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ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
COMMITTEE ON NON-PROFIT ORGANIZATIONS

Comments on the Discussion Draft
of the Senate Finance Committee
For Reforms and Best Practices
In the Area of
Tax-Exempt Organizations

The Non-Profit Organizations Committee of the Association of the Bar of the City of New York is composed of attorneys who represent tax-exempt entities in many capacities. We include private practitioners, attorneys/accountants, inside counsel, attorney/consultants, and a representative from the New York Attorney General's Office, and we represent organizations of all sizes, purposes, and exempt classifications. We are writing to convey our comments on the discussion draft of the Senate Finance Committee's proposals for reforms and best practices for tax-exempt organizations.

We are aware of the abuses that have formed the basis of the Committee's reform proposals. Not only have we read about them in the press, but, although we find intentional abuses to be rare, we meet them in our practices. We agree with the Committee's assessment that the chief abuses occur as a result of (i) excess compensation and other improper benefits to insiders as to the organization; (ii) other insider transactions such as the sale of property, loans, and use of organization's assets for private enrichment; and (iii) conversions and asset sales to for-profit entities for less than their fair market value or in ways that improperly benefit insiders as to the organization. We also believe that there is a need to impress upon organizations standards for good governance and requirements for proper returns and reports to regulatory authorities.

We believe that the abuses should and can be addressed with appropriate remedies. It appears, however, that the proposal has the broader purpose of federalizing non-profit law, requiring more reporting for informational, rather than enforcement, purposes, and using the Form 990 as the chief source of public information about organizations. It is not clear that this purpose will assist in preventing and penalizing abuses and it will be expensive for many organizations.

The universe of exempt organizations is vast. It includes public charities as complex as major universities and hospital systems and as small as local arts groups with annual budgets of $100,000 or less. It includes family grant-making foundations, community foundations, and foundations that have been professionalized into non-family foundations which perform services as well as making grants. We believe that while many of the individual proposals address some of the worst of the abuses, they will impact, many times adversely, many more organizations that are not guilty of the abusive behavior. The proposals not only add a variety of filing fees and penalties, they also attempt to govern internal behavior of an organization even where it is properly run. Our general concerns about the proposals are as follows:

1. The proposals require more filings and create more possible violations. The Internal Revenue Service already has extensive legal tools at its disposal to address many of the abuses, but it does not have the resources to adequately enforce them. Even with an increase in filing fees, it is unlikely that there will be sufficient resources to enforce any new regulation.

2. We are particularly concerned about the additional fees, even on a sliding scale, for newly proposed filings. There are also additional expenses inherent in the requirements for greater professional input into the preparation of financial reports, governance systems, and tax returns. These costs are in addition to the fees already paid to most states in connection with registrations and annual filings. For many small organizations that already operate on a shoestring, these costs will be an additional burden of some importance. Furthermore, these fees and costs are in opposition to the Committee's concern with insuring that more exempt dollars are spent for charitable purposes.

3. We believe that the proposals do not take into account the multiplicity of types of exempt organizations and will stifle innovation and legitimate variety in the non-profit world. In particular, we believe that the many proposed blanket prohibitions and requirements are inappropriate in many cases.

We believe there are ways to address abusive situations while minimizing our concerns:

1. The chief abuses are the result of self-dealing by insiders or for-profit entities. Increased enforcement of existing prohibitions against private foundation self-dealing, private benefit, private inurement, and excess benefit transactions is highly desirable. More resources should be allocated and devoted to enforcement. We believe that no present or proposed law has a chance of preventing or penalizing abuses without the reality of enforcement.

2. Reporting by related entities, as proposed, is desirable.

3. Sharing information with state regulators is desirable.

4. Providing increased public availability of information and documentation is desirable.

5. Encouraging good governance is desirable (although requiring uniformity as to the standards is not). The checklist of standards set out in the proposal should be used as an educational tool and could be included in non-mandatory ways in the Form 990.

We have the following specific comments on the proposed points:

A. Exempt Status Reforms.

1. <u>Five-year review of tax-exempt status by the IRS</u>. Organizations are currently required to file with the Service any changes in their governing documents or changes in purposes or activities. The information return, Form 990, provides significant

financial information. Requiring a five-year submission of this information, together with a filing fee, is redundant and burdensome, particularly for small organizations.

2. Donor-advised fund reform. We recognize that donor-advised funds are often used to avoid the private foundation rules. We agree that many of the Committee's proposals will address the worst of these abuses and we approve them. We have questions about some of the suggested requirements:

(i) Why will grants for foreign organizations be limited to those organizations who are on an IRS published list of approved foreign organizations? If the concern is with funding terrorist organizations, there are available lists of non-approved entities. To limit grants to named organizations appears to substitute the Service's determination of worthy causes for the donors' wishes, and any list is unlikely to keep pace with changing circumstances.

(ii) Why will donor-advised funds not be permitted to expend amounts for grantee selection? This seems to be counter to the proposal's aim of requiring greater accountability for the use of an organization's funds.

3. Supporting Organizations. We recognize that Type III supporting organizations are often used to permit donors to control the organization instead of giving the supported organization effective control over its operations, in violation of the intent of the Code and Regulations. We are concerned, however, about charitable trusts which are treated as Type III supporting organizations under Reg. §1.509(a)-4(i)(2)(iii). Such trusts may only support named organizations, must be accountable to the organization under state law, and must provide sufficient funds to the organization for it to be attentive to the trust's operations. In most cases, these trusts are not abusive and should not lose their public charity status. If further oversight is a concern, it may be desirable to require a minimum payout from such trusts.

4. Revised exempt standards for credit counseling organizations. We have no comment on this section.

5. Revoke charitable status for accommodations to tax shelters. The Code imposes reporting requirements on individuals for participating in listed tax shelter transactions and reportable transactions. This provision shifts a burden to the exempt organization to determine when such a transaction might be occurring and to receive affirmation that the transaction is not a listed or reportable transaction. It is not clear from the proposal who would provide the affirmation. If it is the potential donor, it is likely that most organizations will feel that they must ask for the certification in every case where they are not familiar with the permissibility of a transaction. This will discourage non-abusive donors as well as those seeking impermissible tax benefits.

B. Insider and disqualified persons reforms.

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules. While we recognize that insider transactions

are a chief area of abuse in the non-profit world, we believe that these proposals are more harmful than beneficial. This is particularly so since the present law provides safeguards for the reasonableness of such arrangements under the intermediate sanctions rules of section 4958. The proposal to prohibit all insider transactions would prevent board members from providing below market benefits that are often critical to a small organization's survival. In addition, some of the private foundation rules, particularly the prohibition on the transfer to or use by a disqualified person of a private foundation's income or assets, are not well understood by organizations, practitioners, and the Service, even after 35 years of experience.

As noted above, in this section and others as well, we are in favor of increased reporting as to affiliated entities.

2. Expand definition of disqualified persons. We believe that the expansion of the definition of "disqualified person" to include certain for-profit entities related to a disqualified person is an appropriate modification. We do suggest, however, that a statutory definition of ownership be established to define "substantial influence," as is presently provided for under the private foundation rules of section 4946.

3. Increased taxes for self-dealing, jeopardizing investments, and taxable expenditures. We are not opposed to raising the initial taxes for acts which violate the Code's various insider transaction rules or on foundations' taxable expenditures. If the taxes on self-dealing transactions are substantially raised, however, we believe it would be desirable to modify their automatic applicability to the insider for inadvertent violations of the rules, which is presently the rule under section 4941. As to the proposal for increases on the tax on jeopardizing investments, we are concerned by the lack of present guidelines for describing jeopardizing investments under the Code.

4. Compensation of private foundation trustees. We agree that the payment of compensation to private foundation trustees, in their capacity as trustees, has been abusive in some circumstances. Section 4941, however, already provides stiff penalties for such abusive behavior. There are, in fact, circumstances where such payments are highly desirable. Not all foundations are family grant-making entities. Many private foundations ask outside experts to sit on their boards and require substantial service and expertise in a variety of capacities from these trustees. The abusive cases could be addressed by enforcing section 4941, or less desirably, by limiting the applicability of the prohibition to certain categories of disqualified persons under section 4946, such as substantial contributors and related persons and entities.

5. Compensation of disqualified persons. We are opposed to limiting compensation for disqualified persons in capacities other than as trustee. As noted above, many private foundations have significant operations in addition to grantmaking, and such organizations need to offer competitive salaries to attract talented personnel. In many areas of the country, such as the New York metropolitan area, it is not unreasonable to pay a professional manager of a non-family private foundation $200,000 or more. The additional reporting requirements and fees do not seem to be justified, particularly when the existing Code self-dealing rules under section 4941 are available.

C. Grants and Expense Reform.

1. Treatment of administration expenses of non-operating foundations. As in the cases discussed above, this proposal seems to posit that all private non-operating foundations are wholly grant-making organizations. In fact, many non-operating foundations have direct charitable programs, including providing services to the public and developing programs and initiatives that directly benefit other organizations. In such cases, disallowing administrative costs above 35% of the foundation's total expenses as qualifying distributions could effectively terminate these organizations' direct programs, which appears to run counter to the stated desire of increasing foundation expenditures for charitable purposes. The proposal to increase the reporting requirement for expenses above a certain level would seem to be adequate to uncover abusive situations. If any limit is imposed, it should be made clear that direct charitable expenditures and grant-making due diligence costs are not treated as administration expenses.

2. Encourage additional grantmaking by private foundations. We are in favor of a proposal to reduce the liability for the excise tax on net investment income in years where a private foundation makes more than the minimum amount of qualifying distributions. We do not believe, however, that setting the rate as high as 12% will have any significant impact on private foundation spending. We believe that few foundations, other than those spending their way to termination, will find it desirable to save 2% of their net-investment income by paying out an additional 7% of their asset value.

3. Prohibit foundation grants to donor-advised funds. While on its face this blanket prohibition may appear to be a good proposal to prevent circumvention of the private foundation rules, there are circumstances where such donations serve legitimate charitable purposes, such as pooling foundations' resources for particular programs or to achieve administrative savings.

4. Limit amounts paid for travel, meals and accommodation. While we agree that imposing standards appears attractive, we worry that such limitations will discourage persons from volunteering as uncompensated directors. Any alternative non-profit rate should be sufficiently realistic to actually reimburse parties for their bona fide participation in the foundation's activities.

D. Federal-state coordination of actions and proceedings.

1. Establish standards for acquisition–conversion of a non-profit. This is an area of particular abuse resulting in the benefit to private parties (insiders and otherwise) from the use of exempt assets. Currently, most states have laws and regulations governing non-profit conversions or sales that prohibit such abuses. In addition, the prohibitions under section 501(c)(3) against private inurement and private benefit, coupled with the intermediate sanctions rules, provide both the state and federal government with substantial weapons to fight these abuses. It seems that enforcement is the issue. We are particularly concerned that the Service would have to pre-approve any transaction and would have up to a year to begin its inquiry. There are many cases where the consummation of a transaction may have some urgency. We are also concerned that

the standard for a transaction, that it "be necessary" to serve the public interest, is too broad and ambiguous.

2. Provide states the authority to pursue federal actions. We are somewhat unclear about how this section would operate, and whether states would collect taxes and to whom they would be payable.

E. Improve quality and scope of Forms 990 and financial statements. We recognize that many organizations do not appropriately or fully prepare their Forms 990. Our experience, however, is that this is not due to fraud or other intentional misbehavior, but rather that most organizations are poorly funded and cannot afford sophisticated internal advice or outside professional assistance. It may be that simplification or increased clarity of the instructions and the forms themselves would be very useful and that other education and outreach programs by the Service should be undertaken. Since many organizations have trouble understanding and preparing the forms as they are, we believe that the additional filing requirements will only increase problems of compliance.

1. Require signature by chief executive officer. The tax return already requires a statement under penalty of perjury that the return has been examined and to the best of the signatory's knowledge, it is true, accurate and complete. The proposal would require that a CEO be provided reasonable assurance of the accuracy and completeness of all material aspects of the return. This requirement will be difficult for CEOs of small organizations to comply with, since such organizations generally prepare their returns without professional assistance, and the CEO will not understand the implication of that certification. As a result, signing this declaration will increase the CEO's liability without increasing compliance.

2. Penalties for failure to file complete and accurate Form 990. We believe that the penalties for failure to file, and particularly for failure to file a competed return (*i.e.*, for failure to check even one required box) are draconian. As pointed out above, many organizations prepare their returns themselves without professional advice. To impose penalties of this magnitude, even on a sliding scale, will adversely impact small organizations. Imposing the penalties on individuals who sign the return will also adversely affect small organizations.

3. Penalty for failure to file timely Forms 990. We have no comment on this section.

4. Electronic filing. We believe this development will be beneficial for the organization, the IRS, and the public.

5. Standards for filing. We are in favor of the IRS promulgating standards for filing the Form 990.

6. Independent audits or reviews. The procedures established by the proposal will be very expensive for organizations to comply with. There are many small organizations for which an independent auditor's review of the Form 990 would be an extraordinary expense. Even for organizations with gross annual receipts of more than

$250,000 a year (which is not a high figure considering that the Regulations for section 4958 consider a small organization to be one which has less than $1,000,000 of annual receipts), an independent audit will be a significant expense. Although fund-raising entities which solicit contributions in New York have to meet this standard for state reporting purposes, this is not the national norm. We also believe that requiring a new auditor for an organization at least every five years will result in significant additional costs for organizations, because retaining a firm already familiar with its operations and finances is a cost-saving practice.

7. Enhanced disclosure of related organizations and insider transactions. As we have noted above, we are in favor of enhanced reporting of related entities.

8. Disclosure of performance goals, activities and expenses in Form 990 and in financial statements. Under present law, charitable organizations are required to disclose material changes in their activities, operations or structures. They are also required to accurately report their expenses in their financial statements and Form 990. We believe that requiring organizations with more than $250,000 in annual gross receipts to include in their Form 990 a detailed description of their annual performance goals and measurements for meeting those goals is ambiguous and unrealistic. There has long been substantial and unresolved debate as to how to measure goals and performance. For large complex organizations a statement of goals and measurements is not meaningful. For smaller organizations with few personnel it is another costly requirement to fulfill.

9. Disclose investments of public charities. It is not clear what public purpose would be served by disclosure of a public charity's investments. Organizations could be subject to harassment based on their investments. In addition, a once-a-year snapshot of an organization's investments may not be a fair representation of the investments and investment activity over the course of the year.

F. Public availability of documents.

1. Disclosure of financial statements. We believe that public disclosure of financial statements is appropriate.

2. Website disclosure. We believe that it is appropriate to require posting on an existing website of those materials that are required to be disclosed under other provisions of the Code.

3. Publication of final determination. We do not believe that it is a desirable tax policy to require organizations to make public their audit results and closing agreements. These documents often reflect a compromise by the organization to avoid costly appellate review or litigation, and public disclosure could lead to the implication of wrongdoing, with the result that more organizations will resist compromise if these documents must be made public.

4. Require public disclosure of Form 990-T, an affiliation organization return. We are in favor of increased reporting in this regard.

5. Require public corporation filing of charitable giving return. It is not clear to us the public purpose served by this requirement. Shareholders have an interest in the company's contributions and there are means by which they can ascertain that information. Requiring a corporation to divulge this information to the general public could subject the corporation and the exempt entity to possible harassment where individuals believe that the contributions have been inappropriate. If the purpose of the proposal is to inform the public about which for-profit entities have influence over a charitable organization, this is not accomplished by having the information presented in the corporation's return because it is likely that anyone seeking such information will look to the Form 990.

G. Encourage strong governance and best practices for an exempt organizations.

1. Board duties. The board governance standards set out are widely recognized as being appropriate for many exempt organizations. They are not, however, across-the-board standards and may not apply to all organizations. For example, there are many charitable trusts that pay amounts to named exempt entities and have a single trustee, often a bank or trust company. The standards are not applicable to such an organization. As a result, we do not believe that it is appropriate to require that all organizations comply with these requirements and report this information on the Form 990. On the other hand, we believe that these standards are useful as an educational tool for organizations. As a result, we suggest that the standards be set out in the instructions to Form 990, and, at most, that a statement be required that the return signatory has read the list of good practices.

2. Size and composition of board. We strongly believe that the size and composition of a board of directors should not be a matter of regulatory determination. Unlike a for-profit corporate board, non-profit organizations solicit board members who can offer a variety of services, including fundraising and free professional advice. This practice often results in a larger board of directors than would be efficient for a for-profit entity, but it is critical to the existence of many organizations.

3. Board/officer removal. While we are in favor of the requirement that misbehaving individuals not serve on corporate boards, we do not believe that an organization should be put in the position of affirmatively screening potential board members.

Any authority vested in the Service to remove officers and directors should be available only where the finding of impropriety has been subject to procedural safeguards.

4. Government encouragement of best practices. Our comments on this section are chiefly directed at the accreditation proposal in Paragraph 5.

5. Accreditation. We do not believe that the accreditation proposal is feasible or desirable. Existing non-profit watchdog groups that rate organizations have

only been able to reach a small portion of them, even after years of activity. The process is rigid and can result in arbitrary standards imposed on organizations that do not fit the general mold. We are concerned that it is contemplated that an IRS determination of deductibility or exemption might be based on the assessments of delegee organizations. It appears to us that the funds proposed to be allocated to this purpose are an unrealistic estimate of what the costs would be. We are again concerned that this process will place additional significant burdens on small organizations. Finally, it is not clear to us that this process will address the abusive situations that are the focus of these proposals.

6. Establish prudent investor rules. While many states have adopted a prudent investment standard, others still rely on the prudent person investment standard. In addition, there is flux in the development of a prudent investor rule as evidenced by the ongoing revisions of the Uniform Management of Institutional Funds Act. We strongly believe that investment rules should be a matter of state and not federal policy.

H. Funding of exempt organizations and for state enforcement and education. As we have stated several times above, we are in favor of the enforcement of existing laws directed at preventing and penalizing abuse. We are not in favor of imposing a filing fee for the Form 990, however, because of its impact on small organizations. We are also skeptical that such fees would actually be used for enforcement, given the fact that the legislated allocation of the tax on net investment income was never realized. While we would be happy to see increased state funding for enforcement, we believe that the amounts discussed are inadequate to make any substantial difference in state enforcement.

As noted above, we are generally in favor of sharing federal information with state regulatory authorities.

I. Tax Court equity authorities, private relater and valuation.

1. Tax Court equity authorities. We are not prepared at this time to discuss this section, which entails substantial issues as to the federalizing of state law and the authority of federal institutions to carry out the proposed changes.

2. Private action directive. Derivative actions on behalf of a corporation are generally permitted under state law. Whether this is desirable in federal matters is dependent on an analysis of the policy and permissibility of federalizing non-profit governance.

3. Private relater action – individual. Because of the potential for harassment and given the Service's enforcement limitations, we are opposed to giving individuals the ability to initiate a complaint process against an organization.

4. Valuation resolution. It appears that the desirability of the "baseball arbitration" standard of valuation is to encourage each party to make more reasonable valuations and avoid disputes that often must be resolved in court. While this may be desirable to save the resources of both parties, it is clear from valuation matters which are resolved in court that the court often determines valuation to be between the parties' statements. Given this fact, and the complexity of many of the valuations contemplated

by this proposal, we believe that it should be given further thought after reviewing decisions in valuation cases.

Respectfully submitted,
M. Antoinette Thomas, Committee Chair