Panel on the Nonprofit Sector

Convened by Independent Sector

Strengthening **Transparency Governance Accountability** of Charitable Organizations

a supplement to the final report to

Congress and the Nonprofit Sector

April 2006

PANEL ON THE NONPROFIT SECTOR

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* In March 2006, the Panel appointed Lorie A. Slutsky as its co-convener, replacing Paul Brest, who remains on the Panel as a member.

** These members concluded their service on the Panel in December 2005.

In February 2006 the Panel appointed four new members: Jonathan F. Fanton, president of the John D. and Catherine T. MacArthur Foundation; Steve Gunderson, president and CEO of the Council on Foundations; Valerie S. Lies, president and CEO of the Donors Forum of Chicago; and William D. Novelli, chief executive officer of AARP.

Panel on the Nonprofit Sector

Convened by INDEPENDENT SECTOR

This Supplement is a companion to *Strengthening the Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, issued by the Panel on the Nonprofit Sector in June 2005.

Both reports are available at www.NonprofitPanel.org.

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SECTION I

Introduction

The Panel on the Nonprofit Sector was convened in October 2004 at the encouragement of the leaders of the Senate Finance Committee to consider and recommend actions to strengthen good governance and ethical conduct within public charities and private foundations. Over the next nine months, over 5,000 individuals participated in the Panel's efforts to strengthen transparency and accountability in charitable organizations. They became members of its work and advisory groups, joined conference calls, attended field hearings held in 15 communities across the nation, and made comments via the Panel website or to the Panel staff on the best methods for providing legitimate oversight while protecting the independence crucial to the sector's ability to remain innovative and effective.

The culmination of this remarkable collaboration was the Final Report to Congress and the Nonprofit Sector that the Panel issued in June 2005. It has already helped many charitable organizations improve their governance and management practices, and it also offered guidance to the leaders of the Senate Finance Committee, the IRS and state oversight officials, and other members of Congress. Many of its recommendations were included in tax legislation that was introduced in late November 2005.

That report concluded the Panel's initial work. However, because of the complexity of the issues it was considering and the short time available, the Panel and its Work Groups continued to analyze additional areas related to transparency and accountability. This work led to recommendations in nine additional areas, draft versions of which were posted for public comment on the Panel's website in the fall of 2005. These drafts and the comments submitted were used by the Panel in making the recommendations that are presented in this Supplemental Report.

The Panel subsequently has decided to extend its work in two other areas: self-regulation of the charitable sector and improvement of financial reports issued by public charities and private foundations. To support the development of recommendations on self-regulation, the Panel has appointed a new advisory committee. On financial reporting, it will draw on the expertise of its two existing committees on reforming the Form 990 and the Form 990-PF, as well as other experts in the field. Throughout 2006, the Panel will again call for comments from members of the broader charitable sector to ensure that its ideas account for the rich diversity and varied circumstances of the country's 1.3 million charitable organizations.

The Panel will also continue to work with the sector and with government officials to ensure that charities and foundations operate according to the highest possible ethical standards. It will concentrate on encouraging the implementation of the nearly 150 recommendations in its Final and Supplemental Reports. These carefully integrated actions—to be taken by charitable organizations, by Congress, and by the Internal Revenue Service—together would strengthen the sector's transparency, governance, and accountability. The Panel will, for example, identify sample policies on codes of ethics, conflicts of interest, reporting of misconduct, executive and board compensation, audit committees, and records retention to assist charitable organizations in improving governance and standards of practice.

The Panel on the Nonprofit Sector illustrates the charitable community's continuing commitment to strengthening its transparency and accountability. The thousands of people participating in its work understand that only if the sector continues to show that it is an ethical, responsible steward of the public trust will it be able to continue to provide the programs that benefit millions of people each day.

SECTION II

Recommendations of the Panel on the Nonprofit Sector

1. INTERNATIONAL GRANTMAKING

Introduction

Charitable organizations in the United States have a long history of providing private philanthropic assistance to address critical needs in countries around the world. Private and community foundations, corporate grantmakers, public charities (including religious organizations), and countless individuals have contributed financial resources, tangible goods, and volunteer services to both U.S. and non-U.S. organizations to, among other efforts, combat poverty, preserve the environment, and advance knowledge, civil society, and democracy throughout the globe. In some instances, these services are provided directly by U.S.-based organizations with international program operations; in others, they are provided in partnership with or directly by indigenous organizations.

To be effective, charitable organizations working outside the United States must deal with language and cultural differences, technological challenges, threats of disease, and often hostile environments. Not all host governments, particularly non-democratic regimes, have welcomed nongovernmental organizations and the philanthropies that support them. Organizations working abroad may be at risk because their work poses a threat to corrupt or anti-democratic forces. In some cases, organizations have had to take special steps to protect the staff working on the ground. There have also been occasions where corrupt individuals or anti-democratic or even criminal groups have attempted to co-opt local organizations or their resources to serve their own purposes.

When public charities and private foundations make grants to foreign organizations, those funds pass beyond the reach of U.S. regulators. In these instances, additional procedures are necessary to prevent the use of charitable resources to further non-charitable private interests. U.S. law mandates some of these procedures, while individual organizations have instituted others voluntarily in order to protect the integrity of their charitable work.

Statement of Problem

Since the attacks of September 11, 2001, there has been increased concern that the resources of some charitable organizations and other U.S.-based organizations providing assistance outside of the United States could be diverted to support terrorist activity. As a result, the federal government has increased scrutiny of the international grantmaking and charitable activities of U.S.-based organizations, and the Treasury Department has issued voluntary guidelines for charitable organizations to protect their grants and resources from being used to finance terrorism.[1] In the wake of this extensive scrutiny, there is concern that some corporate grantmakers and charitable organizations will cease making grants to organizations that operate or are based in countries outside of the United States, and as a result many organizations that provide vital international charitable assistance will experience significant declines in their philanthropic support.

Additionally, media reports have alleged that some donors have used donor-advised funds and other charitable vehicles to make grants to foreign entities that then provide inappropriate or illegal benefits to the donor. In response to these concerns, some have called for prohibiting grants from donor-advised funds to organizations that are not based in the United States or restricting such grants only to foreign organizations that appear on a list to be developed by the Internal Revenue Service.[2] There have also been calls for separate, more detailed reporting of grants made to organizations outside the United States.[3]

Recommendations for Congressional Action

No further Congressional action is required at this time to protect charitable assets from diversion, as the current tax law rules appropriately balance protection of such assets passing beyond U.S. borders and flexibility for charities to work with organizations based in other countries to advance charitable objectives abroad.

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[1] U.S. Treasury Department, "Anti-Terrorist Finance Guidelines: *Voluntary* Best Practices for U.S.-Based Charities," November 2002, revised December 2005.

[2] Senate Finance Committee Staff Discussion Draft, 108th Congress (June 2004).

[3] IRS Announcement 2003-29, 2003-1 C.B. 928, "International Grant-Making and International Activities by Domestic 501(c)(3) Organizations: Request for Comments Regarding Possible Changes."

Recommendations for Internal Revenue Service Action

The IRS should *not* institute separate or additional reporting requirements for grants to foreign grantees.

Recommendations for Charitable Organization Action

U.S.-based charitable organizations should use the following Principles of International Charity[4] to guide their international charitable work:

1. Consistent with the privilege inherent in their tax-exempt status, charitable organizations must exclusively pursue the charitable purposes for which they were organized and chartered.
2. Charitable organizations must comply with both U.S. laws applicable to charities and the relevant laws of the non-U.S. jurisdictions in which they engage in charitable work. Charitable organizations, however, are non-governmental entities that are not agents for enforcement of U.S. or foreign laws or the policies reflected in them.
3. Charitable organizations may choose to adopt practices in addition to those required by law that, in their judgment, provide additional confidence that all assets—whether resources or services—are used exclusively for charitable purposes.
4. The responsibility for observance of relevant laws and adoption and implementation of practices consistent with these principles ultimately lies with the governing board of each individual charitable organization. The board of directors of each charitable organization must oversee implementation of the governance practices to be followed by the organization.
5. Fiscal responsibility is fundamental to international charitable work. Therefore, an organization's commitment to the charitable use of its assets must be reflected at every level of the organization.
6. When supplying charitable resources, fiscal responsibility on the part of the provider generally involves:
   a. in advance of payment, determining that the potential recipient of monetary or in-kind contributions has the ability to both accomplish the charitable purpose of the grant and protect the resources from diversion to non-charitable purposes;
   b. reducing the terms of the grant to a written agreement signed by both the charitable resource provider and the recipient;
   c. engaging in ongoing monitoring of the recipient and of the activities under the grant; and
   d. seeking correction of any misuse of resources on the part of the recipient.
7. When supplying charitable services, fiscal responsibility on the part of the provider generally involves taking appropriate measures to reduce the risk that its assets would be used for non-charitable purposes. Given the range of services in which organizations engage, the specific measures necessarily vary depending on the type of services and the exigencies of the surrounding circumstances. The key to fiscal responsibility, however, is having sufficient financial controls in place to trace funds between receipt by the service provider and delivery of the service.
8. Each charitable organization must safeguard its relationship with the communities it serves in order to deliver effective programs. This relationship is founded on local understanding and acceptance of the independence of the charitable organization. If this foundation is shaken, the organization's ability to be of assistance and the safety of those delivering assistance is at serious risk.

Background

Current Law and Reporting Requirements

Organizations recognized for tax-exemption under section 501(c)(3) of the U.S. tax code are required to be "organized and operated" exclusively for charitable purposes. The regulations further require that no more than an insubstantial part of an organization's activities may be in furtherance of a non-exempt purpose.[5] The federal tax rules governing U.S. charities have for many years contained detailed provisions to ensure that assets transferred by a U.S. charity to a non-charity—includ-

[4] Treasury Guidelines Working Group of Charitable Sector Organizations and Advisors, "Principles of International Charity," March 2005. See footnote 16 for further information on the Working Group.

[5] See Treas. Reg. § 1.501(c)(3)-1(c)(1).

ing a foreign organization that has not been determined to be the equivalent of a U.S. charity—continue to be used exclusively for charitable purposes. Various IRS Revenue Rulings[6] have established that U.S.-based charitable organizations will not jeopardize their tax-exempt status by making grants to a non-U.S. organization that is not recognized by the IRS as exempt under section 501(c)(3) if they:

- retain control and discretion as to the use of the funds;
- maintain records establishing that the funds were used for section 501(c)(3) purposes; and
- limit distributions to specific projects that are in furtherance of their own exempt purposes.[7]

To meet these requirements, the U.S.-based organization is expected to conduct a pre-grant investigation of the purpose for which the funds will be used, obtain a written grant agreement with the recipient organization, and conduct field investigations as necessary to ensure appropriate use of funds.[8] The grantmaker is also expected to maintain records and case histories showing the name and address of fund recipients; the amount distributed to each recipient; the purpose for which the aid was given; the manner in which each recipient was selected; and the relationship, if any, between the recipient and (1) members, officers, or trustees of the organization; (2) a grantor or substantial contributor to the organization or a member of the family of either; and (3) a corporation controlled by a grantor or substantial contributor.[9]

A private foundation is also subject to excise taxes if it makes a grant to an organization that has not been recognized by the IRS as a public charity, including foreign organizations, unless it either (1) determines that the foreign grantee would qualify as a "public charity" if it were subject to U.S. tax law; or (2) exercises "expenditure responsibility" procedures to ensure that:

- the grant is spent solely on the purpose for which it is made;
- the grantor foundation obtains full and complete reports from the grantee on how the funds are spent; and
- the grantor foundation makes full and detailed reports with respect to such expenditures to the IRS.[10]

Expenditure responsibility procedures must include a pre-grant inquiry of sufficient depth to give a reasonable assurance that the grant funds will be used appropriately. In addition, a written grant agreement, signed by an appropriate officer, director, or trustee of the grantee organization, must ensure annual reporting, maintenance of appropriate books and records to establish the uses made of grant funds, and repayment of any unused or misused funds. Additional provisions of the agreement must preclude the use of funds for political campaign intervention, lobbying, certain voter registration drives, or non-charitable purposes. Finally, the regulations mandate specific Form 990-PF reporting for all grants subject to expenditure responsibility.[11]

Public charities and private foundations are required to report all cash and non-cash grants, allocations, and contributions made during the year (or approved for future payment) on their annual Form 990, 990-EZ or 990-PF.[12] In addition, a private foundation must also report on its Form 990-PF the following information for each grant to non-U.S. grantees that was paid or for

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[6] See Rev. Rul. 71-460, 1971-2 C.B. 231; Rev. Rul. 68-489, 1968-2 C.B. 210; Rev. Rul. 56-304, 1956-2 C.B. 306 (referenced by the IRS in Announcement 2003-29, 2003-1 C.B. 928). Because both Revenue Ruling 56-304 and Revenue Ruling 68-489 antedate the Tax Reform Act of 1969 (which first established federal tax law's distinction between public charities and private foundations), they are clearly applicable to all organizations exempt under section 501(c)(3). Although, these revenue rulings do not have the force of law, the Service will likely take adverse positions if organizations fail to take substantially similar actions to ensure an appropriate use of funds.

[7] Rev. Rul. 68-489, 1968-2 C.B. 210; see also Chief Counsel Advice 200504031 (Jan. 7, 2005).

[8] Rev. Rul. 75-65, 1975-1 C.B. 79.

[9] Rev. Rul. 56-304, 1956-2 C.B. 306.

[10] See IRC § 4945(d)(4); Treas. Reg. § 53.4945-5(b)(1).

[11] Treas. Reg. § 53.4945-5.

[12] See 2004 Form 990-PF (Return of Private Foundation), Part XV, line 3; Form 990 (Return of Organization Exempt From Income Tax), Part II, line 22. See also 2004 Instructions for Form 990 and Form 990-EZ at 23 (instructing Form 990 filers to attach a schedule of the recipients of grants reported on line 22).

which grant funds or a report from the grantee is outstanding: (1) the name and address of the grantee; (2) the date and amount of the grant; (3) the purpose of the grant; (4) the amounts expended by the grantee based upon the most recent report received from the grantee; (5) the dates of reports received from the grantee; (6) the date(s) and results of any verification of the grantee's reports; and (7) whether, to the knowledge of the grantor foundation, the grantee has diverted any of the grant funds from the purpose of the grant.[13]

Charitable organizations must abide not only by the tax laws restricting the use of their resources for noncharitable activities, but also by other U.S. laws that prohibit any person or organization from engaging in transactions that support terrorist activities. Prior to the 2001 terrorist attacks, U.S. law prohibited individuals, organizations, and business entities from knowingly providing any form of material support[14] related to specific acts of terrorism. Shortly after the attacks, President Bush issued Executive Order 13224, which prohibited transactions with individuals and organizations named in the Order or appearing on the Treasury Department's list of "Specially Designated Nationals" (SDN list).[15] Providing humanitarian assistance, such as food, clothing and medicine, to listed persons and those associated with listed persons is also forbidden. Individuals and organizations that violate the Executive Order are subject to severe civil and criminal penalties.

Recent Federal Government Proposals and Responses from the Charitable Community

The U.S. Treasury Department issued "Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities" in November 2002 to help charitable organizations reduce the possibility that that their funds would be diverted for terrorist purposes. Many organizations expressed concern that the guidelines were impractical for most international work and that strict compliance would not be more effective than existing procedures to prevent the diversion of funds for noncharitable purposes; instead, their main effect likely would be to discourage international activities by U.S. organizations. The Treasury Department subsequently encouraged charitable organizations to propose alternatives for safeguarding charitable assets, which led to the formation of the Treasury Guidelines Working Group of Charitable Sector Organizations and Advisors.[16] This broad-based group issued its report, "Principles of International Charity," in March 2005. It provides commentary and examples of how the current law strikes an appropriate balance between allowing diversity and flexibility in the demonstration of accountability while minimizing the risk of diversion of charitable assets. The Treasury Department revised its "Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities" and posted the revised guidelines for public comment in December 2005.

In May 2003, the Internal Revenue Service requested public comments on how to strengthen requirements that charitable organizations must meet with respect to international grantmaking and activities in order to reduce the possibility of diversion of assets for noncharitable purposes.[17] The American Bar Association Tax Section submitted comments in response to the request, arguing for a risk-based approach to international grantmaking, similar to that used in the financial services sector. The ABA Tax Section comments offer a variety

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[13] See Treas. Reg. § 53.4945-5(d)(2); 2004 Form 990-PF (Return of Private Foundation), Part VII-B, line 5c.

[14] 18 U.S.C. § 2339A lists federal crimes involving material support. Material support includes financial support and services, lodging, training, personnel, transportation, and any goods except food and medicine. The list of prohibited material support was expanded in the USA PATRIOT Act to include monetary instruments and expert advice or assistance.

[15] 66 F.R. 49079 (Sept. 25, 2001).

[16] Coordinated by the Council on Foundations, the Working Group involved a diverse membership of private foundations, public charities, religious organizations, grantmakers, operational nongovernmental organizations, corporations, watchdog groups, employee matching gift funds, legal advisors, and umbrella groups representing various parts of the charitable sector. Their report can be found at www.cof.org.

[17] IRS Announcement 2003-29, 2003-20 I.R.B. 928, "International Grant-Making and International Activities by Domestic 501(c)(3) Organizations: Request for Comments Regarding Possible Changes."

of voluntary options for organizations to use, encouraging them to choose appropriate diligence procedures in different circumstances based on the level of risk inherent in the grantmaking activity.[18]

Rationale

Under current federal tax laws and regulations, charitable organizations that engage in international grantmaking and charitable activities are subject to extensive procedures and reporting requirements to ensure that their resources are not utilized for non-charitable purposes. Many organizations have also adopted voluntarily additional monitoring efforts based on their own experiences and those of similar organizations to assure that they have met their commitment to use their assets only for charitable purposes. The report of the Treasury Guidelines Working Group[19] outlined a number of procedures that some organizations have established to ascertain the qualifications of potential recipients of grant funds and other resources. The more detailed risk-based approach presented in the ABA Tax Section Comments[20] is another resource outlining voluntary diligence measures organizations can take to reduce the risk of asset diversion. Because the ABA Tax Section comments outline a wide variety of procedures that may be used in various circumstances, this resource may be particularly helpful for organizations with less experience in international grantmaking. Each charitable organization must, however, be free to determine the procedures that are most relevant to its experience, resources and circumstances.

While some organizations have instituted the complex computer software and other administrative procedures required to utilize the Specially Designated Nationals list maintained by the Treasury Department, others decline to use this list because of fairness, legal, safety and practical concerns. For example, the list may not include sufficient identifying information about a listed individual or entity to distinguish among similarly named entities or persons, which may cause an organization to deny assistance to a legitimate recipient. Given its shortage of resources, the IRS is not in a position to develop standards and to conduct the requisite due diligence necessary for accrediting charities organized under the laws of other countries in order to prepare and maintain a list of approved charities operating abroad.

It is unwise and unnecessary to introduce expanded or separate reporting of grants made by private foundations or public charities to non-U.S. organizations or individuals. Current IRS reporting requirements for the Form 990 and 990-PF returns should be fully enforced, but imposing new requirements could serve to further discourage vital international charitable activities.

The voluntary Principles of International Charity represent the collective efforts of a broad range of individuals and charitable organizations with extensive knowledge and experience in international charitable activities. These principles are a thoughtful, responsible approach for both government and charitable organizations to follow in preventing the diversion of charitable assets while protecting the critical international activities of U.S.-based grantmakers and charitable organizations.

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[18] See ABA Committee on Exempt Organizations of the Section of Taxation, "Comments in Response to IRS Service Announcement 2003-29, 2003-1 C.B. 928 Regarding International Grant-making and International Activities by Domestic 501(c)(3) Organizations" (July 18, 2003), available at www.abanet.org.

[19] Treasury Guidelines Working Group of Charitable Sector Organizations and Advisors, "Principles of International Charity," March 2005.

[20] See ABA comments, pp. 2-3, 33-39.

2. CHARITABLE SOLICITATION

Introduction

Most public charities must solicit funds from the public to support their programs. These solicitations vary greatly from charity to charity, depending on the size and age of the organization, the needs and resources of the local community, the organization's judgment as to how best to fund its activities in the long- and short-term, and what resources might be available to the particular charity. While charities conduct many of their own fundraising campaigns, they sometimes obtain assistance from for-profit fundraisers. Fundraisers who solicit the public, whether they work for a charity or a for-profit firm, are subject to federal, state, and local regulation, including registration and reporting requirements in most states. In addition, many professional societies of fundraisers have codes of principles and practices that govern the behavior of their members. These codes generally prohibit or strongly recommend against payment of fees to fundraisers based on a percentage of funds raised.

Statement of Problem

State regulators—and, to a lesser extent, the Federal Trade Commission and the Internal Revenue Service—have long been concerned about fraudulent solicitations and about professional fundraisers whose efforts primarily benefit themselves, not a charity. Government officials are also concerned that when a charity pays large fees to a for-profit fundraiser, it may receive only a small percentage of the total amount collected. While there are legitimate reasons for a charity to conduct a costly campaign that brings in little net revenue, such as the potential for an event or a campaign to increase the visibility of the organization or the expense involved in raising funds for unpopular causes, regulators and others fear that high solicitation costs may signal an improper benefit being conferred on a for-profit fundraiser and an abuse of donors, the public, or both. There is also concern about the fiscal loss to government, as donors take a full deduction for contributions even though only a small portion of the money ends up being used for charitable purposes. Registration and reporting forms are not uniform from state to state and most cannot be filed electronically, making it difficult both for charities to comply with applicable requirements and for state officials to enforce their laws. Charities that solicit in multiple jurisdictions or on the Internet find compliance with state and local charitable solicitation laws increasingly confusing and costly.

Recommendations for Congressional Action

Congress should authorize funding to create a national uniform electronic filing system for charitable solicitation registration and annual reporting, but states should continue to be the primary regulators of charitable solicitation activities. The system should be administered by the Federal Trade Commission and be designed in consultation with state regulators and the charitable sector so that central filings would satisfy the requirements of all states in which the charity solicits.

Recommendations for the Internal Revenue Service Action

The Internal Revenue Service should enforce firmly the current legal prohibitions against private inurement, private benefits, and provision of excess benefits, particularly in the context of charitable solicitations.

Recommendations for Charitable Organization Action

1. The charitable sector should encourage the National Association of State Charity Officials (NASCO), the National Association of Attorneys General (NAAG) and the National Conference of Commissioners on Uniform State Laws (NCCUSL) to work together with the FTC, the IRS, and charitable organizations to revise and update the Model Charitable Solicitations Act so it addresses current fundraising vehicles and practices, including the Internet.
2. Charitable organizations should encourage state legislatures to adopt the Model Charitable Solicitations Act or other legislation designed to protect donors and deter and punish charitable solicitation abuses.

Background

Charitable solicitation is regulated by overlapping federal, state, and local laws. States play the leading role in overseeing charitable solicitation, with 38 states and the District of Columbia currently regulating charities. Many cities and counties also have enacted their own charitable solicitation ordinances. State and local statutes are not uniform, varying on such points as registration and annual reporting requirements; required point-of-solicitation disclosures to prospective donors; criteria for exemption from registration or reporting; prohibited acts; and penalties for non-compliance. Charities, particularly those operating in multiple states, must therefore spend considerable time educating

themselves on and complying with the laws of each state in which they solicit, or they must hire a professional firm to make the required filings on their behalf.

The Federal Trade Commission has jurisdiction over fraudulent solicitations in interstate commerce by for-profit organizations, while the United States Postal Service has jurisdiction over mail fraud. The Internal Revenue Service regulates the deductibility of charitable contributions; the requirements for gift substantiation; the compensation of professional fundraisers who are also disqualified persons; and the annual reporting on Form 990 of contributions and grants, revenue from special fundraising activities, and fundraising expenditures. Several times since the 1970s, Congress has considered enacting federal legislation to create a unitary scheme governing charitable solicitation but has always refrained from doing so.

In the 1980s, some states tried to crack down on fraudulent fundraising and curb a perceived waste of charitable assets by limiting the amount that could be paid for fundraising, including amounts paid to professional fundraisers. Some states required point-of-solicitation disclosures about the proportion of the funds that would eventually be received by the charity. The U.S. Supreme Court struck down three of these efforts on the grounds that they infringed on charities' First Amendment free speech rights.[1] The Court reasoned that because charitable solicitation is related to the advocacy of ideas, it is protected speech, and therefore must be regulated using the least restrictive means possible. The Court rejected the presumption by state regulators that a low percentage of gross receipts remitted by a professional fundraiser to the charity is necessarily a good indicator of fraud.[2] While the Court expressed sympathy for state regulators' desire to protect their citizens from deceptive practices, it noted that existing anti-fraud statutes were adequate and much less restrictive tools for combating fraudulent solicitations than the percentage caps and point-of-solicitation disclosures, which it found to be excessive burdens on or unlawful compulsion of speech and thus unconstitutional. However, in 2003, the Court, while affirming these precedents, upheld the Illinois Attorney General's right to pursue an action for fraud against a professional fundraiser that made representations to donors that a "significant amount" of each dollar donated would be going to the charity, when only 15 percent actually went to the charity.[3]

Fundraising Registration and Reporting Requirements

In 1986, NAAG adopted a Model Charitable Solicitations Act. Nevertheless, many states have not voluntarily adopted common practices in a number of critical areas, such as basic reporting requirements, the types of organizations that are exempt from registration and reporting requirements, and the accounting principles on which financial reporting should be based.

NAAG and NASCO have also worked with representatives of the charitable sector to develop a Unified Registration Statement (URS) as part of a standardized reporting project, "The Multi-State Filer Project." However, this project applies only to registration, and not annual reporting, requirements. In addition, although 34 states and the District of Columbia accept the URS, at least 10 of those jurisdictions still require charities to submit supplemental information.

Members of NASCO have also addressed the issue of Internet solicitations. They drafted the Charleston Principles, a set of voluntary guidelines that aim to clarify when a charity's Internet solicitations should subject the organization to a state's regulation. The Principles suggest that charities and fundraisers that utilize the Internet for charitable solicitation should register in their home states (if their home state has such a requirement), and in any other states in which they specifically target people for solicitation, or from which they receive online contributions on a "repeated and ongoing basis or a substantial basis." The Charleston Principles also suggest that at least 100 online contributions a year from a state might be considered "repeated and ongoing," and that contributions of over $25,000

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[1] See *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980); *Secretary of State of Maryland v. Munson*, 467 U.S. 947 (1984); and *Riley v. National Federation of the Blind of North Carolina, Inc.*, 487 U.S. 781 (1988).

[2] As the Court explained in *Riley*, paying a substantial percentage of the donations received to a professional fundraiser might be a reasonable choice for the charity, depending on its goals (e.g., the solicitation might be aimed at raising the charity's visibility or identifying potential new long-term supporters).

[3] *Illinois ex rel. Lisa Madigan v. Telemarketing Associates, Inc.*, 123 S. Ct. 1829 (2003).

might be considered "substantial." While the Charleston Principles help establish useful guidelines for states, they do not have the force of law.

Rationale

Regulation and oversight of charitable solicitation activities has been undertaken principally at the state level, and state regulators have amassed considerable experience in overseeing the solicitation activities of both charities and for-profit professional solicitors. Because of their broad jurisdiction, as well as their ability to monitor local activities and take quick, preemptive action against abusive behaviors, state authorities are in the best position to lead oversight of charitable solicitations. However, the number of charities soliciting funds from multiple jurisdictions (whether through the Internet or other methods) has increased tremendously in recent years, which has raised the cost and the problems associated with compliance with multiple registration and reporting requirements.

Although state charity regulators have made efforts to develop uniform registration and reporting requirements and generally agree that greater uniformity would significantly enhance compliance, it appears unlikely that nationwide uniformity will be achieved without federal intervention. Accordingly, Congress should mandate the creation of such a system and provide funding to support its development. The Federal Trade Commission has the strongest experience at the federal level in overseeing charitable solicitations by for-profit fundraisers, but its authority would need to be expanded to permit appropriate oversight of a national charitable solicitation registration and reporting system.

To ensure that the system meets the needs of state regulators and charitable organizations, Congress should require the FTC to design the registration and annual reporting requirements only if the states, working in consultation with the FTC and the charitable sector, do not do so within a reasonable timeframe. The states should similarly be required to implement a process in consultation with the FTC and charitable organizations for periodic revisions to the registration and reporting requirements. Only if states are unable to agree upon uniform reporting requirements within this reasonable timeframe should federal legislation imposing uniformity be considered.

State solicitation oversight should continue to be supplemented by federal enforcement activity. In particular, FTC and Postal Service action is necessary where state officials cannot adequately police fraudulent solicitations by for-profit fundraisers using the Internet, telephone, or mail service. The Internal Revenue Service has a key role to play in reviewing charitable solicitation transactions for compliance with prohibitions against private inurement, private benefits, and provision of excess benefits. If organization insiders have received improper benefits, the IRS can require the excessive benefits to be repaid and punish both those who received the benefits and any officers or directors who knowingly approved the transaction. The IRS can also revoke the exemption of charities that abuse their exempt status by fraudulently soliciting funds from the public.

Current state and federal laws prohibiting fraudulent solicitation should be vigorously enforced, and, where necessary, strengthened. The Model Charitable Solicitations Act has not been updated since 1986. Because there have been significant changes both in the nature of solicitation activities and the law since that time, the Model Act needs to be revised to reflect current practice. For example, thought should be given to whether the Act should incorporate the Charleston Principles on Internet solicitation. Adoption of a revised Model Act should be seriously considered by each state, and adoption is strongly encouraged for the states still lacking charitable solicitation regulation.

3. COMPENSATION OF TRUSTEES OF CHARITABLE TRUSTS

Introduction

In the United States, charitable organizations can be established as corporations or trusts,[1] each of which is subject to different sets of laws governing their creation and administration. A corporation can only be created with authorization from the state, whereas a trust can be established through a written declaration or deed (known as the trust instrument) that transfers the title and management responsibility for property or other assets to a trustee or trustees. The trustee is then responsible for ensuring that the property is appropriately managed to provide the benefits to the public or specified group of individuals defined in the trust instrument. The trustee can be a bank or other institution, a single individual, or a group of individuals.

Many trustees of charitable trusts are institutions or professional advisors and therefore receive compensation for their services, which generally go beyond general governance to include substantial asset and investment management activities. Individuals who serve as trustees may also receive compensation. Fees for trustees of charitable trusts may be set in the trust instrument, follow a state statutory fee schedule, or be authorized or approved by a state court. Federal tax law prohibits "excessive compensation" of directors and trustees of all charitable organizations,[2] with reasonable compensation generally defined as the amount that "would ordinarily be paid for like services by like enterprises under like circumstances."[3]

Statement of Problem

In some cases, trustee compensation—whether established in a trust instrument, set in accordance with state trust law, or approved by a state court—may be excessive when compared to the compensation of trustees and directors who are performing similar services for similar charitable organizations. Federal tax laws and regulations do not currently provide comprehensive guidance for determining the reasonableness of trustee compensation in cases where compensation has been established by trust documents or set or approved under state law.

Recommendations for Congressional Action

Congress should direct the Secretary of the Treasury to:

1. Amend the self-dealing regulations applicable to private foundations[4] to clarify that when evaluating the reasonableness of a trustee's compensation, the fact that the compensation is specified in a trust instrument or otherwise authorized by a state or local legislative body, agency, or court is not determinative of whether such compensation is excessive.
2. Amend the intermediate sanctions regulations applicable to public charities[5] to clarify that when evaluating the reasonableness of a trustee's compensation, the fact that the compensation is specified in a trust instrument is not determinative of whether such compensation is excessive.

Recommendations for the Internal Revenue Service

The Internal Revenue Service should revise the Form 990 series returns to require that charitable organizations distinguish compensation of institutional trustees from compensation paid to individual trustees.

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[1] Some charities are created informally as voluntary associations, but this legal form leaves individual members liable for the debts of the association and hence is rarely used. More recently, some charities have organized as a limited liability company (LLC), but the rules applicable to LLCs are essentially the same as those applied to corporations.

[2] Excessive compensation is private inurement, prohibited by section 501(c)(3) and penalized with excise taxes on both the overly compensated individual or business and those who knowingly and willfully approve the excessive compensation under section 4941 (for private foundations) or 4958 (for public charities).

[3] Treas. Reg. §1.162-7. See also Treas. Reg. §53.4941(d)-3(c)(1) and §53.4958-4(b)(1)(ii) (both referencing the section 162 standard for determination of reasonable compensation).

[4] Under IRC section 4941, private foundations are prohibited from engaging in specific financial transactions with "disqualified persons," that is, foundation managers, substantial contributors, members of their families, and corporations or businesses in which any of those persons has more than a 35 percent interest.

[5] IRC section 4958 regulations already provide that authorization or approval of a compensation package by a state or local legislative or agency body or court is not determinative of the reasonableness of compensation. Identical standards should apply under both the public charity intermediate sanctions rules and the private foundation self-dealing rules.

Background

Many charitable organizations, especially private foundations and supporting organizations, are organized as trusts. Almost without exception, state statutes explicitly authorize trustees to receive reasonable compensation for their services.[6] Generally, specific fee provisions in a trust document will be respected by state authorities, although courts commonly retain equitable discretion to depart from the fees established in the trust instrument or by statute when those amounts are unreasonably high or low under the circumstances.[7] For the most part, state laws are applicable to all trusts and do not distinguish between compensation of trustees of charitable and non-charitable trusts.

A majority of state laws do not attempt to define in any detail what constitutes reasonable compensation, leaving courts broad leeway to consider a variety of factors in assessing whether a particular fee is reasonable. In most jurisdictions, in the absence of specific fee provisions in the trust document, trustees may set and pay their own fees without any court review unless the beneficiaries complain.[8] In a few states, trustees are entitled to specific percentage payments on the income or principal of the trust.[9] If the trust corpus is large, a percentage compensation arrangement can result in very large fees regardless of the amount, type, or quality of services rendered.

There are wide variations in the duties performed by trustees. Sometimes the role of trustee carries with it substantial duties of asset and investment management, especially in non-charitable trusts, and many banks and other financial institutions provide trustee services as part of their business operations. A charitable trust may have individual trustees who oversee the organization's programs and activities, functioning like directors of a charitable nonprofit corporation, an institutional trustee that provides expert investment management services, or both.

All charitable organizations are prohibited from using their resources to benefit insiders, including by paying excessive compensation to officers, directors and trustees.[10] The self-dealing rules for private foundations and the intermediate sanctions rules for public charities impose excise taxes on both trustees receiving excessive compensation and on other organization managers who knowingly and without reasonable cause approve unreasonably high compensation.[11] For both foundations and charities, reasonable compensation is generally "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[12] The intermediate sanctions regulations provide that, in determining whether a trustee's compensation is reasonable, relevant data may include compensation levels for functionally comparable positions in similarly situated organizations, the availability of similar services in the geographic area, current compensation surveys by independent parties, and actual compensation offers received by the individual from similar organizations.[13] These regulations are explicit that this reasonableness limitation applies to trustee compensation set according to a state fee schedule or approved by a state court.[14] Because there is no similar clarification in the self-dealing regulations, some trustees of private foundations have argued that the IRS should always consider compensation set in accordance with a state's statutory fee schedule as reasonable. A similar argument has also

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[6] See IIIA Austin Wakeman Scott and William Franklin Fratcher, *The Law of Trusts* § 242 n.4 (4th ed. 1988 and 2004 Supp.).

[7] See, e.g., Unif. Trust Code § 708(b)(2); Cal. Prob. Code § 15680(b).

[8] See Unif. Trust Code § 816(15); Unif. Prob. Code § 7-205.

[9] See, e.g., N.Y. Surr. Ct. Proc. Act § 2309.

[10] In its Final Report to Congress, the Panel on the Nonprofit Sector provides a detailed discussion of federal laws limiting compensation of trustees and executives of charitable organizations (pp. 61-72).

[11] In its Final Report, the Panel recommended extending imposition of these excise taxes to managers who knew or should have known, through the exercise of reasonable diligence, that they were approving excessive compensation.

[12] Treas. Reg. §§1.162-7(b)(3), 53.4941(d)-3(c)(1) and 53.4958-4(b)(1)(ii)(A).

[13] See Treas. Reg. §53.4958-6(c)(2)(ii). Although the "rebuttable presumption" of reasonableness described in these regulations is not available where public charity trustees set their own compensation (because they have an inherent conflict of interest) or for trustees of private foundations, following the process described in these regulations for setting trustee compensation with reference to appropriate comparable data may be useful in determining a reasonable compensation level and in demonstrating that the compensation paid was reasonable.

[14] Treas. Reg. §53.4958-4(b)(1)(ii)(A).

been made regarding compensation that is set in a trust instrument, a situation which is not specifically addressed in either the self-dealing or intermediate sanctions regulations.

Rationale

Trustees of charitable trusts, like all charitable organization insiders, are subject to the federal requirement that their compensation must not be excessive. In all cases, the fees paid to a trustee of a charitable trust must be similar to those paid to other trustees or directors providing similar services to similar organizations. This federal limitation is separate from any state law requirement of reasonableness, and a determination that compensation is not excessive cannot rest solely on the fact that a trustee's compensation was set in a trust instrument, was dictated by a state statutory fee schedule, or was allowed or approved under state law or by a state court.

States developed trust law compensation standards, especially statutory fee schedules, largely with reference to private trusts and estates. Under many state laws, a donor may set a trustee's fee at a fixed percentage of trust assets, resulting in compensation which is generally reasonable for smaller, private trusts, but which may be inappropriate for large charitable trusts. Further, payment of a statutory trustee's fee regardless of the trustee's duties and regardless of what similar organizations pay for similar services could easily result in excessive compensation in situations where a trustee is performing minimal services for a large trust. In addition, in a state court proceeding to set or approve a charitable trustee's compensation, the parties involved may have little incentive to ensure that the requested fees are truly comparable to what similar organizations pay directors and trustees performing similar services.

There is a great deal of ambiguity regarding the interplay of the federal reasonableness standards in the private foundation self-dealing regulations and state statutory fee rules. As noted above, the public charity intermediate sanctions regulations already make it clear that the federal requirement that such compensation be reasonable also applies to trustee compensation set in accordance with state statutes or approved by a state court. In audits of estate tax liability, the IRS does not permit deductions for trustee fees that are found to be unreasonable, even if those fees have been approved by a court. There is no reason why the standard for compensation of trustees of private foundations should be any different. However, some have relied upon the current ambiguity and state statutory fee schedules to justify over-compensation of trustees who provide little or no service to a foundation. In order to eliminate this practice, the private foundation self-dealing regulations should be amended to include a statement, similar to that in the intermediate sanctions regulations,[15] clarifying that compensation of trustees of a tax-exempt private foundation must meet the federal standard of reasonableness, even where a state fee schedule or court order may allow payment of higher fees.

Some donors who create charitable trusts may specify substantial fees for trustees in the trust instrument as a favor or in recognition of the personal esteem the donor holds for the friend or professional advisor named as a trustee. Although state trust law may respect the donor's intent to compensate a trustee at a higher level than a court would otherwise allow, federal tax law should not allow excessive compensation regardless of the donor's desire. Therefore, both the self-dealing and intermediate sanctions regulations should be amended to clarify that compensation arrangements specified in a trust instrument are also subject to the federal prohibition on excessive compensation.

In determining whether a trustee's compensation is reasonable, the emphasis should be on the type and quality of services provided, not the trustee's formal title. Institutional trustees may hold the same title as other trustees of a charitable organization, but the scope and quality of the financial services they provide may be quite different. The fees paid to the various types of trustees must therefore be evaluated separately. To assist both regulators and the public in comparing compensation in similar organizations, the amounts paid to institutional trustees should be reported on the Form 990 or 990-PF separately from what is paid to individual trustees.

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[15] The intermediate sanctions regulations currently state that "[t]he fact that a State or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of section 4958." Treas. Reg. §53.4958-4(b)(1)(ii)(A).

4. PRUDENT INVESTOR STANDARD

Introduction

The investment activities of charitable organizations have historically been regulated under common law according to the "prudent man rule," which holds that trustees and others with responsibility for investing money for others should act as "men of prudence, discretion, and intelligence… in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested."[1]

Many states have enacted legislation regulating the investment activities of fiduciaries, in some cases applying a more lenient standard to directors of corporations than to trustees. In recent years, the standards of care applicable to charitable trusts have been updated to reflect the modern portfolio theory of investment, a strategy that seeks to develop an optimal portfolio offering the maximum expected returns for a given level of risk tolerance. This rule is now in the Restatement of Trusts (Third) and the Uniform Prudent Investor Act, and has been adopted in almost all states. However, most states have not changed the standards for investments by nonprofit corporations.

Federal law generally does not regulate the management of investment assets by public charities. Private foundations, however, are subject to the federal prohibition in Internal Revenue Code section 4944 on making "jeopardizing" investments in effect since 1972.

Statement of Problem

There is currently no single, uniform standard of care for investment decisions that applies to all charitable organizations, regardless of where they are organized or whether they are a nonprofit corporation or a charitable trust. Standards of care can vary from state to state, and even within a state, depending on whether the charitable organization is a trust or a corporation. As a result, directors and trustees of otherwise similar organizations may be held to different standards of care for investment decisions. Federal regulations governing prudent investments have not been updated since they were enacted in 1972, and thus do not fully reflect the use of modern portfolio theory in asset management. This creates confusion for organization managers, and may prevent some managers from pursuing appropriate investment opportunities out of an abundance of caution, thereby inhibiting the growth of assets dedicated to charitable purposes.

Recommendations for Congressional Action

Congress should direct the Secretary of the Treasury to revise the section 4944 regulations regarding jeopardizing investments, which are applicable to private foundations, to reflect the modern prudent investor standard.

Congress should *not* enact a federal standard of care for investment decisions for public charities to be enforced by the IRS.

Recommendations for Charitable Organization Action

Charitable organizations should work with their state legislatures to amend state laws to ensure that the modern prudent investor rule, as set forth in the Restatement of Trusts (Third) and the Uniform Prudent Investor Act, is made applicable to all charitable organizations, whether formed as trusts or corporations.

Background

The state standard of care applicable to most nonprofit corporations is the Uniform Management of Institutional Funds Act (UMIFA), promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972. UMIFA liberalized the rules in place at the time that limited the ability of a charity to expend from an endowment fund anything other than the fund's income. UMIFA has been adopted in some form in 47 states and the District of Columbia.[2]

UMIFA also applies to charitable organizations the standard of care applicable to business corporations under state law. Under this rule, the members of a governing board must exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment decision. In making an investment decision, they must consider (1) long- and short-term needs of the organization in carrying out its charitable purposes; (2) the organization's present and anticipated financial requirements; (3) the expected total return on its investments; (4) price level trends; and (5) general economic conditions.

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[1] Justice Samuel Putnam writing in the case of *Harvard College v. Amory*, 1830.

[2] Only Alaska, Arizona and Pennsylvania have not adopted UMIFA in some form.

The state rule regarding investments applicable to most charitable trusts is set forth in the Uniform Prudent Investor Act (UPIA), promulgated by NCCUSL in 1994. UPIA, which codifies prudent investing principles for all trusts, is based on the General Standard of Prudent Investment set forth in the Restatement (Third) of Trusts. (The Restatement was released in 1992 and reflects modern portfolio theory, which by that time had become universally accepted.[3]) UPIA has been adopted in substantially similar form in more than 40 states and the District of Columbia.

Under UPIA, a trustee must invest and manage trust assets as a prudent investor would and must exercise reasonable care, skill, and caution. Trustees must make investment decisions (and regulators must review these decisions) based on the risk and return of the portfolio as a whole, rather than on a stand-alone evaluation of individual investments, and no type of investment is categorically prohibited.

NCCUSL began a UMIFA revision project in 2002, and the drafts incorporate a standard of care similar to that in UPIA.[4] A final draft is expected to be adopted in the near future.

Section 4944 of the Internal Revenue Code, which was enacted in 1969, imposes an excise tax on any private foundation and its managers who make investments "in such a manner as to jeopardize the carrying out of any of its exempt purposes."[5] Treasury regulations under this section, promulgated in 1972, require a foundation manager to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation. The regulations state both that this standard is to be applied while taking into account the private foundation investment portfolio as a whole, and that analysis is made on an investment-by-investment basis. In addition, the regulations describe certain types or methods of investment that will be closely scrutinized in terms of their prudence.[6]

Rationale

Although there is widespread agreement that the prudent investor standard of care set forth in the Restatement (Third) of Trusts and UPIA is the appropriate standard to apply to the investment decisions of charitable organization managers, regardless of where the organization is located or whether it is a corporation or a trust, federal intervention is not needed to create such a uniform investment standard. Efforts are already underway to develop a revised UMIFA, which, if adopted in states that have adopted UPIA, would bring the investment standard for charitable corporations and charitable trusts into accord. Even if a revised UMIFA is not adopted, individual state legislatures could create a uniform standard by amending their state laws to conform to the prudent investor standard of care set forth in UPIA.

The Treasury regulations under section 4944 relating to private foundations' investments were promulgated in 1972, before modern portfolio theory gained widespread acceptance in all sectors of the economy. Treasury regulations now need to be updated to reflect the use of modern portfolio theory in the management of foundation assets and the general agreement that the prudent investor standard of care is the appropriate standard for managers of all charitable organizations.

Many experts have questioned the ability of the IRS to administer the section 4944 regulations prohibiting investments that jeopardize a private foundation's ability to carry out its exempt purposes, noting the paucity of rulings and cases involving violations. A 2002 Task Force of the American Bar Association recommended that Congress repeal section 4944. Given that the Service's expertise is primarily in tax administration, rather than investment practices, and the demands on the Service's limited resources, it is unreasonable to expand its responsibility to include oversight of the investment practices of public charities. Rather, states should continue in their traditional role as the primary agents of oversight and regulation of investment practices of charitable organizations.

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[3] There are two other uniform acts applicable to charitable trusts. The Uniform Principle and Income Act (promulgated by NCCUSL in 1997) gives trustees who are managing trust assets as a prudent investor discretionary power to adjust trust assets between principal and income. The Uniform Trust Code (promulgated by NCCUSL in 2000 and amended in 2001 and 2003) incorporates UPIA wholesale as the standard applicable to the investment of trust assets. The Uniform Trust Code has been adopted in nine states and the District of Columbia.

[4] NCCUSL has not yet adopted a revised UMIFA; the most recent draft of a revised UMIFA referenced above is dated March 2, 2005.

[5] IRC section 4944(a)(1).

[6] See Treas. Reg. §53.4944-1(a)(2)(i).

5. NONPROFIT CONVERSION TRANSACTIONS

Introduction

For the past 40 years, intense financial pressures have led a growing number of nonprofit hospitals, as well as other health care providers and insurers, to convert or transfer all or a substantial part of their assets to a for-profit entity through asset sales, joint ventures, mergers, and other transactions, collectively referred to as "conversions." The financial proceeds from conversion transactions must continue to be used to benefit the public, generally through transfer to a new or existing charitable organization, but the services provided or supported by the charitable organization that receives the proceeds may be substantially different from those offered to the community prior to the conversion. Although conversions in the health care sector have been among the largest and most widely publicized, similar transactions, raising similar legal concerns, have occurred involving other types of nonprofits, including nonprofit educational, broadcasting, and consulting organizations.

Statement of Problem

Although the sale of operating assets by a charity can bring in cash to finance future programs, many people are concerned that conversion transactions result in a loss of vital community services that cannot be adequately provided in any other way. For example, the conversion of a hospital from nonprofit to for-profit status may result in loss of charity care, loss of community education programs, and, if the hospital cannot be made profitable, its complete closure. Others are concerned that such transactions may result in huge windfalls for charity executives, the for-profit buyer, or others involved in the transaction, all of which will be paid for out of the charity's assets. Additionally, once operating assets have been converted to cash, it may be easier for the remaining charitable assets to be diverted, either to a different charitable purpose (perhaps in a different community) or to the benefit of private persons. Some are concerned that there is insufficient federal and state oversight of conversions to protect the public interest.

Recommendations for Congressional Action

No Congressional action is recommended. Congress should *not* enact new legislation requiring federal review or approval of conversion transactions. State charity officials should continue to exercise responsibility for pre-transaction review of proposed charitable conversions and other transactions in which substantially all of a charitable organization's assets are transferred to a for-profit entity.

Recommendations for Internal Revenue Service Action

The Internal Revenue Service should enforce vigorously the current legal prohibitions against private inurement, private benefits, and provision of excess benefits in the context of conversion transactions.

Recommendations for Charitable Organization Action

Charitable organizations should:

1. Encourage states that have not already done so to enact legislation that establishes clear notice, disclosure, and review requirements for all proposed conversions.
2. Encourage the National Association of Attorneys General (NAAG) and the National Association of State Charity Officials (NASCO) to develop guidelines regarding the appropriate role of state charity officials in nonprofit conversion transactions. Such guidelines should include protections from diversion of charitable assets to fund government or non-charity-related operations.

Background

Nonprofit conversion transactions may have profound impact—positive or negative—on the affected communities, as experience with nonprofit hospital conversions illustrates. In some cases, communities appear to be largely satisfied with the hospital services provided by the for-profit company that has acquired the local hospital, and the proceeds from the sale have been used to create major health care foundations that support

[1] Randall R. Bovbjerg, Jill A. Marsteller, Frank C. Ullman, "Health Care of the Poor and Uninsured After a Public Hospital's Closure or Conversion," Urban Institute (2000).

important new charitable health care initiatives.[1] Such transactions arguably constitute an effective redeployment of charitable assets, since they yield a net benefit to the community. In other cases, however, it appears that the quality of hospital services available to the community is substantially reduced after the hospital is converted to a for-profit operation because of the reduction in services that do not yield profits or because of a cut in charity care. Some conversion transactions have also raised serious concerns about charity insiders using their influence to derive inappropriate private benefit. For example, hospital executives may accept attractive post-conversion employment with the for-profit in return for compromising the charity's interest while negotiating the terms of the asset sale. Finally, in some cases, state legislatures have diverted the proceeds of a conversion to fund short-term state government operations, thereby depriving communities of the potential long-term benefits of using the proceeds to support continuing charitable activities.

State charity officials have traditionally had oversight responsibility for the management of charitable assets, including conversion transactions. Twenty-five states have passed nonprofit conversion legislation relating primarily to hospitals and health care organizations,[2] and a number of others have interpreted their laws regulating charities to apply to conversions. A Model Act for Nonprofit Healthcare Conversion was approved by the National Association of Attorneys General (NAAG) in 1998.[3]

The IRS also has an interest in oversight of conversion transactions. As a condition of tax exemption, charitable organizations must be organized and operated for charitable purposes, and charitable assets must be irrevocably dedicated to charitable purposes. Charitable assets may not be used to benefit an organization insider ("private inurement") and no substantial part of the organization's assets may be used for the benefit of any other person ("private benefit"). When dissolved, a charity's assets must be distributed to another charitable organization.

The IRS can revoke an organization's exempt status for violations of the prohibition on private inurement and limitations on private benefit. It also can impose penalties on individuals who benefit inappropriately from a transaction with a charitable organization, such as those who receive excessive compensation or who purchase organization assets at less than fair market value. In addition, the IRS can assess penalties on managers who knowingly and without reasonable cause approve such transactions. The IRS has the authority to review conversion transactions, which are reported on an organization's annual Form 990 information return, to ensure that fair market value was received for the charitable assets transferred and that organization insiders and other parties to the transaction did not benefit inappropriately.[4]

Both the Joint Committee on Taxation January 2005 report and the Senate Finance Committee 2004 staff discussion draft call for a pre-transaction review of contemplated conversion transactions by the IRS to ensure that the conversion is necessary and in the best interest of the public. Under the Joint Committee proposal, charitable organizations would be required to provide key documents to the IRS, which would be required to make these documents publicly available and which would have an opportunity to participate in the conversion proceedings conducted by state authorities. Completion of the conversion would be conditioned on IRS approval (or failure to disapprove) within one year.

Rationale

Health care, education, social service, and other needs vary greatly among communities, and state charity officials are in a better position than the IRS to evaluate the potential benefit or detriment to a local community of a proposed conversion transaction. In addition, because state authorities have local knowledge and broad equity powers, they are better able to perform pre-transaction reviews quickly, and either approve

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[2] Id.

[3] See Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Cambridge, Massachusetts: Belknap Press of Harvard University Press, 2004), pp. 320.

[4] See 1996 EO CPE Text, Charles Kaiser and T. J. Sullivan, "Integrated Delivery Systems and Healthcare Update."

[5] Conversion transactions may involve sales of distressed facilities, often on the verge of closure, and there may be a limited time to review proposed transactions and determine whether they are in the public interest.

beneficial transactions in time to preserve asset value[5] or get an injunction to prevent harmful ones. The IRS has neither the capacity to perform timely review of proposed transactions nor the authority to stop a transaction. If federal approval were required to consummate conversion transactions, as has been proposed, the delay could waste charitable assets as transactions stalled or, in some cases, failed while awaiting federal approval. Thus, state regulators should continue to exercise primary pre-transaction oversight and review of nonprofit conversion transactions.

Since some state officials have less experience with such transactions than others, NAAG and NASCO should provide direction to the states regarding the appropriate role of state charity officials in conversion transactions. Such guidelines should include an admonition that state legislatures should recognize that charitable assets are private assets which have been irrevocably dedicated to a particular charitable purpose. Accordingly, state legislatures should not intervene in conversion transactions to divert the proceeds to the state treasury to finance government operations.

State charity officials are also better placed to monitor the post-conversion use of the charitable assets to ensure that they are used to further appropriate charitable purposes. A conversion often leads to the creation of a foundation, which receives the proceeds of the conversion and then fulfills some aspects of the charitable purpose of the previous organization. Because they are closer to the community, state regulators are better positioned than the IRS to assess the particular needs and resources of the community and can therefore better ensure that the charitable assets continue to be used appropriately.

Many states have passed laws or interpreted existing laws to address conversion transactions, particularly in the health care sector, but there are still a significant number of states without adequate regulation of such transactions. The charitable sector should strongly encourage states to improve their oversight of conversion transactions, including the adoption of nonprofit conversion statutes in states where such transactions are not adequately regulated. Such statutes should clarify the process for pre-transaction review by establishing clear notice, disclosure, and pre-transaction review requirements for proposed conversion transactions, and they should require that charitable assets continue to be used for appropriate charitable purpose after a conversion transaction takes place. To help states make these improvements, NAAG and the National Conference of Commissioners on Uniform State Laws (NCCUSL), working closely with charitable organizations, should develop a model nonprofit conversions act. States that have already adopted legislation regulating health care conversions should expand their laws so they apply to all conversion transactions, regardless of the charitable organization's mission or charitable activities.

The IRS has an interest in ensuring that a charitable organization's assets are preserved for appropriate charitable purposes, and its oversight is an important complement to state enforcement activities. The IRS already has the necessary tools to review completed conversion transactions and, if organization insiders received improper benefits from the transaction, to require the excessive benefits be repaid and to punish both those who received the benefits and officers or directors who knowingly approved the transaction. Current Internal Revenue Code provisions prohibiting private inurement and private benefit should be vigorously enforced.

6. TAXATION ON SALES OF DONATED PROPERTY

Introduction

Gifts of property—including land and stock—are a significant source of support for many charitable organizations. Non-cash gifts may be put to use immediately in fulfillment of the organization's charitable purposes or be retained to generate investment income to support the organization's programs. The organization may also determine that it is best to donate the property to another charitable organization that can better use the gift, or sell it to generate income that will support its charitable purposes. Although federal tax laws generally permit a donor to take an income tax deduction equivalent to the fair market value of real estate and other non-cash property[1] contributed to a qualified charity, limitations apply to the deductibility of gifts of property depending on the type of property donated, the type of charitable organization receiving it, and its anticipated use by the organization.[2]

Statement of Problem

The Internal Revenue Service has reported that some taxpayers, in calculating their income tax deductions, have over-estimated the value of property donated to charitable organizations. Some government officials have expressed concern that the amount of excessive deductions has become so large that they have questioned whether the gifts have valid charitable purposes or if they serve primarily as a vehicle for the donors' tax deductions.

Recommendations for Congressional Action

Congress should amend federal tax laws to strengthen requirements for qualified appraisals used for purposes of substantiating the value of donated property as recommended by the Panel on the Nonprofit Sector in its June 2005 report.

Congress should *not* enact legislation to treat income realized by charitable organizations from the sale of donated assets as taxable unrelated business income.

Background

In 1950, Congress enacted the unrelated business income tax (UBIT), an income tax on the net profits a tax-exempt organization derives from certain activities considered to be an active trade or business that is regularly carried on and is not substantially related (other than providing funds) to the accomplishment of the organization's exempt purpose. Because UBIT was intended to equalize tax treatment of exempt organizations' unrelated businesses activities that directly compete with for-profit entities—and not by a desire to tax exempt organizations on the same basis as other entities—UBIT is generally not imposed on dividends, interest, annuities, royalties, capital gains, real property rents, and certain other types of income.[3]

In its January 27, 2005 report, the Joint Committee on Taxation recommended that donors be allowed to take a deduction equal only to the disposition price received by the charity, provided that the charity sells the donated property within a reasonable time frame.[4]

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[1] In this context, non-cash property generally refers to gifts of art, land, stock, and securities, rather than gifts of clothing, household items, or motor vehicles.

[2] For gifts of ordinary income property (property that would not have resulted in long-term capital gain if it were sold by the donor on the date of the contribution), tangible personal property that is used by the donee in a manner unrelated to the its exempt or governmental purpose, and property that is donated to or for the use of a non-operating private foundation, the deduction is limited to the taxpayer's basis.

[3] See I.R.C. § 512(b), especially paragraphs (1)-(3) and (5). See also IRS Publication 598, which describes the application of the UBIT rules.

[4] See Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures" 305-307, January 27, 2005 (JCS 02-05).

However, the Joint Committee expressed concern that if the value of the gift appreciated significantly after the donation was made, the donor's tax deduction could be inflated inappropriately, resulting in a loss of tax revenue to the government. The Joint Committee therefore proposed that the charity pay UBIT (at the highest UBIT rates) on the capital gain realized on the sale, using the donor's basis in the property as reported on Form 8283,[5] arguing that the act of "accepting, preparing for sale, and selling property for which the organization had no exempt use"[6] would constitute an unrelated business activity that should be subject to UBIT. The Joint Committee justified taxing the entire appreciation on the property, not just the post-gift appreciation, by noting that taxing only post-gift appreciation would require a market value determination at the time of the gift, something the proposal was designed to avoid.[7]

Rationale

Current tax laws, which permit taxpayers to take a deduction equal to the fair market value of gifts of appreciated property (subject to certain restrictions), have long provided strong incentives to make such gifts to charity. These non-cash contributions have become a significant source of support for many charitable organizations, whether they use such contributions in the course of their charitable work or sell the items to generate revenues that fund their programs and services.

Concerns about the appropriate valuation of donated property for the purposes of claiming income tax deductions are best addressed directly, by the implementation of more rigorous and clearly defined standards for appraisers and the methods they use. The Panel on the Nonprofit Sector provided a number of recommendations in its Final Report to Congress that would strengthen appraisal standards and impose stiffer penalties on taxpayers and appraisers for misstatements of value.[8]

Proposals to tax any gains realized by a charity upon the disposition of donated property cannot be justified as an application of the current UBIT, which only taxes income from active business activities. Capital gains and other forms of passive investment income are specifically exempted from this tax, and so the proposal to tax capital gains on sales of donated property must be seen as a new tax on the passive investment income of charitable organizations. Federal tax policy has a long history of granting a tax-exemption to charitable organizations, in part because those organizations perform functions that are essential to the common good. Reversing this policy and taxing the passive investment income of exempt organizations would be deeply damaging to charities and other exempt entities.

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[5] See id. at 306, note 654 and related text. The Joint Committee acknowledges that the tax could apply only to post-contribution appreciation, but for the fact that the value of the property at the time of the gift would not have been established.

[6] Id. at 306.

[7] See id at 306, note 655. Note, however, that in many cases the pre-gift appreciation may be dramatically more than any post-gift appreciation. Note also that the Joint Committee proposal does not allow charities to claim a loss on the disposition of the property, precluding recognition of any post-gift depreciation in the property value. See id. at 306, note 654.

[8] Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, June 2005, pp. 53-55, available at http://www.nonprofitpanel.org.

7. CONSUMER CREDIT COUNSELING ORGANIZATIONS

Introduction

Consumer-credit counseling organizations (CCOs) were first established in the 1960s to help individuals in financial difficulty gain control of their finances, repay their credit card debts, and avoid bankruptcy. In the last decade, new state and federal laws have been enacted to protect consumers from deceptive and fraudulent practices involving credit counseling and debt repair, but these laws often provided specific exceptions for CCOs that have been recognized for tax-exemption under section 501(c)(3) of the federal tax code. These exceptions have been credited with helping spur explosive growth in the number of nonprofit CCOs, as questionable operators moved into the nonprofit sector to avoid the consumer protection laws. Recent IRS enforcement actions have resulted in the denial or revocation of exempt status for many CCOs.

Statement of Problem

While many nonprofit CCOs offer legitimate services that further their legitimate tax-exempt purposes, there are numerous reported instances of CCOs that have abused their nonprofit status. Some organizations have preyed on financially vulnerable individuals through deceptive advertising and used fraudulent business practices for their own gain. Recent revisions to the Bankruptcy Code requiring consumers seeking bankruptcy protection to get credit counseling could increase the possibility of abuse.

Recommendations for Congressional Action

Congress should remove current exemptions in federal consumer protection statutes for tax-exempt CCOs. It also should review existing federal consumer protection statutes and strengthen them as needed.

Congress should *not* add consumer protection provisions to the federal tax code.

Recommendations for Internal Revenue Service Action

The IRS should continue to take aggressive enforcement action against exempt CCOs that are not operating to further a charitable or educational purpose and, in particular, against organization insiders who are inappropriately using those entities for personal gain.

Recommendations for Charitable Organization Action

Charitable organizations should encourage state legislatures to strengthen consumer protection statutes as needed and remove exceptions in those statutes for tax-exempt CCOs.

Background

The first CCOs formed in the 1960s were sponsored by the consumer credit industry, which made voluntary "fair share payments" to the CCOs of a portion of the payments made by the CCOs' debtor clients.[1] CCOs that originally received exemption under Internal Revenue Code sections 501(c)(3) and (c)(4) provided services to clients (sometimes only to those with low incomes), including free public education on financial management, free individual counseling, and free or nominal-cost debt management plans (DMPs) for some clients. After two successful challenges in the late 1970s to IRS denials of section 501(c)(3) status for CCOs that were serving the general public (not just low-income clients) and charging fees to most clients (which could be waived in hardship cases), the IRS stopped challenging CCOs seeking exemption under section 501(c)(3).[2] It is also important to note that many nonprofit human service agencies that are not CCOs have long provided financial counseling and education services as part of their broader programs.

In the 1990s, the Federal Trade Commission and several states attacked fraudulent credit repair organizations, resulting in the passage of federal and state laws intended to protect consumers from deceptive and fraudulent practices. Most of these laws, however, expressly did not apply to 501(c)(3) organizations.[3]

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[1] In addition, CCOs originally received support from government, private foundations, and the United Way. See, e.g., *Consumer Counseling Service of Alabama, Inc. v. U.S.*, 78-2 U.S. Tax Case. (CCH) P9660, 44 A.F.T.R.2d (RIA) 5122 (D.D.C. Aug. 18, 1978)

[2] See, e.g., GCM 38881 (July 21, 1982), citing O.M. 19408, EE-41-80 (March 31, 1980).

[3] See, e.g., Credit Repair Organizations Act, Pub. L. No. 104-208, 110 Stat. 3009 (Sept. 30, 1996).

These two exemptions—from consumer protection laws and from many taxes—are credited with spurring explosive growth in the number of nonprofit CCOs over the last decade.[4] Many of these new CCOs are accused of being "DMP mills" that charge consumers hefty fees for their services and provide little if any education or counseling. In addition, many traditional CCOs have reduced the public education and non-DMP components of their activities as they struggle financially in the wake of reductions in the "fair share" payments creditors previously made to them.

Many states recently have increased their efforts, both through legislation and enforcement, to address abuses within the credit counseling industry. As of September 2004, 26 states had enacted some type of registration or licensing requirement for credit counselors; many of these statutes include substantive limits on fee provisions.[5] In July 2005, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved a Uniform Debt-Management Services Act that addresses both credit counseling and debt settlement services, and covers requirements for registration, insurance, disclosure and fees. The Act gives states the option of applying its provisions to both for-profit and nonprofit organizations.

The federal government, particularly the IRS, has also taken action to stop CCO abuses. In testimony before the Senate Finance Committee during 2003, IRS Commissioner Mark Everson drew attention to the extent of the abuses in this industry. As of April 2005, 60 CCOs, representing over 50 percent of the total revenues of CCOs that file information returns, were under active audit by the IRS. In addition, the IRS has revoked or proposed revocation of the tax-exempt status of CCOs representing over 20 percent of the industry's revenues.[6]

Recent revisions to the federal Bankruptcy Code are likely to increase the desire and need for credit counseling services. Effective October 17, 2005, the new Section 109(h) of the Bankruptcy Code requires a debtor who wishes to file under Chapter 7 to provide certification that he or she has received assistance in preparing a budget analysis and information about credit counseling from an approved nonprofit credit-counseling agency.[7] CCOs wishing to render these services must be approved by the U.S. Trustee pursuant to detailed criteria issued by its Executive Office.[8]

The Senate Finance Committee Staff Discussion Draft of 2004 and the Joint Committee on Taxation January 27, 2005, report both include proposals for revising exemption standards under the Internal Revenue Code for credit counseling organizations. Under these proposals, in order to be considered for exemption under 501(c)(3), credit counseling agencies would have to satisfy several additional requirements, including limits on their activities, limits on their ability to deny services to consumers (or to charge for services), and limits on the identity and activities of their affiliates and board members.[9]

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4 See, e.g., Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (November 20, 2003) available at http://waysandmeans.house.gov.

5 National Consumer Law Center, *Credit Counseling in Crisis Update: Poor Compliance and Weak Enforcement Undermine Laws Governing Credit Counseling Agencies*, November 2004.

6 Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service, Testimony Before the Committee on Finance United States Senate 8 (April 5, 2005), available at www.irs.gov.

7 See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, Section 106 (April 20, 2005). A bill is now pending which would effectively delay the effective date of this Act for one year for persons who lived in the Hurricane Katrina disaster area and whose financial condition was materially adversely affected by the hurricane. See S. 1647 and H.R.3697, 109th Congress (both introduced September 8, 2005).

8 See Department of Justice, United States Trustee Program, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) website at www.usdoj.gov. This website also has a link to a list of credit counseling agencies approved pursuant to 11 U.S.C. § 111 (as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

9 Senate Finance Committee Staff Discussion Draft, 108th Congress (June 2004); Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 327-337 (January 27, 2005).

Rationale

The primary vehicle for protecting consumers from unscrupulous CCOs, whether for-profit or nonprofit, should be comprehensive consumer protection legislation and not the federal tax code. The federal tax code offers people who come together to address a broad range of public purposes defined by law as charitable the freedom to experiment with new ideas and innovative approaches to resolving problems and responding to community needs. While government appropriately sets the parameters of lawful conduct—for example, by prohibiting private inurement and limiting private benefit—government must resist efforts to narrow the broad range of missions embraced by charitable organizations or mandate the methods or programs that may be used to further exempt purposes. Thus, the Senate Finance Committee staff proposals and Joint Committee proposals that would arbitrarily limit such items as the types of services a charitable organization can provide, the content and format of the education programs that could be offered, the composition of an organization's governing body, and an organization's sources of revenue should be rejected. While some of the proposed limitations might be appropriate elements of comprehensive state or federal credit counseling consumer protection legislation or may involve factors relevant to a determination of whether an organization is operating for a charitable or educational purpose, the structure and operations of the charitable sector should not be narrowed with such specific restrictions on program content, method, funding, or governance structure.

In their March 2004 report on credit counseling industry practices, the Senate Permanent Subcommittee on Investigation (PSI) majority and minority staffs. recommended: (1) stronger enforcement of existing consumer protection laws, which already prohibit the profiteering found in some nonprofit CCOs; and (2) extension of the Debt Repair Organizations Act of 1996 to include nonprofit entities or enactment of new consumer protection legislation modeled after the Debt Repair Organizations Act to be enforced by the FTC.[10]

The regulatory requirements for tax-exempt credit counseling organizations should be no less stringent than for their for-profit counterparts, and therefore the current exceptions in both federal and state consumer protection statutes for tax-exempt CCOs should be eliminated. Excepting CCOs recognized under section 501(c)(3) encourages those seeking to avoid legitimate state and federal oversight to migrate to the nonprofit sector.[11]

The Federal Trade Commission is better suited to develop and enforce comprehensive consumer protection regulation than the IRS. Since its mandate includes the protection of consumers, the FTC has the expertise and jurisdictional reach to address the operations of the credit counseling industry as a whole, including for-profit and nonprofit organizations.

Nonetheless, the IRS should continue its increased efforts to ensure that exempt CCOs are in fact serving tax-exempt purposes and not being used for personal gain. Many reported abuses by nonprofit CCOs are instances of private benefit and private inurement already prohibited by the Internal Revenue Code. The recent success of the IRS in pursuing actions against abusers under current law and in denying tax-exempt status to entities that do not appear to operate for exempt purposes suggests that aggressive enforcement can effectively combat CCOs' abuse of their nonprofit tax status and that there is no need to amend the federal tax code.

States should continue to adopt strong procedural and substantive requirements for the operations of CCOs, including registration, licensing, bond, disclosure and fee requirements. State efforts to work towards a uniform and comprehensive solution to the problems that have developed in the credit counseling industry, such as the approval by NCCUSL of the Uniform Debt Management Services Act, should be encouraged. Care must be taken, however, to ensure that human services organizations that are not CCOs but offer some financial counseling services are not unduly burdened by new legislation.

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[10] See Majority & Minority Staffs of the Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, 108th Congress, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling 33-34 (March 24, 2004). The report also recommended that the U.S. bankruptcy trustee issue a central list of qualifying CCOs for bankruptcy petitioners, a provision that was included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and that creditors review and strengthen their standards for CCOs with whom they do business.

[11] The Panel's recommendation leaves open the questions of whether for-profit and tax-exempt CCOs should be subject to the same regulatory structure or whether they should be regulated separately.

8. DISCLOSURE OF UNRELATED BUSINESS ACTIVITIES

Introduction

While the majority of income received by most charitable organizations is exempt from taxation, some revenue may be taxable. This "unrelated business income"—the net profits that a charitable organization derives from a regularly carried-on business that does not have a substantial, causal relationship to the accomplishment of exempt purposes—is taxed at the corporate income tax rate.[1] Other business income ("related business income") and investment income is not taxed. In the Form 990 series information returns they annually file with the Internal Revenue Service, charitable organizations must report all income, both unrelated and related; organizations with unrelated business income also must file a more detailed tax return, the Form 990-T. While Form 990s are publicly disclosed, Form 990-Ts are not.

Statement of Problem

There is a concern that some charitable organizations are understating their tax liability for unrelated business income, and that some directors and officers of charitable organizations are receiving personal financial benefit from the organization's unrelated business activities. The current reporting procedures may not be transparent enough to make it easy for donors, the press, and government regulators to monitor an organization's business activities.

Recommendations for Congressional Action

No Congressional action is recommended. Congress should *not* require that the Form 990-T and the tax returns of for-profit entities owned by or affiliated with exempt organizations be made available to the public on the same basis as other Form 990 series returns.

Recommendations for the Internal Revenue Service

The Internal Revenue Service should:

1. Amend the Form 990 to increase the information it requires about a charitable organization's unrelated business activities.
2. Require public charities to report to the IRS any situation in which an officer, director or trustee owns 10 percent or more of an entity in which the charity also has a 10 percent or greater ownership.

Background

In 1950, Congress enacted a tax on the income derived by otherwise tax-exempt organizations from business activities that are not related to their exempt purpose. The Congressional intent, explicitly stated in the legislative history, was to eliminate unfair competition and "level the playing field" between tax-exempt and taxable organizations.[2] To achieve that goal, the unrelated business income tax (UBIT) imposes a corporate income tax on the net profits a tax-exempt organization derives from a regularly carried-on business that does not, other than providing a source of funds, further the organization's exempt purpose.

All income of an exempt organization, whether related or unrelated, is reported on the organization's publicly available Form 990 return. In addition, exempt organizations must provide information about taxable subsidiaries on the Form 990, including what percent-

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[1] The unrelated business income of a charitable organizations established as a trust are taxed at the trust income tax rate, which is higher than the corporate rate.

[2] See also Treas. Reg. §1.513-1(b).

age of the entity the exempt organization owns and a description of the entity's activities, its income, and its end-of-year asset balance. Organizations that have unrelated business income must also file a Form 990-T tax return, which provides the financial information on which the organization's unrelated business income tax liability is calculated and reported. This requirement even applies to organizations exempt from the requirement to file a Form 990, such as religious organizations and those with annual budgets below $25,000. The Form 990-T tax returns, like the returns of taxable entities such as private corporations, are kept confidential.

The Joint Committee on Taxation has proposed that tax-exempt organizations be required to disclose their 990-T tax returns publicly[3] and that the returns of for-profit entities owned by or affiliated with tax-exempt organizations also be publicly available. The Joint Committee argued that such disclosures were necessary because the public currently does not have adequate knowledge of charitable organizations' unrelated business activities or their relationships with for-profit entities.

Rationale

As the primary source of publicly available information about the financial activities of charitable organizations, the Form 990 returns should include a full and clear description of an organization's unrelated business activities. The IRS should therefore amend the returns to include such a description. In addition, the IRS should clarify the current requirement that all compensation, including non-cash compensation such as incentive compensation, received by a charitable organization's officers, directors, trustees, or key employees from the organization's affiliated entities, whether or not those affiliated entities are subject to taxation, must be reported on the organization's Form 990, if such compensation exceeds a stated threshold.[4]

Disclosure of an organization's Form 990-T return, or the returns of an organization's for-profit affiliates or subsidiaries, is contrary to the longstanding U.S. tax policy of preserving the confidentiality of taxpayers' returns. Requiring disclosure of charities' Forms 990-T would destroy the level playing field created by UBIT and would instead give for-profit organizations an unfair advantage, since they would know more about their tax-exempt competitors than the tax-exempt organizations would know about them. It would also be unfair to require the tax returns of for-profit affiliates of tax-exempt organizations to be made public. This information inequity could jeopardize tax-exempt organizations' ability to recruit partners for joint ventures, could limit their investment opportunities, and could cause the market to undervalue taxable subsidiaries of tax-exempt organizations when put up for sale, thus diminishing the charitable organization's ability to serve the public.

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[3] Joint Committee on Taxation, "Study of Disclosure Provisions Relating to Tax-Exempt Organizations" 93, January 28, 2000. (JCS 1-00). The Senate Finance Committee staff has also made this proposal: see Senate Finance Committee Staff Discussion Draft, 108th Congress (June 2004).

[4] Currently, an organization must disclose all compensation, including non-cash benefits, paid by a related organization to officers, directors, trustees or key employees that receive aggregate compensation of more than $100,000 from both the charitable organization and its related organizations if more than $10,000 was provided by the related organizations. See Form 990, Part V, Line 75 and related instructions.

9. FEDERAL COURT EQUITY POWERS AND STANDING TO SUE

Introduction

Under current law, the regulation of the behavior of charitable fiduciaries is principally a state, rather than a federal, function. State courts possess a broad range of equitable powers to protect assets dedicated to charitable purposes. Suits to enforce charitable duties are primarily brought by state attorneys general, but officers and directors of a nonprofit corporation also may bring suit in state court.

The U.S. Tax Court's oversight of charitable organizations is generally limited to reviewing the Internal Revenue Service's determination of tax exemption or imposition of excise taxes. The Tax Court does not possess broad equity powers over the actions of charitable fiduciaries, nor can private individuals bring suit in the Tax Court against charitable organizations or their fiduciaries.

Statement of Problem

Reports of alleged abuses by some charitable fiduciaries have raised questions about the role the Tax Court should play in the regulation of charitable conduct. Some have recommended that Congress grant the Tax Court the same broad equity powers over charitable fiduciaries that the states have traditionally exercised, including the power to remove board members and officers. It also has been proposed that Congress permit individual directors and members of the public to bring suit against charitable organizations and their directors in the Tax Court for alleged violations of fiduciary obligations.[1]

Recommendations for Congressional Action

No Congressional action is recommended. Congress should *not* expand the equity powers or jurisdiction of the Tax Court over charitable fiduciaries. Congress should *not* change existing law to authorize individual directors and members of the public to bring suit against charitable organizations and their directors in the Tax Court.

Background

The core function of the Tax Court is to examine deficiencies asserted by the IRS in income, gift and estate taxes.[2] In overseeing exempt organizations, the Tax Court has the power to review the IRS's denial or revocation of federal tax exemption, to issue declaratory judgments regarding an organization's qualifications under Section 501(c)(3),[3] and to review the imposition of excise taxes imposed on private foundations and public charities. Tax Court judges are generally selected based on their expertise in federal tax law.[4]

The state courts bear primary responsibility for overseeing the conduct of charitable fiduciaries through their extensive equitable powers. State courts may order accountings, remove and appoint trustees and directors, dissolve the charitable entity, force fiduciaries to restore losses caused by breach of their duties, and enjoin trustees from further wrongdoing.[5] State attorneys general bring most suits alleging charitable breaches, but under state law and common law principles, other persons—including officers and directors of a nonprofit corporation, groups of members meeting specified requirements,[6] and individuals with a reversionary, contractual, or property interest in donated assets[7]—also may sue to redress a breach.

Generally, donors, beneficiaries and members of the public cannot sue charitable organizations or their directors for breach of charitable duties,[8] except for donors who have reserved the right to sue to enforce

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[1] See recommendations included in Senate Finance Committee Staff Discussion Draft, 108th Congress (June 2004).

[2] IRS Section 6213.

[3] The Tax Court may also issue declaratory judgments regarding the qualification of debt obligations as tax-exempt bonds under IRC Section 6234.

[4] See ABA Section of Taxation, Comments on Senate Finance Committee Staff Discussion Draft, July 19, 2004, Appendix G.

[5] See Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* (Cambridge, Massachusetts: Belknap Press of Harvard University Press, 2004), pp. 302-311.

[6] See, e.g. Revised Model Nonprofit Corporations Act, Section 6.30.

[7] See, e.g. Cal. Corp. Code, Section 5142(a)(4).

[8] The most widely recognized exception to this general rule is where the charitable trust is created to benefit a very small class of beneficiaries, in which case those beneficiaries are granted standing. See *American Center for Education v. Cavnar* (1978) 80 Cal. App. 3d 476; *San Diego County Council of Boy Scouts of America v. City of Escondido* (1971) 14 Cal. App. 3d 189; Fremont-Smith at 328.

restrictions on their gifts.[9] The rationale for limiting the right of the public to sue is based on the need to protect charities from nuisance lawsuits and to prevent the diversion of charitable assets in defense of such suits. Even in states which have relied on common law to broaden the ability of members of the public to bring suit, this ability is limited. For example, in 1984, California codified its common law practice whereby the attorney general could authorize a private person known as a "relator" to pursue an action. The attorney general now has discretion to grant private individuals the right to sue under tightly prescribed procedures, but the attorney general remains in control of the case and may take over, withdraw, or compromise the matter at any time.[10]

Current federal law does not authorize a private individual to bring suit to enforce federal tax law. Internal Revenue Code Section 7401 prohibits the commencement of any civil action for recovery of taxes or penalties unless the Secretary of the Treasury authorizes or sanctions the proceedings and the attorney general or his/her delegates direct the commencement of the action.

Rationale

Current state law and common law principles provide sufficient remedies for breaches of fiduciary duties. Redress for such breaches should remain the province of the state courts, since state judges and attorneys general have the greatest expertise in disputes involving corporate and trust governance and fiduciary responsibilities. The Tax Court and the IRS, whose expertise lies in the application of tax law, are not as well-suited to take on these cases.

The creation of an additional forum for litigating disputes over fiduciary obligations may also add to the confusion felt by many charities when they try to comply with their legal obligations. Because of the different approaches taken by state legislatures and courts, charitable fiduciaries are already subject to varying standards of care in fulfilling their duties.[11] Congress and the Tax Court may take yet another approach in formulating and applying standards for fiduciary conduct, thereby adding to the uncertainty.

It does not appear that broadening the equity powers of the Tax Court would increase the effectiveness of the Tax Court or the IRS in performing their core function—enforcing the tax laws. Both already possess powerful tools to protect charitable assets, particularly the ability to impose excise taxes on those who engage in prohibited self-dealing or excess benefit transactions. The IRS also can use the leverage of abatement of individual organization manager excise taxes to induce the resignation of abusive fiduciaries from boards and/or obtain voluntary suspension from board service for a specified period as a condition of such abatement.

Allowing individual directors of charitable organizations to challenge the actions of a charitable board in Tax Court is unlikely to improve compliance with fiduciary obligations. Current state laws generally grant officers and directors of nonprofit corporations and co-trustees of charitable trusts a right of action in state court to address malfeasance, and so no apparent purpose would be served by providing potential litigants with an additional forum.

Courts and state legislatures have been unwilling to subject charitable organizations to the risk of unrestricted claims of breach of trust by members of the public for good reason: the potential for nuisance lawsuits would deter service on charitable boards and the cost of defending such claims would come out of charitable funds. States have addressed the need to balance protection from such lawsuits with organizational accountability by granting standing to sue to a limited number of persons, such as directors and trustees, who are well-positioned to know if the charity is not behaving appropriately and are unlikely to bring frivolous actions. Given the unfettered standing of state attorneys general to pursue suits for breach of fiduciary duty, the limited groups of others with standing to sue, and the right of any person to bring a complaint to the IRS or state charity official, no constructive purpose would be served by expanding the number of persons with standing to sue charities in the federal Tax Court.

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[9] See, e.g. *Smithers v. St. Lukes- Roosevelt Hospital Center*, 723 N.Y. S. 2d 426 (Surr. Ct. 2001); L.B. Research and Education Foundation v. The UCLA Foundation,(2005) 29 Cal.Rptr.3d 710.

[10] Cal. Admin. Code tit, Sections 1-2; Fremont-Smith at 325.

[11] See ABA Section of Taxation, Comments on Senate Finance Committee Staff Discussion Draft, July 19, 2004, Appendix G.

SECTION III

Acknowledgements

Since its inception in October 2004, the Panel on the Nonprofit Sector has benefited from the voluntary contributions of thousands of people. More than 100 experts on charitable organizations, including academics, lawyers, accountants, former state regulators, and executives of public charities, foundations, and corporate giving programs served on the Panel's five Work Groups and two Advisory Groups. Other sector leaders contributed to this effort by preparing discussion papers, reviewing materials for the Panel's Final Report, providing research to inform its discussions, or serving on the two special advisory committees established in the spring of 2005 to consider financial reporting issues. Supporting this work was a staff under the leadership of the Panel's executive director, as well as a legal team with expertise in nonprofit law. The Panel also consulted with technical advisors on the revision of the IRS Form 990 series returns, as well as with communications and research experts. A list of all those who contributed to the Panel's earlier efforts appears in the Appendix to the June report.

Most Work Group and Advisory Group members continued to assist the Panel through the next phase of its work, which culminates in this Supplement to the Final Report. Those volunteers and the staff who supported the Panel's work during this period are listed on the following pages.

We particularly want to highlight the contributions of Marion Fremont-Smith, senior research fellow with the Hauser Center for Nonprofit Organizations at Harvard University, who volunteered countless hours and provided invaluable expertise and assistance in the preparation of this Supplement.

More than 90 organizations, including private foundations, community foundations, public charities, and corporate giving programs, made financial contributions to support the Panel's work. A complete list of the Panel's funders is provided on page 40.

The Panel also expresses its deep appreciation to the organizations that hosted its 15 field hearings around the country and to the thousands of representatives of charitable organizations who participated in those meetings, joined conference calls, and provided insights to inform the Panel's work. This remarkable collaborative effort from all parts of the charitable sector testifies to our sector's long-standing commitment to accountability and our continuing desire to strengthen governance, management, and programs to enable us to be of even greater service to people and communities throughout the world.

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