INDEPENDENT
SECTOR

TO: **Senate Finance Committee**
FROM: **Diana Aviv, President and CEO, INDEPENDENT SECTOR**
DATE: **July 16, 2004**
RE: **Comments on Discussion Draft on Reforms to Oversight of Charitable Organizations**

INTRODUCTION

On behalf of INDEPENDENT SECTOR, a national coalition of leading nonprofit organizations, private foundations, and corporate giving programs, we welcome this opportunity to work with the Senate Finance Committee to explore possible reforms that will strengthen oversight and accountability of public charities and private foundations. Ending the unethical and illegal actions of individuals and organizations that have taken improper advantage of tax laws designed to encourage the vital work of charitable and philanthropic organizations is critical to sustaining the high degree of trust and support that the American people have extended to our sector. We believe that this effort will require a multifaceted approach by both government and the voluntary sector. Many of the current challenges do not lend themselves to quick fixes and short-term solutions, and we share your concern that the actions we take together should not discourage people of goodwill from serving on boards, working in nonprofit organizations, or giving to causes that serve our common good.

Since the Senate Finance Committee released its discussion draft a few weeks ago, we have been working with a number of organizations within the charitable and foundation community that have knowledge or experience relevant to the discussion paper recommendations. They and legal and accounting advisors have been encouraged to study and make recommendations on the many proposals offered in the discussion draft. The proposals that are being considered for possible legislation raise a number of complex issues that have complicated ramifications for the many different types and sizes of organizations in the voluntary sector. We are sharing some of our initial thoughts on some, but by no means all of the proposals raised in the discussion draft. INDEPENDENT SECTOR is committed to continuing our study of all of these proposals to provide further information and recommendations to the Senate Finance Committee in the months ahead. We deeply appreciate your willingness to work with us to find good solutions to the problems that have emerged. Our community stands ready to work with you to move this broad and challenging agenda forward.

INDEPENDENT SECTOR supports the intent of virtually all proposals presented in brief form in the discussion draft, but want to underscore our recommendation for further study and careful consideration of all relevant factors and implications before most of the proposals can move forward with reasonable assurance that they will meet their intended goals and not have adverse and unintended consequences for other charities and foundations. There are extensive costs involved for both government and charitable organizations in implementing many of the proposed reforms, and there is a need for a thorough cost-benefit analysis to determine

appropriate and equitable fees and sharing of costs, particularly given the challenges organizations face in meeting their financial commitments.

There are many excellent initiatives already underway in all parts of the country, by both large and small groups, that are focused on improving governance, practice, and accountability within the charitable community. We observe a growing interest in our sector in exploring how best to connect these initiatives and learn from their experience and from successful models in other industries and other countries to improve and strengthen our systems for regulating and encouraging the critical work of charities and the generous philanthropic spirit of the American people.

I. Exempt Status Reforms

A. Five-Year Review of Tax-Exempt Status by the IRS

INDEPENDENT SECTOR has long supported changes to the regulatory process that would prevent organizations that, for whatever reasons, do not meet the requirements for exemption under section 501(c)(3) of the Internal Revenue Code from improperly acquiring or maintaining that status. The recommendation in the Finance Committee discussion draft presents a good starting point for developing a new process that would strengthen the ability of the IRS to review and make determinations as to whether organizations qualify or continue to qualify for recognition of exemption under section 501(c)(3), but there are several important issues that should be addressed in moving this recommendation forward.

1. The process should include improvements to the initial application for recognition of exemption under section 501(c)(3) (Form 1023) and the IRS review process. In December, 2002, INDEPENDENT SECTOR provided detailed comments to the IRS commending a number of improvements to the Form 1023 proposed by the IRS that would provide more focused, clear information on organizational issues most relevant to the determination of tax-exempt status, particularly in the areas of officers, directors and trustees, fundraising, and membership benefits. We recommended that the Form 1023 be amended further to disclose financial relationships with officers, directors, trustees, and "key employees," regardless of the job titles held by those employees, and we called for clarification of the definitions of family, business, and indirect business relationships to provide more consistent, clear information to the IRS in conducting its review of applications. INDEPENDENT SECTOR now is reviewing the most recent draft of changes to the Form 1023 provided by the IRS and believes this process can produce needed reforms.

2. The process should be coordinated with revisions to the Forms 990 and 990PF, including some of the reforms suggested under Section E of the discussion draft. As noted in my testimony before the Senate Finance Committee on June 22, 2004, these Forms fall woefully short of providing a clear, useful tool for the public, for regulators, and for nonprofit practitioners and should be revised and reformatted significantly. Later in this paper, we address several specific efforts underway to improve the Forms 990 and 990PF, as well as some of the recommendations INDEPENDENT SECTOR has made to the IRS to improve the quality, consistency, and scope of the Form 990. Further, we call for full implementation of electronic filing of the Forms 990 and 990PF, including mandatory e-filing requirements for paid tax preparers and most nonprofit organizations with appropriate phase-in provisions to

ensure that nonprofits have the necessary software tools and other resources to utilize e-filing. Many of these improvements, when implemented, will strengthen the ability of the IRS to identify tax-exempt organizations that are not in compliance with regulations and no longer qualify for recognition of exemption under section 501(c)(3).

3. Reporting forms and processes for a five-year review should be developed with an understanding of and a commitment to the integration of other federal reporting requirements. As new forms may be developed, the criteria to be guided by include:
   - Does the information that is requested enable oversight officials to better assess whether the organization is complying with the law?
   - Is the information available elsewhere, and if yes, should the questions/information or processes be integrated?
   - Does the effort required to gather the information pose an undue burden of time and cost on the nonprofit?
   - Can the questions currently in place be amended or streamlined to facilitate a less onerous process without compromising compilation of necessary information?
   - Can some information currently included in the Form 990 and 990 PF be more appropriately incorporated in a longer form that is completed on a less frequent basis (i.e., changes in organizational documents and governance processes)?

   INDEPENDENT SECTOR ***recommends that a full set of criteria be developed by which to assess what information properly belongs in the Form 1023 and in the Forms 990 and 990PF, and thereafter additional information should be identified that would be relevant to include in a five-year evaluation process.***

4. The call for "a sliding scale processing fee" that would be imposed on all charities for the five-year review if there is not adequate funding from a 990 filing fee or "appropriation of the tax on net investment income of private foundations" requires significant work to assess the costs and the value of the review form and process for both charities and the government. **INDEPENDENT SECTOR** ***recommends that a pilot study be conducted with a small, random sample of charities to gather cost-benefit information based on the budget size, geographic, service scope, and organizational complexity of various types of charities to inform this process.***

5. There is a danger that a new review process could result in additional administrative burdens and new costs for the vast majority of charities that are in full compliance with all rules and regulations and are fulfilling the important functions that justify their recognition as tax-exempt charitable organizations, without meeting the intended goal of identifying and removing the exemption for those few who are abusing their tax status. Therefore, **INDEPENDENT SECTOR** ***strongly recommends that Congress consider a careful study of this proposed improvement before changes are implemented and that any legislation directing a new review process include a "sunset provision" that allows Congress to terminate the initiative if it does not prove to be an affordable method for achieving the desired goals.***

6. ***It is imperative that any legislation include a statutory provision that would require (1) that fees be used for the specified purpose without any corresponding reduction in the budget for tax-exempt oversight activities, and (2) that would prohibit the collection of fees if such***

provisions are not enforced. We are mindful of the enormous burdens upon Congress to find new sources of revenue to cover existing obligations of the federal government. Given Congress's history of failing to implement the appropriation of the excise tax on private foundations for its original intended purpose of funding the oversight of employee plans and exempt organizations, specific legislative action must be in place to ensure that any new fees will not be used for purposes other than tax-exempt oversight or that they will be used to replace, rather than supplement, existing funding for oversight. **INDEPENDENT SECTOR** ***remains committed to the appropriation of the full value of the excise tax on foundations for oversight of tax-exempt organizations.***

B. Donor-Advised Fund Reforms

INDEPENDENT SECTOR concurs in principle with many of the reforms suggested in the discussion draft, particularly those prohibiting grants from donor-advised funds to private foundations and requirements for securing acknowledgements from grantees that grants will not confer a private benefit to the advising donor or related family or business parties. There are, however, many issues in the important area of donor-advised funds that need to be examined carefully to ensure that remedies do not damage this important vehicle for charitable giving.

Community foundations, among others, have been developing standards that would facilitate tracking and affirmation of the thousands of accounts that may be managed by a single organization that could be helpful in considering the establishment of a minimum activity threshold for donor-advised funds. Other efforts are underway to provide specific recommendations for disclosure requirements for donor-advised funds that would likely satisfy the need for appropriate oversight and regulation without excessive administrative burdens.

INDEPENDENT SECTOR is consulting with a working group including community foundations and other public charities, such as federated giving programs, that have experience and expertise in properly managing donor-advised funds. We expect to develop specific recommendations in response to proposals outlined in the discussion draft, as well as other measures that should be considered by Congress to address concerns related to the inappropriate use of donor-advised funds for the personal benefit of donors and related parties. **INDEPENDENT SECTOR** ***urges that no immediate legislative action be taken on this issue pending further study and recommendations forthcoming from experts in the field.***

C. Type III Supporting Organizations

Several media stories, including one cited in the discussion draft, have identified questionable practices at some Type III Supporting Organizations, particularly with regard to loans to donors and other insiders. There are, however, many Type III Supporting Organizations that legitimately are providing important financial support to public charities and that are not abusing the tax system for private benefit. ***Further study is needed to ensure that the legislative solution will address the problems identified without shifting the problems to other types of tax-exempt organizations or unnecessarily impairing appropriately functioning Supporting Organizations***.

D. Revoking Charitable Status for Accommodations to Tax Shelters

INDEPENDENT SECTOR ***agrees that any charitable organization that knowingly participates in a listed tax shelter transaction or reported transaction should be subject to revocation of its section 170 status and a 100 percent tax on accommodation fees or other direct benefits. Consideration should be given to the imposition of fines and penalties on individuals responsible for the transactions and managers who knowingly approve or participate in such transactions.***

II. Insider Disqualified Person Reforms

A. Application of Private Foundation Self-Dealing Rules to Public Charities and Modification of Intermediate Sanction Compensation Rules

Applying the current rules that absolutely bar private foundations from engaging in a broad range of economic transactions with disqualified persons to public charities could be extremely detrimental to a number of charities that perform valuable work. Public charities, particularly smaller charities, frequently receive from board members and other disqualified parties goods, services, or the use of property at substantially below market rates. The board member's knowledge of the organization's needs and his/her commitment to the organization may inspire such acts of generosity. Nevertheless, we agree that the Intermediate Sanctions rules have not been enforced adequately and that there is a need for further clarification of the regulations and enhanced reporting to improve both practice and enforcement. **INDEPENDENT SECTOR** ***supports requiring tax-exempt organizations to include with their Form 990 their conflicts of interest policy and to provide a summary of conflict determinations made during the reporting year. We further recommend the establishment of an independent commission or panel to analyze various types of transactions between charities and disqualified persons and provide specific recommendations as to whether some types of transactions should be barred and how clearer standards for assessing the fair market value of other transactions can be created to guide actions by boards of directors and improve enforcement.***

The rising number of reports of excessive compensation and inappropriate insider transactions by some private foundations and public charities makes it clear that the current legal regime must be strengthened to facilitate compliance and enforcement. There are many definitional and drafting issues that must be resolved with the proposals presented in the discussion draft, but **INDEPENDENT SECTOR** ***generally supports proposals that extend Intermediate Sanctions rules and penalties regarding excessive compensation to private foundations.*** We believe that the following proposals discussed elsewhere in the discussion draft also would help to improve practice and enforcement in the area of excessive compensation:

- Require that compensation consultants retained by a foundation or public charity be free of any relationship with the organization, its board and its management that may impair or appear to impair consultants' abilities to make independent judgments;
- Require that compensation of the chief executive officer be approved annually by the board, unless there is no change other than an inflation adjustment, and that such approval be given in advance unless there are extenuating circumstances documented by the organization; and,

- Enforce penalties for failure to comply with current requirements for full disclosure of compensation of board members, the chief executive officer, and other key senior management staff members.

B. Increase Taxes for Self-Dealing, Jeopardizing Investments, and Taxable Expenditures

INDEPENDENT SECTOR ***supports an increase in tax penalties and suggests that the Finance Committee consider rates established in legislation (S. 1514) introduced by Senator Kay Bailey Hutchison in 2003.***

C. Compensation of Private Foundation Trustees and of Disqualified Persons

These proposals represent a radical departure from the prevailing 'reasonable compensation' standard that has been used to police closely-held corporations, where much greater tax liabilities are at stake. The reasonable compensation standard also underlies the Intermediate Sanctions rules that apply to public charities.

While the vast majority of trustees of charities and private foundations serve without receiving compensation, the nature of the work and expertise needed for some boards, particularly for boards of some foundations, requires fair and reasonable compensation to recruit and retain the right individuals for the time and effort expended. Restrictions on compensation of trustees should not prevent foundations or some charities from assembling a board of directors with the necessary competencies and qualifications to carry out critical governance responsibilities.

INDEPENDENT SECTOR agrees that special attention must be paid by both boards of directors and enforcement agencies to ensure that compensation of disqualified persons does not exceed reasonable compensation standards, and that the introduction of additional filing requirements for such compensation would assist in this effort. This process, however, should not prevent foundations or charities from securing the services of any individuals or firms, including disqualified persons, who have the skills, knowledge and experience needed to fulfill their charitable work. In many cases, there will be comparable federal government rates (including benefit packages) that can be used to develop reasonable compensation standards, while for others, it will be necessary to turn to private industry standards to find comparable rates for positions involving similar work and similar time.

INDEPENDENT SECTOR ***recommends that legislation on both of these issues be deferred until further information can be gathered to establish how best to determine appropriate standards for reasonable compensation to inform boards of directors and assist enforcement procedures; when it would be appropriate to use the government reimbursement rate as the baseline and when it is preferable to use private industry as the standard.***

III. Grants and Expense Reforms

A. Treatment of Administrative Expenses of Nonoperating Foundations

Reforms are needed to improve the transparency and accuracy of reporting of administrative expenses of private foundations. INDEPENDENT SECTOR is working with a number of groups that are developing and testing specific recommendations for clarifying definitions and standardizing

accounting and reporting practices to provide more substantive, accurate information to the IRS, the public, and Congress on administrative expenses. We expect to be able to provide a more complete report on those efforts by the early fall of 2004 and will likely encourage expedited action on these recommendations. ***The establishment of thresholds that would trigger additional reporting requirements for the IRS and the imposition of new processing fees requires more complete data to ensure an effective oversight and review process that serves the interests of public charities that rely on foundation grants to provide essential community services.***

B. Encouraging Additional Grantmaking by Private Foundations

In this time of economic challenge, government deficits and potential cutbacks, as well as essentially flat charitable giving, charitable organizations are struggling to find the resources necessary to meet their obligations. Thus any responsible effort designed to encourage increased charitable giving ought to be encouraged. This includes several provisions in the Charitable Giving Act (H.R. 7) and the CARE Act (S. 476) designed to increase charitable giving by offering additional tax incentives, such as the IRA charitable rollover. **INDEPENDENT SECTOR** ***supports all appropriate efforts to encourage additional giving including but not limited to grant making by private foundations and believes that the incentive described in the discussion draft of removing liability for the excise tax on net investment income for private foundations that pay out more than 12 percent of their minimum investment return for grants can help achieve that goal.***

C. Prohibiting Foundation Grants to Donor-Advised Funds

Additional information is needed to determine whether there are any conditions under which a private foundation can exercise more effective grantmaking by working with or through a donor-advised fund. Specific questions that should be considered:

- Can a private foundation be more effective in assisting local communities by providing grants through a donor-advised fund in partnership with community foundations or federated public charity organizations that house donor-advised funds (such as the Jewish Federation system or local United Way organizations)?
- Can a private foundation exercise more rigorous evaluation and control of grants to charities outside the United States if it works through a donor-advised fund managed by a community foundation or other public charities with well-established international grantmaking programs?
- Should a private foundation be allowed to test the advisability of terminating its independent status to become a donor-advised fund managed by a community foundation or other entity through transition grants to such a fund?

INDEPENDENT SECTOR is consulting with several community foundations and other public charities managing donor-advised funds to assist the Senate Finance Committee in developing legislation that will address identified abuses without harming legitimate philanthropic activity.

D. Limiting Amounts Paid for Travel, Meals, and Accommodations

Employees and volunteers of tax-exempt organizations should be frugal when incurring expenses on authorized travel, but public charities and foundations are not currently eligible to obtain government rates on travel or accommodations. A defined nonprofit/corporate rate would have to take into account the substantial variations in travel costs based on the initial departure and

destination locations, the amount of advance notice for making travel and accommodations arrangements, and the availability of accommodations that meet the needs of various groups by size, security, meeting rooms, and other issues. The proposal to "limit amounts paid by charities for travel, meals, and accommodations to the applicable U.S. government rate or an alternative established/published nonprofit/corporate rate" ***would require substantial study and effort before it could be implemented.*** INDEPENDENT SECTOR is working with a group of public charities and private foundations that participate in both domestic and international travel in the course of their charitable work to develop specific recommendations that will help Congress and the IRS to develop clear guidance on "fair and reasonable" travel costs. **INDEPENDENT SECTOR** ***recommends that further action on such limits be deferred pending further study.***

IV. Improving the Quality and Scope of Forms 990 and Financial Statements

INDEPENDENT SECTOR believes that the Forms 990 and 990PF, in their current design, fall woefully short of providing a clear, useful tool for the public, for regulators, and for nonprofit practitioners who must complete the form, and we strongly concur that significant reforms are needed.

- **INDEPENDENT SECTOR** ***strongly supports the proposal to require tax-exempt organizations to file electronically, given appropriate phase-in requirements (for example, the process could begin by requiring paid preparers and/or organizations with $1 million or more in gross receipts to file returns electronically).*** This should be the first step in improving the quality of Forms 990 and 990PF. Electronic filing will reduce significantly the number of incomplete or inaccurate returns filed in error and will allow the IRS immediately to notify an organization of incomplete returns or inaccuracies related to mathematical errors. This process would provide further assurance to nonprofit CEOs who must rely on their paid preparers to file an accurate, complete return.

- **INDEPENDENT SECTOR** ***supports recommendations to impose penalties on tax return preparers*** (including paid staff operating in the capacity of a professional preparer) for failure to file returns or for intentional errors and omissions in filing a return. ***Implementation of penalties for failure to file a complete and accurate 990 outlined in the discussion draft should be tied to the implementation of electronic filing which will prevent most inadvertent or unintentional errors and omissions. There should also be sufficient provisions to allow a CEO and paid preparers to correct errors and omissions before penalties are imposed.***

- **INDEPENDENT SECTOR** ***strongly agrees that the IRS should promulgate standards for reporting of financial data that conforms to generally accepted accounting principles and practices.*** INDEPENDENT SECTOR provided detailed comments to the IRS in early 2003 regarding the establishment of regulations that would reconcile Form 990 reporting with organizations' audited financial statements (see attached documents). There is a clear legal basis for this requirement, since the proper reporting of such expenditures is necessary to evaluate whether an organization conducts exempt activities commensurate with its resources. Proper reporting also ensures that no private party is receiving an undue benefit from use of the organization's assets.

Given the significant additional administrative burden that compliance with such accounting standards imposes, **INDEPENDENT SECTOR** ***recommends that compliance with those standards should be mandatory only for 990 filers with gross receipts in excess of $1 million for the tax year under consideration.*** This $1 million threshold for imposing additional responsibilities on exempt organizations is used elsewhere in the Code and the Treasury Regulations. For instance, Section 6652(c)(1)(A) imposes an enhanced penalty for failure to file the Form 990 on organizations with gross receipts exceeding $1 million dollars for the tax year. Similarly, Treas. Reg. section 53.49458-6(c)(2)(ii) provides a special rule for public charities with gross receipts of less than $1 million in meeting the rebuttable presumption of reasonableness with respect to the compensation of disqualified persons.

While INDEPENDENT SECTOR supports the intention of other proposals to improve the quality and scope of Forms 990 and financial statements, we have a number of concerns about these proposals that should be addressed in developing legislation.

- INDEPENDENT SECTOR agrees that all nonprofits should be encouraged to file returns on a timely basis, however allowing only one four-month extension seems to be unrealistic. Many times extensions are required because professional auditors provide substantial discounts for audits and return preparation during "off peak" periods. Extensions can also be required because of staff or operational changes within an organization or other extenuating circumstances. ***As an alternative, organizations requesting extensions should be required to post on their websites and/or provide to donors a copy of their applications for extension of time to file stating the reason why their return is not available. A processing fee could be imposed for organizations requesting a second (or third) extension.***

- INDEPENDENT SECTOR agrees that an annual independent financial review or audit is a good practice for all nonprofits, but the financial thresholds suggested in the discussion draft appear to be too low. A standard audit costs a minimum of $8,000, and a financial review costs a minimum of $3,000, not including staff expenses of the organization. The $1 million threshold used elsewhere in the tax code and Treasury regulations seems to be a more appropriate threshold for requiring independent audits. Legislation developed by the New York State Attorney General in consultation with the charitable community uses the $1 million threshold for an audit requirement, while legislation currently being considered by the California legislature uses a $2 million threshold. **INDEPENDENT SECTOR** ***recommends that a higher threshold be advanced such as that being considered in New York or California.***

- INDEPENDENT SECTOR agrees that nonprofits should rotate their auditor, or at least the lead and reviewing partners, every five years. However, we also recognize that this may not be feasible for nonprofits located in some regions where there may be few auditing firms with the relevant expertise in nonprofit financial practices or for smaller nonprofits that must turn to auditing firms that are able to provide services on a pro bono or low-cost basis. Similarly there are few large auditing firms that have expertise and capacity to deal with very large and complex private foundations and public charities. Here rotating the auditor may make more sense. ***Therefore,*** **INDEPENDENT SECTOR** ***recommends that Congress provides some***

flexibility for specific guidelines for implementation of the audit requirement to be developed in regulations.

- INDEPENDENT SECTOR agrees that disclosure of performance goals, expenses and activities would be helpful to donors and that such disclosure should not be a point of review for the IRS. Significant guidance and training would be required for both charities and donors for this information to be meaningful. Moreover, there is wide variation of views on what constitutes reasonable performance goals, given the diversity of missions, methods, services and activities of nonprofit organizations. **INDEPENDENT SECTOR** ***therefore suggests that this proposal would be addressed more effectively through the development of best practice and performance standards within relevant fields of practice.***

- INDEPENDENT SECTOR is not clear what public purpose would be served by requiring disclosure of investments on request. For larger organizations with extensive and highly diversified investment portfolios, lists of investment transactions can be thousands of pages long. ***This proposal requires further study to determine the most effective and least costly method of addressing legitimate questions and inquiries from the media or members of the public at large, adequate enforcement of any requirements, and prevention of harassment or other inappropriate requests for investment information.***

V. Encouraging Strong Governance and Best Practices for Exempt Organizations

INDEPENDENT SECTOR supports the intent of recommendations outlined in the discussion draft to improve the governance of public charities and private foundations, and we have been working with our member organization, BoardSource, in convening experts and practitioners to examine the specific proposals offered in the discussion draft. Deborah Hechinger, president of BoardSource, has submitted their comments, which we endorse.

In addition to those comments, we would note that:

- ***INDEPENDENT SECTOR supports the recommendation that individuals who are not permitted to serve on boards of publicly-traded corporations or who have been convicted of fraud or other crimes related to service as an officer or director of a tax-exempt organization or an organization that falsely presented itself as a tax-exempt organization should be prohibited from service on the board of an exempt organization for five years following the conviction.***

- ***INDEPENDENT SECTOR concurs with the proposal to grant the IRS the authority to require the removal of any board member, officer, or employee of an exempt organization who has been found to have violated self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation rules***.

While INDEPENDENT SECTOR finds merit in the proposals to establish standards for best practices for tax-exempt organizations that would guide government grant making decisions and participation in the Combined Federal Campaign, we emphasize that establishing such processes

will not be easy and will require substantial consultation with the charitable community. It should be noted that some current accreditation programs establish minimal norms of conduct for an entire sub-sector (for example, zoos) and other accreditation programs establish aspirational goals of excellence that perhaps only 5 percent of the sub-sector (for example, museums) will obtain.

As noted in my June 22nd testimony, the diverse nature of the charitable sector encompassing organizations with vastly different budgets, missions, operations, and spheres of endeavor makes it extremely difficult to apply a "one-size-fits-all" set of standards that, to be applicable, does not settle on the lowest common denominators of practice**.** **INDEPENDENT SECTOR** ***believes the time has come to create a more holistic, national-local federated system that provides, where it makes sense, consistent standards of governance and practice and effective disincentives to wrongdoing. This national effort should concentrate on sharing uniform standards of good practice where they apply, reconciling different standards of practice when they are contradictory, and still recognizing the diversity that exists among sector organizations. It should include investing further in existing successful programs, identifying current gaps in standards, and filling them where needed.***

Such an effort will require a true public-private partnership that draws on the expertise of relevant federal and state agencies with responsibility for oversight of charitable organizations, as well as experts and practitioners within the charitable community itself. I cited in my June 22 testimony several current initiatives within the charitable community that have established standards for nonprofits operating in specific geographic or service areas. Some of these programs have implemented systems to educate nonprofit board members and staff about compliance with those.

INDEPENDENT SECTOR ***encourages exploring the creation of an independent national entity and/or state entities, with public-private funding that would establish ethical and best practice standards for voluntary sector governance, financial management, and operations.*** This will require a serious investigation of models from other industries and countries, as well as further study of the current successful regional and sub-sector standards programs, such as those established by the Better Business Bureau Wise Giving Alliance, the Evangelical Council for Financial Accountability and the Standards for Excellence program of the Maryland Association of Nonprofit Organizations, now being replicated in five states. ***Moreover the sector should examine how best to connect such entities and build on the good programs that already are in place.***

This national initiative also must involve a continuing education campaign to share with charity and foundation leaders information about legal requirements and best practice standards, including technical assistance to aid charities and foundations in moving toward best practice standards and identifying and resolving problems before they escalate. Such work should build upon the work already being conducted by organizations such as CompassPoint in the San Francisco area, BoardSource, and many others.

There is some private philanthropic interest in exploring the development of such a national effort, though the successful implementation of this critical work will be an ongoing financial challenge and will undoubtedly require joint public-private support.

VI. Funding of Exempt Organizations and for State Enforcement and Education

INDEPENDENT SECTOR strongly supports the concept of developing adequate public-private funding partnerships to improve oversight and enforcement of regulations governing exempt organizations, education and training of public charities to meet appropriate standards, public access to information on exempt organizations, reporting of abuses by charities and complaints by donors and beneficiaries, and information sharing among federal and state charity regulators. ***The proposals outlined in the discussion draft are very broad in scope and deserve careful study by experts and practitioners in government and the charitable community to develop a clear implementation plan outlining how funds would be expended, specific goals and objectives for the proposed efforts, and the costs and benefits for charities, government regulators, and the public.***

New fees that would draw on scarce resources that are needed to support vital charitable activities should not be imposed before a thorough cost-benefit analysis is completed. Further, as we noted earlier in this memorandum, protections must be in place to ensure that any such fees will be used for their intended purpose of supplementing, not replacing, current budget allocations for exempt organization oversight.

CONCLUSION

Oversight of this vast and diverse sector that has as its purpose identifying and eliminating illegal or improper action, to be effective, must be flexible and accommodate the variations among organizations within the sector. In offering reform proposals, our goal should be to ensure that we do not thwart the generosity of Americans or constrain the ability of organizations to serve the common good. Some of the proposals in the discussion paper are ripe for immediate development and legislative action and ought to be propelled forward. Other ideas included in the discussion paper deserve further study. Therefore, we urge members of the Senate Finance Committee to encourage such study within the sector and to welcome the recommendations that will flow from that process.

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ATTACHMENT I

INDEPENDENT SECTOR Comments
In Response to IRS Announcement 2002-87
Submitted January 28, 2003

America's "independent sector" is a diverse collection of more than one million charitable, educational, religious, health, and social welfare organizations. It is these groups that create, nurture, and sustain the values that frame American life and strengthen democracy. In 1980, a group of visionary leaders, chaired by the Honorable John W. Gardner, became convinced that if the independent sector was to continue to serve society well, it had to be mobilized for greater cooperation and influence. Thus a new organization, named to celebrate the independent sector's unique role apart from government and business, was formed to preserve and enhance and protect a healthy, vibrant independent sector.

Today, INDEPENDENT SECTOR ("IS") is a coalition of more than 700 national organizations and companies representing the vast diversity of the nonprofit sector and the field of philanthropy. Its members include many of the nation's most prominent nonprofit organizations, leading foundations, and Fortune 500 corporations with strong commitments to community involvement. This network represents millions of volunteers, donors, and people served in communities around the world. IS members work globally and locally in human services, education, religion, the arts, research, youth development, health care, advocacy, democracy, and many other areas. No other organization represents such a broad range of charitable organizations and activities.

IS very much appreciates the opportunity to submit comments in response to IRS Announcement 2002-87. IRS Form 990 is the paramount source of current information on the operations of many types tax-exempt organizations, including charitable organizations. Therefore, IS is particularly interested in ensuring that the Form 990 provides a clear and accurate picture of organizations' operations while avoiding the imposition of unduly burdensome reporting requirements.

I. General Comments

In general, IS believes that the efforts to revise the Form 990 are important steps in improving the quality and consistency of the information charities provide to the IRS and to the general public on an annual basis. Measures to increase tax-exempt organizations' transparency and accountability by revising the Form 990 must strike an appropriate balance among multiple goals: providing sufficient data to determine compliance with the applicable tax laws, informing donors and the general public, and minimizing organizations' administrative burdens. Accordingly, we particularly appreciate attempts to improve the reliability of fund-raising expenditure reporting and increased disclosure with respect to corporate governance procedures, since this information is vital to improving public confidence in the nonprofit sector. At the same time, we caution against imposing onerous requirements on all tax-exempt organizations with foreign operations because we believe that such requirements are neither an efficient nor an effective means for preventing the few instances where exempt organizations may have provided funding to inappropriate foreign organizations or activities. In addition to supporting revisions to

the Form 990 itself, we also encourage the IRS to improve public access to Form 990 information by providing electronic filing of the Form 990 and offering public access to such filings on the IRS website as soon as possible.

II. Specific Comments

We have the following specific comments with respect to the various changes.

A. Compliance with SOP 98-2.

We agree with requiring the use of SOP 98-2 for certain 990 filers as a means of improving the accuracy of fundraising information and further reconciling the Form 990 reporting with organizations' audited financial statements. There is a clear legal basis for this requirement, since the proper reporting of such expenditures is necessary to evaluate whether an organization conducts exempt activities commensurate with its resources and to ensure that no private party is receiving an undue benefit from use of the organization's assets.

Given the significant additional administrative burden that SOP 98-2 imposes in assessing whether expenses meet the three-pronged test for allocating expenses between fundraising and programmatic or administrative purposes, we recommend, however, that compliance with SOP 98-2 should only be mandatory for 990 filers with gross receipts in excess of $1 million dollars for the tax year in question. This $1 million dollar threshold for imposing additional responsibilities on exempt organizations is used elsewhere in the Code and the Treasury Regulations. For instance, Section 6652(c)(1)(A) imposes an enhanced penalty for failure to file the Form 990 on organizations with gross receipts exceeding $1 million dollars for the tax year. Similarly, Treas. Reg. section 53.49458-6(c)(2)(ii) provides a special rule for public charities with gross receipts of less than $1 million dollars in meeting the rebuttable presumption of reasonableness with respect to the compensation of disqualified persons.

B. Recommendations for Requiring Additional Fundraising Information

1. Disclosure of Allocation Method Used

In addition to the SOP 98-2 requirement, we also recommend that the Form 990 require filers with over $1 million in gross receipts to identify the nature of the costs and the allocation methods that they have employed in reporting costs for activities with joint purposes. Identifying the allocation methods used is another important step in obtaining a clear understanding of expenditures and determining whether organizations are characterizing them appropriately. There are three allocation methods that are typically used for determining fundraising costs: the physical units methods, the relative direct cost method and the stand alone joint-cost accounting method. As a recent GAO report on tax-exempt organizations points out, "Each method can produce a different financial portrait, and no one method is appropriate in all circumstances."[1]

[1] "Tax-Exempt Organizations: Improvements Possible in Public, IRS and State Oversight of Charities", GAO-02-526 (April 1, 2002). The report illustrates how the choice of allocation method can affect the accuracy of expense reporting. For instance, if

2. Explanation of Fundraising Costs

We recommend that Part II of the 990 provide a space for organizations to explain their fundraising expenditures, if they choose to do so. This will give organizations an opportunity to describe the factors that may make their fundraising program particularly costly and will help to prevent donors from making unfair judgments about an organization's performance on the basis of assumptions about its spending efficiency.

C. Foreign Grants

We oppose requiring separate schedules for grants made to foreign recipients and imposing any other additional reporting obligations on exempt organizations with foreign operations, foreign grant making programs and other types of business relationships with foreign parties. While we understand the interest in protecting against the risk that exempt organizations' funds could be diverted for terrorist or other inappropriate activities, we do not believe that there is any basis for the IRS to impose such significant burdens on all exempt organizations that have ties to foreign countries. Despite the large scale of US charities' activities in foreign countries--from aid and missionary organizations to university branches and scientific research organizations--and the substantial amount of US charities' expenditures in foreign countries, there is no evidence to indicate widespread abuse of such funds for terrorist purposes.

For purpose of the tax rules, the locus of an exempt organization's activities is irrelevant, so long as such activities are conducted for exempt purposes. It is well established that charities may conduct some or all of their exempt activities in foreign countries, including by making grants to foreign organizations for charitable purposes. Rev. Rul. 71-460, 1971-1 C.B. 231 (activities in a foreign country permitted); Rev. Rul. 66-79, 1966-1 C.B. 48 (grants to foreign organizations permitted). The Form 990 already requires organizations to describe the nature of their exempt activities. Requiring organizations to provide separate lists of foreign grants, as well as more specific information on foreign funding and other transactions with foreign parties, imposes an undue burden on thousands of legitimate organizations-- from organizations funding a single missionary to large universities operating branches in foreign countries. More importantly, it is highly unlikely that including these questions on the Form 990 would cause any organization to reveal plans to illegally divert funds for terrorist use or other inappropriate purposes.

D. Corporate Responsibility

We agree that exempt organizations should be required to disclose on Form 990 whether they have adopted conflict of interest policies or have independent audit committees. Such

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an organization pays an outside fundraiser $1 million dollars to conduct a direct mail solicitation by using a letter containing 90 lines of public education and 10 lines of fundraising, the physical units method would allow the organization to allocate $900,000 to program expenses and $100,000 to fundraising. However, such an allocation would clearly be inappropriate if 90 percent of the $1 million fee was for the development of a mailing list.

information indicates whether organizations have established procedures that protect against the misuse of their assets.

The Instructions to the Form 990 should provide a definition of "independent audit committee" for this purpose. We recommend the following definition:

> For purposes of the Form 990, an independent audit committee is a committee comprised solely of independent directors of the organization. In order to be considered "independent," directors must meet the following criteria. The director or any member of his or her family, as defined by section 4958(f)(4), must not: (1) be compensated by the organization (other than fees received for being a director), (2) be employed by a present or former auditor of the organization, and (3) must not be part of an interlocking directorate in which an executive officer of the organization serves on the board of another organization that concurrently employs the director in question.[2]

E. Additional Changes to Improve Public Information and Increase Public Confidence

1. Disclose Related Directors.

We recommend that Part V of the Form 990 include a question asking whether officers, directors or trustees are related to each other, through either family or business relationships. This question currently appears as question 2 of Part III of the Form 1023. It is important to repeat it on the Form 990 because many organizations change the composition of their boards on a regular basis. We recommend that the Form 990's instructions provide the following definitions of the terms "family relationship" and "business relationship":

For "family relationship," we recommend that the instructions provide that an individual has a family relationship with his or her spouse, ancestors, children, grandchildren, great grandchildren, and siblings (whether by whole or half blood), and the spouses of children, grandchildren, great grandchildren and siblings. This definition follows the intermediate sanctions definition of "family members" found in section 4958(f)(4).

For "business relationship," we recommend that the instructions provide a definition that encompasses both "direct" business relationships and "indirect" business relationships. An officer, director, trustee or key employee would have a direct business relationship with another officer, director, trustee or key employee if they have an employer-employee, independent contractor, lessor-lessee or other direct contractual relationship.

[2] This definition of "independent director" is derived from a rule proposed by the New York Stock exchange ("NYSE"), requiring all companies listed on the NYSE to have a majority of independent directors. NYSE Listed Company Manual § 303A.01 (proposed).

An indirect business relationship would exist through a "35-percent controlled entity." The term "35-percent controlled entity" should be defined as in section 4958(f)(3), except that for these purposes the definition should be based only on ownership by officers, directors, trustees, key employees and their family members, thereby avoiding the need for applicants to determine if anyone else exercises "substantial influence" over the applying organization.

An officer, director, trustee or key employee would then have an indirect business relationship with another officer, director, trustee or key employee if:

- the individuals are both owners of a 35-percent controlled entity;
- one individual is an employee, independent contractor or otherwise has a contractual relationship with a 35-percent controlled entity owned in part or in whole by the other individual; or
- one individual is the owner, in part or whole, of a 35-percent controlled entity that is an independent contractor or otherwise has a contractual relationship with another 35-percent controlled entity owned in part or in whole by the other individual.

While this definition would require the exempt organization to identify all 35-percent controlled entities, almost all exempt organizations will have no more than a few such entities.

2. Annual Reports and Audited Financials Available to the Public

We recommend that questions N and O be added to the introductory section of the Form 990, as follows:

N. Does the organization publish an annual report? Is it made available to the general public?

O. Does the organization produce audited financials? Are these financials made available to the general public?

These questions will alert the public as to whether there are additional sources of information available that will be helpful in evaluating the organization's performance.

3. Allowing Consolidated Returns for Affiliated Organizations

We recommend that the Form 990 provide a parent organization the option of filing a combined Form 990 for itself and all affiliates that are subject to its supervision and control, and that meet the current criteria for filing a group return. Presently, where an organization has a group exemption ruling, the parent must file at least two returns-- one for itself and one for the organizations covered by the group exemption. These separate Form 990's include material inter-company income, expenses, assets and liabilities that distort the overall operations and financial position of the organization and make it difficult for donors and others to use the information return data. The distortion of organizational data is exacerbated when oversight organizations evaluate charities based solely on statistical analysis of Form 990's. Using raw unconsolidated data in cases where the related entities perform separate but complementary functions can lead to highly erroneous conclusions about organizational performance. Allowing

a parent and its closely controlled affiliate charities to file a combined Form 990 would provide meaningful financial information for the entity as a whole; and preclude the public from making erroneous judgments based upon fragmented information that is now required under IRS guidelines.

Conclusion

We appreciate the IRS' efforts in revising Form 990 and the IRS' invitation to comment on the proposed changes. We are available to discuss any of our comments if desired.