole which permits serious contraventions of the law needs to be eliminated. The current regulations as written most certainly should not be applied to operating nonprofit organizations.

Placing a reasonable ceiling on the total compensation permitted to foundation trustees – which I mention in the previous section --would probably eliminate 90% of the self-dealing activities in the foundation world.

Eliminating Inappropriate Expenditures

A number of the recent scandals have focused on enormous travel expenditures for foundation boards, high living by foundation and nonprofit executives, the ownership of airplanes by foundations, special perks to CEO's, sizable loans to nonprofit executives, large set asides for deferred compensation and huge severance payments to departing nonprofit CEO's.

Egregious activities such as the purchase of jet airplanes, first class travel for board and staff and large loans for nonprofit staff and boards should be proscribed by the Congress. A reasonable rate for travel, hotels, meals and other expenses could be set by

the IRS -- perhaps a modification of the U.S. Government rates. Penalties for violations of these costs could be levied on both foundations and public charities, subject to review for special circumstances justifying higher expenditures.

Disclosure is the best way to eliminate most of the inappropriate expenditures within the sector. The form 990's submitted to the IRS by both foundations and operating nonprofits should be modified to ensure that the proper information about travel costs, loans, questionable purchases and special perks are included.

Modifying the Form 990's and 990 PF's

The following changes in the forms would improve data collection and transparency.

1. Part 8 of the 990PF should have separate sections for foundation trustees and for foundation managers and other employees . Currently, trustees and employees are lumped together, and it is difficult to distinguish between them.

2. Part 8 should also include a uniform method for recording the amount of time spent on foundation business by trustees.

3. The form should include a detailed breakdown of allowances, travel and other expenses incurred by individual trustees and foundation managers.

4. The form should require the listing of the ten largest contractors to the foundation in question, as well as specify the relationship between these contractors and the trustees.

5. 990's for both foundations and nonprofits should list the cost of board meetings, including travel and accommodations.

6. 990's for operating nonprofits should require a lit of all donors to the organization greater than $1,000.

The CEO of both foundations and nonprofits should sign the completed 990 form to assure both IRS and the public that he/she is taking responsibility for the financial statements and substance of the report. IRS should also require that all nonprofit organizations with a budget of $1 million or more be required to have an annual audit that is publicly available.

While additional information about the organization's goals, performance and activities

can enhance the value of the 990 report, the latter will not necessarily become user friendly. A better way to inform the public about a large number of nonprofits and foundations would be for the Congress through legislation or the IRS through regulations to require all foundations large enough to be listed the Foundation Directory – some 16,000 foundations – and all nonprofits with a budget of over $300,000 to issue an annual or biennial report to the public with details about their goals, priorities, governance, programs, other activities, investments and evaluations.

Additional Measures to Enhance Public Accountability

There has been an enormous increase in donor advised funds, yet these institutions are neither required to disclose their grantmaking nor pay out annually a minimum amount of their assets. Since their donors receive greater tax breaks than those who give to private foundations, they should meet the same requirements for disclosure and accountability as private foundations and public charities. And they should be required to spend at least the same percentage of their assets every year that foundations must pay.

Much of corporate philanthropy has remained under the public's radar screen, even though it is related to their tax breaks. For this reason, all publicly traded corporations should be required to file an IRS form every year listing all charitable contributions of over $5,000, either cash or in-kind, and the names of grantees receiving such gifts.

Boards of Directors

The maximum size of nonprofit boards cannot be mandated either by legislation or by regulations. That is a matter to be determined by the organizations themselves. There are many nonprofit boards that have 20, 25 or 35 members that work effectively. Often, their size is an important asset, enabling them to achieve regional, ethnic, professional and community diversity and capacity.

There is, however, a good rationale for insisting on boards that have more than one or two members, as is the case today with a number of small foundations. Although the Senate Finance Committee staff recommends a minimum of three board members, I would argue that a minimum of five provides a better guarantee that the organization can have a broad perspective and better understanding of the organization's purpose and programs.

I strongly support the recommendation of the Senate Finance Committee staff that any person who is not permitted to serve on a board of a publicly traded company should

not be allowed to serve on a board of a tax exempt organization. Such a trustee can seriously undermine the integrity of both the individual organization in question and the sector as whole.

Accreditation

A growing number of state nonprofit associations and other nonprofit intermediary groups have begun to set accountability and ethical standards for their member organizations. This effort to improve nonprofit performance in accordance with accepted principles and guidelines is a move in the right direction. But it is a slow and time-consuming process that will take years to implement. It is also a process that does not lend itself easily to enforcement measures.

While accreditation bodies have existed for sometime in the health and education fields, most nonprofits are not covered by accrediting agencies or even by umbrella or trade associations. The Council on Foundations and the Philanthropy Round Table together have fewer than 3,000 members out of the more than 65,000 foundations that populate the sector. Independent Sector has a little more than 600 national organizational members, many of them donor institutions. The more than 40 state nonprofit associations may have a combined membership of some 30,000 groups. So who then has the legitimacy and authority to represent the more than 2 million nonprofits that compose our sector? Who can serve as the accrediting institutions? The answer is that either we do not know or aren't quite sure.

Allocating federal funds for accrediting nonprofit organizations of all sizes, shapes and purposes is a bad idea that cannot work. To which organizations will the IRS give its money? To what sectors of the nonprofit community? What about the politics of the selection process? Accreditation is a quagmire that the federal government would be well advised to avoid.

Several national nonprofits that are establishing standards of conduct have also begun to sell their "good housekeeping" seals of approval. This raises some serious ethical problems. Such practices also are unfair to organizations that cannot afford these payments. These practices should not be encouraged.

The best that the federal government can do is to let the standard-setting movement take its natural course. The more nonprofit organizations base their operations on sound principles and accountability measures, the more they will strengthen government efforts to oversee and police the sector.

Encouraging Additional Foundation Grantmaking

The Senate Finance Committee staff has suggested that the excise tax -- which should be reduced to a uniform 1% for all private foundations – should be waived for all foundations that pay out more than 12% of their net investment income exclusively in grants. Such an incentive to greater grantmaking is an excellent idea. I would suggest that the percentage be lowered to a more realistic figure of 9% or 10%.

The most effective means of increasing the amount of money foundations give in grants to nonprofits is to require that administrative costs not be included in the calculation of the minimum pay out. In other words, foundations should give its current minimum pay out of 5% -- or better yet 6% -- in grants only.

Conclusion

There is an urgent need for the federal and state governments to improve their oversight and policing of the nonprofit sector. Further abuses and poor practices will erode public confidence in the nonprofit sector even more than it has. This is not a time to delay reform measures.

The Chair and members of the Senate Finance Committee have provided important leadership in bringing this issue into the public arena. Hopefully, the Committee will persuade its Senate colleagues and members of the House of Representative to move quickly to initiate necessary legislative reforms and provide the IRS and State Attorneys General the resources they sorely need to do their job effectively.