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Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities

1. **The Type 3 supporting organization**

It still has valid applications, but there is an opportunity for abuse if the "supported charity" is unaware that it is being supported or if the assets are being passed back and forth between a donor advised fund and the supporting organization.

2. **Donor Advised Fund (DAF) Perceived Abuses**

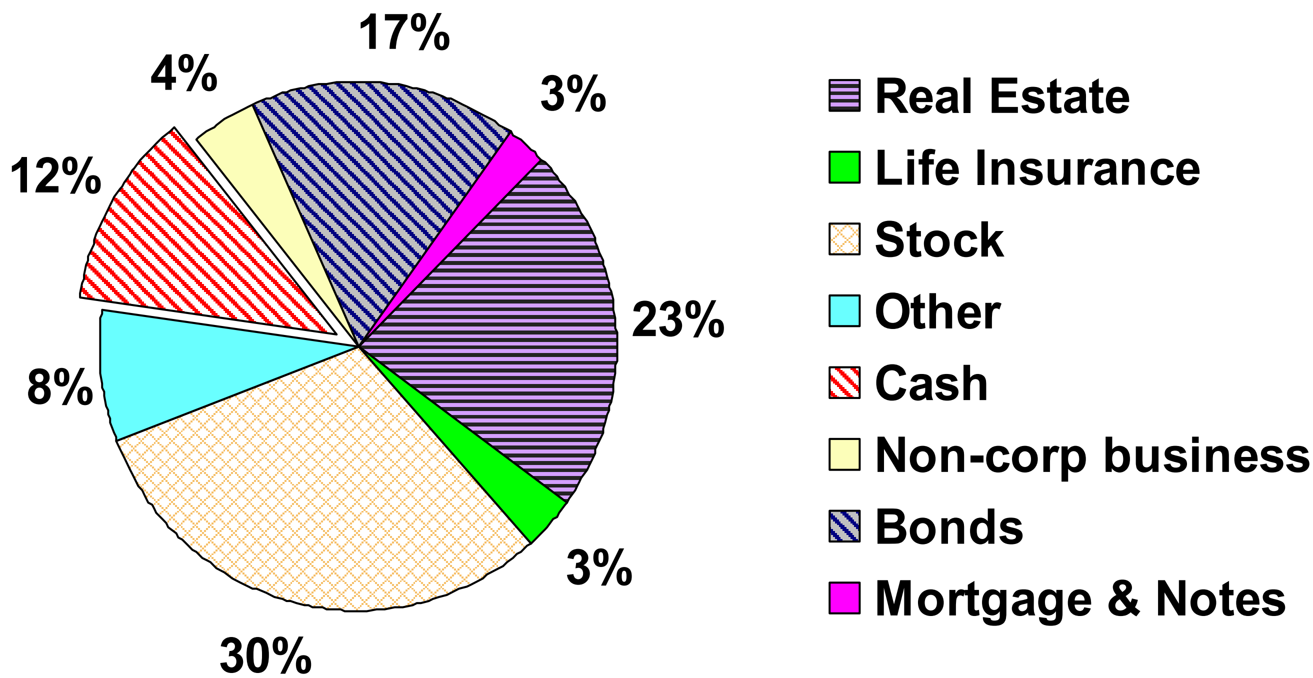
a. There should essentially be the same self-dealing, private inurement, personal benefit, and §4958 type restrictions for private foundations, public charities, and their associated DAFs. However, in smaller communities it becomes difficult, if not impossible, for community leaders to participate on boards without running afoul of §4941 prohibitions since these board members often provide rent-free or rent-reduced facilities, personal services through legal and accounting functions, and financial advice, etc. There may not be the luxury of having nonparticipating vendors without removing the most valuable board members from the philanthropic process.

b. Paying salaries to donors from a DAF is inappropriate. These funds, designated for charitable purposes, should not be operated as the donors' personal piggy banks to provide a means of employment.

c. Mandated 5% aggregate payouts to the grantee charity may have a place, but it should be based over an average of all the funds held within the umbrella charity (not on a DAF fund by fund basis), there are too many administrative problems associated with a newly created DAF to insist that it immediately start making distributions, especially if funded near the end of the calendar year.

d. Charitable distributions from a DAF should <u>generally</u> be limited to a §501(c)3 public charity, church or a government entity. However, in smaller communities, the local chambers of commerce and community organizations do perform charitable activities deserving of support, even if these organizations are exempt only under §501(c)6. Some discretion should be afforded to the umbrella charity, perhaps a certification should be required that the grantee applied the grant to a charitable purpose and that no private benefit was received. A private, non-operating foundation should not be a grantee supported by a donor advised fund.

e. The proposed restrictions on donations of real estate, closely held stock, and other hard to value assets to a DAF are too onerous. To require an immediate sale may not be prudent with such assets. For example, a forced sale of a donated life insurance policy may trigger surrender charges. The donation of a business note may require a sale at a steep discount. Alternatively, holding development potential real estate may result in higher sales prices, especially if marketed in an orderly fashion. These assets have great potential as gifts, making up a significant portion of donors' wealth, e.g., farmland in the US is valued at $1.046 trillion dollars [1], and non-publicly traded businesses have a greater value than that of all publicly traded stock. Artificially limiting contributions to cash and publicly traded stock, which comprises a minority of donor's wealth, is shortsighted. Assets, as reported by the IRS, in estate tax audits clearly demonstrate that hard to value assets comprise the bulk of a potential donor's estate.



Other concerns exist about placing hurdles when using assets other than cash or public stock. To force the sale of hard to value assets quickly may place the charity in a "step transaction" situation, as charities would have a disincentive to accept an asset without knowing of a ready buyer. The purpose of increased oversight is not to impede a donor's efforts to support philanthropy

f. Hoarding assets in a DAF should be discouraged, charitable distributions should commence by at least the third year of funding. By the same token, hoarding in public charities is wrong too.

g. A common way to "clean up" small private foundations that are too uneconomical to continue operating is to transfer them to a DAF, where there is better infrastructure and oversight. Don't make this difficult, there are already too many little foundations out there that need to be consolidated. A local community foundation in central Illinois reports that 22% of its support is a direct result of consolidating small and uneconomical foundations

h. While it may make sense to restrict distributions for grantee selection, it may be appropriate for a DAF to pay a consultant to provide professional services concerning grant strategy and to train successor donor advisors. Usual and customary fees should be allowed for consultants unrelated to the donor.

3. **Five year review of public charities**.

a. Most well managed charities are already doing self examinations and performance audits as a part of grant seeking activities, and as long as the expenses and time commitments are not excessively burdensome, this review should be useful. Of the nearly 1 million tax-exempt entities recognized by the Internal Revenue Service, some inefficient and outdated organizations should be allowed to close their doors and merge with organizations that are better managed.

b. Too many credit counseling organizations are charities in name only, with their kick backs, commission paid "counselors", and debt reduction marketing tools, it is not always a nonprofit enterprise.

c. Reasonable compensation should be based on comparable nonprofit salaries for work performed. To compare a nonprofit executive to a for profit executive's salary schedule is not justification to pay multimillion dollar salaries to administrators who are in positions with no independent oversight and no "shareholders" to insist on goals, performance and production.

d. Too many charities are "family enterprises", that exist because of the founder's ego, with the founder handing down the reins of control to an anointed heir, they treat the charity as their own private piggy bank and expect the perks associated with active management to continue after retirement.

4. **Oversight**

a. More attention needs to be directed to IRS forms 8282 and 8283. Too many charities neglect to acknowledge or submit either form, and opportunities to double check outcomes for donated assets are circumvented. The 990 form needs to be updated to more consistently report activities and financial health; it is too easy to mislabel administrative and fundraising expenses as a part of charitable distributions.

b. Charities that are participants in tax shelters and listed transactions should be taxed like any other for-profit entity. This should not be limited to unrelated business taxable income that too many charities shrug off as the price for doing business; their entire year's revenue should be taxed.

c. The filing of tax opinion letters concurrently with the donor's income tax return for a particular tax shelter type transfer should be required as a check and balance to prevent charities from being unwitting participants in a tax shelter.

d. Chief executives for large nonprofit organizations should be held to the same standards as for profit companies, as seen in the Sarbanes Oxley certification, as long as the audit requirements do not create an excessively large budget item for small nonprofit organizations.

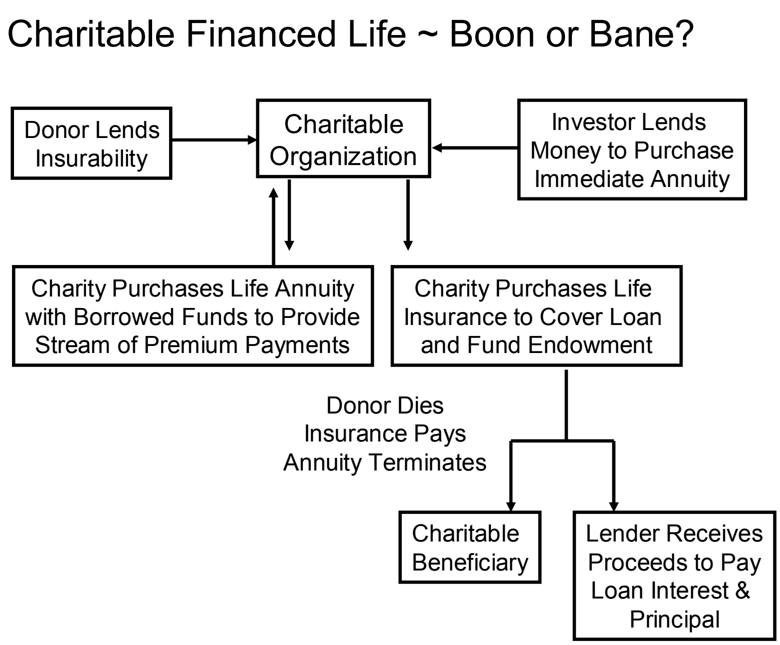
e. Small charities (less than $100,000 annual revenue and/or $5 million asset base) should not be required have to have audited returns, otherwise too many of their limited resources are consumed in compliance, instead of their necessary charitable purposes. Unfortunately, many times it is the small charities that need the most oversight and have the worst bookkeeping and compliance skills

5. **Insurance Programs for Charity**

The old adage, "you should never look a gift horse in the mouth", may not hold true with gifts involving life insurance because so few nonprofit organizations really understand it as a risk management tool and not as a traditional investment. Tax-exempt organizations can and should consider creative and beneficial uses of life insurance products on board members, significant donors and key staff in the furtherance of their charitable purposes. However, the use of "dead pools" converts life insurance into an unethical form of wagering on the lives of people who have no financial or philanthropic interest in the charity.

While nothing should be easier than making a beneficiary designation change to make sure an insurance settlement passes in whole or part to a charity, few donors make those simple choices. Why not? Their advisors do not suggest it as a planning option, donors do not realize that insurance proceeds can be split up among many beneficiaries and changing a revocable beneficiary designation generates no income tax deduction or generates no new sales of product. The problem is that, too often, predatory sales practices target revenue starved nonprofit organizations.

"Life insurance contracts should only be issued to persons with a familial or recognized economic relationship with the insured and should not be merely an investment vehicle."
- The American Council of Life Insurers



Why shouldn't a charity gratefully accept a donor's offer to name it as either a primary or successor beneficiary? Charities have been burned by over-aggressive agents touting insurance as a way to build an endowment if the charity will just let the insurance sales team solicit their best donors. The common result is that dollars the charity needs today are redirected into commissionable products with less immediate value that are often dumped on the charity's doorstep when the donor loses interest in this new endowment plan. As a result, many charities do not want to have anything to do with either insurance products or insurance producers, and that is unfortunate because insurance and annuity beneficiary designations are perhaps the easiest deferred gifts to solicit, as the products are so often found in donor's hands.

The appeal to free and easy money is seductive, and premium financing concepts have become popular with cash-strapped charities. Annuity Arbitrage, Financed or Leveraged life, Charity Owned Life Insurance (CHOLI), Foundation Owned Life Insurance (FOLI), Life Insurance and Life Annuity Based Contracts (LILAC), and Investor Owned Life Insurance (IOLI) are various sales concepts promoted to nonprofit boards. Unfortunately, many of these sales concepts neglect to fully disclose the potential for complications or explain why this money generating concept is a great idea for tax-exempt entities but will not work for individuals as a way to generate the massive amounts of wealth predicted. If the concept hinges solely on the buyer's tax-exempt status, then is this a marketing concept that should be properly promoted to charity?

a. The charity is selling or leasing its exclusive insurable interest in order to generate profit for commercial lenders in a transaction that has little economic benefit other than to generate large premium payments for insurers and interest payments for lenders. The money goes through complex convolutions in an attempt to create a perpetual motion money machine. It is especially problematic when charities assign an ownership interest to its non-charity partners, or, in a prearranged deal, permits a buyer to acquire a massively discounted asset that would otherwise not be legally owned by these commercial entities. Private inurement or personal benefit seems to be the overwhelming problem, and if this is a small charity using a significant donor, then there may also be a §4958 issue to further complicate the transaction. Unfortunately, insurable interests and insurance law are state-by-state issues. For those interested, (http://www.deathandtaxes.com/insint.htm) JJ MacNab has a state insurable interest listing.

b. If the charity is receiving life insurance settlements produced from borrowed money, that probably produces debt-financed income/UBTI, and because many of the promoters have "exclusive" rights to market various concepts, they may require nondisclosure agreements, that triggers IRS "listed transaction" rules. When sales people market this perpetual money concept to the public, it may present an unregistered securities problem (SEC/NASD), and to circumvent the nondisclosure requirement that triggers IRS oversight, some promoters are now turning to patents as a means of concealing activities and avoiding complete disclosure to all the interested parties.

c. Life insurance has, as a risk management tool, its special tax treatment because it serves the public good. However, these investor owned life insurance programs amount to wagering since the lender benefits from selling a larger than average policy that has no relationship to economic risk on the survival of the insured. After the insured dies, the charity receives little, or nothing, when all expenses are paid. If lawmakers eventually deem this concept is not "insurance", then its tax advantaged nature may change. Insurance is often a good thing within an endowments' diversified portfolio, but participants need to be clear on what is guaranteed and what risks are assumed if interest rates, mortality assumptions, tax laws, or underwriting procedures change.

d. For promoters who place the borrowed money into a charity owned single premium immediate annuity (SPIA) and hook it to the loan/financing as a way to make premium payments, many companies prohibit the underwriting of products that play one company off against another. Aggressive and unethical promoters try to whipsaw the insurance carriers by stressing any diminished mortality that increases annuity payments from one carrier while whitewashing the same health or underwriting concerns for the life insurance actuaries in order to keep the premiums lower. If this isn't fraud, it comes near that, but what promoter fail to address is that buying a SPIA with borrowed money probably results in debt financed income (UBTI) which means that all of the income passing to the charity to pay those life premiums will not be income tax free.

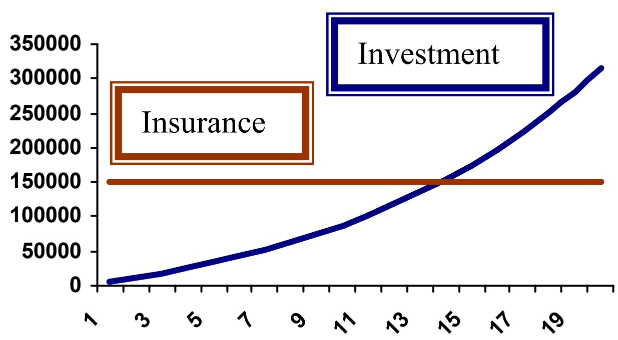
   Other than stirring around commission dollars that benefit the promoter and the lender, how does this actually help the charity? Many proposals have been remarkably unclear about exactly what is guaranteed to the charity for its contribution of an insurable interest to this program. Who is willing to describe the down side if interest rates rise and loan payments eat into the windfall dangled in front of the charity? Also, many of these insured "donors" do not realize they are using up their own limited capacity to buy insurance.

e. A few promoters are actually getting charities to pledge endowment funds as collateral, and this is a major concern for unsophisticated organizations that have been promised "free money" with little or no risk. Some of the legal and financial commentators express concerns about investing a significant portion of a charity's assets in an insurance contract by pledging endowment funds and running afoul of the prudent investor rules or the Uniform Management of Institutional Funds Act (UMIFA).

The use of life insurance in charitable giving still makes sense for a number of donor situations.

1. Those supporters from whom the charity has come to depend on for support and guidance, much like a key-employee in a commercial enterprise, may use an insurance contract to guarantee ongoing financial support for a specific project of importance to the donor. By leveraging small amounts of annual premiums, often a larger gift may develop over time.

Is this a cost effective approach? Maybe, maybe not. What has to be determined is if this contract being treated as an "investment" or is it the result of extra money being contributed over and above normal contributions by a donor who fully intends to continue making premium payments. If it is treated as an investment, then some basic assumptions have to be addressed, as there is nearly always a point beyond which a tax-exempt charity can more efficiently invest in their endowment fund the same premium dollars and generate a greater impact. The problem for many insurance agents is they forget that the wealth building tax advantages of an insurance wrapped investment will not apply to an already tax-exempt 501(c)3 charity. Does it make sense to buy a new policy solely for the use of a charity? Maybe, if there's a risk that the donor's services and support would be lost to the charity before typical mortality or before a traditional investment account could build up enough value to sustain itself, but there is a "crossover" where the traditional investment account will eventually outperform the insurance contract.



Example - $5,000 annual premium paid for 20 years into a VUL insurance policy ($150,000 death benefit for a 65 year old nonsmoker, earning an assumed 10% in sub-accounts) as compared to the same $5,000 annually invested into a mutual fund (10% returns) for 20 years. The VUL policy collapses before statistical mortality if the policy does not maintain at least a 10% gross return and if the premiums do not continue past 20 years. The cash values available to the charity from the policy, if surrendered after 20 years, in this hypothetical illustration would be $134,482 as compared to the traditional investment account value of $315,012. The "crossover" for investment efficiency occurs if the donor does not die prior to year 14, so each case must be evaluated on its individual merits. Obviously many different kinds of policies exist, but in the interests of simplicit, the basic policy vs. investment comparison was made.

While it is true that a life insurance death benefit passing to charity is like found money, few policies actually perform as illustration projections prepared years ago predict. Interest rates, crediting levels and mortality expenses change, and this variability is not factored in when policies are transferred to charity. Where is the problem? The guaranteed levels of performance are usually considerably less than wildly optimistic projections than those used by many agents when interest crediting rates were 10% to 14%. To that end, annual reviews of a charity's insurance portfolio should be conducted by an objective analyst to ensure the policies are performing as designed. If they deviate significantly, then decisions can be made in a timely manner to preserve the value by reducing death benefit or increasing the premium payments or, if the charity chooses to surrender the policy it should be done before the policy has a chance to implode.

2. Donors who have old policies once acquired for other reasons (e.g., mortgage or debt risks, education for children, survivor income security, veteran's policies or those provided by employers) may no longer need the coverage and choose to transfer ownership to a nonprofit. If the donor transfers the ownership of the contract to a nonprofit organization, then besides removing the asset from the donor's estate, it will often generate an income tax deduction if all of the rights of ownership are completely transferred. How is the deduction calculated? Generally, the donor receives a current income tax deduction equal to the lesser of cost basis or fair market value of the policy.

An unrecognized problem for an asset potentially worth more than $5,000 is the valuation of the policy. Some would argue that the insurance carrier could easily assess and report its value on an IRS form 712. However, careful examination of an IRS form 8283 (required if the value is more than $500) would seem to prohibit the agent and insurance carrier, as parties to the transaction, from performing the valuation and thus there may be a real need for an outside appraiser to assign value.

Gift acceptance policies of the charity should address the following issues:

- Will the organization make ongoing premium payments if the policy underperforms? Or will the original donor continue to make gifts of cash or better yet appreciated assets in order to meet ongoing premium liabilities?
- Does the state recognize that the charity has an "insurable interest" in the life of the insured?
- Should a cash value policy be surrendered or held, and what types of policies should be accepted.
- How should the policy be booked for campaign purposes?
- Is there a minimum quality threshold for the carrier's financial ratings for size and financial strength?
- Who evaluates the current and ongoing annual policy statements and projections showing "guaranteed and projected performance values"?
- Define terms that confuse development officers, e.g., is the policy is truly "paid up" or has the premium simply "vanished" only to reappear later?
- Understand that there are some tax traps if the policy has outstanding loans,
- Should the charity viaticate its gifted policies? Will the donor object to an investor having access to his/her medical profiles and be upset with the occasional ghoulish aspects of selling the policy to an investor looking for a quick return on an investment.
- How do charities track death claims?

3. Other charitable uses of life insurance offset the gift of assets by replacing the wealth so heirs are not unduly affected. These "wealth replacement" policies are very popular when working with large bequests and charitable remainder trusts or gift annuities. Why shouldn't the heirs just inherit those assets and skip the insurance policy hassle? It might be more tax efficient to have heirs receive an asset that always steps up in value at death, i.e., life insurance, unlike receiving annuity payments or retirement plan proceeds that come with an accompanying income tax. Part of this strategy is to avoid passing down income in respect of a decedent (IRD) type assets and artificially inflating the taxable estate of the deceased donor. If the life insurance is properly structured and held outside of the estate, then the proceeds pass to heirs without income, gift, or estate tax liabilities. With the proposed loss of step-up in basis under EGTRRA 2001 when the estate tax is phased out insurance may still be a preferred asset.

Caution is Needed

A number of problems can develop because so few financial advisors understand the nonprofit culture, and because few development officers completely understand how life insurance functions, is marketed, and sold. Charities need to be careful. For example, charitable reverse and split dollar concepts jeopardized their organization's exempt status. Charitable split dollar (CSD) was a tax evasion/avoidance tool that ran afoul of self-dealing, fraud and step transaction rules because the charity was often used as a conduit to pass benefits to noncharitable beneficiaries all the while accepting tax deductible assets to pay the premiums. [2] The problem from the charity's perspective was one of strings being attached to these "gifts" that required the exempt organization to direct those contributions to pay the premium. Clearly, this was not a gift that allowed the charity the choice to invest prudently while the donor deducted the entire "contribution" as the charity asserted that neither goods nor services was provided to the donor.

The IRS eliminated this form of abuse with rules found in Notice 99-36. In Notice 2000-24, it provided compliance guidance on the new reporting requirements imposed by the Ticket to Work and Work Incentives Improvement Act of 1999 as it related to charitable split-dollar insurance arrangements. Congress used this law as signed on December 17, 1999 in HR 1180 to remove CSD as a planning option for charities and insurance producers. Ignoring these rules subjects the charity to excise taxes and possible loss of exempt organization status.

Other potential abuses include financed insurance where the charity borrows the premium to insure a number of lives or invests its funds in a "dead pool" of a large number of policies with the expectation that someone will die annually and thus provide a return on its investment. Additionally, charitable organizations are pushing the ethical and legal envelope by using commissioned agents to sell a gift annuity (CGA). Action [3] by the SEC claiming jurisdiction over the sale of a CGA may foretell the end of charities that improperly cozy up to financial services professionals. Although the Philanthropy Protection Act of 1995 seemed to preclude offering a commission for a gift annuity, these aggressive practices are still common.

Summary

Billions of dollars of life insurance are in force in this country, and frequently these policies are no longer needed for their original purpose. Charities ought to explore the use of insurance along with other gift options when they discuss philanthropy with their donors. However, the "something for nothing" pitch to charities on the hope that the charity will receive a cash payment or an eventual significant future windfall, all without having to invest any money, is mostly optimistic hype.

[1] Economic Research Service, United States Department of Agriculture
July 16, 2004 http://www.ers.usda.gov/StateFacts/PDFFiles/US-Fact-Sheet.pdf

[2] Charles H. Addis, et ux. v. Commissioner; No. 02-73628 (9 th Cir., 8 Jul 2004) ; Charles H. Addis, et ux. v. Commissioner; 118 T.C. No.32; No. 6628-00 (10 Jun 2002);
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[3] Securities and Exchange Commission, Washington, D.C. Litigation Release No. 17290 / December 21, 2001.
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