

S. HRG. 108-603

**CHARITY OVERSIGHT AND REFORM: KEEPING  
BAD THINGS FROM HAPPENING TO GOOD  
CHARITIES**

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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

—————  
JUNE 22, 2004  
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Printed for the use of the Committee on Finance



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## **CHARITY OVERSIGHT AND REFORM: KEEPING BAD THINGS FROM HAPPENING TO GOOD CHARITIES**

**TUESDAY, JUNE 22, 2004**

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SG-50, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Nickles, Snowe, Thomas, Santorum, Bunning, Baucus, and Bingaman.

### **OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. I thank you all very much for your attendance, particularly for witnesses that have gone to an awful lot of work and come some distance to testify. We thank you for this.

I am going ahead with my opening statement. If we start the first panel and Senator Baucus comes, it is always our practice to have the Ranking Member have an opening statement as well, and we will interrupt for him to make his opening statement.

Today, the Finance Committee considers a very serious matter, ensuring that charities keep their trust with the American people. We will hear testimony today that is troubling, very troubling, suggesting that far too many charities have broken the understood covenant between the taxpayer and the nonprofits. That covenant is that charities are to benefit the public good, not fill the pockets of private individuals.

Too many well-meaning charities have fallen prey to the charlatan pitch about easy money. Some charities are blinded by their own mission and the need for additional dollars. These charities are willing to sign on to deals that provide dollars to promoters and insiders, but only pennies to charity. Taxpayers are the losers.

In addition to well-meaning charities being led astray, we also have a growing number of individuals who knowingly set up a charity to evade taxes.

Finally, we have charities, even big-name charities, that seem to just have had their wheels fall off. Often, problems at these charities can be traced back to poor governance or failure to abide by best practices.

Since becoming Chairman of the Finance Committee, I have been active in oversight in many areas, including charities. I have con-

ducted investigations into such organizations as United Way, Red Cross, and Nature Conservancy. I am pleased that my oversight has brought about good reforms at these organizations.

However, the Finance Committee is limited in its resources to perform oversight. It is clear that we need to look at more general reforms to address recurrent problems in the nonprofit sector.

The staff of the Finance Committee, on a bipartisan basis—and I want to emphasize that, because we have had great cooperation, particularly from Senator Baucus, the Ranking Democrat—have produced a discussion draft. I want to mention and emphasize “discussion.”

This draft serves as a very useful beginning point to consider possible broad reforms. I welcome a dialogue about the best means of achieving the ends that I hope we can all agree on, a vibrant and engaged private sector that enjoys the confidence of the American people that charitable donations are being used to meet charitable needs, the obvious, in other words.

Reforms to that end will benefit all charities, particularly the strong majority of charities that do their job and do their job well, and play, as we all know, such a vital role in our country.

In view of these much-needed reforms as a partner to the important efforts by President Bush to encourage charitable giving in the CARE Act, championed by Senators Santorum and Lieberman, I continue to work to see that the CARE Act is brought to conference and signed into law.

Just as I have worked with administrations on encouraging greater contributions to charity, I hope the administration will work with the Finance Committee to bring real reform to the nonprofit sector.\*

We have the good fortune that Senator Baucus is here. I have already said how he and his staff have cooperated very well with getting this effort to this point and writing the draft discussion paper that we have talked about, so at this point we will have the opening statement by Senator Baucus.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR  
FROM MONTANA**

Senator BAUCUS. Well, thank you very much, Mr. Chairman.

Clearly, this is a very important hearing. Charities play a vital role in our country. With many individuals still bearing the brunt of this economic downturn and the unemployment rates still very high, Americans rely very much on charities for help, and our charities have not let us down.

Charities rushed to the aid of those who were harmed by September 11, providing comfort, counseling, and financial assistance, and they play a pivotal role aiding victims of natural disasters that have paralyzed parts of the country during the past few years. Charities helped rebuild homes and repair national parks from fires in the west.

While these efforts show up on the front page of the paper, the quiet work of so many goes unnoticed: the after-school program

\*For more information on this subject, *see also*, Joint Committee on Taxation document, “Present Law Relating to Charitable and Other Exempt Organizations and Statistical Information Regarding Growth and Oversight of the Tax-Exempt Sector” (JCX-44-04), June 22, 2004.

that keeps a teenager on the path to college, the soup kitchen that feeds a senior citizen whom society has left behind, the conservation group that preserves the remote streams so that our grandchildren may enjoy nature.

In my home State of Montana, organizations like the YMCA in Billings provides support to over 300 victims of sexual assault every year. The Montana Boys and Girls Clubs provide after-school outlets for over 100,000 children, and the Montana Food Bank Network serves more than 1.5 million meals every year.

But while charities are focused on doing good works and preserving the public trust, there have been a number of high-profile examples of problems in this expanding sector: inflated salaries paid to trustees and charity executives; insider deals with insufficient transparency; charities engaging in abusive tax shelters; and charities serving as conduits to finance terrorist activities and operations.

This proliferation of sloppy, unethical, and criminal behavior is unacceptable. It has led to a crisis in confidence among charities. It has hurt fundraising by legitimate charities, and it overshadows the good work done by the majority of civic-minded groups. Like the recent corporate scandals, these events make Americans second-guess their faith in bedrock institutions.

Today we are privileged to hear from a host of witnesses who are committed to addressing this crisis. Individuals who are set to testify today come to the table with insights built on years of experience in charities and public policy.

Our first panel includes two highly regarded state officials, Mr. Josephson and Mr. Pacella, and the Commissioner of Internal Revenue, Mark Everson. His organization grants tax-exempt status to almost 100,000 organizations every year and is responsible for ensuring compliance with Federal tax laws.

Two years ago, Senator Grassley and I had the General Accounting Office look into how the IRS could better perform oversight on the charitable sector. GAO's report included important recommendations on the collection of information from charities and well thought out suggestions on improving coordination between the IRS and State charity officials.

I am concerned that too little has been done to increase the level of cooperation between the Federal Government and States in this area, and look forward to hearing from the panel on what progress has been made.

Our second panel includes witnesses who will tell firsthand accounts of abusive tactics and tax shelter involvement by some in the charitable section.

Two of our witnesses on this panel are whistleblowers who fear reprisal if their identities are made public, and I appreciate very much their willingness to come forward.

One witness will discuss the ongoing problems in the car donation area. As previously highlighted by a GAO report that Senator Grassley and I requested, this practice has been rife with abuse.

Often, charities receive pennies on the dollar for donated cars that have fetched thousands of dollars in tax deductions. This witness' testimony will shed light on the fraud perpetuated by car auctioneers and brokers who feed on innocent charities.

The second witness will detail a scam that involves cheating American taxpayers to the tune of millions of dollars a year with a down payment assistance charity.

I also look forward to hearing from Ms. MacNab and Mr. Adkisson, who, by the way, 2 years ago previously testified before this committee and we are very grateful for their reappearance.

They will discuss other abuses. This panel in particular should serve as a wake-up call on how some charities are being used for unethical, and potentially criminal, activities.

Finally, our third panel will address how we should fix these problems. I want to make special mention of my friend Rock Ringling, the managing director of Montana Land Reliance.

Rock runs a tight ship. The Land Reliance serves as a model for other conservation groups across the country, and Rock will offer suggestions and best practices in the land donation area.

All of us, clearly, are very fortunate to have all of you as witnesses here, and we eagerly anticipate your testimony, and thank you, too, for the opportunity to ask you questions. Let us go on and try to make the most out of this hearing so that we are happy that you did a good job.

Thank you.

The CHAIRMAN. I thank Senator Baucus for introducing the witnesses, so I am not going to repeat that introduction.

I would like to say, for this panel, as well as the other two panels, that without your asking, your entire statements, that probably ought to be longer than five minutes, will be included in the record as you submit them. Then we would ask you to summarize for five minutes.

I would ask the members, we are going to take 5-minute rounds of questioning. I do not think we will be able to have a second round of questioning today, and I would ask if each, including the chairman, would stay within their 5 minutes.

Then sometime within a half hour, or a little more than a half hour, there will be votes. I did not discuss this with Senator Baucus, but if we could take turns going to vote, I would like to do that so we could keep the hearing going, because we need to get done around 12:30. So, if that is all right with you.

Senator BAUCUS. Fine.

The CHAIRMAN. Yes. So it may be a bad way to conduct a meeting, but there is no way we would ever have committee meetings if we did not have them while the Senate is in session.

So, with those details, I think I have mentioned everything. We will start with Mr. Everson, then go to Mr. Josephson, then Mr. Pacella. Then we will ask questions when the whole panel is done.

Mr. Everson?

**STATEMENT OF HON. MARK EVERSON, COMMISSIONER,  
INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Commissioner EVERSON. Chairman Grassley, Ranking Member Baucus, other members of the committee, thank you for the opportunity to testify this morning on the oversight of charitable organizations.

As you know, I share your view that this is an important subject and one of increasing concern. Several months ago, the IRS for-

mally articulated four enforcement priorities. These have now been included in our recently issued strategic plan, which will govern our operations from 2005 to 2009.

This committee is already quite familiar with IRS efforts to, (1) address non-compliance by corporations, high-income individuals, and other contributors to the tax gap, the centerpiece of which is our battle against abusive shelters; (2) assure that tax practitioners adhere to professional standards and follow the law; and (3) augment our investigations of tax and financial criminal activity.

I am appreciative of your support in each of these critical areas, which are essential to our Nation's system of tax administration.

Our fourth enforcement priority is equally crucial to the country. It is to discourage and deter non-compliance within tax-exempt and government entities, and the misuse of such entities by third parties for tax avoidance or other unintended purposes.

Non-compliance involving tax-exempt entities is especially disturbing because it involves organizations that are supposed to be carrying out some special or beneficial public purpose.

While the vast majority of tax-exempt entities follow the law, there are increasing indications of failures in governance and outright abuse within this sector. We have seen lavish compensation packages for executives, inappropriate related-party transactions, or in some cases operation of what is essentially a profit-making entity, with no public purpose, in the guise of a charity to escape the payment of taxes or regulatory oversight. For example, State consumer protection laws.

The IRS is addressing non-compliance by tax-exempt entities on a number of fronts. In one area of particular concern, credit counseling organizations, we have launched an unprecedented audit effort.

Fully one-half of the total revenues of the known filing universe are either already under active audit or will be later this summer. Thus far, we have issued a proposed revocation of exemption to one entity. I expect there will be more in the not-too-distant future.

In the area of compensation, this summer we will begin contacting hundreds of organizations to assess their compensation policies and procedures. Over time, we will adjust audit plans accordingly, to include associated issues like insider loans or sales to executives and officers.

We are also initiating a broader review of foundations, to include examinations of 400 entities, half of which will be somewhat akin to our detailed National Research Program audits already under way for individuals.

We are also enhancing our cooperative efforts with State charity regulators, but here we are handicapped to a real extent by existing law. We can routinely share information with State tax authorities, but not with regulators of charities. Provisions in the Senate version of the CARE Act would mitigate concerns in this area.

Equally vital to effective regulation of charities is devotion of greater resources to the tax-exempt sector. Historically, IRS regulates taxes. This chart shows an example of an organization which was started in 1995, contrasting with IRS staffing over this period and staffing adjusted per exempt organization filing.

After years of decline, we are augmenting our efforts. As you know, the President has requested a 10.7 percent increase for IRS enforcement efforts.

I am deeply appreciative of the efforts this committee has made to secure that funding, and I want you to know that within that request is a 17 percent increase for examinations in the tax-exempt area.

Before closing, I would like to turn to the important subject of misuse of tax-exempt and government entities by third parties for tax avoidance or other unintended purposes.

The same floating consortium of unscrupulous attorneys and accountants who first brought us abusive shelters designed to escape IRS detection through complex structures involving partnerships and subchapter S corporations has now moved on to the use of tax-exempt and government entities as combination parties for the generic tax products they develop and market.

As this chart indicates, almost half of the 31 types of transactions listed to date potentially involve tax-exempt entities. That is the red, 14 out of the 31 of our listed transactions.

Viewed against the number of disclosures of listed transactions that we have received, some 4,300, the number is even greater, almost 60 percent potentially involved. Again, I am not suggesting that they all involve charities or other exempt entities, but they can. That is the structure of the transaction.

More troubling is that this appears to be a growing trend. Five of the eight transactions we have listed in fiscal year 2004 potentially use a tax-exempt entity.

Senator BAUCUS. I am sorry, Mr. Commissioner. You said it is 31 listed transactions?

Commissioner EVERSON. We list potentially abusive transactions. What I am saying, Senator, is for a full 14, almost half of those, the way they are structured, can involve a tax-exempt entity. Some of these are municipalities, some of these are charities. In six of these cases, they are specifically charities.

Senator BAUCUS. By "listed," do you mean, in the Code, the listed transactions that should be revealed and disclosed?

Commissioner EVERSON. These are the types of transactions that we have put people on notice that we think they are potentially abusive, and they are going to receive special scrutiny as we examine the returns.

Senator BAUCUS. And you are saying about half of them involve tax-exempts.

Commissioner EVERSON. About half of them potentially involve, can involve, tax-exempt entities. I am suggesting that six of them are specifically structured for tax-exempt entities.

Senator BAUCUS. Thank you.

Commissioner EVERSON. This last chart is based on a real transaction that demonstrates how a charity can be used for an unintended purpose. In this case, the foreign currency options strategy, generates a large paper gain to the charity, \$1.5 million in this case, and a loss to the taxpayer which reduces the taxpayers taxes by half a million dollars. The charity does not feel any pain from the gain, which is untaxed, but has received a cash payment of \$50,000 for its participation in this transaction.

I look forward to an ongoing dialogue with the committee on these subjects. If we do not act to guarantee the integrity of our charities, there is a risk Americans will lose faith in, and broadly reduce their support of, charitable organizations, which are vital to our social fabric. If Americans cannot trust their charities, they will stop giving and those in need will suffer.

Thank you, Mr. Chairman.

The CHAIRMAN. I especially appreciate your concluding sentence there. It is very important, and the basis for our interest in this, because we want to continue a good thing going in America.

[The prepared statement of Commissioner Everson appears in the appendix.]

The CHAIRMAN. Now, Mr. Josephson?

**STATEMENT OF WILLIAM JOSEPHSON, ASSISTANT ATTORNEY GENERAL-IN-CHARGE, CHARITIES, STATE OF NEW YORK, OFFICE OF ATTORNEY GENERAL, NEW YORK, NY**

Mr. JOSEPHSON. Senator, I would like to express my appreciation to you, to Senator Baucus, to Dean Zerbe of your staff, and Pat Hecht of your staff for the wonderful cooperation we have had in preparing for these hearings.

I have a statement, as you know. I submit it for the record. I would just like to hit the highlights.

[The prepared statement of Mr. Josephson appears in the appendix.]

Mr. JOSEPHSON. One of the cases that I talk about in my statement involves a private foundation. This private foundation had assets of more than \$11 million, when it came to our attention those assets had declined to about \$7 million.

Why? Because the board of that foundation, probably stimulated by its lawyer, took \$3.4 million in compensation and pension benefits out of that private foundation. This was not a private foundation that did particularly complicated grants. This is what we call a plain vanilla private foundation, grants to public charities, museums, the opera, and so forth.

We talk about board responsibilities. Too often, we see boards that are inattentive or ill-informed. The Albany Urban League went down the drain completely and stuck the taxpayers not only with failed contributions, but with a half a million dollar tax lien that could not be satisfied. And this was a board that was a distinguished board. It had high-level representatives on it of the Albany community, who paid very little, if any, attention.

The IRS needs to pay much more attention to the application for exemption process. We need to deal with governance issues in the course of the review of the 1023. I give examples in my statement of things that the 1023 should cover which it does not now cover.

The 990 needs to be reformed not only to make it user-friendly, which it is not now, to make the information accessible to the press, to members of the public, but also to enable us to track the governance commitments that charities have made in their application form.

We very much need to be able to work with the Internal Revenue Service. Commissioner Everson has already talked about the importance of enacting the amendments that are pending in H.R.

1528, as amended by the Senate, to enable the State charities officers and the IRS to talk to each other.

We need to be able to review exemptions. Exemptions should not be permanent. We have done a study in New York of our 50,000 registrants have not filed for 2 years or more. The number have not filed is 12,000.

On the basis of our examination to date, we estimate that 6,000 of the 12,000 will prove to be defunct. We need a plain, speedy, and efficient way of dealing with these defunct organizations.

We have a situation in New York where we came across a private foundation that was deliberately paying the 4942 excise tax rather than making the 5 percent distribution. For some reason, the IRS has not picked that up. That is an example of the kind of thing that we need to be able to work with the IRS on.

IRS resources are crucial. Crucial. Commissioner Everson has already talked about the inadequacies of the resources. The Securities and Exchange Commission, as I say in my statement, is funded from registration fees. The Banking Department in New York is funded from registration fees. We need to get something like that to the IRS.

We need very much to have electronic filing. We need to support the IRS's State Registry Program so that we can get access to current data.

We need to deal with the extension problem. Too many extensions are routinely granted. The result of that, is that current data is not available for nearly 2 years. Electronic filing, when it comes in, should be required.

We need very, very much to deal with the string of abuses that are detailed in my statement, including abuses that are compelled by state law. I give you an example of how New York State law permits trustees of charitable trusts to take two or more trustees' commissions, plus the institutional trustee's commission, and yet the IRS, in a private letter ruling, approved this. We need to preempt that kind of state law largesse.

As the Committee staff has proposed, we need to make Section 4958 applicable to all private foundations, not just to public charities, because its provisions on excessive compensation and benefits are much better than the self-dealing provisions in Section 4941.

The states need, as the committee staff has proposed in its white paper, the ability to enforce those provisions, just like we can enforce the private foundation provisions.

I see I am over my time. There is much more I could say, but I am grateful for the opportunity, please.

The CHAIRMAN. Thank you, Mr. Josephson.

Now, Mr. Pacella?

**STATEMENT OF MARK PACELLA, PRESIDENT, NATIONAL ASSOCIATION OF STATE CHARITY OFFICIALS, HARRISBURG, PA**

Mr. PACELLA. Thank you, Mr. Chairman and members of the committee. I am here today as the president of the National Association of State Charity Officials, or NASCO, as it is commonly known.

NASCO is affiliated with the National Association of Attorneys General, and it serves as a forum for State charity officials to exchange views and experiences relating to the regulation of public charities, as well as to foster interstate cooperation regarding charitable enforcement initiatives and efforts.

On behalf of NASCO and its members, I would like to thank the committee for the opportunity to participate in today's important proceedings, and also thank our members from New York for all of their hard work over the past several years with the committee.

State charity officials serve as the primary regulators over public charities that are most likely to pursue breaches of the fiduciary duties of care, loyalty, and good faith that our State common law and statutes impose on those charged with the responsibilities of administering charitable assets.

Despite the broad authority that State charity officials have, however, many States lack resources to effectively regulate the charities that operate within their jurisdictions.

An example being, in the 50 States that we have, less than half are able to be regular and active participants in NASCO's annual conference each year. Most States do not have personnel that are dedicated exclusively to charitable enforcement. Very often, they are tied into broader consumer protection responsibilities and circumstances like that.

NASCO wants to stress that, given the relative scarcity of our enforcement resources, it is very important that we leverage the resources that we have and encourages the committee to make reforms in three general areas, the first being reporting and accountability, the second being information sharing and cooperation among State and Federal regulators, and the third being exploiting the opportunities we have in technology, particularly in the areas of electronic filing and the Internet.

With regard to reporting and accountability, the committee has already heard testimony, and I am sure has been privy to the fact that the IRS is inadequately staffed and NASCO supports reforms to strengthen the accuracy and the timeliness of the form 990. It is the IRS form 990 that serves as the initial source of information for both members of the public and regulators alike.

Unfortunately, those forms are often submitted by organizations with many inaccuracies and incompletions, and it becomes difficult to differentiate bad actors from the simply inept when you look at these forms after a while.

Moreover, the forms are often filed one or more years after the fiscal period for which they relate has passed, making it doubly difficult for regulators to be on top of, or pursue, enforcement actions in a timely manner.

As part of the testimony that is being submitted in written form, NASCO is offering a number of recommendations for specific changes to the form, as well as the instructions.

One material recommendation that we ask the committee to consider is mandating that the IRS form be consistent with the financial statements of an organization. For large organizations that have audited financial statements, that would subject the information in the 990's to a set of third eyes, an independent auditor to review the information that is set forth in those forms.

For most organizations, most of the smaller organizations, they do not have audited financial statements and tight reporting requirements in the 990 that are required to be carried over into their financial statements would serve to improve the accuracy and consistency of those statements as well.

We do not believe that these recommendations require any changes to generally accepted auditing or accounting principles, and we look forward to the accounting profession working with State and Federal regulators to improve the accuracy of these reports.

NASCO strongly supports the reforms contained in the Senate version of H.R. 1528. It is very important, we believe, that State and Federal regulators be able to share information and share it effectively.

Ironically, State regulators are more apt to find out about IRS activity through a target of our investigation than we are from the IRS itself, the rules that have been imposed on them are that difficult to deal with.

The last point, being exploiting technology and the Internet. We do think that it is very important that the IRS's electronic filing initiative be supported and that its State retrieval system be enacted or brought into fruition as soon as possible. That could serve as a single point filing system for all State regulators and the Federal Government as well.

Right now, the paper is, itself, practically impossible to deal with and oftentimes regulators' attentions are only drawn to those public filings now when circumstances, for whatever reason, bring them to our attention.

Having that information available in electronic format is an important thing, but being able to do something with it is even more important. We want the committee to know that NASCO is working with GuideStar in a project, funded by a Technologies Opportunity Program Grant through the Commerce Department, it is a \$1.3 million grant.

If NASCO NET, as the project is known, is successful, it will enable the efficient posting of documents and information about enforcement activities that State regulators and Federal regulators could share.

The information would be available to the public and it would also extend state-of-the-art information technologies and regulatory tools to jurisdictions that lack those resources and the expertise to put that together on their own.

We do not have a sustainability model to fund this. NASCO very much supports the proposal in the white paper to recommit the 2 percent excise tax to charities enforcement and hope that State regulators will be able to share in some of those revenues to help support this sort of initiative, and others.

Again, thanks very much to the committee for allowing us to participate in today's proceedings. Thank you.

[The prepared statement of Mr. Pacella appears in the appendix.]

The CHAIRMAN. All right.

I announced five minute rounds of questioning, so it would be in this order, first come: Grassley, Baucus, Thomas, Bingaman, Bunning, Nickles, and Santorum.

To any or all of you on the panel, some of my questions will be directed to specific people, but anybody that wants to help with this one, I read with interest the Commissioner's written testimony about efforts to improve governance at nonprofits.

What are the panel's views on this issue? How important is it to get governance and best practices right to prevent problems, and particularly examples from enforcement that would highlight this?

Commissioner EVERSON. Perhaps I will start, Mr. Chairman. We do think this is a central issue. The comparison was made between these issues and the corporate scandals.

The Congress and the administration did respond in the case of the corporate issues, Sarbanes-Oxley, and the President's Corporate Fraud Task Force. I believe that some of the abuses here do go right back to governance.

The term was used, maybe lackadaisical or asleep at the switch. There is some of that. We need to have clear conflicts of interest policies within these organizations. They need to be looking at compensation. Internal auditing for larger organizations is another best practice.

I think, as we go forward, we will be issuing a publication of best practices. As you probably know, we do not have any direct authority in that area. It is not as if we oversee the governance mechanism within these organizations. But we will do everything we can to set up what we think are the right basic bedrock principles.

The CHAIRMAN. Do either of the other members want to comment?

Mr. JOSEPHSON. Governance, Senator Grassley, is the most crucial issue. I hope that when Derek Bok speaks before the Committee later he will talk about his Nature Conservancy experience, because in his talk at Harvard on this issue a few weeks ago he really did a wonderful job of analyzing the contradictions that are inherent in a board governance staff model.

I have referred already to what happened to the Albany Urban League. We see all the time the too-large, or inattentive, or ill-informed, or not diligent board. It is not limited to the board. As the staff well knows and the white paper discusses, other lines of defense, the accountants, the paid preparers, are not doing their job.

The IRS tells us that 25 percent of all 990's are either filed incomplete or inconsistent on their face. We know that 4720's that disclose the existence of self-dealing and other prohibited transactions are rarely filed.

I give you an example in my statement of a private foundation that has made illegal political contributions. It did not file the 1120 POL. This story could go on and on.

I do not want to leave out lawyers. I told the committee earlier that a lawyer masterminded this scheme in which \$3.4 million was taken from the Grand Marnier Foundation. We have lawyers who tell their clients they have filed the 990's when they have not.

We have lawyers who are executives of private foundations and members of law firms who bill their charities for their work as their executives, inflating the law firm's bill, inflating their take in the law firm, and depriving the charity of money.

Mr. PACELLA. I would confirm Mr. Josephson's comment. I think that boards should be viewed as the public's very first line of over-

sight over the affairs of public charities. They have the most immediate and direct opportunity to regulate what goes on in their organization.

Two quick examples, I believe the Chairman had asked for. In Pennsylvania, we have been reviewing hospital transactions, conversions, mergers, sales of assets. We do that by trying to ensure that the board has exercised due diligence in coming to whatever their decision is, whether it is a merger or a sale.

In one particular community hospital sale, the board submitted paperwork to us that suggested that they wanted to sell the hospital for a consideration of \$19 million. Our review questioned whether they had publicly offered the asset for sale. They had not. We asked them if they would consider that. They did.

When they went back and offered it publicly, they ultimately got approximately \$38 million. That was an increase of nearly 100 percent, about another \$19 million that now serves health care issues in the community.

In another case involving the Allegheny Health Education and Research Foundation, a bankruptcy in 1998, the board was not attentive to the ongoing affairs of the organization.

By the time the situation got bad enough and there was a financial collapse, there had been some \$80 million in restricted charitable endowments that had been misapplied to support the bankrupt system's operations in the months leading up to the bankruptcy. We succeeded in getting about \$26 million of that back, but obviously we are way short of a full recovery.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

My first question is, how big a problem is this? I mean, in terms of dollars, what amounts are we talking about here annually? Either amounts of scam, insider trading or whatnot, or lost Federal revenue because taxes or excise taxes are not collected? Do we have a sense of how big this problem is? Anybody? Mr. Everson, do you have an idea?

Commissioner EVERSON. I do not have precise indications. Let me simply say, Senator, the very fact that we have elevated this to make it one of our four service-wide enforcement priorities indicates how serious we think this problem is. As I indicated, I think it is one that is growing.

Clearly, there are many billions of dollars that are lost each year through the shelters that I have spoken about, which you are well familiar with. So, that is clearly one indication.

But as I have indicated, I believe that the longer term issue here, and the more important one, is respect for charitable organizations, and the consequences if that is not corrected.

Senator BAUCUS. If you were tasked to figure out how big a problem it is, what would you do? How could you find out?

Commissioner EVERSON. In the foundation area we are going to be doing some more detailed examinations that are akin to the National Research Program that you are already familiar with for individuals.

We will learn quite a bit as we do these examinations. We will be able to adjust our programs, and I suspect that we will develop better data regarding the size and scope of the problem.

Senator BAUCUS. Do you have a timeline on that project?

Commissioner EVERSON. We are launching in coming months, and I suspect over the next 6 to 12 months we will start to get some pretty good information.

Senator BAUCUS. So at least a year from now you will have a much better handle on the size and magnitude of the problem.

Commissioner EVERSON. I believe that is a fair statement.

Senator BAUCUS. And also by then starting to know more precisely what it is you have to do to get at them.

Commissioner EVERSON. I think that is correct. Again, to make a pitch for the budget, if we secure the resources we will have more people to be doing those kinds of examinations, because as you dig into this, as I said, this is an area where the audit coverage has been the lowest because it has been viewed as a compliant area. Because tax-exempt organizations do not generate revenue, it has sort of been left off on the side. But we cannot afford to do that now.

Senator BAUCUS. Could you all expand a little more on the federal/State sharing? I understand what some of the impediments are, and the CARE Act helps that a bit. But could you expand on the degree to which you are heeded now, and what is really needed here?

Commissioner EVERSON. Certainly. I would be delighted to, Senator.

Mr. JOSEPHSON. I would like to talk very briefly about fundraising abuse, which may not rise to the senatorial level, but it is a common problem.

Senator BAUCUS. Well, we are interested in fundraising. [Laughter.]

Mr. JOSEPHSON. Professional fundraising. Professional fundraisers who, themselves, create charities that they then raise money for and give precious little to charity. We see that over and over again. Attention needs to be paid to the currently ineffective Code Section 6113, which does not regulate that.

I would like to give you an example, a particularly gross example. We are looking at the kinds of charities I have just described, charities that appear to be arms of professional fundraisers.

One of these did not smell right to me, so I asked our accountants to take a look at why its assets jumped from \$100,000 to \$2 million in a year. And this gets into another area that I know the Committee is concerned about.

Our accountants discovered that this charity, this two-bit charity, received in 1 year an Ingstrom helicopter, a Lescom plane, a Boeing Steeraman, a Tiara Pursuit 25-foot boat, an Aerocommander, another Aerocommander, a Merlin 3B, and Easterly sloop.

Is this charity liquidating? No. These assets were held for at least a year. Do any of these assets have anything to do with the charitable purpose of this charity? No.

Is the charity spending any money on maintenance or storage of these? No. We suspect—and this is another issue that the IRS Commissioner and we have to be able to work together on—that these were phony donations and that the contributors are still

using this property. I would like formally to refer that matter to Commissioner Everson right here and now.

Commissioner EVERSON. Well, I would like to refer it back, but I cannot do that under the law. [Laughter.]

Mr. JOSEPHSON. Exactly correct. This was not a set-up, but, as I said, we cannot talk to each other.

Senator BAUCUS. I was going to say, that is a great set-up.

Mr. JOSEPHSON. And we have to be able to.

Senator BAUCUS. All right.

So, again, you are agreed on what the changes in the law should be so you can share.

Mr. JOSEPHSON. Yes, sir. Yes.

Senator BAUCUS. Now, would any civil rights groups or groups interested in privacy raise a fit over this?

Mr. PACELLA. Really, I think that historically the confidentiality rules have simply carried over from the private taxpayer side to the public charity side.

I do not believe that any of the dynamics or any of the public policy considerations that weigh in favor of confidentiality for any of our individual tax returns or that of monied commercial corporations are in any way applicable to public charities. These are public monies that are being privately administered. If anything, they should be subject to more public scrutiny.

Senator BAUCUS. One quick question, Mr. Chairman.

Mr. Josephson, you mentioned Mr. Bok's testimony and a speech he apparently gave a couple, 3 weeks ago about the Nature Conservancy.

I read his testimony and was a bit struck where he said that the review that the Nature Conservancy performed revealed that Sarbanes-Oxley types of regulations should apply, but only on a voluntary basis. That is, they do the best they can.

I was a little surprised that he did not go a little further and say we should have some mandatory, appropriate, whatever they might be, selective provisions from Sarbanes-Oxley that would apply to charities. I am just curious what your reaction to that might be.

Mr. JOSEPHSON. We are all in favor of that. Attorney General Spitzer himself proposed State legislation this year that would incorporate into State law many of the Sarbanes-Oxley provisions that we think are relevant.

We applaud the staff's proposal that requires the chief executive officer of charities to sign the 990 or the 990 PF. We think that the staff's proposals for severe penalties on paid preparers who do not do their jobs are entirely appropriate.

Senator BAUCUS. Would you change the staff proposal in any way, any of the three of you?

Mr. JOSEPHSON. Yes, I would. I agree with the staff's proposal that the accountant audit responsibility should be rotated. That is going to be difficult, perhaps, for the small charities in less-populated areas. Perhaps there needs to be an exception for that. But for the major charities, absolutely.

Senator BAUCUS. But would you change the staff proposal in any way?

Mr. JOSEPHSON. Yes.

Senator BAUCUS. And the way would be to do what?

Mr. JOSEPHSON. The way would be to require smaller boards, committees, audit committees, compensation committees, independence on the part of board members. All of the staff proposals that analogize to Sarbanes-Oxley are absolutely appropriate in the charitable sector.

Senator BAUCUS. Mr. Pacella, Mr. Everson, any comment on the staff proposal?

Commissioner EVERSON. I do not have a detailed comment. I think that the white paper raises a lot of very important issues and needs to be looked at carefully and addressed, and we are going to do that.

Senator BAUCUS. All right.

Mr. Pacella?

Mr. PACELLA. We would agree, with the proviso of building some safeguards in for the small organizations, the small, locally-based organizations.

Senator BAUCUS. Thank you, Mr. Chairman. Thank you very much.

The CHAIRMAN. Thank you.

Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman.

Let me ask some kind of broader questions. You all go into great detail, and I understand that, but there is great reason to be a charitable group, to obtain the status, and so on.

What is the definition of a charitable group and how do they become charitable unless you agree that they are?

Commissioner EVERSON. Well, they make an application to us and they have to have a broader public purpose that they are serving. Let me talk about credit counseling just as an example, because I did mention that.

Credit counseling was an industry or a subsector that existed for a long time, and it educated and counseled families or couples or individuals that got into financial difficulty. These were organizations, small and large alike, that did this work and they did it carefully.

But what has happened here that is disturbing, is that now some entities, newer entities, have gotten involved. They are funneling debt service packages to related parties.

Senator THOMAS. But my question is, is there not a definition? If it does not apply to them, why do you allow them to be in that category?

Commissioner EVERSON. Well, because, as I indicated before, this is an area where I do not think we have provided adequate attention. We have upped our resources to address this very problem.

It was mentioned earlier, we are devoting a lot more focus on the determination process, the front end when they make an initial application. But sometimes they will say one thing on the application and then act differently as they go down the road. The only way you are going to get after that is through an audit process, and our audit coverage here is quite low. It is less than half a percent.

Senator THOMAS. I see. But that is the way you handle everyone else in the tax situation, is if it does not appear right, you audit it. Right?

Commissioner EVERSON. That is correct. So what I am suggesting is, and why we have asked, Senator, for all of the additional resources is that this was a sector that was more compliant, and now we are seeing a deterioration in behavior so we need to adjust our plans accordingly.

Senator THOMAS. But you all asked about more money. Now, would changing this bring in more money to offset the costs that you all are talking about?

Commissioner EVERSON. I think that you need to do three things. You need to start with the President's proposal, which, as I indicated, would provide 17 percent increased spending and examination in this area.

We need to address this sharing issue that has just been discussed. That is terribly, terribly important, because if you look at abusive tax shelters, right now we are sharing with 46 different States information, and they are pursuing some cases and we are pursuing others. We cannot do that with these gentlemen. We need to be able to do that so we leverage cooperative efforts.

The third, is we need to jointly assess all of the issues that surfaced in the white paper, and some of the things that are in my testimony as well.

Senator THOMAS. Now, the States are interested in it because of State tax. Is that correct?

Mr. JOSEPHSON. That is correct.

Senator THOMAS. Not all States are involved in it then.

Mr. JOSEPHSON. I would like to emphasize the importance of the exemption granting and the exemption review process. Exemption is a privilege, it is not a right. Charities that receive the exemption ought to periodically justify that they are doing the job they said they would do when they applied, and they ought to justify their governance practices.

Senator THOMAS. Do you have a definition of what is proper? What is the characteristic that you would measure against?

Mr. JOSEPHSON. We try to evaluate the extent to which any charity uses charitable funds for its charitable purposes.

Senator THOMAS. What is a charitable purpose?

Mr. JOSEPHSON. To the extent that we have data, we look at the ratio between administrative expenses and program expenses.

Senator THOMAS. All right. But do not go on any further. What is charitable? You have said they have used it for something different, but it still qualifies.

Mr. JOSEPHSON. Yes.

Senator THOMAS. Do you define charitable?

Mr. JOSEPHSON. I think that this charity that I referred to earlier that has become a donation vehicle is not using its assets for charitable purposes.

Senator THOMAS. Clearly. But do you define that?

Mr. JOSEPHSON. You find a lot of that, yes.

Senator THOMAS. No. Do you define it? How do you determine that? You determine most other taxes fairly clearly. You act here like charitable is, oh, maybe it is this, maybe it is that.

Mr. JOSEPHSON. This particular charity is a health care charity. That is a traditional area for charities.

Senator THOMAS. Well, you are still not answering my question. Would you answer my question, please, sir? Do you have a definition of charity?

Mr. JOSEPHSON. Yes, we do. We have the traditional definition that is dated from the 16th century: health care, education, social service. The definition of charity has not changed in 400 years.

Senator THOMAS. It has not been, in the tax law, defined, has it?

Mr. JOSEPHSON. Yes, it has.

Senator THOMAS. All right. Then that is what I am asking you.

Mr. JOSEPHSON. That is the traditional definition which is in the Internal Revenue Code.

Senator THOMAS. Do not talk to me about the 1600's. That is not the issue. We are talking about today, so that you can look at it and say, this charity is one that qualifies for charity.

Mr. JOSEPHSON. Yes. In New York, we have a series of charitable definitions. The most pertinent to traditional charity is what we call a Type B charity, and that is what we measure charitable performance by.

Senator THOMAS. That is my question. I hope it is very clear. Thank you.

The CHAIRMAN. Senator Bingaman?

Senator BINGAMAN. Thank you very much.

Commissioner Everson, let me ask about the overall budget level for the IRS this coming year. The IRS Oversight Board has said—and this is reading from their latest report in March—the Board believes the administration's 2005 budget cannot achieve its stated goals to add almost 2,000 personnel to bolster the IRS enforcement efforts, and will threaten hard-earned improvements in customer service.

This year's request will lead to a \$230 million shortfall in the IRS budget because it fails to budget adequately for the anticipated \$130 million of Congressionally mandated civilian pay raises, rent increases, and at least \$100 million of unfunded expenses.

In fact, fiscal year 2005 is the fourth year in a row in which the administration has called for IRS staff increases, while not covering pay raises or required expenses."

Do you agree with that?

Commissioner EVERSON. I do not agree with the board assessment in this area. I support, down the line, the President's request. The President has provided a request for the IRS that is 10 times—10 times—the average request for a non-Homeland, non-DoD agency. The overall request is 5 percent, in contrast to 0.5 percent.

What I do ask the Congress to do, is to fully fund that request. There are some indications already that the marks going back to the appropriators are less than would provide for that. It is critically important that the request be funded.

If there are things like the civilian pay increase, an additional 2 percent is provided, that would cost us about \$100 million. We can find a way to absorb that. It is a \$10 billion-plus organization, and as the Chairman and others have said, we have got to be more efficient.

We are searching for ways to be more efficient. We can do some things to close some of those gaps, but we cannot do that if, instead

of the \$10.7 million the President has asked, only \$10.3 million or \$10.4 million is provided.

Senator BINGAMAN. Let me ask about the abusive tax shelters. Did you say there were 31 that you identified?

Commissioner EVERSON. What we do, sir, is on an ongoing basis is issue guidance and a list of transactions that we consider potentially abusive so that they get special scrutiny if they show up on a return. As of now, there are 31 that have been listed as having those characteristics.

Senator BINGAMAN. And these are tax abuses that are, in your view, illegal, contrary to current law, and ones which, under current law, you can prevent it. To the extent you can identify them, you can take them to court and stop that. Is that right?

Commissioner EVERSON. We can do that. It is going to depend on the facts and circumstances of the individual transaction. What we do, is we talk about the general transaction, and sometimes the facts and circumstances are different.

Some are more egregious than others. You may be familiar with a transaction called Son of Boss. We have a settlement offer out on that. That is a very abusive transaction, one of the worst.

Senator BINGAMAN. Some of the later witnesses here, in their testimony, cite what they consider to be abuses. J.J. MacNab has some examples in the testimony that has been filed. One of them is this Life Heritage Plan, LIFE.

The testimony says the charity sets up a trust which sells either fixed income shares or dead instruments to the insurance company. Using the money raised, the trust purchases 10,000 life insurance policies totalling \$2 billion from a different insurance company on the lives of the charity's donors.

The charity receives the first million in death benefits each year for 30 years. The remaining pool, which is about \$2 billion, goes to the insurance company or the investor. Each donor receives a small death benefit, \$10,000, as an entitlement to have the policy purchased on his or her life.

So, the charity gets \$30 million, but that is nothing more than rent for the insurable interest that is transferred to the trust for the use of the institutional investors who benefit substantially more.

Now, that is not one of the tax abuses you are talking about, because that is perfectly legal, as I understand the current state of the law. Am I right about that?

Commissioner EVERSON. I would hesitate to comment. You covered a lot of ground there. I understand there are issues with insurance and the interaction with charities at this point that we are carefully looking at, but have not yet reached final conclusions. So, that would cause us concern. We are looking at these kinds of issues.

But I would say, stepping back for a minute, it buttresses the broader comment that I have made that we are seeing more and more structured transactions not through a traditional gift of cash or securities, but to interacting with these charities, again, created by the attorneys and the accountants trying to create something of mutual benefit that I think is oftentimes at variance with what the

expectation has been about how these organizations will govern themselves.

Senator BINGAMAN. Can Mr. Josephson also comment on that?

Mr. JOSEPHSON. May I comment on that?

Senator BINGAMAN. Please.

The CHAIRMAN. Yes. Go ahead.

Mr. JOSEPHSON. The New York State Insurance Department issued a ruling recently that would prohibit exactly the kind of scheme that you are talking about. I am sorry to say that one of your former colleagues is lobbying the New York State legislature to overturn that ruling.

Senator BINGAMAN. Thank you.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Commissioner, many of the financial violations of charitable organizations arise from directors and officers obtaining unjustified compensation from their organization.

Can you comment on how it may be determined what is and what is not excessive or unjustifiable compensation?

Commissioner EVERSON. Certainly, sir. This is a facts and circumstances test. You have got to look at the nature of the institution, what are comparable practices in other organizations, size has something to do with it, and technical expertise.

There are a range of issues, but you can spot some pretty clear problems as you look at some of these organizations. But it depends on the individual examination of our career professionals who will take a look, and they need to render a judgment.

Senator BUNNING. Should it be subjective or should you have some type of statute that would fix compensation within a reasonable parameter?

Commissioner EVERSON. I think it is about right where it is now. You rely on the audit process to look at it. I would be hesitant to develop a cookie-cutter, or more mechanical, approach. I do not think that is consistent with a good regulatory scheme, because there are differences in circumstances.

Senator BUNNING. In your testimony, a number of current law penalties may be imposed in situations where salaries in excess of reasonable compensation are paid. Can you comment on how often these penalties are imposed?

In addition, could you comment on the differences between the penalties that are available to be imposed in situations of abuse in the public charity context, such as the tax on excessive benefit transactions, and the penalties that are available in the private foundation context, such as the tax on self-dealing and taxable expenditures, and the effectiveness of each? Do you think it would have an impact to expand the private foundation's self-dealing rules to the public charities?

Commissioner EVERSON. I would like to take that in two parts.

Senator BUNNING. All right.

Commissioner EVERSON. My understanding of the potential penalties, is that you can assess sort of a surtax. If an individual has paid too much, then you can subject the individual, not just the charity, to a 25 percent, I believe it is, penalty.

That has not been used as often as it ought to be. We are going to start to increase the use of it as we go along here, particularly these credit counseling organizations that I mentioned where we are focusing more attention.

But we have not done much of this. My inquiries have indicated, perhaps, it is a handful each year. So, we need to do more of that, absolutely. I think we should carefully consider whether there are other areas where there are abuses.

But, again, I would suggest not on a cookie-cutter or mechanical approach, but using the judgment of the the independent experts that we have, as to whether things or reasonable or not. Yes, other penalties might be a good idea.

Senator BUNNING. Other than the anecdotal information that we have on abuses, the IRS has not really dug into this in depth. Is that correct?

Commissioner EVERSON. I am not sure that I agree with that assessment. We have looked at this enough, and we have seen enough changes in certain segments of this sector, that, again, we have elevated this to one of our four service-wide priorities. We have requested significant additional funding. We have launched the four or five different initiatives that I mentioned earlier.

Now, beyond that, I would agree with my colleagues on the panel who have indicated that we have other work to do. We need to revise the reporting in this area. We have launched electronic filing. That will give us a better capability to analyze the data. So, there are a lot of things that are happening.

But yes, if you are saying that we have been slow to get at this, probably it is fair to say that this problem has crept up over time, and our response has lagged.

Senator BUNNING. Well, for us to look at increasing, as requested, the amount of dollars being spent on this specific area, there has to be some justification.

Commissioner EVERSON. Yes.

Senator BUNNING. So, the justification would be if the audits of those entities would reveal a lot of abuse, and therefore return to the Treasury the money that we are expending to actually capture that money back for the abuses.

Commissioner EVERSON. Yes.

Senator BUNNING. So, unless we can be convinced of that, I do not know how you can expect us to justify the expenditure of the additional dollars.

Commissioner EVERSON. Senator, of the \$300 million in additional funding that the IRS has requested for enforcement, we conservatively estimate overall a 5:1 direct return. Beyond that, there is an indirect return, a change in behavior that takes place when people are held accountable.

Senator BUNNING. Do we not have the laws on the books now?

Commissioner EVERSON. We have, largely, the laws on the books now. But I think what the white paper is indicating that there needs to be a discussion on certain additional steps, so we get consistency in this sector with some of the other approaches that are taken in a regulatory scheme.

Senator BUNNING. Thank you.

The CHAIRMAN. Thank you, Senator Bunning.

Now, Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you very much, and Commissioner Everson, and to other panelists. Thank you for participating in this.

Mr. Chairman, I compliment you and Senator Baucus. I think this is a very interesting hearing and one that hopefully will help make some changes.

Commissioner Everson, you mentioned two or three things. One, there are about 3 million tax-exempt entities today?

Commissioner EVERSON. Yes, sir. There are about a million charities and a comparable number of pension plans. This whole sector includes Indian tribes, governmental entities. We have four different sorts of organizations in the IRS. Our smallest is the one that deals with this whole basket of tax-exempt and government entities.

Senator NICKLES. And in the charities, you would include all the education groups?

Commissioner EVERSON. Those organizations would be included in the charitable group. Right.

Senator NICKLES. I appreciate that.

Well, just a couple, three comments. One—and some of you alluded to this. Mr. Josephson, I think, did—that a lot of charities—not all charities. Most charities do most great, and my compliments to them. Some charities do great fundraising and very little goes to the recipients, or to the intended people. That irks the heck out of me.

I do not want to contribute, nor do I want somebody else to contribute, \$100 or \$1,000 to a group and find out that 90 some percent of it went to fundraising expenses, and very little bit of it went to the beneficiaries.

Mr. JOSEPHSON. And it deals with revenue loss, as my colleague said.

Senator NICKLES. Absolutely. I look at this from both sides. If you are talking about big sums—Mr. Everson, do you have a figure, what the total amount of charitable contributions that people claim on their returns? Do you happen to have that?

Commissioner EVERSON. I do not have that with me, sir, but we could certainly give you the data on that.

Senator NICKLES. If you would give that to us, and what that meant, if you have an estimate of loss in revenue.

Commissioner EVERSON. In 2002, on 40,399,695 returns, \$140,571,365 in charitable contributions was claimed.

Senator NICKLES. I am not saying we should take away that deduction, but conversely, if you looked at—let us just use a large figure. If it had \$100 billion in charitable deductions, and let us say it cost the government—were you wanting to add something, Mr. Josephson?

Mr. JOSEPHSON. I think I can provide that information. Marian Freemont-Smith's new book, *Governing Nonprofit Organizations*, estimates an annual contribution total of \$241 billion.

Senator NICKLES. All right. Well, I was going to use \$100 billion for simplification. If it is \$241 billion, let us say it is an \$80 billion average tax rate, or whatever that figure would be. Or maybe I will make it smaller.

If a person is making a \$100 contribution and they deduct \$100, but only \$5 or \$10 goes to the recipient, the Federal Government, if that person is in a 30 percent tax bracket—

Mr. JOSEPHSON. That is what our recommended amendments to 6113 would deal with. That is an extremely abusive situation and it is very difficult to deal with on an individual case, because I cannot justify the allocation of my scarce resources to deal with lots of \$100 or smaller contributions.

Senator NICKLES. I have not looked at your recommendations that closely, Mr. Josephson, but I am happy to look at it. I am just trying to get a little bit of a grasp on the figure.

But I happen to think there are a lot of charities, particularly a lot of the ones that are using phone and mail. You can burn a lot of money on phone solicitation and mail solicitation and generate very little net for the purpose.

Mr. JOSEPHSON. Probably the biggest volume of complaints that we get on the State level are from people who feel they have been abused by professional fundraisers.

Senator NICKLES. All right.

If we did a better job, or is there some disclosure that if charities had to disclose the percentage of their dollars raised, their fundraising expense, or maybe reverse that, the percentage of money that actually goes to the beneficiaries, should that figure be required if they are going to contribute?

Here is your United Way list of beneficiaries, and some are very efficient, and maybe 90 percent of the money raised goes to the intended purpose, and others might be less efficient, and maybe 3 percent of the money goes to the beneficiaries. Is there one place where people could find that?

Mr. JOSEPHSON. We need to work with the committee on that issue. There are three 1980 Supreme Court cases that inhibit the ability of the States to require that kind of point-of-solicitation disclosure.

Now, the recent Madigan case gives us an opening in situations where there is fraud. I think we can construct a Code provision that will get exactly at what you are worried about, Senator Nickles. I would be happy to work with the committee staff on that.

Senator NICKLES. All right. I appreciate that.

Mr. Everson, do you have any comment on that?

Commissioner EVERSON. I think that I view that as a consumer protection issue and not necessarily a tax issue.

Senator NICKLES. Well, they are both. Charities can be a very efficient, much better method, frankly, than government as far as providing assistance to those people who really need it. They can be better in many respects.

Conversely, if you have a charitable organization that is taking a lot of tax-exempt money and using very little of it for beneficiaries, the taxpayer is getting ripped off and the beneficiaries are getting very little for a lot of money expended.

Commissioner EVERSON. Fair enough.

Senator NICKLES. So, there are tax consequences, too.

Commissioner EVERSON. Clearly, our predisposition is to disclosure, that disclosure is helpful. I think that is really what you are arguing for.

Senator NICKLES. I think sunshine disclosure would be very healing in the process. I think it would be an embarrassment to a lot of charities if people knew the percentage of money, or the small percentage of money, in some cases, that goes to the actual beneficiaries. Maybe that would change donating behavior, so it might fix itself.

I am also very concerned about some of the scams. I think, whether there are some insurance things that may be legal—but if you look at the total dollars, again, that people may be contributing and the amount of money that goes to the school, or whoever, is putting that together, I think some of it looks pretty questionable and it needs to be reviewed. I guess you have mentioned you are in the process of reviewing that, so I appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Pacella, did you have something to say?

Mr. PACELLA. Yes. I did want to offer a response.

Senator Nickles, the Supreme Court cases that Mr. Josephson referenced made clear that the States cannot constitutionally compel a point-of-solicitation disclosure as to how much is going to go to a particular charitable cause.

What the Supreme Court has told us, is that we can require the registration and reporting of a charity's finances and the constitutional way to get this information out is for States to disseminate this information.

There are approximately 38, 39 States that have registration reporting requirements on the books. Pennsylvania is one of those. But this ties back in a critical way to the accuracy of these 990 reports that you have all heard us mention earlier.

That old adage about “garbage in, garbage out,” the battlefield has really concentrated now on the accuracy of the financial information that these organizations report.

Even donors that have the presence of mind to make inquiries and check with their State registration offices, Better Business Bureaus, or whatever, to find out what information they can glean about what an organization's finances have been, are oftentimes frustrated, if not completely circumvented, because of the inaccuracies of these 990's that get filed, the wiggle room that exists in reporting requirements, the fact that sometimes the most timely information available may, honestly, now, be 3 years old, that does not really give donors much insight into how much of the \$100 they are considering today for the benefit of the local food bank, or whatever, is actually going to get there.

So, disclosure is something that has been very well litigated, and I think that question has been answered for us. It is critical that we tighten the reporting requirements so that States can disseminate accurate and timely information.

Senator NICKLES. Thank you.

The CHAIRMAN. Senator Santorum?

Senator SANTORUM. Thank you, Mr. Chairman.

Commissioner, how widespread is this problem? I mean, what percentage of charities are involved in activities that you would consider to be problematic?

Commissioner EVERSON. I do not think we have a precise answer at this time, Senator. This was a sector of the country that was

pretty compliant. And, as I have indicated, we have seen two things that are happening here, and that is why we have articulated the enforcement priority the way we have.

The first, is we have seen abuses within the sector that we have been talking about this morning, governance abuses, insider dealing, dealing of related parties where you are really just funneling money to profit-making entities.

Then the second thing we have seen, which is particularly of concern to this committee in terms of the abusive shelters, is the use of these organizations as accommodation parties for tax avoidance schemes. I do not know if you had come in yet during my opening statement, but this chart is a transaction.

This is based on a real transaction where a product is marketed by the attorneys and accountants. It involves foreign currency. It is pretty complicated, with offsetting options.

What happens is the taxpayer gets a half a million lower tax bill, the charity gets a paper gain of \$1.5 million, which of course does not cause any pain to the charity because they do not pay any taxes, but they get \$50,000 in cash by having these offsetting arrangements.

Those kinds of things, that is not what was happening 10 or 20 years ago. But because we have tightened up on some of the other shelters, now people are finding these channels, and that is very disturbing to us.

Senator SANTORUM. Is this legal?

Commissioner EVERSON. We have listed that as an abusive transaction and we are stopping that kind of thing. But you have to stop it through the disclosure and regulations that we issue, and then you have to follow through with the audits.

But, here you have got a couple of different issues that I would say are tough. We have been talking a lot about charities here. The charities issue these annual reports that we have been talking about.

Some of these—not this scheme, but others—go through municipal organizations which are also not regulated at all by the IRS, so it is very difficult for us to pick up all the participation in these kinds of tax shelter transactions.

Senator SANTORUM. I would maybe just come back to my initial question again. You said you have gotten records of abuses and anecdotal evidence. My question comes then, how widespread is this?

Commissioner EVERSON. Well, this goes into the billions of dollars.

Senator SANTORUM. I understand. But that is a particular scheme, if you will. We have got hundreds of thousands of charities out there.

Commissioner EVERSON. Right.

Senator SANTORUM. How many charities are involved in these kinds of activities?

Mr. JOSEPHSON. Senator, I can give you a clue about that. I have about six accountants on my 50-person staff. They go through, annually, about 2,500 registration statements.

Annually, they refer to the lawyers on my staff about 200 matters. Now, we cannot, obviously, devote resources to all 200 of those matters, but the accountants are picking up nearly 10 percent of

charities whose registration statements raise concerns. That is a big number.

Senator SANTORUM. So, you are saying 10 percent raise concerns. What percentage of those do you look at and then find problems?

Mr. JOSEPHSON. That is a triage problem. I have got 19 lawyers to deal not only with those 200 referrals, but to deal with press reports, complaints, articles like appeared in the Chronicle of Philanthropy on illegal loans from charities to their directors and officers. We are looking at all 165 of those from New York.

So far, we have restored to charity more than half a million dollars. Our examination is continuing. We have to look at the major abuses. Therefore, it is very difficult for me to give you a precise answer to your question.

Senator SANTORUM. I think that is a good point, to look at major abuses. I certainly would like to see that happen. I am one who strongly believes in charities and the tremendous purpose that they serve.

While I commend the Chairman and Ranking Member for having this hearing, at the same time I hope that people do not view this hearing and say, well, gee, we need to walk away from charitable giving, that this is a scandal-filled area that people are just using charities to rip us off of our money.

I know comments were made about, how much money is going to the bottom line, whether it is telemarketing or direct mail. I daresay, if we look at our own campaigns and find out how much money we send and spend on direct mail and telemarketing and what our net is from doing prospecting and doing telemarketing prospecting, you would find out that we do not make any money doing that either, and I do not think we disclose that to our donors when it comes to how much contributions we get.

But there is a point beyond how much money you get, and that is to get names on the list who you can then get contributions from in the future, and that it actually is worth not making any money on some direct mail pieces to get names of donors who will give in the future where you can make money.

So, I just want to make sure that we are not suggesting that there are practices out there that are being engaged by charities that are somehow traditional in nature, but nefarious by the fact that you are not getting lead on the target, or dollars netted to the charity.

Commissioner EVERSON. I could not agree with you more. I would like to be clear on this, Senator. As I said in my oral statement, the vast majority of charities are still operating the way they traditionally have. What I feel our job is here, is to find the pockets where there are problems or where there are trends. So, I agree that this is a very vital sector.

Senator SANTORUM. I see my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Before I dismiss the panel, Senator Baucus had a follow-up question he wanted to ask.

Senator BAUCUS. My curiosity perked up a little bit when you mentioned those Supreme Court cases that make it unconstitutional to what, to collect what kind of information?

Mr. PACELLA. Those three cases, Shaumberg, Munson and Reilly, and Reilly was last decided in June of 1988, stand for the proposition that States cannot regulate by percentage the amount of money that goes to program services. So, we cannot license or prohibit a charity's ability to deliver its message, to conduct solicitations on the basis of how much gets to charity.

Senator BAUCUS. On the first amendment?

Mr. PACELLA. On the basis of the first amendment, that it is a fully protected activity, and that to do so would unfairly discriminate against organizations that are newer that do not have an established donor base, that may have, particularly unpopular causes, politically unpopular causes, or whatnot, and that the better practice that the constitutionally correct way to do it is to simply require the reporting and then allow the regulators to disseminate the information, that it is burdensome speech and will so alienate prospective donors if they are forced to hear, at the outset of a solicitation, that only 5 percent of your contribution is going to go to the cause I am about to ask you to support.

Senator BAUCUS. But you think you can get around that with other forms of disclosure to help get at the problem?

Mr. PACELLA. As Mr. Josephson said, the court had made very clear that States can vigorously prosecute fraudulent solicitations in our anti-fraud laws. It is just that we cannot engage in a prophylactic practice that burdens the first amendment rights of non-profits.

Mr. JOSEPHSON. Senator Baucus, I would like permission to submit for the record an article on exactly this issue that I have just published in the New York Law Journal, which suggests to me that the Madigan decision gives us some enforcement avenues that we did not have before.

Senator BAUCUS.

Mr. Chairman, I think that would be a good idea if—without objection, we could include that.

The CHAIRMAN. Without objection, it will be included.

[The information appears in the appendix.]

Senator BAUCUS. One brief point. Mr. Everson, the Son of Boss program got an amnesty period which has just expired, and I sent you a letter asking for the results, and you gave me a copy of your letter today, which does not say very much.

Commissioner EVERSON. No, it does not.

Senator BAUCUS. But I would deeply appreciate if you could, as quickly as possible, answer the questions in that letter so we have a better idea of the magnitude of the Son of Boss program and the degree to which people are coming in.

Commissioner EVERSON. Yes. Yes.

Senator BAUCUS. And whether there are serial abusers, et cetera.

Commissioner EVERSON. Yes. I am not prepared to comment today. We have been seeing some pretty good volumes coming in each day. As you can imagine, this kind of thing ramps up as you go along. It is a little bit like when people mail their returns on the 15th. I expect that, as early as next week, I will be able to talk with you about it.

Senator BAUCUS. The Chairman and I wrote you a letter.

Commissioner EVERSON. Yes.

Senator BAUCUS. We would appreciate your response.

Commissioner EVERSON. Yes. We will get that to you as soon as we have some good, hard numbers.

Senator BAUCUS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I will have some questions that I am going to submit to this panel. I might as well announce, for other panels as well, from members that cannot be here or people like me that did not have time to ask all the questions you want to ask, we will submit questions for response in writing.

Thank you, all of you on this panel, for a fine presentation.

[The questions appear in the appendix.]

The CHAIRMAN. Now I would like to call the next panel. Senator Baucus has already done this, but would Mr. Adkisson come, Ms. MacNab, come.

Then we have confidential witnesses whose names are not their real name. I am going to call the first person "Mr. Car" and the second person "Mr. House." And when you hear their testimony, you will understand why their identity cannot be known.

As I announced to you, we are in the middle of votes this morning. So, I am going to go over and vote while you folks testify, and Senator Baucus will listen. In about 6 minutes, I will be back. Senator Baucus will go over and he will vote on the first vote, and stay and vote on the second one, then come back and I will go over and vote.

So, would you proceed with Senator Baucus chairing?

Senator BAUCUS. Ms. MacNab, why do you not proceed?

**STATEMENT OF J.J. MacNAB, CFP CLU QFP, ANALYST,  
INSURANCE BAROMETER, LLC, BETHESDA, MARYLAND**

Ms. MACNAB. Mr. Chairman, Mr. Baucus, and members of the committee, thank you for inviting me to speak before you today.

Americans are generous people. We love our charities. But when we donate money to our favorite causes, we want to trust that those charities will do the right thing with that money. Since charities are tax-exempt, we also want to know that they are not abusing the subsidies that our tax dollars are effectively funding.

I have three examples I would like to cover here today, and there are many more outlined in my written testimony. All have a common theme. They allow people and corporations to do things that they just could not do without the cooperation of a charity. All receive a benefit that would otherwise be unavailable to them.

A thief is able to steal, because wrapping his con game in a charity shell gives him credibility. A few thousand taxpayers are able to fund personal expenses using tax-deductible donations to a non-profit that is not picky about cutting grant checks.

And institutional investors are able to purchase billion dollar life insurance pools, where ordinarily State insurance laws would make such investment pools illegal.

The first topic I want to cover is outright fraud, where unwitting consumers were duped into losing their life savings simply because they trusted a charity.

In 1999, the Baptist Foundation of Arizona filed for Chapter 11 bankruptcy, owing more than \$600 million to 13,000 investors,

most of them elderly and retired. In what turned out to be the largest fraud case ever involving a religious trust, thousands invested their money with a foundation which promised high investment returns and charitable grants for Baptist causes, but turned out to be nothing more than a complicated pyramid scheme.

Three foundation executives have pleaded guilty to defrauding investors, and in 2002, Arthur Andersen agreed to pay \$217 million in damages for their role in helping charity executives cover up the scheme.

My next topic is donor-advised funds that allow donors to use tax-deductible donations to fund personal expenses. While most of the nonprofits in this arena place reasonable limits on their donors' control, a few charities out there are not picky about where they send grant checks.

On the contrary, they encourage their donors to use the money for their own expenses. There are many more details in my written testimony, but I would like to go through a very quick laundry list of examples that I found on just one Virginia charity's web site.

Example one: There are limits on adoption expenses that a person can deduct. Just run your adoption costs through the charity and you can deduct 100 percent of those expenses, with no phase-out for higher adjusted gross incomes.

Example two: Set up a 501(c) plan with tax-deductible money and repay yourself for charitable employment when you retire. The tax benefits are the same as a qualified pension plan, but there are no ERISA rules, higher contribution limits, no penalties for early withdrawal, and the plan can discriminate in favor of highly compensated employees.

Example three: Donations to international charities are not generally tax-deductible, so before writing a check to a foreign country, just set up an account with a U.S. charity, let them write the check, and you can deduct 100 percent.

Example four: Use your donor-advised fund monies to pay for your family's reunion in Italy this summer.

Example five: Run your for-profit life insurance business through your donor-advised fund. People will buy your insurance because they like charity, and you can defer all of your taxable income until you retire. Finally, use your donor-advised fund monies to pay your children's tuition costs.

Obviously, none of these examples are suitable uses for tax-deductible donations.

My last topic is perhaps the most serious and the fastest growing.

Senator NICKLES. Where did you find this?

Ms. MACNAB. All one charity, the National Heritage Foundation, in Virginia. There are many, many more examples, many of which were actually highlighted in some articles in national publications in 1999.

My last topic is perhaps the most serious and fastest-growing of them all. Charities participating in complicated shelters, which enable outside investors to enrich themselves by renting a charity's ability to purchase insurance on the life of a donor.

To summarize briefly, the charity sets up a trust, sells interests in the trust to outside investors, which are usually insurance com-

panies, hedge funds, or private banking clients. The money raised is used to purchase life insurance on the lives of the charity's wealthiest donors.

While the donors are alive, the trust pays interest income to the investors, and when the donors pass away, a small portion of the death benefit goes to the charity, while the investors collect the bulk.

The institutional investors investing in this plan would be unable to purchase the insurance contracts on their own. They must borrow or rent the charity's insurable interest. The charities are willing to sell this interest for pennies on the dollar, simply for the reason that those are pennies they would not have had otherwise.

Each insurance pool ranges in size from \$200 million to \$2.5 billion, and the charities who participate collect anywhere from \$10 million to \$30 million. Under most current State laws, these "dead pool" schemes are already prohibited, because while a charity may have an insurable interest in the life of a donor, the trust, funded by the outside investors, does not.

For this reason, the promoters have been aggressively lobbying at the State level to get the insurable interest laws expanded, effectively gutting the important consumer protections inherent in these laws, just so they can arrange more dead pools for their institutional clients.

Thank you for your consideration today. It is my hope that shining a harsh light on the very few abuses that do occur in this industry will have the effect of wiping out the bad practices before they have a chance to spread.

Senator BAUCUS. Thank you, Ms. MacNab.

[The prepared statement of Ms. MacNab appears in the appendix.]

Senator BAUCUS. Mr. Adkisson?

**STATEMENT OF JAY D. ADKISSON, EDITOR OF QUATLOOS.COM  
AND DIRECTOR OF PRIVATE CLIENT SERVICES SELECT  
PORTFOLIO MANAGEMENT, INC., ALISO VIEJO, CALIFORNIA**

Mr. ADKISSON. Thank you, Senator Baucus and members of the committee.

Congress is presented with a challenge of furthering contributions to charities and foundations, protecting their integrity while simultaneously discouraging their abuses. In doing so, Congress must be careful not to throw out the baby with the bath water: a fine against a charity hurts the charitable purposes; a revocation of the tax-exempt status hurts the donors.

Instead, the director should be held personally liable for their misconduct, and the misconduct of the charity taken at their behest. The reforms of Sarbanes-Oxley should be applied to directors of charities and foundations, and the IRS should implement an effective whistleblower program for those employed by charities and for foundations gone astray.

Some private foundations serve as little more than glorified personal trusts for their beneficiaries and are primarily formed to private a source of perpetual employment for errors.

In these cases, the hard dollar donations made by the foundation are just the thinnest sliver of the foundation's wealth thought necessary to maintain its tax-free status.

That private foundations are subject to little oversight has resulted in some persons using them as conduits for offshore tax evasion. Donations are made to foreign charities and foundations, and this is shown on the diagram on the right, which then funnel the donations back to the control of the original donor.

Because foreign charities and foundations are subject to no oversight or U.S. reporting requirements, these schemes are generally successful so long as the U.S. donor is willing to commit offshore tax evasion.

This is a gamble that some are willing to make because of the perception that their odds of being caught are low. Obviously, a concern with such arrangements is that they are a potential to act as conduits for money laundering and terrorism.

To combat these abuses, the private inurement rules must be strengthened and given teeth. Oversight of private foundations must be increased to a sufficient level to deter such abuses, particularly to foreign charities and foundations.

In the past several years, some charities have allowed themselves to be used as accommodating parties for complex and abusive tax shelters.

The display diagram on the left shows one such transaction. An S corporation issues a second class of stock, which the S corporation's owner then donates to an accommodating charity.

For several years, a large portion of S corporation's tax liability, but little cash, is flowed to the charity. This practice is known as "parking a tax-producing asset."

After a few years, the charity either re-sells the parked stock back to the S corporation's owner, or better yet, to an electing small business trust forum to benefit the owner's children, thus also avoiding the estate tax.

Only at this time does a charity receive any real benefit from the transaction when the stock is repurchased from the charity, usually at a pretty substantial discount.

It is telling that the owner of the S corporation is told by the promoters not to take a charitable deduction for the donation of the parked stock. The reason for that is, if they take the donation, they are concerned that it will raise red flags and scrutiny of the transaction will be triggered.

Rather, what they want to do is park this S corporation stock, leave it there for a few years, and potentially avoid millions of dollars of tax liabilities flowing up to the charity, which simply is not going to pay any taxes. Or, as Commissioner Everson said on the first panel, "they feel no pain" for participating in abusive transactions.

While this particular arrangement has been made a listed transaction and is no longer widely promoted in this particular forum, it is just the latest and greatest of tax schemes involving the parking of tax-producing assets with charities. It is likely that we will see a return of this scheme in a more sophisticated form, and probably involving complex derivative contracts.

Instead of attacking these parking transactions on an abuse-by-abuse basis, limitations should be imposed that restrict the consequences absorbed by the charity to the hard dollar benefits that are actually received by the charity.

In other words, if a charity receives a hard dollar benefit of only \$10,000 from a donation, that should be the limit of the tax liability that it can sponge up, and not the \$1 million in tax liability that the parked asset would attribute to it.

Taking on parked transactions is removing single weeds on the tax shelter landscape. Congress should finally address one of the root causes of tax shelters, both charitable and corporate, which are the opinion letters given by the major tax law and accounting firms to cover abusive transactions, and presumably avoid penalties.

From a marketing standpoint, the opinion letter is a critical part of a tax shelter sale. Tax shelter promoters tell their clients that they should play the tax audit lottery, since audit rates are historical lows.

According to the promoters, the client would pay the tax anyway, and thus has no disincentive to engage in the tax shelter, since penalties are presumably avoided by the existence of a thick and expensive opinion letter.

Congress should require the filing of tax opinion letters concurrent with the first tax return for the involved transaction. Such filing would worry tax shelter purchasers that the IRS would immediately know about the transaction, thus ending the entire concept of the audit lottery.

I expect that requiring the filing of tax opinion letters would immediately eliminate the vast majority of tax shelter sales, at least for the time being, with little cost to the government.

There is an old saying that goes around in my circles, which is, as the tax laws get tighter, the tax lawyers get smarter. Only by requiring the filing of opinion letters are you ever really going to put an end to the tax shelter business.

Thank you very much.

Senator BAUCUS. Well, thank you, Mr. Adkisson. I like your last suggestion very much. It would seem to have some effect.

Regrettably, the vote has expired over in the Senate, so I have got to run over so I can vote. So the committee will be in temporary recess until Chairman Grassley returns.

[Whereupon, at 11:38 a.m., the hearing was recessed to reconvene at 11:40 a.m.]

The CHAIRMAN. Could we call to order, please?

The next witness—and I am sorry I missed the two witnesses that have already testified—is “Mr. Car.”

Would you start with your testimony, please?

**STATEMENT OF “MR. CAR,” A CONFIDENTIAL WITNESS, TO  
DISCUSS FUNDRAISING**

Mr. CAR. Mr. Chairman, members of the committee, I want to thank you today for giving me the opportunity to testify. I am speaking to you regarding the issue of middlemen and car donations.

The reason I want to speak today is in honor of my mother, who passed away from cancer, and my frustration that well-meaning families who donate cars in the hopes of helping those in need are not seeing real benefit from the donation of their cars.

I speak to you from first-hand knowledge. I was a manager at an auto auction for over a year, and then I worked as a vehicle wholesaler for approximately a year. Now I am in retail sales of used and new cars.

Let me start by giving you the basics on how car donation works. First, people see an advertisement in their local newspaper proposing fair market value as a tax deduction.

Second, there is a toll-free number to call, at which point either the charity will answer the call, or the call is forwarded to a third party broker. AT this point, you give a description of your vehicle to the broker, year, make and model.

The broker will verify if they are accepting those cars at the present time. The broker will then tell you to refer to Kelly Blue Book for your tax deduction.

Next, the broker will tell you that your car will be picked up by a local towing company in 5 to 10 working days. In most cases, the towing company is owned by either an auto action or a used car dealer.

At this point, if the car goes to an auction, standard commission for the auto auction is 25 percent of the vehicle's sale price. If the car goes to a used car dealer, there is usually flat rate pricing. Flat rate pricing will typically be \$75 for a car, and \$125 for a truck. These are the rates for cars produced between 1985 to today.

In addition, the broker, at the beginning, gets a sliding scale reimbursement between 30 and 45 percent of the check value they receive for performing the following duties: advertising, operating the toll-free hotline, and title work, and assigning auctions to pick up the cars. The check value is NOT what the car is sold for.

I have provided an example of this in my written testimony. However, this is unfortunately the best case scenario.

Let me now tell you how flat rate prices and fees are a way for insiders to cheat the charities. Again, these are cases that I know first-hand. We received a vehicle donation from a charity of a 1999 Ford Contour. We received a fax to pick up the order, and the car was a \$75 unit.

This meant the car was already assigned to be sold at a used car lot, and regardless of the sale price, the most the broker would get is \$75, and the charity would only get a percentage of that, between \$30 to \$40. The car actually sold for \$3,500. Thus, the middlemen got over \$3,000 profit, and the charity, pennies. This is common industry practice across the board and it is known as flat rate sale fees.

Another example of an even more terrible practice is what is known as "fixing cars," where middlemen are purposely disabling vehicles that were pre-screened as running vehicles, and therefore worth more, so when the vehicle arrives on an auto auction or used car dealership, they can call the broker and inform them that the car was misrepresented. The broker, 99 percent of the time, does not contact the donor to reconfirm the vehicle's condition. Again, this is common practice.

For example, a 1996 Ford Crown Victoria was picked up in running condition and driven onto the truck. However, 2 days prior to auction the vehicle was disabled by a middleman turning a distributor cap to off-set the timing. In this case, the auto auction disabled the vehicle and then they sold it to themselves through their used car license.

The Crown Victoria went for \$275, and then the middlemen took a timing light to re-set the distributor, and drove the car away. The insiders later sold the car for \$3,700.

Mr. Chairman, I was personally approached by a couple who had donated their car because their son died from a fatal illness. They wanted to donate the vehicle to charity to try and make a difference. The car was sold at auction for \$4,200. Once all percentages were taken out, the charity received less than \$300.

There has to be something that can be done about this. So many people out there donate their cars to make a difference for research, treatment, and transplant. But the truth is, there would not be enough money from that car donation to buy my late mother's medication for 1 month, let alone help the progress of research and treatment.

I want to close, Senators, by asking you how you would feel if you donated your vehicle to a charity that was worth \$4,000, and after all expenses were paid out, less than \$400, 10 percent, went to research to save lives, and in some cases less than 5 percent.

I hope the answer is that you see the real need for reform in this area to make sure car donations are being used to help those in need, and not opportunistic middlemen.

The CHAIRMAN. Thank you, Mr. Car.

[The prepared statement of Mr. Car appears in the appendix.]

The CHAIRMAN. Now we go to "Mr. House."

**STATEMENT OF "MR. HOUSE," A CONFIDENTIAL WITNESS, TO DISCUSS EXPLOITATION OF CHARITABLE ASSETS FOR PRIVATE GAIN**

Mr. HOUSE. Mr. Chairman and Senators, thank you very much for inviting me to testify today. I am a licensed financial professional with over 23 years of experience, and I have been in a prime position to witness a nonprofit run amuck.

I will talk about how a seemingly good idea gets twisted and perverted in the hands of the wrong individuals. The story involves fraud, deception, waste, and abuse, all cloaked in the shroud of a nonprofit organization.

The organization I am speaking about is AmeriDream, Inc., a public charity and the largest home purchase, down-payment assistance nonprofit in America.

I should make it clear before I begin that my story is about AmeriDream as it was 18 or so months ago. Things have changed at this organization for the better. It is a much different and a much better organization than the one I will describe today.

My testimony will focus on two key individuals, the foundations of AmeriDream, who I will call Mr. Red and Mr. White, both who made millions from the charity they controlled.

First, though, let me begin by describing what AmeriDream does. AmeriDream provides down-payment gifts to low and moderate in-

come families who cannot save enough money to provide the down-payment themselves.

In the simplest of terms, the gift program works like this. A home seller has a buyer who has sufficient earnings to pay a monthly mortgage payment. For whatever reason, though, the buyer cannot scrape together enough money for a down-payment, and the home seller, through their real estate agent or potential mortgage lender, enrolls the property in the AmeriDream gift program.

In turn, AmeriDream provides a down-payment to the buyer of up to 3 percent and receives a 3.75 percent “fee” in return from the home seller.

HUD requires that the home seller not give the buyer the down-payment directly. In order for HUD to insure the buyer’s mortgage loan, HUD regulations require a 501(c)(3) organization to act as a go between for the buyer and the seller.

On the face of the transaction, everyone is a winner. The home seller sold his home, the buyer is now a new homeowner, the real estate agent receives a commission, and the mortgage lender loans their money and receives “points.”

Let me give you a typical example. Joe has a house he wants to sell that should sell for \$100,000. The selling agent knows about AmeriDream. The seller finds a buyer, Mary, who does not have the funds for a down-payment, but can make the monthly payments.

Then Joe’s house is enrolled in the AmeriDream program. It is enrolled as the transaction goes forward. The price is then massaged to \$103,750, or alternatively it is set for \$103,750 initially with an eye to the AmeriDream program and the fact that the \$100,000 will ultimately be the amount going to Joe as money back.

The reason for this is, as part of enrolling, Joe needs to pay AmeriDream 3.75 percent, or \$3,750. So at the end of the day, Mary buys the \$100,000 home for \$103,750, and of the \$3,750, it all goes to AmeriDream, which then retains \$750 itself and reimburses itself the \$3,000 it paid the bank earlier for Mary’s down-payment.

Now, let me talk to you about what the insiders, Mr. Red and Mr. White, did at AmeriDream to fleece the charity from revenues it got from this program, I estimate in the \$20 million range.

The founders and board members of AmeriDream, Mr. Red and Mr. White, first set up, along with Mr. Blue, a marketing company called Synergistic Marketing, LLC, now a corporation located in Ohio.

Mr. Red and Mr. White ensured that Synergistic Marketing received a contract from AmeriDream. Synergistic’s contract was to market to real estate agents, brokers, and homebuilders.

According to AmeriDream’s Form 99 in 2002, Synergistic was getting \$1 million a month, \$12 million for the year. Out of a million a month, approximately \$600,000 to \$700,000 would go to these three individuals, or \$6 or 7 million to those three for the year. The rest went to employees, salaries, and operating expenses at Synergistic.

At the same time, Mr. Red and Mr. White were getting a salary of \$175,000 approximately per year from AmeriDream. This inside deal where they got millions more in outside contracts was at best approved by a rubber stamp board that was dominated by Mr. Red and Mr. White. This is only one example.

At a time when Mr. Red and Mr. White had a desire for more cash, they created a fake investment company, Valao Mortgage, and transferred \$4 million from AmeriDream to Valao. Mr. Red borrowed a million dollars from Valao through Avalar Properties, LLC. Mr. White, through his business partner, also borrowed a million dollars.

I understand Mr. Red and Mr. White used part of this money to pay \$250,000 each to become percentage owners in the Playboy golf scramble. Mr. Red defaulted on his loan.

In my limited time to speak, this gives you a general flavor of the situation at AmeriDream that I saw from the front row, where insiders took advantage of a weak and absent board to enrich themselves with the assets of the charity.

Let me end by noting that while the good news is that Mr. Red and Mr. White are no longer at AmeriDream, unfortunately, to my knowledge, there have been no actions taken against Mr. Red or Mr. White at either the State or Federal level.

Thank you, Mr. Chairman.

[The prepared statement of Mr. House appears in the appendix.]

The CHAIRMAN. Thank you very much.

We will have five minute rounds of questioning.

Mr. House, I understand that AmeriDream had a jet. Could you please explain?

Mr. HOUSE. Yes. AmeriDream had a jet, and it was Mr. Red and Mr. White who enjoyed it. Mr. Red wanted to buy a jet. He found one to purchase. But he and Mr. White could not have financed it by themselves, and had the chairman of the board of AmeriDream sign off on a statement that made AmeriDream effectively a co-signer of the loan.

The jet was used almost exclusively by Mr. Red and Mr. White for personal pleasure, for example, using it to fly to Mexico for golfing. As a side note, the then-chairman of the board is a former fraternity brother of Mr. White and lives in Mr. White's basement.

The then-board chairman was allowed to invest \$1 million of AmeriDream assets for which he received a monthly management fee of \$3,000 for managing these assets. It is not disclosed in the Form 990. He then lost over \$700,000 of the million dollars.

The CHAIRMAN. Mr. Car, why are charities getting pennies on the dollar for the cars that are donated?

Mr. CAR. Why are they getting only pennies on the dollar for the vehicles donated, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. CAR. Because the charities are not paying attention to what options they are using to get the highest market value for the vehicle, and there are overlooking the flat sale fee of \$75 and \$125 that I mentioned earlier.

They are basically not minding the store. If they did, the charities would see the cars going for much more money than they are

now, and the charities would be getting more money to those that need it.

The CHAIRMAN. Ms. MacNab and Mr. Adkisson, I would ask your views on why these abuses are happening, why charities are willing to participate, and, finally, your thoughts and views on how widespread is the trend of abuses involving charities.

Ms. MACNAB. I see it happening right now because regulatory supervision is almost non-existent. Whereas, in the financial world, you have State and Federal agencies fighting a turf war over who gets to take care of the bad guys, when it comes to charities, it is kind of a reverse turf war. Everybody assumes that someone else will handle it. Even though there are several agencies that can take over the regulatory spanking, no one is stepping up to the plate.

Also, audits are non-existent. If you talk to a handful of charities, no one can remember the last time anybody lost their tax-exempt status. If you are going to have a voluntary compliance system, there has to be some expectation that you can get caught if you do something wrong.

The second thing that is going on, why charities are participating in these plans, is right now charities are having a couple of hard years. Fundraising is down, corporate donations are down. They have lost money on their own portfolios in the market, and they are looking for money anywhere they can get it.

There is also an expectation that they should be acting more like the corporate world. They see corporate executives getting paid more. Charity pay is increasing quite quickly. They see corporations engaged in complicated schemes and making a lot of money off of it. They mimic their corporate brothers and try to do the same thing, and there is nobody right now that tells them no.

The CHAIRMAN. Mr. Adkisson, did you have anything to add?

Mr. ADKISSON. What I would add to that is, very simply, in a charity there are no angry shareholders. In a corporation, you have people that, if things start to go south, you know you have shareholders that rise up and eventually they throw out the directors. You do not have that in a charity.

With regard to how widespread the problem is, I think with regard to the large corporate tax shelters that we are seeing, they are promoted by some of the large tax and accounting firms. I really do not think that the major charities are getting involved in those.

What I tend to see, are sort of intermediate level charities, charities that are having trouble raising money otherwise that are getting caught up in these things.

But as Commissioner Everson said, from their perspective, if they take in \$100,000 in donations but there was \$10,000 of taxes attributed to them, they have nothing to lose because they are not going to pay tax on the larger sum. There is no pain for a charity to be involved in a tax shelter, none, as we said here today.

The CHAIRMAN. As a follow-up, what then would you suggest we should do about it, particularly to deter charities from participating in tax shelters?

Mr. ADKISSON. My suggestion would be, and there are a wide range of things that you have to do. One of them is, of course, that

you start making the directors have some liability for participating in these schemes.

Charities fail my "beer and barbecue" test. You cannot have a charity over to your house for beer and barbecue. You can have the directors over, but you cannot have the charity over. Until you start holding the directors of the charities responsible, you are not going to make any progress.

The CHAIRMAN. Do you have anything to add to that, Ms. MacNab?

Ms. MACNAB. Can you repeat the question, please?

The CHAIRMAN. Well, it is kind of, what do you do to deter charities from participating in tax shelters, and also to follow up on the situation you just described in answer to my first question.

Ms. MACNAB. I think the most important thing they have to do right now, is actually find some of these tax shelters and handle them, perhaps punish the charities, perhaps close down a few charities. There need to be some examples made so that the rest of the charity world say, all right, that technique does not work, let us not do that type of game. Right now, there is no fear.

The CHAIRMAN. All right. Thank you.

Senator Baucus?

Senator BAUCUS. Yes. Thank you, Mr. Chairman.

How do you make directors more accountable? What requirements? How do we do that?

Mr. ADKISSON. Well, I think the first thing you start doing, is you start making them responsible similar to how directors are made responsible under Sarbanes-Oxley. You start making them file the 990's. You start making them to where they cannot turn a blind eye to things as they, to a large degree, can now. I think that the suggestions of the staff's white paper are probably right on point in what they need to do to bring accountability.

Senator BAUCUS. I asked an earlier witness their reaction to the white paper. Would you modify it in any way?

Mr. ADKISSON. I do not have any substantial problems with the white paper and the way that it is drafted. I do think that we have to be careful not to penalize the charities, except in worst case scenarios, because when you penalize a charity, you are really penalizing the charitable purpose for which it was formed.

Now, some charities are just shams. To the extent that a charity is just a sham, there is no need to treat it as a charity in the first place. If you pull the plug on that, that is great. If you go out and you hit a major charity that is conducting significant charitable activities and you fine it, all you are really doing is hurting the purpose of the charity.

Senator BAUCUS. Ms. MacNab, did you have any thoughts on directors?

Ms. MACNAB. No, I agree with that. For example, I gave six examples of donor-advised funds that were used for dreadful personal expenses. The vast majority of the donor-advised fund marketplace is doing the right thing. They are limited grants to 501(c)(3) charities. They are making sure that when money gets paid out, it is not for personal expenses.

I actually think that the items outlined in the white paper try to take into account that most of the charities out there are very

good at what they do, while it still tries to curb some of the worst practices.

Senator BAUCUS. Right.

Now, again, trying to get a handle on the problem, Mr. Josephson said that in his department, one rough estimate is maybe about 10 percent of the filings are red flagged. In your gut feeling, what percentage of charities are bad actors, bad apples here?

Ms. MACNAB. It is very hard to tell. I would have to say at least 10 percent of the Form 990's that I have reviewed have had many red flags on them.

Senator BAUCUS. Why are the Form 990's so sloppy? Does the IRS just not look at them?

Ms. MACNAB. It is my theory that no human actually reviews them. [Laughter]. No, seriously. I look at a Form 990 and I see two or three sections left blank. I see information put on page one that has nothing to do with information on page three.

I have problems getting Form 990's from certain charities. For example, a charity in Upstate New York is interesting because it uses a tax-exempt shell to market de-tax strategies. They are tax protestors. I cannot get Form 990's from that charity.

Senator BAUCUS. Now, maybe it is a logistical nightmare, but what if these are all made publicly available on the web or something? Would that help?

Ms. MACNAB. Well, it is true that it takes too long to get the data, but even once you get the data, it is almost useless.

Senator BAUCUS. Because they are just not filled out completely.

Ms. MACNAB. They are not filled out completely. There are discrepancies that anyone who reads them would find.

Senator BAUCUS. Now, one of the earlier witnesses mentioned another form that might be helpful here. I have forgotten what it was.

Ms. MACNAB. Well, there is the initial application.

Senator BAUCUS. Form 1023.

Ms. MACNAB. The initial application is what gets the charity its initial tax-exempt status. Most of the charities I run into that are problematic are not doing anything of the mission they originally claim to be.

I mean, they might say, well, we want to educate people in a certain thing, and now they are selling insurance products. It has nothing to do with what they put on the initial application.

Senator BAUCUS. What about financial statements filing? Would that help? Is that overkill or would that help?

Ms. MACNAB. It would help. But, again, someone has to review them and someone has to make sure they are accurate. I have a case in my testimony where I talk about a foundation, a public charity in Arizona, that took in \$53 million in donations of charitable gift annuities. One week before he closed up shop in bankruptcy, he sent out financial statements showing he had \$42 million in assets.

Senator BAUCUS. I agree with you. I mean, I think I agree with you that probably nobody reads them. I think that is probably correct. But how do we solve that? Does that mean a lot more IRS personnel? What does it mean?

Ms. MACNAB. Or a lot better targeted audits. I do not know that you need more people. I do not know the logistics of the IRS. I do know that, from what I can tell, how they choose to audit a particular person or a particular charity, is they comb through forms and they look for red flags.

Sometimes you have to look outward, go look at what promoters are promoting, and target those for audit. If you can see that a particular accounting firm is marketing a particular tax shelter, go look for those tax shelters. Talk to people in the field.

Senator BAUCUS. I am showing my ignorance here, but the 1023 is the initial filing?

Ms. MACNAB. Yes.

Senator BAUCUS. And the purpose of the 990 is what?

Ms. MACNAB. That is the annual filing.

Senator BAUCUS. Annual filing.

And I read somewhere that you file once to get your tax-exempt status.

Ms. MACNAB. To my knowledge, no one reviews it in the future to make sure you are still doing something charitable.

Senator BAUCUS. That is my question. That is my question. Over time, they may change.

Ms. MACNAB. That may be occurring. I do see it happening.

Senator BAUCUS. Again, you think part of the answer is audits?

Ms. MACNAB. I think part of the answer is smart audits. Jay and I work out in the field. There are numerous attorneys, CFPs, CPAs out there that are running into these things on a daily basis. Why not set up a dialogue where the IRS can actually ask us what we are seeing?

Senator BAUCUS. Right. So, you agree that there should be much more sharing between State governments and—

Ms. MACNAB. And sharing between the private sector. They do not need to share information with us, but we do need to share information with them.

Senator BAUCUS. All right.

Are there any privacy questions there?

Ms. MACNAB. I am perfectly willing to turn in, if I run into tax shelters—I am sure Mr. Adkisson is, too—and there are many, many lawyers out there that run into plans that they think are just awful and would be happy to turn them in if something were to happen to those plans.

Senator BAUCUS. All right.

Before I let you go here, has anybody said anything that is outrageous that you want to respond to, or is there something you want to say, something in the back of your mind, so we make the most out of this hearing, that has not yet come up or should come up, or should be emphasized?

Ms. MACNAB. I would like to reiterate that the charity world is still the good guys. We hear all these horror stories, we hear all these abuses. It is still a fairly limited number of groups that are doing these horrible things. For the most part, charities mean well. They invest well. They take their fiduciary duty very, very seriously. I want to protect those guys from the bad ones. I just wanted to make that clear.

Senator BAUCUS. Are the good guys getting a bad name? Do you find that confidence in charitable giving is starting to decline because it is known that there are a lot of bad apples?

Ms. MACNAB. I think confidence is having some problems. I think people are delaying donations that they would otherwise make. I told my doctor I was coming to this hearing. He said, what is it about? I said, charity abuses. The first thing he said is, oh, like United Way.

That is not what should be popping in people's minds when they think about charity, and I would like to clean up some of the bad characters, so that the first thing they think of is, oh, what a great sector that is.

Mr. ADKISSON. I think you can see an erosion in confidence based on the number of private foundations that are being formed. I have a lot of clients that come and say, I really do not want to give to a charity because I do not know how my money is going to be spent, so what are my alternatives?

The alternative for them is to start a private foundation. An increase in the formation of private foundations reflects, to some degree, a loss of confidence in public charities.

Senator BAUCUS. I am told I am supposed to ask a question of Mr. House. I guess you know as well as we, you are referring to Mr. Red or Mr. White, they apparently sought to shelter some income through the Virgin Islands. I wonder if you could comment on that.

And Ms. MacNab, if you can speak to how big a problem this is, in general, sheltering, either generally, or sheltering in tax havens.

Mr. House?

Mr. HOUSE. Yes. Mr. Red sought to shelter the approximately \$3 million he was making a year from the marketing company, and how he did that, was he established a residency in the U.S. Virgin Islands, which has a separate tax system than mainland United States.

He became a shareholder of a company located in the U.S. Virgin Islands that, through various management contracts, siphoned off the \$3 million to the U.S. Virgin Islands company.

The U.S. Virgin Islands company had obtained an economic development credit certificate from the U.S. Virgin Islands government that granted him an income tax credit of over 95 percent of taxable income which the individual shareholders received from the dividends paid to them by the U.S. Virgin Islands company. So, on a \$3 million income, the net tax was potentially \$150,000.

Senator BAUCUS. What was the key that allowed this to happen, or is allowing this to happen? Is it a certain part of the Code? Is it offshore havens? Is it lack of audits? What is it that is allowing this to happen?

Ms. MACNAB. You have some creative promoters out there that put together the program and sold it for large fees. It is remarkably commonplace. The Virgin Islands plans, I keep bumping into it everywhere I go.

The same mind-set that is perfect happy to use a charity to do a tax shelter is the same mind-set that was perfectly happy to set up their residence in the Virgin Islands in order to get the tax

credit, although I find most of these people never actually move to the Virgin Islands.

Senator BAUCUS. So what is the solution?

Ms. MACNAB. More audits, I am afraid. And, again, looking outward. If I can go online and I can target realistically and figure out who those people are that are doing the U.S. Virgin Islands deal just on public data that I find on the Internet, the IRS can do that, too.

Senator BAUCUS. A question for Mr. Car, is how much should charities generally be receiving from car donations? What should they receive, as opposed to, in some of these scams, they are actually receiving?

Mr. CAR. They should be getting at least 60 percent of the sale price. My first-hand experience is that 40 percent goes to the middlemen, which will certainly allow them modest profit, and 25 percent goes to the auction house.

I also believe there should not be a buyer's fee at an auction house to purchase a donated vehicle. They should be eligible for the public and not just automotive dealers.

Senator BAUCUS. I assume a lot of this would subsidize if the donor actually knew that the charity was getting such a low percentage. Is there a way for the donor to know the bottom amount that is actually going to the charity? What if there were some reporting procedure of some kind. Would that help? Anybody? Mr. Car?

Mr. CAR. I feel, if a donor is going to donate their car, wherever the car is going to be sold, they should go by the market report for what auction is selling that car. The screening process allows you to get a good idea of what the vehicle is going to sell for.

Then once the vehicle is sold, the donor is notified of the write-off at that time. That way, we do not see \$300 cars being sold at auction and \$1,500 tax deductions.

Senator BAUCUS. Thank you.

The CHAIRMAN. We thank this panel for their participation.

I am going to call the next panel. I think maybe Senator Baucus had introduced all of you, but I want to go back and say that we have Diana Aviv, president and CEO of Independent Sector here in Washington, DC; Mr. Derek Bok, president emeritus, Harvard University; Mr. Willard Boyd, professor of law, president emeritus, University of Iowa, and also a director there of the Iowa Nonprofit Resource Center, and chairman of the Iowa Governor's Task Force on the Role of Nonprofit Organizations in Iowa. He lives in Iowa City.

Then we have Rick Cohen, executive director of the National Committee for Responsible Philanthropy; Mr. Herman Art Taylor, president and CEO of BBB Wise Giving Alliance, Arlington, Virginia, and then as my colleague has said, Rock Ringling, from Helena, Montana.

We will take you in the order that you were introduced.

Diana?

**STATEMENT OF DIANA AVIV, PRESIDENT AND CEO,  
INDEPENDENT SECTOR, WASHINGTON, DC**

Ms. AVIV. Chairman Grassley, Senator Baucus, and distinguished members of the committee, thank you for inviting me here today to talk about how we might work together to strengthen our Nation's public charities and private foundations.

I serve as the CEO of Independent Sector, which is a national coalition of nonprofit organizations, foundations, and corporate philanthropy programs that collectively represent tens of thousands of charitable organizations.

Senator Grassley, thank you for your dedication to upholding the highest possible standards of good governance for our nonprofit sector, while also recognizing the important contributions of the nonprofit community. Thank you, Senator Baucus, for the same commitments. We appreciate it.

Through the actions of tens of millions of donors, volunteers and professionals, the Nation's charitable sector has improved the quality of life for generations of people. Our national voluntary network, now number 1.4 million organizations, is facilitated by invaluable tax policy intended to stimulate the impulse to give.

It is also built on a solid foundation of laws and regulations designed to ensure that charitable organizations are working exclusively for the public good. That said, the greatest measure of the value of nonprofits is the public trust in our work, our methods, and our high purpose.

Today, that trust is being jeopardized by the actions of a very small number of individuals who have used charities and foundations for personal gain or who have engaged in practices that compromise their missions. We have heard a little bit about that already today.

There are many factors that have led to the kinds of problems that have been highlighted today, including the following. In the last 25 years, the charitable sector has grown considerably and some of its leaders are not familiar with good governance practices.

The legal framework has not kept pace with growth and the diversity of organizations, and public resources are not sufficient to ensure that laws governing the sector are properly enforced. The forms 990 and 990 PF filed annually by charities and foundations too often are inaccurate and inconsistent.

The current challenges do not lend themselves to quick fixes. Changes must be given careful consideration and tested before sector-wide reform is implemented. As we consider ways to address the problems within the charitable sector, it may be useful to be guided by the following principles.

One: preserving the vitality and independence of the sector and its effective ethical operation must be at the core of policy changes.

Two: preventing, discouraging, and eliminating unethical and illegal practice will require a multi-faceted approach. No singular action will succeed in fully addressing the issues at hand.

Three: it is essential that corrective efforts do not produce outcomes that stifle the great American traditions of giving and volunteering. Reforms should not be so draconian that people of honorable intent are discouraged from serving on boards, working in nonprofit organizations, or giving to good causes. Equally impor-

tant, the legal framework must not be so laissez faire that people are able to manipulate the system for personal gain.

Four: accommodations should be made for smaller organizations for whom the burden of compliance would hurt their work.

Five: the range of solutions will depend on the involvement both of government and of the voluntary sector, each with different and discreet responsibilities.

Distinguished members, my written testimony provides a number of specific recommendations. I will highlight a few for your consideration.

First: revise the tax reporting forms 990 and 990 PF to enhance the quality, consistency and transparency of information, and ensure full adoption of electronic filing of these forms.

Second: eliminate barriers to shared enforcement by Federal and State regulators and increase oversight funding for such enforcement.

Third: increase penalties for wrongdoing and work with the charitable community to explore the best way to clarify rules on a range of issues, including appropriate compensation, donor-advised funds, and the evaluation of gifts of property.

Fourth: support voluntary sector efforts to expand and coordinate existing successful initiatives to set clear standards and self-regulation programs.

Fifth: encourage work by the sector to promote ethical, accountable, and transparent practice and create a coordinated system for education and technical assistance. This will require additional resources, both from government and from the sector.

We in the charitable community are keenly aware of our responsibilities to take on these challenges. We appreciate your willingness to work with us to separate the good actors from the bad, and in so doing preserve all that is valuable in America's nonprofit sector.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Aviv appears in the appendix.]  
Now, Mr. Bok?

**STATEMENT OF DEREK BOK, PRESIDENT EMERITUS,  
HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS**

Mr. BOK. Yes, Chairman Grassley, Mr. Chairman. Thank you for inviting me here.

I am currently the faculty chair of the Hauser Center on Nonprofits and Philanthropy at Harvard and I guess I am here in that capacity.

Like the last speaker, with whose remarks I feel a great deal of sympathy, I applaud your desire to look carefully at the governance and accountability of nonprofits.

They have become a major sector. There is not enough accountability or oversight at the present time. I think we all understand that. There are recent abuses, very well catalogued, this morning.

I see in the white paper a number of good steps that begin to address this problem—the basic standards for 990's, electronic filing, provisions to ensure more prompt filing, independent audits, prohibiting conflicts of interest and insider dealing.

But trying to regulate this sector runs into two very difficult problems. I speak, now, as an old professor of regulation.

One, is that you are dealing with an extraordinarily heterogeneous sector. For example, when I was a CEO of a nonprofit, I guess, with a budget between \$1–2 billion, my daughter was the head of a small community development corporation, trying to get six buildings renovated in Salem, Massachusetts, with a board composed of people drawn from that poor neighborhood.

Trying to get a set of rules that will provide the proper accountability and oversight for the first organization without imposing enormous burdens of red tape on the second organization, of which there are countless wonderful small organizations like it throughout the United States, is a first-class problem.

It is also difficult to know how to regulate such a heterogeneous sector because we have not yet had nearly the research and debate about this sector that we have had with the corporate or the government sector.

I wanted to give a few illustration from the white paper of things that seem to me to run into these dangers and illustrate the general points I just made.

First of all, there is a proposal that there be no more than 15 members on a nonprofit board. I just got through serving as a member of an independent review committee for Nature Conservancy that tried to restructure their board so it could be more effective.

We found we needed seven different committees on that board to attend to seven very different, but important, aspects of the operation of that organization. We also found that if you are going to have those seven subcommittees of the board operate effectively, you do not want to give people multiple assignments, because if you have board members on two or three committees, they are likely not to do an adequate job for one or two.

So if you are going to get seven subcommittees and you are going to avoid multiple assignments that will dilute the sense of responsibility, you are going to have to have more than 15 members.

So, in a sense, you would be defeating the purposes of proper board surveillance if you imposed that kind of a limitation.

I could add, from my experience with universities, that I do not know of any university board that does not have more than 15 people. There are more than 15 members, because these are very large and complicated institutions. If you are going to have adequate oversight, you need a substantial-sized board to look at all these organizational activities. So, that would be one example of a questionable regulatory proposal.

Another, is the requirement that each nonprofit establish goals, and list publicly its goals, and its performance measures and how it has performed in light of those measures.

The first problem here is that some organizations have hundreds and hundreds of different programs. When I think of the university that I once presided over, I cannot even guess how many hundreds of separate programs we have.

To have meaningful goals, you would have to have separate goals for each of them. It would be a prodigious job to try to establish the performance goals for all of these programs.

The second problem is that the nature of what many nonprofits do does not lend itself to performance measures. I mean, I do not know how you would develop a performance measure for, say, Harvard College, to try to measure how Harvard College has performed, or how the divinity school has performed, or how the classics department has performed.

And universities are not unique. I think the nature of many non-profit organizations, like symphonies, opera societies, and battered women's shelters, is that they are dealing with intangibles, not market shares, profit and loss, and so forth where you can establish quantitative goals, but areas of activity in which it is extremely difficult to measure performance. So, I fear that, although one can see why such a requirement would be proposed for this sector, it is not likely to work very well.

Another example of a troublesome rule is the provision saying there can be no compensation for members of the board of a foundation, with accompanying limits on the travel expenses and the kinds of hotels they can stay in, and so forth. One can also see how abuses could appear in that area.

But if you go too far and forbid any compensation at all and you limit the expenses to deny business class travel and so forth, you wonder whether you are not going to discourage people from serving who are, after all, donating their time and spending lots of days a year for nothing. You could easily make that service sufficiently difficult that you will have a hard time attracting the kinds of people that you want to give the kind of oversight which we are all concerned about supplying.

I will not go on, but simply say that I think that if we look carefully at this white paper, there is a lot of good in it. But I think it goes beyond simply trying to identify abuses and tries the much more ambitious task of trying to mandate a set of optimum standards of performance.

I think that is very, very difficult to do at this stage for any set of organizations, but particularly for a sector this large, this uncharted, this heterogeneous.

So, I would favor a more limited approach in which one tried to identify abuses and tried to eliminate them and also enacted rules to provide the essential kinds of information and disclosure, but not try, at this stage, the more ambitious step of attempting to specify what is the optimum sized board, what is the optimum compensation that its members should receive, and some of the other, more detailed provisions that I see in the white paper.

Thank you very much.

The CHAIRMAN. Yes. And we thank you, because your observations and your experience is something that we obviously want. That is why I made very clear that we had a staff draft out there for comment.

Mr. BOK. Right. I appreciate it.

The CHAIRMAN. So, we will take that into consideration.

[The prepared statement of Mr. Bok appears in the appendix.]

The CHAIRMAN. Mr. Boyd?

**STATEMENT OF WILLARD L. BOYD, PROFESSOR OF LAW AND  
PRESIDENT EMERITUS, UNIVERSITY OF IOWA, DIRECTOR,  
IOWA NONPROFIT RESOURCE CENTER, AND CHAIR, THE  
IOWA GOVERNOR'S TASK FORCE ON THE ROLE OF NON-  
PROFIT ORGANIZATIONS IN IOWA, IOWA CITY, IOWA**

Mr. BOYD. Mr. Chairman and Senator Baucus, we are grateful to you for holding this hearing emphasizing the importance of the nonprofit community to the Nation. Even though we live our lives in an increasingly globalized society, we actually live our lives locally.

In the American tradition, our voluntary nonprofit organizations are the building blocks of community. Through our local nonprofits, we provide community service, develop community values, and take community action together as citizens.

Now, I want to speak particularly about the small nonprofits such as we have in Iowa. In Iowa, our 3,600 charitable 501(c)(3) nonprofits that filed 990 forms in 2003 are small and rely heavily on volunteers in all aspects of their operations.

Approximately 72 percent of all Iowa charitable organizations filing tax returns have revenues under \$500,000. Forty-four percent have revenue less than \$100,000. So, we believe that Iowa nonprofits do a lot with very little. We are committed to doing good, well and responsibly.

While we share the desire for accountability and transparency, we are nevertheless concerned about over-regulation of very small, very effective, and very dedicated volunteer organizations.

The majority of our Iowa nonprofits have less than six full-time paid employees. Staff compensation is very low compared to what the private for-profit sector and the government sector are able to provide, and seldom are we able to provide health and other fringe benefits.

Now, little or no funds are available for training, but this does not deter the staff from improving their effectiveness and efficiency. Their commitment to serving the public sets an example for all Iowans.

Now, President Bok spoke about his association with an educational program at Harvard, and I want to speak on behalf of the associations of nonprofits, which many States have, and the nonprofit programs in many of our colleges and universities.

For example, in Iowa, our three regions universities and the community colleges provide inexpensive and accessible training opportunities. In particular, the University of Iowa and the University of Northern Iowa work with Iowa State University in providing nonprofit training activities in various parts of the State at low cost.

The University of Iowa's Nonprofit Resource Center also works with the University of Northern Iowa in support of its important National Center for Public and Private Schools Foundations, with which you, Senator Grassley, are particularly well versed.

We are concerned in the white paper about the elimination of Section 3, "Supporting Foundations," and what that might mean in that regard.

The Iowa Nonprofit Resource Center at the University of Iowa concentrates on the generation and dissemination of substantive in-

formation on legal, tax, and managerial issues confronting nonprofit organizations such as how to fill out 1023, and a 990 IRS forms.

Our web site is a major vehicle for reaching every Iowan nonprofit. It contains a number of important resource sections. First, we list over 50 informative, practical books on different aspects of nonprofit organizations which can be reached using the State library system to find the book closest to you geographically.

Second, all of our higher educational institutions, including the community colleges, can list directly on our web site courses that they are offering in their communities that would be useful for nonprofit personnel and boards. Third, we list useful local, State, and national web links such as Independent Sector.

Fourth, we list consultants who can help with respect to information technology, finance, and the like. Finally, we have a "frequently asked questions" section. We also have started a monograph series. The first one is "Legal Guide for Iowa Nonprofits," which includes tax information, and "The Governing Board for Iowa Nonprofits." This monograph contains practical appendices, including a job description for the board, what are the board members to do specifically, and a job description for the chairman of the board.

Now, the chair of the board is a critical figure in the effectiveness of the nonprofit organization. Very little attention is paid to identifying and training board chairs. So, we are emphasizing the importance of board chair development and succession.

We also include a board self-evaluation form, a requirement of Sarbanes-Oxley, committee charters, an outline of an informational board manual, a listing of important policies that the governing board should have in place, as well as conflict of interest bylaws, and disclosure forms. We are developing other monographs such as "Human Relations," "Community Foundations," et cetera.

Our Governor's Task Force is focused on improving nonprofits. We are in the process of developing a compendium of good practices modeled on the Minnesota standards for nonprofit excellence which are similar to those in Maryland and Utah.

In doing so, we are involving the offices of Iowa's Secretary of State and Attorney General. We are eager for them to publish these practices on their web sites in order to notify all nonprofit organizations of good practices and the importance of adhering to them.

We also want to develop a legal compliance audit for nonprofits over and above the financial audit. We believe that this would help assure compliance with those operational, tax, and accountability laws and regulations which govern.

We are also developing a board bank training system where, with the local chambers of commerce, we are identifying outstanding people to serve on boards, and working with the organizations, to train boards.

We have a new State nonprofit corporation statute in Iowa which clearly defines the fiduciary duties. We also want to stress mission statements and accountability, but we want to develop our own kind of very small, very simple annual report that can be distributed, by each nonprofit organization.

What I basically want to say, is our nonprofit organizations are fragilely financed. We cannot afford a very elaborate system of certification or accreditation. We are basically concerned about buying health insurance, reasonably.

We are basically concerned about indemnification of board members who give of their time voluntarily. They could have a successful defense against a harassing suit, but they would not be able to get reimbursed from the nonprofit because it did not have enough money. So, we are trying to find directors' and officers' insurance for them that is reasonable.

In Iowa, our community foundations are growing. Those must be meeting national standards in order to be qualified. We are appreciative of what you are doing with respect to non-itemizer tax deductibility. I want to simply say, is that we believe very strongly in education.

I am very happy to have been here today because I met somebody from the Internal Revenue Service who might help us to get training sessions in Iowa. They speak about being able to hold sessions for 150 in six or seven different cities. The nearest to us would be Chicago. I want seven sessions in Iowa on how to fill out the 990's and how to fill out the 1023s, and what we should do better.

My time is up, but I do want to say that we are eager to work with you. Thank you.

The CHAIRMAN. Thank you, Mr. Boyd.

[The prepared statement of Mr. Boyd appears in the appendix.]

The CHAIRMAN. Now, Rick Cohen?

**STATEMENT OF RICK COHEN, EXECUTIVE DIRECTOR, NATIONAL COMMITTEE FOR RESPONSIVE PHILANTHROPY, WASHINGTON, DC**

Mr. COHEN. Thank you. Thank you for permitting me to offer the perspectives of the National Committee for Responsive Philanthropy on this important issue of nonprofit and philanthropic accountability.

For nearly three decades, NCRP has been the Nation's nonprofit philanthropic watchdog, representing mostly the grassroots nonprofits, monitoring the charitable grant making of foundations and corporations and their responsiveness and accountability to people in need.

Like you, the board and staff of NCRP have seen the past year's news coverage of disappointing, sometimes appalling, excesses involving mismanagement and misappropriation of foundation resources.

These cases traverse foundations by type, size, and geography. There is no one problem area any worse than any other. The response of many has been to bemoan the presence of a few bad apples, to bemoan the lack of government oversight, but to do just about nothing to clean the bad apples out of the barrel.

As a philanthropic watchdog organization, we have released an 18-point agenda with specific suggestions for reform of public and private philanthropy which is responsible for \$500 million of philanthropic assets.

Our agenda is premised on three fundamentals. One, the laws and regulations for addressing accountability of foundations and correcting the excesses reported in the press need to be strengthened.

Two, notwithstanding the improved statutory and regulatory standards, the philanthropic sector itself has to get serious about dealing with the malefactors that sully the good work of so much of organized philanthropy.

And three, there should be an increase in the resources devoted to governmental oversight of philanthropy at the Federal and state levels, and we issued a program for this a few months ago.

NCRP's agenda for increasing philanthropic accountability is consistent with much of the intent and content of the committee's white paper. I will highlight six salient points of our agenda which we submitted as written material to the committee.

First, we call for reducing the private foundation excise tax to 1 percent of investment income, and devoting the bulk of that payment to government oversight of nonprofits and foundations, consistent with the purpose of the original enactment of that tax in 1969.

In January of 2004, we estimated that the reduction of the excise tax would free up \$140 million for foundation grant making to which it should be dedicated, and then we outlined a specific agenda for the use of the entire remaining \$350 million that included doubling the budget of the tax-exempt government entities division of the Internal Revenue Service to enable it to carry out its oversight functions far more efficiently and effectively than it currently does now.

Also, creating a fund of \$140 million for the Commissioner of IRS to use to supplement the charity investigative and oversight arms of the State Attorney General offices, and using the remainder for research and data collection by IRS and other nonprofit organizations.

Second, like some of the other speakers, we call for a radical overhaul of the IRS Forms 990 and 990 PF to generate the pertinent information about foundations and public charities for review and oversight, including information that would reveal potential insider relationships between foundations and vendors or inappropriate and excessive expenditures. Right now, the reporting forms simply do not do the trick.

In addition, the routine and automatic delays in submitting 990's cannot be given a green light. We believe that 990's and 990 PFs should be e-filed whenever possible, and that data should be publicly searchable on the Internet.

Third, we call for expansion of charitable grant making disclosure beyond private foundations. Even with enforcement potential and improved 990's, unless there is enhanced disclosure of grant making, the public will be ill served in its oversight of philanthropy.

Corporate charitable grant making should be disclosed across the board, not just corporate grant making that occurs in private foundations. The grant making of public charities should be better disclosed and meeting the standards that currently only pretty much community foundations address in the public charity field.

And all grant makers should meet the currently unenforced IRS standard of reporting not only the grantee and the amount of the grant, but the specific purpose of the grant and disclosure of any potential conflicts of interest.

Fourth, while NCRP does not advocate any specific limits or caps on the salaries of foundation CEOs, we do believe that foundation trustees have not given enough attention to the total compensation of top foundation staff, including severance packages, delayed compensation, all benefits, stock options, and even the non-foundation compensation of foundation executives that they get from serving on corporate boards, and other plums.

What we also believe, is that foundation administrative expenses should be removed from their qualified distributions currently set at 5 percent of net assets of private foundations. Right now, some significant portion of foundation payout is not granted to non-profits, but the foundation's administrative expenses.

We believe it is actually entirely appropriate to raise the payout to 6 percent and make it all grants. The committee's white paper suggestion of a higher private foundation payout in return for lower foundation excise tax or other fees is also attractive, although we think it might be worthwhile examining a calibration of different levels of higher payout in return for different alternative tax and fee scenarios.

Fifth, we are concerned about the fees paid to foundation trustees. We believe that, in general, there is no reason to pay trustees for their services other than compensating them for their travel and accommodations, which should be reasonable.

However, if there is a need to pay trustees for what is supposed to be a voluntary role, we believe that the annual payment to trustees of no more than \$8,000 a year is more than sufficient, and we hope that nearly all foundation trustees would refuse it.

More to the point, we believe there should be absolutely no self-dealing, where foundation trustees or firms associated with foundation trustees or other foundation leaders get hired to deliver investment, accounting, legal, or other services to the foundations. There needs to be a stop to the kinds of self-dealing that escape through legal loopholes and do not get tackled by the IRS or the States' attorney generals.

Last, we are concerned about donor-advised funds. The rather lax requirements we are talking about for strengthening public and private foundations do not exist virtually at all for donor-advised funds.

The recent phenomena of donor-advised funds tops billions of dollars managed by a range of institutions. Unfortunately, there is no payout requirement on donor-advised funds, and there should be. It should be at least comparable to private foundations.

And the grant making of donor-advised funds, currently basically unreported, should be completely reported, meeting the public disclosure requirements placed on private and public charities.

There is no requirement for the kind of detailed grant reporting and conflict of interest identification that private foundations are supposed to comply with. These standards, too, should be extended to donor-advised funds as well.

I see I have extended past my time. I will cease now and take questions later.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Cohen appears in the appendix.]

The CHAIRMAN. Mr. Taylor?

**STATEMENT OF HERMAN ART TAYLOR, PRESIDENT AND CEO,  
BBB WISE GIVING ALLIANCE, ARLINGTON, VIRGINIA**

Mr. TAYLOR. Thank you, Senator Grassley, for asking me to participate in these hearings.

What I would like to do, is talk today about the parallel role of government and private monitoring efforts that attempt to get to the accountability of nonprofit organizations.

I agree with what has been said earlier, that no one solution can get at the problem, but that there must be balanced energies expended by both government and the private sector for us to tackle this difficult challenge.

As has been heard earlier, government seeks to identify and prosecute fraud, abuse, abusive tax-exempt status, and other financial improprieties, while private monitoring efforts like ours seek to help donors make informed judgments.

This is important because a major survey we commissioned in 2001 showed that 70 percent of Americans say it is difficult to know which charity is legitimate and which one is not.

We believe that standards can play an important role in the voluntary self-regulation of the sector. We have come up with standards which are the result of a three-year, open process where we have received input from charity leaders, foundation executives, accountants, philanthropic experts, and other regulators, as well as the donating public.

The standards are comprehensive and not simply a review of charity finances. These 20 standards cover areas such as charity governance, charity effectiveness in meeting their mission, finances, most importantly, and also ensuring that appeals are accurate and complete.

In spite of the diversity of our sector, we believe that standards can be strong and still not reach to the lowest common denominator.

Some of the typical problems we see in doing reviews of charities in relation to our standards are that 53 percent of the charities we review that do not meet our standards have financial improprieties, including things such as reports that do not cover the financial statements properly. Coincidentally, finances are also the donor's major primary concern.

We also found that 29 percent of organizations that do not meet our standards have problems with their fundraising programs, and we like to see that you know about that.

We believe, as I said, that more needs to be done on the government side, as well as on the private side. On the private side, we will be announcing very soon an online system that will allow any charity to register its information with us and be reviewed in part of our charity review program.

We think this will go a long way in allowing charities that want to demonstrate their accountability to be able to do so. We also

have introduced recently a national charity seal that will allow organizations that want to promote the fact of their accountability, to do so.

We will also be working with the local Better Business Bureaus so that this technology will be available to them so that they can do reviews of local charities.

We believe that government can be helpful in this effort to increase the accountability of our charities, and you have already heard from several speakers who want to see the 990's improve. We echo that. We also think that there should be electronic filing of 990's.

There should obviously be additional support for Federal and State agencies that are doing accountability work, such as the IRS and State charity regulators.

We also think, though, that government can encourage voluntary efforts that are aimed at strengthening the nonprofit infrastructure, and these would be supportive of organizations that are involved in improving the management of nonprofit organizations, that are involved in offering governance technical assistance so that organizations can be governed properly, and other areas that will strengthen organizations so that they know how to do the right thing.

Finally, we believe that government can also help us by encouraging organizations to use voluntary accountability programs such as ours.

We just want you to know that, whatever steps government decides to take, we will continue to stand in for the donor and provide them with the information that they need in order to make good decisions.

Thank you.

[The prepared statement of Mr. Taylor appears in the appendix.]

The CHAIRMAN. Mr. Ringling?

**STATEMENT OF ROCK RINGLING, MANAGING DIRECTOR,  
MONTANA LAND RELIANCE, HELENA, MONTANA**

Mr. RINGLING. Mr. Chairman and members of the Senate Finance Committee, I appreciate the opportunity to share with you my perspective as a managing director of the Montana Land Reliance on the future direction of the conservation easement program.

In my limited time this morning, I would like to accomplish three things. First, I would like to give you a brief introduction to the Montana Land Reliance, our mission, and our values.

Second, I would like to share with you some of my views regarding the potential for reform that would both protect taxpayers and put this program within reach of the average farm and ranch households in America.

Third, I would like to answer any questions you may have in this regard.

The Montana Land Reliance was founded by a group of forward-thinking Montana farmers and ranchers in 1978. Today, some 26 years later, the mission of our organization remains the same as when it began, to provide protection for private lands that are ecologically significant for agricultural production, fish and wildlife habitat, and open space.

In those 26 years, Montana private land owners have protected the unique Montana heritage of 537,000 acres. To put that in perspective, even though we restrict ourselves to working only with Montana land owners, the Montana Land Reliance holds an estimated 15 percent of the easement acreage granted to local and regional land trusts in the United States.

We accomplished this work through a strict adherence to a number of important principles. First, we have a strong, independent board of directors, two of whom have testified before this committee.

The board has hands-on oversight over organizational policy and takes an active role in reviewing easement agreements.

Second, we have an operating policy of strict adherence to accounting and legal standards. In addition to adopting the national standards and practices developed by the Land Trust Alliance, we have in place a set of policies that constitute what we believe to be a conservative, but appropriate, approach to the utilization of the conservation easement program.

The CHAIRMAN. Mr. Ringling, would you stop there just for a minute? Senator Baucus is on his way back up. I have only got a couple of minutes to get over to the floor to cast my vote. I have not missed one in 11 years, and I do not want to miss one now.

Mr. RINGLING. Do not start now.

[Whereupon, at 12:54 p.m., the hearing was recessed to reconvene at 1:00 p.m.]

Senator BAUCUS. The hearing will come back to order.

I guess we are in the middle of testimony by Rock Ringling.

Rock, I do not know where you were, but why do you not take up where you were? Handle it any way you want.

Mr. RINGLING. All right.

Senator BAUCUS. First of all, I want to introduce Rock Ringling. He is a Montanan. He is a great guy. I have known Rock for years. He just does a lot for Montana in lots of different ways. The Montana Land Reliance is certainly one, but he is just a real solid citizen of our State, and we are very proud of him.

I am proud to have you here, Rock.

Mr. RINGLING. Thank you, Senator.

Third, we create a personal relationship with each easement donor. This allows us to understand their motivation for wanting to join with us in creating an easement agreement and to determine how best to craft an agreement that meets their objective as property owners.

That is in keeping with the public benefit requirements of the conservation easement law and is consistent with our mission at the Montana Land Reliance.

Mr. Chairman, these operational values are at the core of everything we do at the Montana Land Reliance, and I believe similar values are at the core of the work done by the vast majority of our fellow members of the land trust community in your States and throughout America.

Before I close, I would like to take just a moment to discuss the potential reforms to the conservation easement system. As you know, we have engaged very directly in this discussion with committee staff and we hope our observations have been helpful.

We believe there are a number of reforms you can enact that would help to protect the integrity of the conservation easement program. Let me touch on a few.

First: encouraging land trust to meet accreditation standards would be a step forward and can be done without creating additional bureaucracy. In Montana, we have taken the initiative of putting together a Montana Association of Land Trusts that will provide independent oversight and accreditation for Montana's land trust community.

Second: requiring that appraisals meet uniform, national requirements could be a useful tool, as long as the proper standard is determined. More specifically, mandating the use of uniform standards of professional appraisal practice would, we believe, be inappropriate reform.

Third: making it easier for the IRS to review easement donation is consistent with current Montana Land Reliance policy. As a matter of practice, we recommend land owners attach the easement agreement, the appraisal, and a letter from the land trust detailing the public benefit of the easement. Codifying this practice would, in our view, make good sense.

Fourth: increasing existing fines and penalties will be of no concern to most land trusts like ours who already insist on the highest legal and accounting standards.

Last: I want to touch on what we believe is the most important reform, which is to level the playing field in the conservation easement arena. For the past three years, the Montana Land Reliance has been proud to work with Chairman Grassley, Senator Baucus, and over 200 endorsing land trusts in proposing legislation to allow working farmers and ranchers equal access to the conservation easement program.

This legislation, S. 701, passed by this committee last year as part of the CARE Act, would help remove inherent inequities in the current system that favor land owners with high personal incomes over the bulk of working farmers and ranchers in America for whom the current system does not work.

Mr. Chairman, we are proud to be a part of the land trust community and honored to have been asked to visit with you today. We believe that by leveling the playing field through passage of S. 701 and by consideration of additional technical reforms, the current successful conservation easement program in America can be improved to work better for all of us.

We at the Montana Land Reliance and the land trust community stand ready to work closely with you and this committee on this important work.

Thank you.

Senator BAUCUS. Thank you very much, Mr. Ringling.

[The prepared statement of Mr. Ringling appears in the appendix.]

Senator BAUCUS. Mr. Bok, how would you more precisely get at the problems you were addressing, namely, more oversight, et cetera, but recognizing the vast heterogeneity of charities and not basically throwing the baby out with the bath water?

That is, how do you solve that? You have got smaller charities, you have big charities. Some charities should have larger boards.

Should we even get into the area of trying to decide the size of boards, for example? You appropriately raised questions, and I am just curious how you try to address them.

Mr. BOK. Well, I think it depends on the particular rule involved. For example, there are one or two of the proposed rules that have to do with the 5-year certification, for example, with the IRS. These rules propose fairly detailed reporting requirements.

It would be very simple for a large organization to comply, but it would really be quite beyond the totally amateur, small neighborhood group. I think that problem can be taken care of pretty easily by developing some kind of a threshold.

I mean, one can estimate pretty easily what the budget of an organization has to be in order to hire some kind of professional management.

But if you impose complicated rules and reporting requirements on smaller organizations that do not have professional management, organizations that are just working with part-time volunteers from the neighborhood, they will be totally baffled. But that could be taken care of by just having a reasonable threshold amount.

Maybe you might have some very simple reporting requirements for your small, neighborhood organization, but you should not get into the more complicated filings where you have to explain the nature of your procedures and whether you are complying with accreditation practices, and so forth until you are up at the size where you can be pretty sure people will have full-time, trained managers who can deal with those kinds of requests.

Senator BAUCUS. Yes. Right. But you heard what Montana is doing, as you heard from Rock Ringling. Are those kinds of requirements, at least with respect to easements and donations, you think appropriate, generally? Maybe you could explain again, Rock, what we are doing in Montana.

It does not really get to the size of the board and it does not get to the stated goals, I do not think, that were listed in the white paper. But I am just curious of your reaction to what Montana is doing. You might, again, Rock, explain what it is.

Mr. RINGLING. Mr. Chairman and Senator Baucus, what we have done in Montana is we have formed a Montana Association of Land Trusts. Within that, we have put together standards and practices that were just basically operating principles for those land trusts to follow, and also basically pure audits, where other people in the land trust community can basically do an audit to make sure that those principles are being followed.

Basically what we have realized, is that we are an industry and we need to act and basically be accountable, not only to the people who make donations to the nonprofit, but also those private landowners who make donations of easements.

Senator BAUCUS. Mr. Bok, how does that sound?

Mr. BOK. I think the only answer I can give, is I am a great admirer of the Montana land trust, but I do not know enough about land and easements so that I would wish to hazard a guess.

My offhand feeling would probably be that organizations that get into the business of donations of land are already substantial enough that they can manage this process pretty well.

It is when you get into battered women's shelters and local opera societies and things like that that you are into wonderful groups that are really pretty much purely amateur and cannot deal with much complexity when it comes to government filing and accountability requirements.

Senator BAUCUS. Right.

I wonder if you could share with us what lessons you have learned after reviewing Nature Conservancy and all that they were going through. What are some of the lessons learned that are applicable generally to this committee's inquiry?

Mr. BOK. I am trying to think of what we learned in Nature Conservancy that really could be generalized safely into rules. I think an awful lot of good was done and a lot of useful reforms have come through, but only a few of them, I think, are generally applicable.

The white paper includes some of those, such as prohibiting various kinds of self-dealing and conflicts of interest.

As for the rest of it, I would really have to go over our report point by point and ask myself that question, is this generalizable or not. I have the feeling it would not be a very long list. What we were dealing with was fairly specific, such as our proposals on the work of the board and the size of it, and the subcommittees, and the independent audit.

Most of our proposals were done pretty much with the specifics of a very large nonprofit in mind, and I do not think would be generalizable.

Senator BAUCUS. All right. Thank you.

Mr. Taylor, you were going to say something.

Mr. TAYLOR. I wanted to comment on Mr. Ringling's example, because I believe it is a great opportunity, a great learning moment for what self-regulation can do, subsector self-regulation of a problem area.

It appears to me that what has been done there—and I have not seen the standards—is the kind of thing that organizations in subsectors of the nonprofit community can do to police themselves. I just wanted to highlight that and applaud it.

Senator BAUCUS. All right. I have no other questions at this time. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I thank you for cooperating while we had to vote. I thank you very much.

I am just going to take 5 minutes for questions. I will probably have some to submit for answer in writing.

Mr. Boyd, I think you made very clear a very valid point about not being so eager for reform that we hurt and discourage small foundations and charities.

Is there any way you can quantify for me kind of the tipping scale or the balance between reform and burden, like, for instance, some sort of dollar figure or asset figure that we should use so that we do not get that burden too much for organizations that maybe cannot follow it.

If it is difficult for you to quantify that now, it may be that I am just asking you to think about it and get back to us. But if you have a thought, I would take that right now.

Mr. BOYD. Well, it is a thought. I think, certainly maybe \$5 million in revenue. Otherwise, I think you are going to run into some

difficulties. I noticed, you, in your regulation, are speaking about the larger national charities. They have a sliding scale for reviews. I think \$10 million might be it.

On the other hand, what we are trying to do, again, locally, as in Montana and elsewhere, is to improve the standards for everybody in the community, try to improve their capacity. That is one of the things I look at. There is a matching grant program suggested. We do not have much money to match right now in the States, so we are trying to work very hard with the Attorney General and the Secretary of State in our State to develop this program for all. But I would say \$10 million is the dollar figure for grant oversight.

The CHAIRMAN. All right.

The next question is not directed to a specific person, but two or three of you might respond to this.

This comes from the fact that there were a lot of organizations we should have heard from today and just did not have time to do it. One group that came in to visit with staff was the Evangelical Council on Financial Accountability. I think this is an organization started, in part, by Billy Graham to bring financial accountability through an accreditation program for churches.

In meeting with the Finance Committee, the head of the organization made an interesting point. In their site visits to churches, the number-one problem, and usually the reason for many other problems, was weak governance and oversight by the board.

So, I would like your response to this observation. How important is a board's quality, primarily? Yes, sir, Mr. Cohen?

Mr. COHEN. Well, obviously the board is at the heart of the governance of nonprofits and foundations, so there is no underestimating the role that it plays, and also the importance of board members taking their job seriously in knowing what actually constitutes proper board behavior.

I would say, however, that the board is not the only player in that. When you have the evangelical group, that shows an outside organization that also promotes standards for organizations.

When Mr. Josephson talked about the Albany Urban League, you had both funders, standard-setters, and other organizations that were aware of this that could have also intervened.

So there is a mutual accountability, both board members knowing the right kind of behavior, but the sector paying attention to its peers and making sure that the bad issues, the bad behavior is brought to the surface.

Mr. TAYLOR. I will comment.

The CHAIRMAN. Go ahead, sir.

Mr. TAYLOR. The boards of directors are key in the governance and oversight of a particular organization. One of the things we must do with boards, is make sure that they are free of conflicts and that they are independent in order to do their jobs effectively.

I think anything we can do to assure that boards are conflict-free would do a great job in making sure that nonprofits are well-managed and well-governed.

The CHAIRMAN. All right.

Mr. Bok, then Ms. Aviv.

Mr. BOK. I do think you have a real dilemma on your hands. Of course the board ought to be key, and often is key. On the other hand, in large numbers of organizations, which, again, are relatively small, board members are real amateurs and volunteers.

They do not know a great deal about the kinds of things that have been said today, and they may be very good at understanding the local community and its needs, but not very good at understanding what a really effective board is supposed to do by way of oversight.

Another problem is that most of these people are not paid. They are volunteers. They think they are doing a great favor to the organization by showing up at the meetings.

So, you can try to impose accountability and penalties if the board is not sufficiently vigilant, but you are going to discourage a lot of people from serving because you are going to frighten them.

They are not people who are serving for money; they are doing it for love. So, if it becomes an unpleasant burden with government sanctions, you are going to cut into the quality of people who will serve.

So, yes, the board is very important, but there is a first-class problem of developing model boards with the right expertise and the right motivation to serve. So, I just would not underestimate the difficulty you have got in making all boards of nonprofits serve as effectively as they ideally should.

The CHAIRMAN. Ms. Aviv, and then we will close down.

Ms. AVIV. Senator Grassley, in response to the earlier question as well about the size of nonprofits and so on, of the 1.4 million nonprofits, 70 percent of them have budgets of less than \$500,000. So, the vast majority of nonprofits do not have large budgets.

We believe that in many of the instances there are folks who come in to serve on boards who do not have the education, and where the problem is a matter of education and technical assistance, it needs to be provided by the sector. We need to set some standards. There are such diverse groups. You mentioned one, the Evangelical Council. Art Taylor runs another.

There are many local groups as well, in Minnesota, in Maryland, that have developed all kinds of standards that can help facilitate and educate these groups so that at least they have the knowledge base that is needed and the resources available to be able to provide the kind of oversight that is needed. We obviously need strong boards and good governance.

The CHAIRMAN. Yes. Besides thanking you, I wanted to say this about the hearing, generally. I think that we have heard some very sobering things. As I mentioned earlier, this hearing is just the beginning of a discussion about how to bring about reforms of the charitable sector.

I think that areas that we particularly need to think about is balancing the requirements that might be placed on charities, particularly small charities, and not overwhelming the ability of charities to achieve their important mission.

Finding that balance will be a task in the weeks ahead. My hope, with the help of Senator Baucus, is that we can look at introducing legislative reforms yet this fall, and even earlier on for some provisions. I appreciate very much the nonprofit sector working with us

to find that balance, and all of you have spoken to that, and I thank you and this panel.

Senator BAUCUS. Mr. Chairman?

The CHAIRMAN. Yes?

Senator BAUCUS. I just wanted to say, I think this has been a good hearing. It has been very thoughtful. A lot of people have given their heartfelt and thoughtful and reflective reviews.

It is not just a big rush to judgment, but it is trying to deal with some of the subtleties and some of the ambiguities, and I deeply appreciate the time that you all have taken. Thank you very much.

The CHAIRMAN. Thank you all very much.

[Whereupon, at 1:20 p.m., the hearing was concluded.]



# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### PREPARED STATEMENT OF JAY D. ADKISSON

Mr. Chairman and members of the Committee, I thank you for the opportunity to appear to discuss the growing problem of tax schemes and shelters involving charitable organizations. I am Jay D. Adkisson,<sup>1</sup> the Director of Private Client Services for Select Portfolio Management, a registered investment advisory that advises several of the largest charities in the nation. I am also the creator and editor of Quatloos.com, an internet website that warns the public about various sophisticated tax frauds and financial frauds.

Charities are meant to serve the common good. To encourage such entities, Congress has honored charities, foundations, and other public service entities with perhaps the greatest benefit that Congress is capable of bestowing: Exemption from the tax laws. And by far, the greatest number of public charities live up to the high level of societal responsibility which they exist to fulfill. Public charities facilitate critically important funding for such things as cancer research, disaster relief, infrastructure development in third-world countries, and preservation of the arts.

Yet, as moths to the flame, those whose livelihoods consist of torturing the tax code for the economic benefit of their clients and themselves are drawn to charities not because of any philanthropic reasons, but solely, only, and exclusively because of the technical tax exemption for such organizations. This tax exemption is simply too tempting for the purveyors of tax schemes and shelters to ignore, and so they have devised and will continue to devise strategies to take advantage of the exemption in ways both never contemplated by Congress and which provide the associated charities with relatively nominal benefits, if any benefits at all.

Indeed, as the Treasury Department and Internal Revenue Service continue their laudable campaign against the recent proliferation of tax shelters marketed to corporations and affluent individuals, so will the tax planners who create those schemes look to hide their strategies within the exempt ambit of charities.

#### CORPORATION SOLE

Tax scams are cyclical in nature. An abusive strategy that is discovered and then prohibited by a change in the law will eventually resurface after a few years in a slightly modified form. One such scam that has survived in various forms since the inception of the Internal Revenue Code has been that of converting yourself, your business, and your family into a “church” that thereafter lives, according to promoters, a perpetually tax-free existence.

The most recent incarnation of the church scam is the so-called “corporation sole”. There are, actually, statutes on the books of many states that authorize a form of corporation called the “corporation sole”, and it is meant to provide a limited liability form of organization for a true church organization. However, tax scam promoters are marketing the corporation sole as the ticket for the average American to make him and his business tax free. According the website of one corporation sole promoter: “Once you declare your pauper status, your income is tax-free to you and your assets cannot be encumbered with a property tax. Your earnings are also tax-free and are considered the Income of the religious organization.”<sup>2</sup>

While the Internal Revenue Service has attempted to warn the public about the corporation sole scam,<sup>3</sup> it continues to proliferate, largely as the successor-in-scam to the so-called “Pure Trust”. Although the IRS also put out warnings about Pure Trusts, the aggressive marketing of those entities continued well beyond the time that the IRS notified the public of the illegality of their use as tax avoidance vehicles. Only after the

Department of Justice began aggressively prosecuting the promoters of pure trusts did the fad of the pure trust scam begin to subside. The IRS should heed the lessons learned from the boom in pure trusts and request the aggressive prosecution of corporation sole promoters now before sales of the latter scam gain further momentum.

#### PRIVATE FOUNDATIONS

The corporation sole scam is primarily marketed to small business owners and others who typically will not spend the money for qualified tax professionals to advise them as the validity of the scheme. Yet, not far removed from the corporation sole is a form of entity that is actively marketed by highly qualified and respected tax professionals, yet which is susceptible to abuse, which is the Private Foundation.

Foundations serve an important role in America, disbursing over \$27 billion in contributions, gifts and grants last year,<sup>4</sup> and by far the vast majority of foundations fulfill the important public purposes for which they were formed. Unfortunately, however, a seemingly increasing number of foundations are being created not to serve any public purposes, but merely as thinly-disguised tools to further the lifestyles of the wealthy persons who create them and to pass assets between generations with minimal, if any, tax consequences.

During the course of my professional practice I have run across private foundations whose activities to benefit the public were little more than annually paying for the expenses of the donors to review the reefs off the coast of Cozumel to make sure that they were still there. To the extent that these foundations made *bona fide* charitable contribution, there was often a significant *quid pro quo* that was received, such as the option to purchase choice seats at college football games. There also seems a perception

among some wealth planners that private foundations are not regularly audited, and that there are only slight penalties for a client who uses a private foundation as essentially a form of family trust.

That private foundations are marketed as wealth accumulation and estate planning tools emphasizes that many, if not the majority of, donors consider the assets of the foundation to continue to be family assets even after the donation is made. Thus, private foundations are sometimes marketed as a “get your donation now, and let your children live off the management fees forever after” sort of arrangement. Yet, as Congress and the IRS continue to restrict the inurement of personal benefits for those managing private foundations, so will such persons look for creative ways to transfer wealth out of the foundation, or as wealth planners sometimes say, “rescue” the wealth from the purposes for which it was intended. As great wealth continues to accumulate in private foundations, it should be anticipated that “rescue” strategies will begin to appear whereby strategies are developed to repatriate significant portions of certain foundation’s wealth back into the family unit. Thus, it can be anticipated that the future abuses of private foundations will not be as much with the original donation, as it will be with sophisticated transactions designed to repatriate the wealth held and grown with the private foundation back to direct family ownership and control.

#### FOREIGN FOUNDATIONS

Such “rescue” strategies have historically being implemented through the use of foreign foundations and charities. Various offshore tax promoters have been shameless in their marketing of foreign foundations as tax shelters. In 1997, at the Shorex Exhibition held in London, I had the occasion to see a presentation by Mr. Marc Harris, a former

CPA and American expatriate whose firm, the Harris Organization, was promoting to U.S. persons the uses of Panamanian Foundations as the centerpiece of blatant offshore tax evasion schemes. A year later, I attended a seminar in Nassau where Mr. Harris made the pitch to approximately 200 affluent Americans. Although Mr. Harris was recently extradited to the United States and is serving a fourteen year sentence for his participation in a freon smuggling scheme, to the best of my knowledge none of Mr. Harris' clients have ever been prosecuted for the use of his structure. Indeed, even today numerous offshore promoters pitch the use of foreign foundations to U.S. persons as vehicle for tax evasion, with such foundations being funded by contribution of the participating U.S. person's domestic foundation.

Of significant concern must be the interplay between domestic private foundations and foreign foundations and charities, and their potential to act as money laundering conduits. Once money has passed outside the U.S. banking system, it is difficult to track especially if the foreign foundation or charity is domiciled in an offshore jurisdiction or one with weak regulatory controls. Over the years, I have personally seen schemes where payments ostensibly made to a foreign charity were quickly funneled back into the control of the original donor for investment purposes. It is not difficult to image schemes where the payments are funneled not back to the original donor, but instead to those with more malicious purposes than mere evasion of the tax laws.

It is therefore suggested that gifts, contributions, and grants made by a domestic private foundation in the U.S. be limited either to purposes and organizations within the U.S., thus allowing the U.S. public which has helped to shoulder the burden of the

original deduction to share in the benefits, or to such foreign charities which have established their bona fides by registering here.

#### PARKING TAX-PRODUCING ASSETS

Further up the hierarchy of abusive charitable schemes are those which generate artificial losses, absorb income, or effectively “park” assets for a period of time in anticipation that the assets will be repurchased at a later time. With such schemes the charitable benefits are nominal compared to the taxes saved by the donors, and, it is with such schemes that the recent abuses have been the greatest.

Among the first of these schemes were Charitable Family Limited Partnerships, which was marketed by a variety of tax law firms in the late 1990s. This involves the contribution of an illiquid asset is made to a charity, giving the donor a large deduction for the gift, then after a number of years the charity re-sells the asset back to either the original donor, or better yet a trust formed for the donor’s children, at a substantial discount. That the charity would resell the asset back to the original donor, or the original owner’s designee, was a foregone conclusion since only that was the only way that the charity could realize significant cash for the assets. From the donor’s viewpoint, the effect of the arrangement was that basically the donor had a call option on the asset and could directly or indirectly redeem it at any time.

The concept of donating an asset to a charity in anticipation of the donor purchasing the same asset from the charity at a substantial discount some years later proved to be too tempting for giant accounting firm KPMG, which by the late 1990s had shamelessly sold its ethical soul in exchange for the quick bucks to be made selling complex tax shelters. But the arrangement that KPMG devised would not be limited to

merely taking a large donation up front and getting the same asset back at fraction of its value later. Indeed, KPMG often told the targets of its promotion that they might be better not taking the initial charitable gift deduction at all, for that might increase the odds of the transaction being audited and the real prize discovered: The avoidance of potentially tens of millions of dollars of income taxes which otherwise would have been paid to the owners of S-Corporations.

Broken down into its basic components, the KPMG shelter was relatively simple. The owners of the S-Corporation would issue a second series of stock to the owners, which would then be donated by the owners to a cooperative charity. The S-Corporation would then attribute a significant portion of the income taxes it was generating to the stock held by the charity. The shelter was designed so that the charity would receive little if any cash distributions while it held the S-Corporation stock. After a few years, the owners of the S-Corporation would repurchase the S-Corporation stock back from the charity, either at the then fair market value or at a discount. Only at that time would the charity receive any significant cash benefits, although these benefits were substantially outweighed by the income taxes saved by the S-corporation owners.

Although the hard dollar benefits received by the complicit charities are almost trivial compared to the taxes saved by the donors involved in the schemes, the charities have almost no incentive not to participate since they historically have little risk of realizing any adverse tax consequences. If the donor in these schemes is able to attribute, for example, \$10 million of phantom income to the charity, and the charity receives \$100,000 in cash, from the charity's viewpoint it is only concerned with the \$100,000 in cash, since of course the tax exempt status of the charity means that it will not be paying

taxes on the \$10 million of phantom income anyway. There is thus little more downside for the involved charities than the reputational risk of being caught in a tax shelter. Yet, the promoters of these schemes mitigate the reputational risk as well, by providing lengthy, detailed, and convoluted letters that opine that these arrangements are “more likely than not” to pass tax court muster.

#### THE PROBLEM OF OPINION LETTERS

With mention of the opinion letters of the promoters, we have thus arrived at one of the common denominators for tax shelters. It is said that a tax shelter can be defined as a transaction that no financially savvy person would enter into but for the tax benefits. But it can also be defined as transaction that no client would participate in if he or she was not protected from penalties by the opinion letter arranged by the promoter. Indeed, the role of the opinion letter is central to the transaction. The existence of the opinion letter suggests to the client that the transaction, while offhand the transaction sounds bogus, may actually have substance within the convoluted and often indecipherable mess that is the tax code. The existence of the opinion letter allays the fears and concerns of otherwise skeptical outside advisors. And in the end, the opinion letter allows the client to gamble the non-payment of tax consequences against today’s historically low audit rates.

While the investigations of promoters and the acquisition of their client lists by subpoena helps to rebalance this equation back in favor of common sense and compliance, such is only a temporary fix insofar as new and less visible promoters will pick up the cudgel and hope that the limited manpower of the federal and state taxing agencies will concentrate on the bigger fish.

The solution is to attack one at the roots of the sources of the tax shelter problem, by requiring the contemporaneous filing of tax opinion letters as a prerequisite to penalty avoidance. Whether or not the tax authorities ever review the letters, the mere filing of the letters tells potential customers that they will be alerting the authorities to the shelter at the outset, just as the laws requiring the registration of shelters now require. If the opinion letters are filed in electronic format, allowing them to be searched *en masse* by reviewers looking for key phrases, there would be tremendous concern on behalf of promoters and their customers that if a new shelter was discovered that all the opinion letters referencing that transaction would be immediately tagged for review. Also, the cost of requiring the contemporaneous filing of opinion letters would be nominal, especially in regard to the potential benefits of chilling tax shelter sales.

#### VALUATIONAL GAMES AND CHARITIES

The filing of opinion letters will not, however, address another significant area of abuse in regard to charities, which is the contribution of intellectual property and complex financial derivative products. Although as to intellectual property these issues were significantly addressed in Revenue Ruling 58-260, the temptation to play valuation games will simply be too great for tax planners to ignore. Yet, it is easy to envision a scheme where intellectual property or complex financial derivative products are temporarily “parked” with a cooperating charity, giving the original donor a large initial deduction, perhaps allowing the charity to absorb some income or capital gains taxes while parked, and then after the limitations period has run on the original donation the charity will re-sell the soft asset either back to the original donor or as directed by the original donor to a trust so as to avoid estate taxes, etc.

A restriction should be imposed that limits the overall tax benefits received by the donors to the true hard-dollar value received by the charity. Thus, if a scheme or shelter arrangement were to give the donor \$10 million in tax benefits while the charity itself benefits only to the extent of \$1 million, the donor would not be able to take advantage of the tax benefits of the transaction beyond the \$1 million benefit actually received by the charity.

#### CONCLUSION

In conclusion, the favorable tax benefits given to charitable organizations and foundations will continue to be abused by those economically motivated to press the legal envelope of the tax code in the hopes of creating phantom deductions and avoiding taxes in amount far exceeding the value of the benefits received by the involved charity. Congress must maintain its vigil for abuses that are particular to these entities, such as those involving private inurement, and take action now against practices common to all tax shelters, such as requiring the filing of opinion letters, so that the reputation of charitable organizations and foundations as organizations which serve the public good and nothing more, remains unstained.

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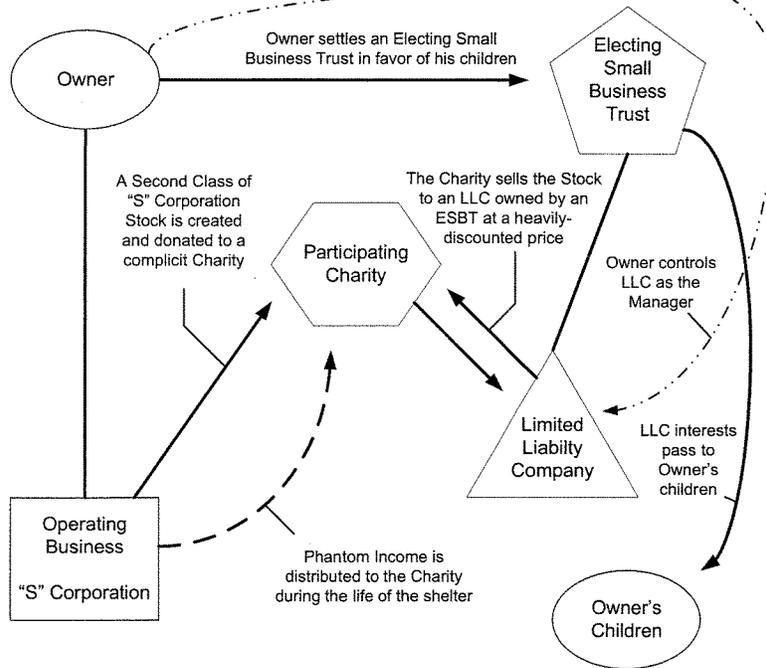
<sup>1</sup> The author thanks Carin Amaradio, Tony Amaradio and Ed Stone for their assistance in preparing this submission.

<sup>2</sup> [http://www.the7thfire.com/debt\\_elimination/corporation\\_sole\\_FAQ.htm](http://www.the7thfire.com/debt_elimination/corporation_sole_FAQ.htm)

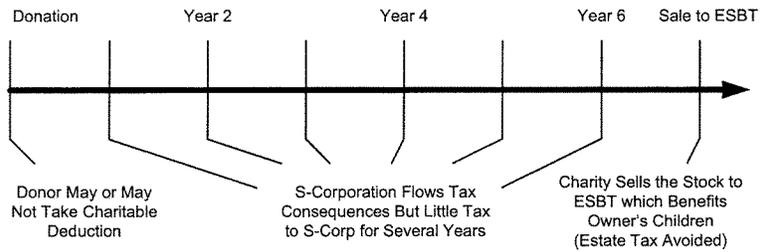
<sup>3</sup> IR-2004-42, March 29, 2004.

<sup>4</sup> IR-2004-9, January 14, 2004.

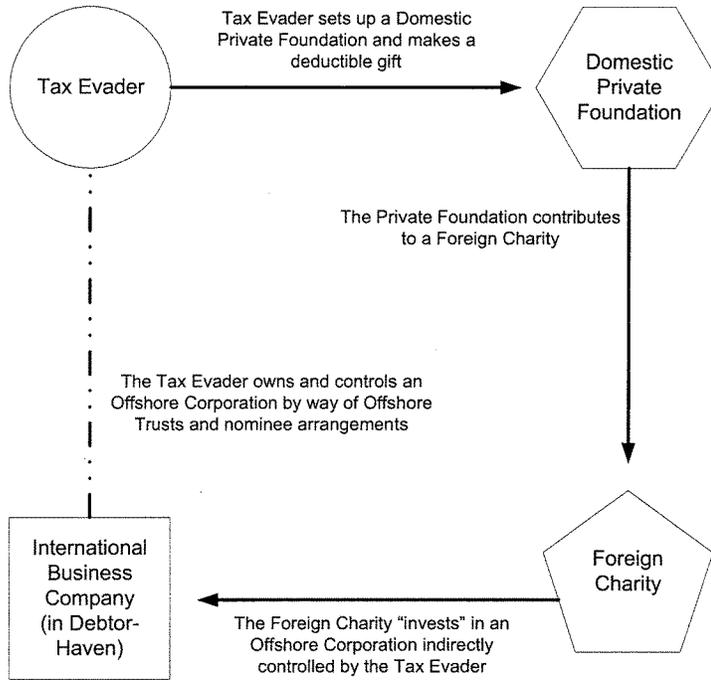
S-Corp/Charity Shelter



**TIMELINE**



Domestic Foundation to Foreign Charity Scheme





INDEPENDENT  
SECTOR

Testimony of  
Diana Aviv  
President and CEO  
INDEPENDENT SECTOR  
Washington, DC

United States Senate  
Committee on Finance  
June 22, 2004, Hearing  
“Charity Oversight and Reform:  
Keeping Bad Things from Happening to Good Charities”

1200 Eighteenth Street, NW  
Suite 200  
Washington, DC 20036  
202-467-6100  
202-467-6101 fax  
diana@IndependentSector.org  
www.IndependentSector.org

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**Testimony of Diana Aviv**  
**President and CEO, INDEPENDENT SECTOR**  
**Before the Senate Finance Committee**  
**June 22, 2004**

**EXECUTIVE SUMMARY**

America's 1.4 million charitable and philanthropic organizations serve, educate, assist, enrich, and empower millions of Americans in thousand of local communities. This voluntary network is supported by tax policies that encourage giving and grant tax exemption on the condition that funds are used for the common welfare and not for private gain. The sector's greatest asset is the trust the public has placed in it, as evidenced by the tens of millions of Americans who give generously of their time, financial resources, and talents.

In recent years, the actions of a few in the charitable sector have eroded that trust. Many factors are fueling these concerns: growth in the sector and insufficient knowledge by trustees and professional staff about legal obligations and good governance; federal and state laws that are not consistently and fully enforced; annual information returns filed by charities that are confusing and inadequate; and gaps in legal framework and laws regulating the sector.

Ending unethical and illegal practice will require a multifaceted approach by both government and the voluntary sector. The current challenges do not lend themselves to quick fixes and short-term solutions. Among the recommendations are:

- Revise the Forms 990 and 990PF filed by charities and foundations to enhance the quality and transparency of information, and ensure full adoption of electronic filing of these forms.
- Eliminate barriers to shared enforcement by federal and state regulators and increase funding for oversight and enforcement.
- Amend the laws to increase penalties for wrongdoing and work with the charitable community to explore the best way to clarify rules for such issues as appropriate compensation, donor-advised funds, and valuation of gifts of property, without undercutting the program and its benefit.
- Voluntary sector should expand and coordinate successful standards and self-regulation programs and, with public and private support, increase education and technical assistance for trustees and staff leaders.

Some recommendations warrant immediate attention and implementation, while others require more careful consideration and deliberation. Actions to improve the work of the voluntary sector should not be so draconian that people of goodwill are discouraged from serving on boards, working in nonprofit organizations, or giving to causes that serve our common good. The legal framework within which charities function must not be so laissez-faire that unscrupulous people are able to manipulate the system for personal gain.

**Testimony of Diana Aviv  
President and CEO, INDEPENDENT SECTOR  
Before the Senate Finance Committee  
June 22, 2004**

Mr. Chairman, Senator Baucus, and distinguished Members of the Committee, thank you for inviting me to join you today at this important hearing and for the opportunity to share with you my recommendations concerning actions that must be taken by the nonprofit sector and by government to strengthen the transparency, good governance and accountability of voluntary organizations. These recommendations are intended to build on some of the initiatives underway in the nonprofit sector that are dedicated to improving governance and practice. Our public charities and private foundations appreciate your deep concern and your willingness to work with us to separate the thousands of good actors from the few bad actors and, in so doing, preserve all that is valuable in America's nonprofit sector.

INDEPENDENT SECTOR is a nonprofit, nonpartisan membership organization committed to strengthening, empowering, and partnering with nonprofit and philanthropic organizations in their work on behalf of the public good. Our coalition of approximately 600 nonprofit organizations, foundations, and corporate philanthropy programs collectively represents tens of thousands of charitable groups as well as millions of donors and volunteers serving a wide range of causes in regions across the country.

**I. CONTRIBUTIONS OF THE CHARITABLE AND PHILANTHROPIC SECTOR**

Throughout our history, America's nonprofit organizations have played a critical role in advancing the well being of society in the United States and abroad. Since this country's earliest days, philanthropy and charitable organizations have dedicated themselves to strengthening community life, serving the most disadvantaged members of society, enriching our knowledge, encouraging creativity, improving our health and welfare, and contributing to our democratic way of life. Working independently and in concert with government, the charitable sector has served as the vehicle through which many of our collective responsibilities have been discharged. Through its collaborative work with government, and the private actions of its 1.4 million education, health, social service, religious, and public interest organizations, among others, the charitable sector has improved the quality of life for generations of people.

Among its many contributions, America's voluntary endeavors have advanced positive social change in our country and contributed to such movements as the abolition of slavery, women's right to vote, the creation of public education, the welcoming of immigrants to our shores, and the strengthening of civil rights and liberties of our citizens. To be sure, our work is not yet done. But there is much of which to be proud. Philanthropic initiatives enabled Jonas Salk's work that resulted in the polio vaccine;

built the great museums of America; advanced rocket science research; and created the 911 emergency telephone system. Today's great works by the nonprofit sector are illustrated through these few examples:

- The Mid-South Delta Initiative promotes economic development in 55 counties and parishes along the Mississippi River in Arkansas, Louisiana, and Mississippi. In the last 18 months, this group's partners have started two dozen businesses, created approximately 1,500 jobs, and built or rehabilitated 300 homes for low-income families.
- Big Brothers Big Sisters, headquartered in Pennsylvania, taps into a network of volunteers from houses of worship and other community-based groups to provide one-on-one mentoring to over 200,000 children across all 50 states.
- The Central Park Conservancy, a nonprofit organization, raises funds and mobilizes volunteers to provide all basic care and to support more than 85 percent of the budget for New York City's award-winning urban park. The park is visited annually by over 25 million visitors from the United States and around the world.
- The John D. and Catherine T. MacArthur Foundation has launched a \$50-million Science, Technology and Security Initiative that will work in partnership with leading universities to cultivate a new generation of experts on science and security issues who will provide vital data to government and policymakers to combat terrorism and technologies for mass destruction.

Nonprofit organizations, both large and small, each day serve, educate, assist, enrich, and empower millions of Americans in thousands of local communities. Voluntary organizations and the individuals who serve them have improved virtually every corner of our community landscape.

The growth and renewal of our national voluntary network of public charities and private foundations is facilitated by an invaluable tax policy designed to stimulate the impulse to give to a wide array of institutions serving the public good. The tax-exempt status nonprofit organizations enjoy requires the funds that support these activities to be used, not for private gain, but for the common welfare.

Among the charitable sector's most significant assets, however, is the trust the public has placed in it. This is based on the belief in the high purpose of the missions of charitable organizations and confidence that their leaders will serve the common welfare and will not profit financially from the work of the organization, beyond reasonable compensation for services rendered. The public assumes that boards of trustees will govern in a manner that is responsible, accountable, and ethical. The support and trust the sector enjoys is clearly evidenced by the tens of millions of Americans who give generously of their time, financial resources, and talent to nonprofit institutions in the United States and around the globe.

In recent years, the actions by some in the charitable sector have eroded that trust. The stories reported in media outlets across the country over the past year, now numbering in the hundreds, have detailed examples of alleged excessive compensation of executives, self-dealing, questionable fundraising practices, conflicts of interest, and lavish

expenditures. While these stories refer only to a handful of organizations—indeed only a minute percentage is responsible for such problems—the sector as a whole faces a “spillover effect” in which the good work of thousands is threatened by the actions of a few. Thus, the sector as a whole is called upon to address these issues in order to maintain public confidence in its work. There is much that needs to be done, and we will be encouraging you, as well as other federal and state public officials, to assist in this process.

## **II. REGULATIONS GOVERNING THE CHARITABLE SECTOR**

### **A. Qualification for Tax-Exempt Status**

Charitable nonprofit organizations, as defined under section 501(c)(3) of the Internal Revenue Code (IRC), must be exclusively dedicated to purposes that advance the public good. Where other types of nonprofit organizations benefit the private social or economic interests of their members,<sup>1</sup> charitable organizations must benefit the broad public interest and Congress has therefore provided, with very limited exceptions, that only those charities organized under section 501(c)(3) are eligible to receive tax-deductible contributions.

To be recognized as a charitable organization, an organization must satisfy the requirements outlined under section 501(c)(3) of the Internal Revenue Code based on an application and examination by the Internal Revenue Service. The application details the charitable purposes the organization will serve, the sources of funding the organization has received or expects to receive and its plans for spending those funds, members of the organization’s governing board and the rules they will follow in governing the organization, and other information relevant to the IRS’s determination as to whether the organization meets the criteria under section 501(c)(3) or other sections of the IRC.

The Internal Revenue Code further classifies 501(c)(3) organizations as either public charities or private foundations. A public charity must document that it meets certain operational conditions (e.g., that it is operating or will operate as a school, hospital, or religious institution), normally derives at least one-third of its annual financial support from the general public in the form of qualifying contributions and grants, or that it will function as a “supporting organization” to one or more specific organizations that meet the required support tests. A private foundation generally derives its financial support from the contributions of a single individual, family, corporation, or other entity. Private foundations receive less favorable charitable tax deduction treatment for their donors and are subject to substantially more restrictive rules governing their operations.

### **B. Disclosure Requirements**

With the exception of religious institutions, all tax-exempt organizations are required to file an annual information return, the Form 990, with the Internal Revenue Service if they have annual revenues of \$25,000 or more. The form provides details on the

<sup>1</sup> The Internal Revenue Code defines over 27 categories of organizations that are exempt from federal income taxes, including private country clubs, business associations such as Chambers of Commerce or the National Association of Manufacturers, labor unions, fraternal organizations, and many others.

organization's revenues and expenses for the year; net assets; officers, trustees, directors and key employees and their compensation; income-producing activities and information on taxable subsidiaries; and a statement of program service accomplishments. An extensive list of other reportable facts, many of which are applicable only to specific categories of exempt organizations, are also requested on the Form 990. Public charities are required to attach an accompanying schedule (Schedule A) that details compensation of the five highest paid employees and the five highest paid independent contractors, eligibility for non-private foundation status, lobbying expenditures, and transactions with other organizations. Public charities with gross annual receipts of less than \$100,000 and total assets that are less than \$250,000 in value at the end of the year may choose to file the shorter, simplified Form 990EZ.

**C. Special Requirements of Private Foundations**

Private foundations file a different annual information return, the Form 990PF. This form also requires information on revenues and expenses, assets and liabilities, compensation of trustees and officers, and grants programs and other activities. Private foundations (other than exempt operating foundations) are subject to an annual excise tax of 2 percent of their net investment income<sup>2</sup> and must make "qualifying distributions" equal to at least 5 percent of the value of their non-charitable assets. Qualifying distributions include gifts of money and/or property to charitable organizations and, under specific prescribed conditions, to individuals, as well as other costs related to carrying out the charitable work of the foundation. Private foundations are also subject to specific rules prohibiting self-dealing between the foundation and disqualified persons, including major contributors, foundation managers, and their family members, and corporations or partnerships controlled by major contributors and managers; prohibiting the investment of its income or principal in a manner that would jeopardize its tax-exempt charitable purposes; and prohibiting engagement in most lobbying and related efforts to influence legislation beyond self-defense activities. Officers, directors, and other "disqualified persons" who engage in acts of self-dealing are subject to both a penalty tax and an obligation to make the foundation whole. Participation in any other prohibited activity subjects the foundation to specific tax penalties.

**D. Intermediate Sanctions**

In 1995, Congress passed new legislation that requires the IRS to impose tax penalties on individuals and corporations that have received "excess benefits" from transactions with public charities and the managers and directors of the charities who permitted such transactions knowing they were improper. An "excess benefit" occurs when the value of the economic benefit (generally cash or property) provided directly to an individual or company exceeds the value of the service or good received by the charity in exchange for that benefit. INDEPENDENT SECTOR and its members were engaged actively with Congress in the development of this provision, known as "intermediate sanctions," and have worked to advise organizations about how to comply with the new provisions of the law.<sup>3</sup>

<sup>2</sup> Under specific circumstances, the excise tax can be reduced to 1 percent in years where the foundation's qualifying distributions have increased by an equivalent amount.

<sup>3</sup> INDEPENDENT SECTOR's publication, *Intermediate Sanctions: What You Need to Know*, is available on its website.

#### **E. Other Applicable Statutes and Regulations**

In addition, charitable nonprofit corporations must adhere to a wide range of other federal, state, and local laws, regulations, and reporting requirements that are often overlapping and complex. In most states, nonprofit corporations must file annual or biennial reports with the Secretary of State or the Attorney General. Nonprofit corporations must also apply for and maintain local property tax exemptions, and also comply with local laws regulating business licenses and charitable solicitations. Charitable solicitation, in particular, is an area closely regulated by most states. Today, almost all states have some kind of law or regulation governing charitable solicitations. These regulations cover the use of professional fundraisers, co-ventures with for-profit enterprises, licenses, and registration and reporting requirements. Nonprofit organizations must also comply with laws governing restricted donations, and directors have a duty to comply with donor restrictions. Some states also place limitations on the use of income from endowment funds.

Directors of nonprofit organizations are also subject to a wide range of well-established and codified legal duties and responsibilities. These duties are grounded in common law and state and federal statutes. The standards of conduct and duties of directors include the obligation to be attentive to the affairs of the corporation (duty of care) and to act in the best interest of the institution (duty of loyalty). Many states have statutes that define and govern what is required when a director has a significant personal interest in a transaction or decision of the entity.

### **III. FACTORS FUELING ACCOUNTABILITY CHALLENGES**

The outpouring of generosity immediately following the terrorist attacks of September 11, 2001, catapulted the charitable sector to new heights of visibility, resulting in media scrutiny and the expression of Congressional and public concern regarding the distribution of some funds that had been collected. Since then, investigative reports in newspapers nationwide have examined the inner-workings of some nonprofit organizations and foundations, including possible cases of conflicts of interest, questionable compensation to trustees or staff, and public charity fundraising practices. A number of these practices, if true, are unlawful, while others break the bounds of sound governance and ethical conduct. While only a handful of organizations and individuals are engaging in such behavior, the egregious nature of these reports has raised questions about the entire charitable sector's credibility and threatens to weaken the public trust. Research by Paul Light, a senior fellow at the Brookings Institution and professor at New York University, reveals that public confidence in the charitable sector was shaken in 2001 and has yet to rebound. There are several factors contributing to these problems:

#### **A. Growth in the Sector**

Over the last quarter century, the charitable sector has grown at more than double the pace of its for-profit counterpart. The total number of public charities, foundations, religious congregations, and other groups has grown from 739,000 organizations in 1977

to an estimated 1.4 million organizations today. Small organizations (those with less than \$5,000 in annual revenues) are not required to register with the IRS and, if counted, would increase the number of nonprofits even more.

This is a sector with expenditures of over \$875 billion each year employing 11.7 million workers, roughly 9 percent of the workforce in the United States. Nonetheless, more than 70 percent of charities have annual budgets of less than \$500,000.

In this rapidly expanding domain, many professional leaders and board members elect to work in the voluntary sector because of the opportunity to contribute to society. Among them are professional leaders and board trustees who may not be sufficiently knowledgeable about either the legal obligations associated with running a nonprofit or the requirements for good practice and governance.

#### **B. Inadequate Enforcement**

A major problem for the nonprofit and philanthropic sector is that federal and state laws pertaining to oversight of the voluntary sector are not consistently and fully enforced. While the IRS Exempt Organizations Division plans to hire an additional 72 examination agents this year, the number of employees in the tax-exempt division is still not up to the level of a decade ago when the sector was significantly smaller. With 90,000 new organizations seeking tax-exempt status annually—an almost 50 percent increase in the last 10 years—much of the exempt division's resources are devoted to determining whether to approve applications. The IRS's audit rate has been falling for some time and is currently under 1 percent of returns filed annually. State charity officials estimate that over half their limited resources allocated for oversight and enforcement of charitable nonprofits are consumed by processing paper copies of the Forms 990, 990PF and other registration materials. Federal legal restrictions on information sharing between the IRS and state charity regulators further inhibit effective oversight and enforcement.

#### **C. Confusing and Inadequate Reporting**

While regulators spend a great deal of time processing Forms 990 and 990PF, the financial information reported too often is incomplete, late, or inconsistent with that of similar organizations, and does not enable easy identification of problems or abuse.

There are significant differences in the accounting methods used by some nonprofits to record fundraising and administrative expenses, and the IRS forms do not adequately allow explanations of variances caused by financial transactions such as restricted funds received in prior years or pledges for contributions that have not yet been received. Reporting requirements call for recording of such data the year in which the pledge was made or the grant received, and not in the year in which the funds were spent. As a result, financial statements may give the false impression of irresponsible fiscal management or an inaccurate picture of successful operations. The forms also do not require that organizations clearly distinguish transactions with board members, staff, or others that involve potential conflicts of interest.

**D. Cost of Doing Business in Today's Fiscal Climate**

One of the most difficult challenges charities face is securing adequate resources to serve their missions. Both private and public sources of funds have been constrained recently by fluctuations in the economy and federal and state budget deficits. At the same time, costs of doing business have continued to increase. Lower salaries and reduced benefit packages often make it difficult for some charities to attract highly qualified staff where stakeholders expect particular services to be carried out by highly qualified professionals. In the case of nonprofit hospitals situated in cities with very high housing costs, attracting top-level physicians to fill some positions without offering supplemental housing help has been very difficult. For some positions, such as financial investment professionals who are part of the team responsible for managing substantial investment portfolios, it is difficult to attract or retain staff unless they are paid market rates. Nonprofits also are being pressed to streamline practices and run more efficient operations, drawing on innovations in technology and the demonstrated success of other organizations. These worthy investments require additional resources, which are not readily available.

Given the intense competition for resources, some public charities have sought alternative forms of fundraising without the requisite expertise to manage such ventures. The urgent need for resources has created a climate in which unscrupulous profiteers successfully have persuaded some charities to team up on schemes that have produced a small benefit for the charity while violating common sense standards of good business practice.

**E. Legal Framework and Regulations Lag Behind Changes in the Sector**

State and federal laws and regulations governing the charitable sector have not always kept pace with changes in fundraising practices and the development of new vehicles to promote charitable giving, thereby creating gaps in the legal framework that have allowed individuals who profit unduly from "charitable" endeavors to go undetected and unpunished.

Donor-advised funds were initially created in part as an alternative to the legal requirements for private foundations that inhibited donors of more modest means from engaging more fully in philanthropy. These funds are administered primarily by community foundations and other established charities that have instituted internal policies and practices to prevent intended or unintended abuse by individual donors for their private benefit. The legal framework for donor-advised funds has provided an opening for a few individuals and for-profit entities to set up funds that operate primarily as tax shelters, rather than truly serving charitable interests, allowing such donors and their financial advisors to maintain inappropriate control over investment of the funds and to direct resources to pay personal expenses of the donors and their family members.

The rising cost of steel and scrap metal has generated a growing market for used vehicles that can be dismantled and resold for the value of their parts. Many charities have become involved in vehicle donation programs that address this market niche while generating valuable resources to support the charities' service programs. While many of these vehicle donation programs operate responsibly and provide substantial needed resources for charities, others offered by outside vendors operating on behalf of charities have

inappropriately encouraged taxpayers to claim exaggerated tax deductions for their donated vehicles, while providing minimal returns to the charitable organizations. The lack of clear standards for determining the value of these contributions for the purpose of tax deductions has produced confusion and both intended and unintended misuse of the important tax incentive provided by the federal government to encourage charitable giving.

In recent years, there have been a growing number of reports of individuals who have created charitable organizations that serve primarily as vehicles for various fundraising or financial services vendors to gain lucrative contracts for private gain, leaving minimal resources for legitimate charitable activities. These activities are not apparent in the initial applications for recognition as charitable tax-exempt organizations filed by the organizations and, without careful review, may not be detectable in the annual Forms 990 filed by the organizations.

**F. Diversity of the Sector and Changing Standards of Behavior**

The voluntary sector comprises a broad band of organizations with different missions, operations, and spheres of endeavor. In this diverse mosaic, it is difficult to achieve a one-size-fits-all set of standards to cover adequately compensation and benefits, board structures, fundraising practices, and other governance and management issues.

Some of the questionable practices, though not the most egregious ones detailed in news stories, have been in place for years. Charities and foundations have gone about their business with limited collective thought concerning general standards for board compensation, fundraising efforts, and travel and hotel arrangements, among other practices. For some, generous latitude on particular practices was seen to be part of the cost of doing business with major donors or a benefit of working in a nonprofit field that did not offer competitive salaries with the for-profit sector. Just as the standards for practice are changing in corporate America and government, what might have been considered within the domain of acceptable organizational procedure in the past is now appropriately being examined by the sector itself.

**IV. STEPS TO ADDRESS ACCOUNTABILITY CHALLENGES**

Preventing, discouraging and eliminating unethical and illegal practice within the voluntary sector will require a multifaceted approach that depends upon the involvement of both government and the voluntary sector. No singular action will succeed in fully addressing the issues at hand. Nor do the current challenges lend themselves to quick fixes and short-term solutions. Moreover, it is important that corrective efforts do not produce outcomes that might stifle the great American traditions of giving and of volunteering. Actions to improve the work of the voluntary sector should not be so draconian that people of goodwill and honorable intent are discouraged from serving on boards, working in nonprofit organizations, or giving to causes that serve our common good. Equally important, the framework within which we function must not be so laissez-faire that unscrupulous people are able to manipulate the system for personal gain.

To be effective, some of the reform efforts must be undertaken by the charitable community itself. It is our task to set standards and guidelines for effective practice; it is our job to educate our colleagues in the sector about good governance and proper procedures; and it is our responsibility to encourage ethical, accountable and transparent practice. The charitable community must increase and improve its efforts to set clear standards of practice for management and governance and, in concert with government, establish the systems and services necessary to ensure adherence to those standards. With public and private funding, the voluntary sector can and should offer training and technical assistance to those who need education and guidance in good governance and ethical practice.

Government must see to it that the law is upheld and that wrongdoing is deterred and dealt with appropriately. Where legal remedies and regulations do not address adequately a particular abusive practice, it is prudent to consider carefully additional action that specifically addresses the problem at hand and ensure that the proposed remedy does not injure the rest of the sector.

One of the major challenges of the day is the capacity to identify easily possible wrongdoing. Public officials and other interested parties ought to have access to accurate, comprehensive, and current information on the financial operations, governance practices, and program activities of public charities and private foundations. Such information is needed to enforce relevant laws and regulations and allow donors to make informed decisions about how charitable organizations operate or benefit the public good.

Both state and federal agencies charged with regulation and oversight of charitable organizations must have the necessary resources to fulfill their duties. This includes more personnel, improved information sharing systems between federal and state regulators, and updated technology that allows for electronic filing and data collection.

The following recommendations are intended to serve as a framework for transparent, accountable, and ethical practice within the sector.

#### **A. Improving the Quality and Transparency of Information**

##### **1. Revise Forms 990 and 990PF to Provide More Consistent, Timely, and Useful Information About Financial and Other Governance Issues**

The Form 990, filed annually by tax-exempt organizations with gross annual revenues of more than \$25,000, and Form 990PF, which is filed by private foundations, have become the primary sources of information on charities and foundations. These forms are currently filed in paper format with the IRS and with state charity offices where the public charity or private foundation operates. Through the generous support of several private foundations, these forms are available on the Internet for free inspection by the public through GuideStar/Philanthropic Research, Inc. Yet the time and cost involved in processing these forms, first by the IRS and then by GuideStar, means that

information is several months or even years old before it is accessible to the public. Furthermore, in their current design, these forms fall woefully short of providing a clear, useful tool for the public, for regulators, and for nonprofit practitioners who must complete the form. *The Forms 990 and 990PF must be significantly revised and re-formatted, in consultation with accounting and legal experts and practitioners from the charitable community.*

In January 2003, INDEPENDENT SECTOR submitted comments to the IRS recommending several changes to the Form 990 to gather more specific, clear information on related party transactions, governance practices (such as conflict of interest policies and independent audit committees), and the availability of audited financial information. The Council on Foundations has submitted numerous recommendations to the IRS in recent years for changes to the Form 990PF to improve its utility and to clarify and simplify the process of providing accurate, relevant information through the form. Recently, the American Institute of Certified Public Accountants Tax Exempt Organization Taxation Technical Resource Panel submitted several other suggestions to the IRS to improve the quality and utility of the Form 990, including the very helpful suggestion that a new form be developed for organizations exempt under section 501(c)(3) and 501(c)(4) and a separate form for all other categories of exempt organizations.

The IRS established a committee in 2003 to “redesign the Form 990 to make it a tool for EO [Exempt Organizations Division] to improve identification of compliance issues while continuing to serve as an informative document for any entity’s contributors and other members of the general public.”<sup>4</sup> The changes are expected to be complete for incorporation into the fiscal year 2005 Form 990 reports that will be filed in 2006. INDEPENDENT SECTOR and many other nonprofit organizations, research centers, and private foundations stand ready to work with Congress and the IRS to ensure that revisions will better address the interests of the public, government regulators, and the charitable community.

## **2. Implement Electronic Filing of Forms 990 and 990PF and Create a More Integrated Public Disclosure System**

Manual processing procedures currently consume substantial resources at the IRS and at state charity offices. Better use of these funds would be possible if electronic filing were required of all nonprofit organizations. Electronic filing would allow the IRS to provide immediate feedback to filers and reject forms that are incomplete or that have conflicting information. This would in turn improve the quality of information and reduce the cost of correcting unintentional errors for both regulators and charities. Furthermore, electronic filing would reduce the cost and time involved in making the forms available for public inspection. By making electronic filing mandatory, Congress moves us closer to a system that is transparent and accessible to regulators, donors, media, researchers, and the

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<sup>4</sup> *IRS FY 2004 EO Implementing Guidelines, September 2003.*

public at large. Electronic filing would make it possible for all interested parties to differentiate more easily the good actors from the bad.

The IRS has made measurable progress in implementing an electronic filing option for these forms and earlier this year received its first electronically filed Form 990. Electronic filing for the Form 990PF is expected to be available in early 2005. The IRS has been working on a system to integrate electronic filing on both the federal and state levels, but is still seeking funds to support this important effort. Virtually all state charity offices lack the funding to implement their own electronic filing systems or to access any integrated systems developed by the IRS. ***Congress should ensure that the IRS has sufficient funds to implement its full e-filing initiative, including its federal-state access program, in the next two years, and ensure that funding is provided to enable state charity offices to utilize the IRS system.***

Currently there are few software options that nonprofit organizations and their tax preparers can use to e-file their returns. Due to the foresight and support of several private foundations, there is a free software option for e-filing the Form 990EZ that is offered by the National Center for Charitable Statistics. Many commercial software firms that support the accounting and tax preparation work of most nonprofits and their tax advisors are planning to add an e-filing option to their packages, but without sufficient incentives or requirements for nonprofits and foundations to e-file their returns, software firms are hesitating to make the investment the e-filing option would require.

With appropriate software, electronic filing should be within the reach of most public charities and private foundations. A 2002 study conducted by the National Center for Charitable Statistics revealed that 80 percent of Forms 990 submitted by public charities are prepared by paid tax professionals, who generally have access to current accounting and tax software. ***Congress should consider requiring electronic filing of the Forms 990 and 990PF by paid tax preparers and by larger nonprofits and foundations, thus ensuring that software developers will respond to this growing need. Appropriate phase-in periods and revenue thresholds should be developed in consultation with the charitable community and financial experts.***

Electronic filing, while cost effective in the long run, does require a one-time investment to change to such a system. This cost may be beyond the financial capacity of smaller organizations that do not use paid preparers or lack the necessary technology. The Electronic Data Initiative for Nonprofits (EDIN), led by INDEPENDENT SECTOR and the Council on Foundations, has worked for the past three years to advance electronic filing of the Forms 990 and 990PF at the state and federal level and resolve obstacles to the widespread adoption of e-filing.<sup>5</sup>

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<sup>5</sup> Other members of EDIN include the National Council of Nonprofit Associations, GuideStar, and OMB Watch. The National Center for Charitable Statistics serves as an advisor to the coalition. Funding has been provided by seven private foundations.

While private philanthropy has been and will continue to provide crucial support to this effort, *Congress should ensure that sufficient public resources are available to make certain that smaller organizations have the necessary access to the Internet and the appropriate technology to utilize electronic filing.*

### **3. Updating the Certification Process for Charitable Tax Exemption**

There is an interest by some in a more thorough examination of a sampling of public charities from time to time to ascertain whether the organizations continue to meet the requirements for recognition as charitable tax-exempt organizations. Such a review might include the most recent version of the charity's organizing and governing documents, detailed information on major vendor contracts, and information on the types of services provided by the charity. Some information currently required on the Form 990 might be more suitably addressed in a new long form that charities would only complete every five or seven years.

If such a review is contemplated, before it is implemented, *Congress should take steps to ensure that the Internal Revenue Service has sufficient resources to carry out an effective review process. The form should be designed carefully in consultation with the charitable community to ensure that the goal of identifying organizations that are serving improperly as conduits for private gain is met without imposing unnecessary administrative costs on responsible charities.*

### **4. Standardizing and Correcting Financial Standards for Nonprofit Organizations**

A further problem with analyzing financial information reported by nonprofit organizations on the Form 990 is the lack of consistent, reliable, and clear financial standards that are followed by all organizations. The Financial Accounting Standards Board (FASB) is the independent, private agency charged with setting financial accounting and reporting standards for nonprofit organizations. These standards, known as Generally Accepted Accounting Principles (GAAP), are used in preparing audited financial statements, which many nonprofit organizations are required to provide with grant applications and reports to state and federal funding agencies, private foundations, and other donors. The standards have evolved significantly over the last 20 years, with new Statements of Financial Accounting Standards (SFAS) issued to clarify rules for specific types of financial transactions.

While the FASB standards have served to make audited financial statements more comprehensive and transparent generally, many scholars and nonprofit and accounting practitioners argue that some aspects of the standards instead have distorted the representation of a nonprofit's financial standing. Robert N. Anthony, professor emeritus at Harvard University, has been sharply critical of the SFAS No. 116 and No. 117 issued by FASB in the mid-1990s and stated that

“SFAS No. 117 challenges the accountant to find a sensible way of preparing an operating statement for nonprofit organizations that have contributed endowment, plant, or museum objects. The statement mixes operating transactions with nonoperating transactions and leads to what many believe to be a useless bottom line.”

Many have suggested that the IRS revise the Form 990 to reflect GAAP standards and consider requiring all nonprofits to adhere to the GAAP standards. Such a measure would only be helpful to donors, regulators, nonprofit managers, and board members if the FASB standards were corrected to address the issues raised by SFAS No. 116 and 117. As FASB is primarily focused on the needs of for-profit businesses and its board is almost entirely composed of business leaders and managers from the for-profit world, FASB should establish a new review panel of scholars, accounting professionals, and nonprofit practitioners to revise GAAP standards for nonprofit organizations. While FASB standards are not under the jurisdiction of Congress, it would be helpful for *Congress to direct the Internal Revenue Service to consult with FASB and the charitable community about amending the standards when revising the Forms 990 and 990PF.*

## **B. Strengthen Federal and State Oversight and Enforcement**

### **1. Increase Funding for Federal and State Charity Regulators**

Federal and state offices charged with oversight and regulation of charitable organizations and activities need substantially more resources to ensure appropriate levels of education, oversight, investigation, and enforcement. The number of charitable organizations and private foundations and the applications for tax-exempt status have increased dramatically in the last decade, while resources in the Exempt Organizations Division of the IRS have declined.

In legislation enacted in 1969 that imposed an excise tax on private foundation investment income, Congress made clear that vigorous and extensive administration would be needed to ensure that private foundations promptly and properly use their funds for charitable purposes. The rationale for the excise tax on private foundation investment income was formalized by Congress in 1974 when it passed legislation creating the Internal Revenue Service Office of the Assistant Commissioner for Employee Plans/Exempt Organizations and permanently authorized an appropriation tied to the tax to pay for the expenses of the new division. This appropriation was never made, however, and the amounts raised by the excise tax—now estimated at about \$500 million annually—have been funneled into general revenues appropriated for unrelated purposes. *We urge that these authorized funds or other revenues be authorized and appropriated specifically for IRS and state charity regulators for oversight, education and enforcement.*

There is considerable reluctance in many parts of the sector to accept the levy of additional fees for this purpose, given the history of the excise tax, and the financial challenges so many public charities face at the present time. *If, however, an additional fee is under consideration, we urge that it be accompanied by a careful analysis of its impact on organizations that do not have sufficient resources to meet their current obligations. Exceptions should be made for organizations that cannot afford to pay such a fee.*

## **2. Remove Barriers to Shared Enforcement Efforts**

One of the challenges state and federal charity regulators face in coordinating efforts to investigate and prosecute charitable abuses is the confidentiality rules established in Section 6103 of the Internal Revenue Code. INDEPENDENT SECTOR and the National Association of State Charity Officials (NASCO) have endorsed provisions in the CARE Act and the Tax Administration Good Government Act that would allow the IRS to disclose to appropriate state officers certain information about investigations related to the determination to deny or revoke tax-exempt status. Both of these provisions would permit the IRS to disclose such information only to state officials charged with overseeing tax-exempt organizations and the information could be used only to administer state laws regulating tax-exempt organizations. A report issued on June 9, 2004, by the IRS Advisory Committee on Tax Exempt and Government Entities (ACT) notes that the proposed provisions in the CARE Act and the Good Government Act “would significantly increase the effectiveness of both EO (Treasury) and state regulators by allowing them to coordinate their investigative and audit activities where appropriate.”

In its report on H.R. 1528 Taxpayer Protection and IRS Accountability Act of 2003, the House Ways and Means Committee stated that it “believes state officials charged with oversight of organizations described in section 501(c)(3) have an important and legitimate interest in receiving certain information about such organizations before the IRS has made a final determination with respect to an organization’s tax-exempt status or liability for tax. By providing state officials with early access to information about the activities of section 501(c)(3) organizations, regulators will be able to monitor organizations more effectively and better protect the public’s interest in assuring that charitable contributions are used for charitable purposes. The Committee stresses the importance of maintaining the confidentiality of taxpayer returns and return information and believes it is important to extend existing protections against unauthorized disclosure or inspection of return and return information to disclosures made or inspections allowed by the Secretary of return and return information regarding section 501(c)(3) organizations.”

*We concur with the Committee’s assessment of both the importance of taxpayer confidentiality and of the need to provide information to law enforcement officials, including those charged with oversight of charitable organizations.*

***Congress should ensure that these provisions are enacted into law as quickly as possible.***

A further barrier to effective coordination of efforts to address abuses lies within the maze of conflicting state charity rules and regulations. Current regulations often create more work and expense for responsible nonprofits while complicating joint investigation and enforcement efforts to stop those who intentionally use charitable organizations for private gain. In the mid-1980s, the National Association of State Charity Officials (NASCO) developed a model charitable solicitation act that has provided useful guidance to individual states in developing their own legislation. That model act has not, however, been updated since its release in 1986. ***Congress should consider requiring the appropriate federal agencies to develop uniform federal regulations in consultation with state charity officials and the charitable community that would allow for greater cooperative enforcement and information sharing among states and with the IRS.***

### **3. Strengthen the Laws**

In some cases, existing laws and regulations have not kept pace with changes in the sector and have not prevented the introduction of new schemes that direct charitable and philanthropic resources for private gain. ***Policymakers and nonprofit leaders should work together to explore possible changes in the laws to curb abuses that may not be addressed adequately through existing laws.***

**i) Lessons from Sarbanes-Oxley.** Some have proposed that provisions of the Sarbanes-Oxley Act,<sup>6</sup> which was developed to correct malfeasance within the corporate sector, might be applied to the charitable sector as well. Several states, including New York and California, have introduced legislation primarily focused on larger nonprofits that includes requirements such as the establishment of independent audit committees, certification of financial documents by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), and restrictions on interested party transactions. INDEPENDENT SECTOR, in conjunction with BoardSource, has developed guidelines and recommendations on how nonprofits voluntarily might apply relevant sections of Sarbanes-Oxley legislation to their practice. We recognize that many of those provisions will not be applicable or economically feasible for adoption by all charitable organizations. ***We recommend that Congress consider carefully proposals to apply Sarbanes-Oxley provisions to nonprofit organizations to determine whether the particular provisions are relevant and helpful to effective governance and oversight and ensure that exemptions apply to smaller organizations that are unable to afford the cost of implementing these provisions.***

<sup>6</sup> The American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act and enacted in 2002, requires publicly traded companies to adhere to significant new governance standards that broaden board members' roles in overseeing financial transactions and auditing procedures.

**ii) Board and Staff Compensation.** Media reports have raised legitimate questions about compensation for board members and staff executives. Many trustees of public charities make generous contributions of both time and money to the organizations on whose boards they serve. While the vast majority of trustees of charities and foundations serve without receiving compensation, the nature of the work and expertise needed by some board members, particularly for some foundations, may require fair and reasonable compensation. When trustees are compensated for serving on a board or any committee, care must be taken to ensure that compensation levels are transparent, fair, and reasonable, and take into account the nature and amount of work required of trustees as well as benchmarks from comparable institutions. Compensation levels should be fixed by an affirmative vote of a majority or higher percentage of the board of trustees, and reported clearly and fully on the Form 990 or 990PF filed by the organization.

Congress has a long and proud history of supporting and strengthening the capacity of the nonprofit sector. To be effective, nonprofits must have the ability to attract a wide variety of qualified individuals to serve as board members. Policymakers should be mindful not to support policies that create a disincentive to serve on a nonprofit board. *As Congress considers clarifying legal standards for trustee compensation, careful study will be required to ensure that legislation does not produce the unintended consequence of making board service too onerous and unappealing for individuals whose expertise is needed or where substantial time is necessary for the proper discharge of responsibilities.*

Excessive compensation for both board members and staff executives of public charities is currently addressed by “intermediate sanctions” provisions in the Internal Revenue Code [IRC (section 4958)]. The IRS can impose an excise tax equal to 25 percent of the amount of the excess benefit on any disqualified person who receives that excess benefit and an additional tax if the excess benefit is not corrected or repaid within a specified period. An excise tax of 10 percent of the excess benefit (up to a maximum of \$10,000) also can be imposed on organization managers who participated in an excess benefit transaction, knowing that the transaction was improper.

Restrictions on “self-dealing” for private foundations allow compensation to disqualified persons for the performance of services that are reasonable and necessary to fulfill the charitable purposes of the foundation, as long as that compensation is not excessive. These restrictions are similar to the “intermediate sanctions” rules, but penalties are significantly lower. An initial tax of 5 percent of the amount involved in the “self-dealing” violation can be imposed on the disqualified person benefiting from the transaction and a tax of 2½ percent can be imposed on any foundation manager who knowingly participated in the act of self-dealing. In 2003, Senator Kay Bailey Hutchison (R-TX) introduced legislation (S.1514) that would increase the excise taxes on self-dealing for

private foundations from 5 percent to 25 percent. *Congress should consider, where appropriate and useful, making the rules concerning excessive compensation for public charities and private foundations more consistent and imposing the more severe penalties on excessive compensation and acts of self-dealing proposed by Senator Hutchison.*

iii) **Gifts of Tangible and Intangible Property.** Questions have been raised about the validity of appraisals and other methods used to support claims for tax deductions by donors of both tangible and intangible property. A December 2003 report on in-kind contributions of motor vehicles from the General Accounting Office, prepared at the request of the Senate Finance Committee Chairman, has noted problems in the enforcement of existing laws for both individual taxpayers and public charities and the need for greater clarity regarding appropriate valuation methods for establishing deductible amounts.

The Senate recently passed legislation that would address this discrepancy by limiting a taxpayer's deduction to the amount received by the charity through the eventual sale of the vehicle. We share concerns expressed by the Joint Tax Committee in their assessment of the Senate proposal that "the price at which the charity sells the donated vehicle is beyond the control of the donor and may not approximate fair market value." The House has now passed an alternative proposal included in President Bush's 2005 budget proposal that would require independent appraisals to support deductions claimed by taxpayers for donations of motor vehicles. This alternative proposal offers a more workable solution that would address issues raised in the December 2003 GAO study, without unduly harming reputable charities that rely on these services to support vital programs.

We believe that changes are necessary to ensure that donors are not taking excessive deductions for charitable donations. The charitable community has recommended that the IRS amend the Form 8283 (that taxpayers must submit to the IRS when they claim total tax deductions of \$500 or more for gifts of property) to specifically address the calculation of tax deductions for donated vehicles based on the "guidebook value" minus "adjustments for condition" to determine "fair market value" and to record Vehicle Identification Numbers (VIN) for donated vehicles. *Congress can assist the charitable community in requiring these changes and further clarifying the basis taxpayers should use in calculating tax deductions for contributing motor vehicles and other tangible property. At the same time, Congress should take care not to increase so greatly the cost and complexity of making these important charitable contributions that it eliminates the incentive to make such donations.*

Further guidance on the issue of curbing excessive tax deductions for gifts of tangible property is provided in the final report of a special advisory panel created by The Nature Conservancy, which was chaired by Ira M. Millstein.<sup>7</sup> The

<sup>7</sup> The Nature Conservancy Governance Advisory Panel was chaired by Ira M. Millstein, senior partner of Weil, Gotshal & Manges LLP.

advisory panel noted that, consistent with tax laws, the Conservancy has not taken positions on the value or deductibility of any easement or gift of land and undertook its own appraisals to determine whether the prices paid or received by the Conservancy were supported but not to determine the propriety of the donor's appraisal. The panel recommended that the Conservancy enact "careful, systematic, and strict procedures that will ensure compliance with all aspects of the spirit and letter of rules for charitable contributions."<sup>8</sup> The panel applauded a staff recommendation that the Conservancy refuse to sign a donor's Form 8283 to verify a tax deduction unless it could ascertain that the donor's appraiser is "state-certified, not barred from practicing before the IRS, and has experience appraising conservation lands and easements." Further, the panel approved the staff recommendation that the Conservancy ascertain whether the appraiser "uses generally accepted professional appraisal standards, accounts for the enhancement to any neighboring property owned by the donor, and certifies his or her awareness of any conflict of interest."

These recommendations, like many others offered by the advisory panel related to improvements in governance and management practice, serve as a valuable model that should be studied by other nonprofit organizations for possible adoption or adaptation. While few gifts of tangible property, beyond land donations and a small percentage of fine art objects, are of sufficient financial value to justify the expense involved in ascertaining appraisals to the extent recommended for The Nature Conservancy, *all nonprofits should establish and follow clearer standards for accepting the Form 8283 estimates provided by donors to support tax deductions for contributed property.*

*In crafting new proposals to address possible taxpayer abuses in claiming tax deductions for charitable donations, Congress should establish appropriate thresholds for the financial value of those deductions to ensure that it does not create barriers inadvertently to accepting contributions by responsible charities.* Further investigation is called for concerning the costs of responsible appraisals and systems for the certification of appraisers to avoid unwanted, unintended consequences of discouraging responsible donors while leaving loopholes for those who would manipulate the system for personal gain.

**iv) Donor-Advised Funds.** Donor-advised funds have long provided a powerful tool for people of modest means to participate in philanthropy in a meaningful way. Donors make an initial irrevocable gift to a qualified public charity, frequently a community foundation, and are able to maintain some involvement in how those funds are distributed and invested for charitable purposes while relinquishing legal and financial filing and reporting requirements to the public charity where the donor-advised fund is held. Virtually all community foundations and other public charities offering donor-advised funds have well-established policies and procedures in place governing the involvement of donors

<sup>8</sup> Report of the Governance Advisory Panel to the Executive Committee and the Board of Governors of The Nature Conservancy, March 19, 2004, page 16.

and the use of the funds to guard against possible abuse. A few individuals and corporations have, however, taken advantage of the lack of clear legal requirements for donor-advised funds and used those funds for personal gain.

President Bush offered legislative proposals governing donor-advised funds as part of his fiscal year 2001 budget, citing a desire to make it easy to use donor-advised funds, encourage the growth of these philanthropic vehicles, and minimize possible abuses with regard to benefits to donors and their advisors. President Clinton also offered similar proposals in the final years of his administration. The charitable community has responded positively to these proposals and has offered many specific recommendations to ensure that legislation will meet its intended goals. In particular, the Council on Foundations' Proposal to Strengthen the Legal Framework of Donor-Advised Funds, based on extensive work by its Community Foundations Leadership Team, recommends the development of a "bright line" test to prevent compensation and other inappropriate financial benefits to donors, their advisors, or their family members; clarification of the distribution rules and requirements for donor-advised funds; and increased penalties for violations of the rules governing donor-advised funds. *Congress should consider seriously the well-developed recommendations of the Council on Foundations and other charities as in crafting legislation regulating donor-advised funds to ensure that the legislation will address appropriately possible abuses without discouraging the development of these valuable philanthropic vehicles.*

v) **Travel and Hotel Expenditures.** Concerns about inappropriate travel expenditures, including hotel accommodations, have also been raised in congressional debates over provisions to limit the administrative costs of private foundations in H.R. 7, the Charitable Giving Act of 2003, as well as in media reports. Travel costs can vary substantially based on the amount of advance notice for securing accommodations and the availability of accommodations that meet the needs of the group by size, security, meeting rooms, and other issues. It is often necessary for foundations and charities to require their board and staff to travel to locations nationally and internationally where they operate or fund programs to ensure adequate oversight and understanding of the community needs those programs endeavor to address.

*Tax law and regulations might provide clearer guidance for foundations and charities to determine what are "fair and reasonable" travel costs and expenses, but it is important that those guidelines provide sufficient flexibility to allow charities and foundations to meet, confer, consult, and collaborate with colleagues and partner organizations to further their charitable purposes.*

### C. Improving Self-Regulation and Practices within Voluntary Sector

The diverse nature of the charitable sector encompassing organizations with vastly different budgets, missions, operations, and spheres of endeavor makes it extremely difficult to apply a "one-size-fits-all" set of standards that, to be applicable, does not

settle on the lowest common denominators of practice. Some categories of nonprofit organizations—hospitals and health clinics, higher education institutions, and specific types of social service organizations—are well organized with established systems of accreditation and clear standards for many governance practices. Some membership associations serving museums, performing arts organizations, religious institutions, organizations working overseas, environmental groups, federations of health and human service organizations, and state-wide associations of nonprofits have developed comprehensive voluntary standards for management and governance practice and provide some training and education to assist organizations in complying with those standards. There are standards that have been developed for organizations that serve particular geographic regions. Some cross-sector “watchdog” organizations, such as the Better Business Bureau Wise Giving Alliance, have developed specific standards for organizations that solicit funds from the general public and review and provide public reports about the compliance of nonprofit organizations with those standards. INDEPENDENT SECTOR earlier this year released a statement of values and code of ethics intended as a model for use by charities and foundations. A range of different foundation groups, including community foundations, large private foundations, and corporate giving programs, have developed good governance principles that can serve as excellent prototypes for the rest of the foundation community. There are also substantial segments of the sector with no organized self-regulation.

This patchwork of standards for good practice, accreditation, and other self-regulatory mechanisms causes confusion for the public and for staff leaders and boards of directors within the sector. The time has come to explore a more holistic, national-local federated system that provides, where it makes sense, consistent standards of governance and practice and effective disincentives to wrongdoing. A national effort might concentrate on sharing uniform standards of good practice where they apply, reconciling different standards of practice when they are contradictory, and still recognizing the diversity that exists among sector organizations. It should include investing further in existing successful programs, identifying current gaps in standards, and filling them where needed.

*Our nonprofit sector would be well served to use this window of opportunity to explore whether it is advisable to create an independent national entity and/or state entities, with public-private funding, that would establish ethical and best practice standards for voluntary sector governance, financial management, and operations.* This would require a serious investigation of models from other industries and countries, as well as further study of the current successful regional and sub-sector standards programs, such as those established by the Evangelical Council for Financial Accountability and the Standards for Excellence program of the Maryland Association of Nonprofit Organizations, now being replicated in five states. Moreover it might examine how best to connect such entities and build on the good programs that already are in place.

*This national effort also must involve a continuing education campaign to share with charity and foundation leaders information about legal requirements and best practice standards, including technical assistance to aid charities and foundations in moving*

*toward best practice standards and identifying and resolving problems before they escalate.* This effort should build upon the work already being conducted by organizations such as CompassPoint in the San Francisco area and many others.

There is private philanthropic interest in exploring the development of such a national effort, but the successful implementation of this critical work will be an ongoing challenge and will undoubtedly require joint public-private support that may include some additional fees on a sliding scale.

#### V. CONCLUSION

Mr. Chairman, Mr. Baucus, and distinguished Members of the Committee, I have shared some recommendations for how the voluntary sector and government can work in concert to strengthen effective governance, practice, and accountability of the nonprofit sector. Some of these actions warrant immediate attention and implementation, while others will require more careful consideration and deliberation, if they are to be useful. I conclude by calling to your attention the numerous excellent initiatives already underway in all parts of the country, by groups large and small, that are focused on improving practice within the charitable community. Public charities and private foundations stand ready to work with you to move this agenda forward.

We in the nonprofit and philanthropic community are keenly aware of our responsibility to take on these challenges, but also to describe the outstanding accomplishments of so many organizations and the central role charitable organizations and philanthropies play in their communities, nationally and internationally. We know that you share our appreciation of the value of the sector and it is in that spirit that together we look for the most effective ways to preserve its important contributions.



# Committee On Finance

Max Baucus, Ranking Member

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**NEWS RELEASE**

<http://finance.senate.gov>

For Immediate Release  
Tuesday, June 22, 2004

Contact: Russ Sullivan  
202-224-4515

**Statement of U.S. Senator Max Baucus  
Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities**

“This is an important hearing. Charities play a vital role in our country. With many individuals still bearing the brunt of this economic downturn, and the unemployment rate still very high, America relies on its charities for help. And our charities have not let us down.

Charities rushed to the aid of those who were harmed by September 11, providing comfort, counseling and financial assistance. Charities play a pivotal role aiding victims of natural disasters that have paralyzed parts of the country during the past few years — the western fires come to mind. Charities helped rebuild homes, and repair national parks.

While these efforts show up on the front page of the paper, the quiet work of so many goes unnoticed:

- the after-school program that keeps a teenager on the path to college,
- the soup kitchen that feeds a senior citizen whom society has left behind,
- and the conservation group that preserves a remote stream so that our grandchildren may enjoy nature too.

In my home state of Montana, organizations like the YWCA in Billings provide support to over 300 victims of sexual assault every year. The Montana Boys and Girls Clubs provide after-school outlets for over 10,000 children. And the Montana Food Bank Network serves more than 1.5 million meals every year. The list goes on.

But while many charities are focused on doing good works and preserving the public trust, there have been a number of high-profile examples of problems in this expanding sector:

- inflated salaries paid to trustees and charity executives,
- insider deals with insufficient transparency,
- charities engaging in abusive tax shelters,
- and charities serving as conduits to finance terrorist activities and operations.

This proliferation of sloppy, unethical, and criminal behavior is unacceptable. It has led to a crisis in confidence. It has hurt fundraising by legitimate charities. And it overshadows the good work done by the majority of civic minded groups. Like the recent corporate scandals, these events make Americans second-guess their faith in bedrock institutions.

Today, we are privileged to hear from a host of witnesses who are committed to addressing this crisis in confidence. The individuals who are set to testify today come to the table with insights built on years of experience in charities and public policy.

Our first panel includes two highly-regarded state officials, Mr. Josephson and Mr. Pacella, and Commissioner of the Internal Revenue Service (IRS), Mark Everson. His organization grants tax exempt status to almost 100,000 organizations every year, and is responsible for ensuring compliance with the federal tax laws.

Two years ago, Senator Grassley and I had the General Accounting Office (GAO) look into how the IRS could better perform oversight on the charitable sector. GAO's report included important recommendations on the collection of information from charities, and well-thought-out suggestions on improving coordination between the IRS and state charity officials.

I am concerned that too little has been done to increase the level of cooperation between the federal government and states in this area. I look forward to hearing from this panel on the progress that has been made on this front.

Our second panel includes witnesses who will tell first-hand accounts of abusive tactics and tax shelter involvement by some in the charitable sector. Two of our witnesses on this panel are whistleblowers who fear reprisal if their identities are made public. I appreciate their willingness to come forward and testify today.

One witness will discuss the ongoing problems in the car donation area. As previously highlighted by a GAO report that Senator Grassley and I requested, this practice has been rife with abuse. Often charities receive pennies on the dollar for donated cars that have fetched thousands of dollars in tax deductions. This witness's testimony will shed light on the fraud perpetrated by car auctioneers and brokers who feed on innocent charities. A second witness will detail a scam that involves cheating American taxpayers to the tune of millions of dollars a year with a down-payment assistance charity.

I also look forward to hearing from Ms. MacNab and Mr. Adkisson, who will discuss other abuses. This panel should serve as a wake-up call on how some charities are being used for unethical and potentially criminal activities.

Finally, our third panel will address how we should fix these problems. I want to make special mention of my friend, Rock Ringling, the Managing Director of the Montana Land Reliance. Rock runs a tight ship. The Land Reliance serves as a model for other land conservation groups across the country. Rock will offer suggestions on best practices in the land donation area.

I am eager to hear from the rest of the witnesses on this panel about what we should do to keep the bad guys out of charities, without hurting the good charities in the process. I look forward to your testimony and thank you for coming today."

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Statement to Senate Finance Committee

June 22, 2004

My name is Derek Bok. I currently serve as faculty chair of the Hauser Center on Non-profits and Philanthropy at Harvard University. In the past, I have served for 20 years as the president of one large non-profit entity (Harvard University), and I am presently the chair of a large citizens' organization (Common Cause) and a medium-size foundation (the Spencer Foundation). I also was a member of an independent committee recently invited by the Nature Conservancy to investigate its system of governance and accountability and recommend changes. My other relevant experience is as a long-time professor of regulation at the Harvard Law School.

I firmly support the Senate Finance Committee's decision to examine the governance and accountability of non-profit and philanthropic organizations. Collectively, these entities have accumulated very large sums of money, perform many important services, and exert considerable influence in many spheres of American life. They also benefit from significant tax advantages. As a result, there is good reason for the government to try to make sure that they meet reasonable and proper standards in their organization and operations.

At the same time, it is important to bear in mind that the non-profit sector is extremely heterogeneous, including everything from billion dollar hospitals and universities to tiny neighborhood organizations and local choral societies. The governance and accountability of these organizations are subjects still in their infancy, having not yet received anything remotely like the attention lavished on government institutions and private corporations. Under these circumstances, at least two risks arise in any attempt to craft general regulatory measures for this sector.

- First, there is a danger that in enacting rules in response to a few particularly flagrant, widely publicized abuses, regulators will impose burdens of paperwork, record-keeping, and other costs on all non-profits that will more than equal any benefits achieved by government intervention.
- Second, in such a heterogeneous sector, it is quite possible that rules enacted with particular organizations in mind will prove inappropriate for other kinds of organizations and thereby lead to unanticipated, undesirable consequences.

Although the staff paper includes several eminently worthwhile proposals, such as timely submission of 990s and electronic filing, several of the other proposals threaten to give rise to one or both of the problems described above. Since space is limited, I will mention only three examples.

1. My first illustration is the requirement that non-profit boards "be comprised of no less than three members and no greater than 15." There may be good reason for establishing some minimum number of members.

After all, a board of one person is hardly a board in any meaningful sense. On the other hand, the reasons for a maximum figure are much harder to discern. In the review of The Nature Conservancy Board, for example, our outside committee concluded that a board of in excess of 15 was necessary to establish a sufficient number of committees to allow adequate oversight while avoiding multiple committee assignments that might cause Board members to spend insufficient time on each committee to do the job properly. Similarly, almost all university boards include more than 15 members, in part because more members are needed to oversee these large and varied organizations properly and in part to strengthen the fundraising capacities required to raise hundreds of millions of dollars each year. It is not clear to me what legitimate public purpose would be served by prohibiting these practices.

2. A second proposal in the draft would require every non-profit with gross receipts in excess of \$250,000 to “include in its Form 990 a detailed description of the organization’s annual performance goals and measurements for meeting these goals.” An enormous effort would be needed to fulfill this requirement properly in the case of major universities, which typically include literally hundreds of separate programs, most of which have goals too intangible to allow truly meaningful performance measures. Since the development of such measures for non-profits is still at a primitive stage, one can anticipate that many organizations will respond to such a requirement by stating very broad and general purposes with very dubious and self-serving performance analyses. It is not at all clear that the benefits derived from such reports will justify the substantial expenditure of time and effort required to prepare them.
3. The third and last example is the proposal that all non-profits submit periodically to the IRS, “current articles of incorporation and by-laws, conflicts of interest policies, evidence of accreditation, management policies regarding best practices, a detailed narrative about the organization’s practices, and financial statements.” The problem here is the burden that such a requirement will impose on countless tiny local non-profits with amateur part-time executives and boards composed of neighborhood volunteers. Many of these organizations are wonderful examples of local initiative, spontaneity, and enthusiasm. Yet rules such as this one threaten to bring about the disappearance of these small, informal grass-roots organizations, because they will lack the expertise to cope with complex government reporting requirements. Granted, some good may be accomplished, and some mistakes will be avoided. On balance, however, I fear that such rules will have a harmful effect by professionalizing and bureaucratizing local organizations that should be allowed to be operated and controlled by amateurs and volunteers. Rather than risk such a result, Congress might wish to consider imposing such

detailed reporting and financial requirements only on organizations above a substantial size, leaving smaller organizations subject to only minimal restrictions needed to prohibit clear and important abuses.

In conclusion, while supporting the effort to strengthen the accountability of non-profit organizations, I would urge great care in approaching this complex and unfamiliar task. Instead of attempting the difficult feat of crafting model procedures in an effort to encourage optimum performance, or giving the IRS the vast, uncharted task of developing (directly or indirectly) standards for accrediting all non-profits, I would begin by concentrating on curbing reasonably clear abuses. Otherwise the costs resulting from unanticipated problems and excessive administrative burdens may well outweigh the positive results that a more cautious, incremental approach can achieve.

**U.S. Senate Committee on Finance**  
**Hearing on Charity Oversight and Reform**  
June 22, 2004

Testimony by Willard L. Boyd, Professor of Law and President Emeritus, University of Iowa and the Field Museum (Chicago); Director, The Larned A. Waterman Iowa Nonprofit Resource Center; and Chair of the Iowa Governor's Task Force on the Role of Nonprofit Organizations in Iowa.

Mr. Chairman and Senator Baucus, we are grateful to you for holding this hearing emphasizing "the importance of the nonprofit community to the nation." Even though we live in an increasingly globalized society, we live our lives locally. In the American tradition, our voluntary nonprofit organizations are the building blocks of community. Through our local nonprofits we provide community service, develop community values and take community action together as citizens. In Iowa, our 3,614 charitable 501(c)(3) nonprofit organizations that filed 990 forms in 2003 are small and rely heavily on volunteers in all aspects of their operations. Approximately 72% of all Iowa charitable organizations filing tax returns have revenues under \$500,000. Forty-four percent have revenues of less than \$100,000. Iowa nonprofit organizations do much with little funding. We are committed to doing good — well and responsibly. While we share the desire for accountability and transparency, we are, nevertheless, concerned about over-regulation of very small, very effective and very dedicated organizations. The majority of Iowa charitable organizations have six or fewer employees. Staff compensation is very low compared to the business and government sectors and often does not include health and other fringe benefits. Little or no funds are available for training. This does not deter staff from improving their effectiveness and efficiency. Their commitment to serving the public sets an example for all Iowans.

Our three Regents universities and the community colleges provide inexpensive and accessible training opportunities. In particular, the University of Iowa and University of Northern Iowa work with Iowa State University in providing nonprofit training academies in various parts of the state. The University of Iowa Nonprofit Resource Center also works with the University of Northern Iowa in support of its important National Center for Public and Private School Foundations with which Senator Grassley has been a prime mover.

The Iowa Nonprofit Resource Center at the University of Iowa concentrates on the generation and dissemination of substantive information on the legal, tax, and managerial issues confronting nonprofit organizations. The Center's website is a major vehicle for reaching every Iowa nonprofit organization. Our website contains several valuable sections. First, we list over 50 informative and practical books on different aspects of nonprofit organizations. Through a link to the Iowa State Library system, a nonprofit can find the book closest to it geographically. Second, all of Iowa's higher educational institutions can list directly on our website those courses that are relevant to improving nonprofit organizational management, thereby ensuring our nonprofit leaders access to training that improves their performance. Third, we list useful local, state and national web links. Fourth, we list available consultants who are knowledgeable in finance, information technology, fund-raising, marketing, and management. Finally, we have a FAQ (Frequently Asked Question) section, which provides basic information.

The Iowa Nonprofit Resource Center has also developed a monograph series. Our first two are: "Legal Guide for Iowa Nonprofits" which includes tax information and "The Governing Board for Iowa Nonprofits." The "Governing Board" monograph contains practical appendices including a job description for board members and a job description for the chairman of the board. The chairman of the board is a critical figure in the effectiveness of the nonprofit organization. Very little attention is paid to identifying and training

board chairs, so we are emphasizing the importance of board chair succession. We also include a board self-evaluation form, committee charters, an outline of an informational board manual, and a listing of important policies that the governing board should have in place. We are developing monographs on strategic planning, volunteers, human resources, fund-raising, community foundations, and website development.

The Governor's Task Force is focused on improving nonprofit practice. At our June 10, 2004, meeting we agreed to develop a compendium of good practices modeled on the Minnesota Standards for Nonprofit Excellence which are similar to those in Maryland and Utah. We are involving the Offices of Secretary of State and Attorney General in this process. We are eager for them to publish these practices on their websites in order to notify all Iowa nonprofit organizations of good practices and the importance of adhering to them. We also want to develop a legal compliance audit for nonprofits over and beyond the financial audit. This would help assure compliance with those operational, tax, and accountability laws and regulations governing nonprofits.

The 2004 Iowa General Assembly enacted — and Governor Vilsack signed — a new Iowa Nonprofit Corporation Act based on the American Bar Association Revised Model Nonprofit Act. For the first time Iowa has defined by statute the fiduciary duties of nonprofit board and staff members. This Code includes the longstanding Iowa Code prohibition on loans to board members and officers.

To strengthen nonprofit accountability, we need to stress the importance of mission statements. Mission statements are the benchmark for evaluating the success of a nonprofit as well as clearly notifying the public of what the nonprofit actually is supposed to do. A for-profit corporation can be judged by the value of its stock and its dividend. The nonprofit's success is judged by how well it achieves its mission. We emphasize outcome evaluation. Although outcomes are

often hard to quantify, an assessment effort is a systematic way of thinking about effectiveness. In our Task Force we are discussing the format of a simple nonbeaucratic annual report which each organization, however small or large, will make available in web and print form. In addition to budget and fund-raising information, it will include a forthright statement of mission and program activities.

Our small, fragilely financed Iowa nonprofits face numerous challenges including the enormous difficulty of providing fringe benefits, particularly health care. Our Task Force is exploring regional joint purchasing. We are also concerned about liability of our unpaid volunteer directors, officers and staff. We recognize there are both federal and state volunteer liability protection laws, but they do not cover the costs of a successful defense by an individual volunteer if the nonprofit organizational resources are insufficient to indemnify.

We are greatly challenged to raise funds for operations. The movement by grantors and donors away from general operating support of basic infrastructure to restricted giving that focuses on particular programs imperils basic operational effectiveness. We also worry about an emphasis on "entrepreneurship" which can lead an organization astray from its charitable mission. Even if the UBIT is paid, there can be drift away from the basic nonprofit mission.

We are proud that the community foundation movement is growing rapidly in Iowa. It has been greatly advanced by Endow Iowa, a matching state grant and tax credit program as well as gambling revenue grants for those counties that do not have gambling. We recognize the importance of good stewardship by the community foundations. We focus on accountability in fund-raising and fund application.

We deeply appreciate your commitment to a tax policy that provides donor incentive such as the charitable deduction by non-itemizers which is so important in Iowa. We are alarmed that

nationally the percentage of income people are giving to charity has been declining. We are committed to strengthening volunteerism, which is the root of private giving. Our Task Force wants to enhance community service learning opportunities for young people and seek out senior citizens to perform vital volunteer activities that they will find invigorating and fulfilling. Even though Iowa has the second highest percentage of volunteers in the nation, we intend to do better. Montana has the fifth highest percentage of volunteers.

As you address accountability issues of justifiable concern to you, I hope you will not nationalize America's nonprofit organizations. Historically, they have been chartered, governed, and made accountable under state law. The Internal Revenue Service needs more staff to enforce its existing nonprofit regulations. Adding more federal regulation and accreditation of all aspects of governance and operations would certainly crush small organizations financially, operationally, and psychologically. Ironically, twenty-four years ago, the President of the University of Chicago and I, as President of the University of Iowa, had a lengthy conversation with then Presidential candidate Ronald Reagan about the concerns he and we had about the financial and bureaucratic costs of proliferating accreditation in higher education. Over-regulation of small organizations would also run counter to the efforts of the Federal Faith Based and Community Organizations program that is designed to make federal funds more accessible to small organizations by reducing redtape and by funding managerial training at the local level.

We applaud this hearing because it is an opportunity to emphasize the importance of the nonprofit sector in the life of America. Historically, we have relied upon the local private nonprofit sector to meet many community needs. We must continue to strengthen that tradition. Thank you for all you are doing to assure that voluntary associations can continue to build strong communities.

## PREPARED STATEMENT OF HON. JIM BUNNING

Whether guided by a strong faith in religion or a desire to give back and improve society, Americans consistently choose to give freely of their time and money. Thanks to this philanthropic spirit, American charities are among the most successful and dynamic in the world to further encourage this generosity, the United States government has long given charities preferred tax status and greater latitude in the marketplace. The tax code was designed to convey these special benefits while preventing abuses in the system, but it is far from perfect. The I.R.S. has generally exercised limited review of not-for-profit organizations, as they face a large number of new organizations with increasingly complex structures and missions.

While most of the work of charitable organizations continues with the best intentions and successes, we have unfortunately seen growing problems with the activities and regulation of a few American charities. The last few years have been marred by scandal, often involving good, thoughtful groups that were enticed to bend the rules and exploit loopholes by greedy investors.

Not-for-profits and foundations should not be tax shelters or fronts for fraudulent investment schemes.

In order to ensure that the thousands of charities doing good work are not tainted by the inappropriate activities of a few, we need to take a close look at the tax code, I.R.S. oversight, and penalties for fraudulent activities.

We owe the charities that work to better society and the Americans who share their hard-earned pay to ensure charities are fulfilling their mission.

I look forward to hearing the views of our witnesses today, both those who work in tax enforcement and those who work at the charities themselves. I thank the witnesses for appearing before the committee to testify on this important issue.

Thank you Mr. Chairman.

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TESTIMONY OF MR. CAR – A CONFIDENTIAL WITNESS  
SENATE FINANCE COMMITTEE – JUNE 22, 2004

Mr. Chairman, members of the committee, I want to thank you today for giving me the opportunity to testify. I am speaking to you regarding the issue of middlemen and car donations. The reason I want to speak today is in honor of my mother who passed away from cancer and my frustration that well-meaning families who donate cars in the hopes of helping those in need aren't seeing real benefit from the donation of their cars. I speak to this from first-hand knowledge. I was a manager at an auto auction for over a year and then I worked as a vehicle wholesaler for approximately a year and am now in retail sales of used and new cars.

Let me start by giving you the basics on how a car donation works. First, people see an advertisement in their local newspaper proposing fair market value as a tax deduction. People usually are looking at donating an older vehicle that they do not use -- but in some cases the cars are nearly new. Second, there is a toll free number to call at which point either the charity will answer the call or the call is forwarded to a third-party broker. At this point, you give a description of your vehicle to the broker, year, make and model. The broker will verify if you have a clean title. The broker will then tell you to refer to Kelly Blue Book for your tax deduction. Next, the broker will tell you that your car will be picked up by a local towing company in five to ten working days. In most cases, the towing company is owned by either an auto auction or used car dealer.

At this point, if the car goes to auction, standard commission for the auto auction house is 25% of the sale price of the vehicle. If the car goes to a used car dealer there is usually flat rate pricing. Flat rate pricing will typically be \$75 a car and \$125 for trucks. These are the rates for cars produced between 1985 and today. In addition, the broker at the beginning gets a sliding scale reimbursement between 30 - 45% of the check value they receive -- for performing the following duties: advertising, operating the toll free hotline, title work and assigning auctions to pick up the cars. Check value is NOT what the car sold for. For example, if a car sells at auction for \$1000, the auto auction receives 25% - \$250; the broker will receive 30 - 45% of the \$750 remaining. However, the auto auction double dips by charging a buyers fee to the purchaser and will thus make close to \$350. However, this unfortunately is the best case scenario.

Let me now tell you about flat rate sales, the way for insiders to cheat the charities. Again, these are cases that I know firsthand. We received a vehicle donation for a charity of a 1999 Ford Contour. We received a fax for the pick up order and it was a \$75 unit. This meant that the car was already assigned to be sold at the used car lot and, regardless of sale price, the most the broker would get is \$75 -- and the charity would only get a percentage of that -- example, \$30 - \$40. The car actually sold for \$3,500. Thus, the middlemen got well over \$3,000 dollars profit and the charity pennies. This is common industry practice across the board and is know as "flat rate sales" fees.

Another example of an even more terrible practice is what is known as "fixing cars" where middlemen purposely disable vehicles that were prescreened as running vehicles -- and therefore worth more -- so when the vehicle arrives at the auto auction or used car dealership they can call the

broker and inform them the car was misrepresented and the broker 99% of the time does not contact the donor to reconfirm the vehicles condition. Again, "fixing cars" is a common practice in the industry. For example, a 1996 Ford Crown Victoria was picked up in running condition drove onto the truck . However, two days prior to auction the vehicle was disabled by turning the distributor cap to offset the timing. In this case the auto auction disabled the vehicle and then they sold it to themselves through their used car license. That car, the Ford Crown, went for \$275 dollars and it was then after the auction, that the insiders took a timing light to reset the distributor for the timing and drove the car away. The middlemen later sold the car for probably about \$3,700.

Another technique is to simply pull out the fuse block or blow the fuse and then put it back in after they've purchased the car themselves for less than its actual value. This, again, is very common. In fact, I personally was approached by a couple who donated their vehicle because their son died. They wanted to donate their vehicle to the charity to try and make a difference. The car was sold at auction for \$4,200. Once all the percentages were taken out that charity received less than \$300. There has to be something that can be done about this. So many people out there donate their cars to make a difference for research, treatment and transplants. But the truth is, there wouldn't be enough money from that car donation to buy my mother's medication for one month let alone help the progress of research and treatment.

I want to close, Senators, by asking you how you would feel if you donated your vehicle to charity, it was worth \$4000 and that after all expenses were paid out less than \$400 -- 10% -- went to research to save lives. In some cases less than 5% is effectively being contributed. I hope the answer is that you see the need for real reform in this area to make sure car donations are being used to help those in need -- not opportunistic middlemen.

**"Recommendations for Reform of the United States  
Philanthropic Sector"**

*A Statement to the United States Senate Committee on Finance  
By the National Committee for Responsive Philanthropy  
June 22, 2004*

The National Committee for Responsive Philanthropy (NCRP) has long advocated for significantly improving philanthropic accountability and responsiveness and the means for providing necessary oversight and enforcement. It is insufficient to call for stronger oversight and enforcement of the standards of philanthropic accountability if the standards are inadequate or completely missing. This statement outlines the elements of philanthropic accountability that should be the basis for both public policy and foundation self-regulation to create a truly responsive and accountable philanthropic sector.

For more than a year now, the media have regularly uncovered and reported on egregious instances of abuse and mismanagement in the nation's private foundations. Most of the nonprofit and philanthropic sectors' leaders have dismissed nearly every case of felonious behavior as an exception to the rule, the bad apple ruining the otherwise pristine collective barrel of American philanthropy. This defense was excusable in perhaps the first, second, and third cases of abuse that were uncovered. But as more examples of astoundingly illegal and unethical behavior are revealed, this line of defense sounds both hollow and cowardly.

It is not enough to offer vague calls for better accountability within and public oversight over the philanthropic sector as other leaders have done. It is time to be specific. It is time to recommend comprehensive reforms to bring about new standards of public and private accountability to the 65,000 private foundations that control \$500 billion in philanthropic assets in the United States today. Independent research, by the way, estimates that at least 45 percent of those \$500 billion belong to the American public, having been

accumulated thanks to various tax breaks that foundations receive at their inception and throughout their institutional lives.<sup>1</sup>

Speaking of the American people, public trust in the nation's charities and foundations is at historically low levels. They have read the news stories about scandals in philanthropy, and they have concluded what most of the media and many lawmakers—but only a few leaders of philanthropy—have concluded as well: It's time for change. The current laws and regulations pertaining to foundations were established more than 30 years ago, when the philanthropic sector was much smaller, both in numbers and dollars. In the last ten years alone, the number of foundations has doubled and their assets have more than tripled.

The U.S. Congress has a responsibility and obligation to pass new and better laws to regulate private philanthropy. Because foundations wield so much financial power and influence over their grantee organizations—which know foundations the best, the calls for reform will not be coming from the nonprofit sector. And the public has no say in who sits on foundation boards of directors, so there are no outside share- or stakeholders to bring foundations into line. The government, therefore, must step in and take action. No other entity has the authority, integrity, or courage to do so.

This statement will provide concrete suggestions for reform of the nation's philanthropic sector. Foundation leaders will be unhappy with many of them, but this statement was crafted not to please the philanthropic elite, but to bring a sense of democratic and fair governance and oversight to billions of dollars that are not living up to their legal mandates or ethical obligations.

The suggestions are organized into three broad areas:

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<sup>1</sup> Mark Dowie. *American Foundations: An Investigative History*. Cambridge: MIT Press, 2002.

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- Maximizing foundation accountability and transparency
- Maximizing foundation support for nonprofits
- Maximizing foundation support for justice and democracy

These suggestions were drafted based on my organization's observation of and research on current deficiencies among the nation's foundations, as well as comments from our organizational members and board of directors.

It is an honor and privilege to offer this statement to the United States Senate Committee on Finance. I sincerely hope that they are helpful in the Committee's initial efforts to bring about a new era of reform and transparency for the United States philanthropic sector.

#### **Maximizing Foundation Accountability and Transparency**

- Use the foundation excise tax: Reduce and consolidate the private foundation investment excise tax to 1% of investment income and devote the bulk of the tax payment to IRS and state government oversight of nonprofits and foundations—as the foundation excise tax was originally intended to be used when first enacted. The remainder can and should be used to supplement government oversight through grants for nonprofit activities such as research and data collection on the nonprofit sector, nonprofit accountability standard setting, and special investigations.

In January 2004, NCRP reaffirmed its support for simplifying and reducing the tax from a complex variable rate that wavers between 1 percent and 2 percent, to a consistent 1 percent rate of private foundation investment income. The reduction in the excise tax will

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free up potentially more than \$140 million for foundation grantmaking. But \$350 million or more will remain in general revenues, and it should be used to address its originally intended purpose—the public oversight costs for philanthropic accountability.

NCRP's legislative proposal for making the foundation excise tax a tool for a more accountable philanthropic sector includes the following:

1. Reduce the foundation tax to a simplified, consolidated 1 percent of private foundation investment income, but require that the money that foundations "save" from the tax reduction go to nonprofit organizations in the form of grants—as opposed to being used by foundations to increase foundation executives' salaries, foundation trustees' compensation, and other expenses.
2. Dedicate 20 percent of the remaining excise tax to more than double the budget of the Tax Exempt/Government Entities division of the Internal Revenue Service from its current budget of less than \$60 million to approximately \$130 million, enabling it to more effectively oversee and audit private foundations, public grantmaking foundations, donor advised funds, and other philanthropic grantmaking mechanisms, as well as nonprofits in general, to weed out the more than a few bad apples currently undermining the accountability of philanthropy and charity.
3. Dedicate 40 percent of the remaining excise tax to create a fund of \$140 million, which the Commissioner of the Internal Revenue Service (IRS) can use to supplement the charity investigative and oversight arms of state attorneys-general offices.

4. Allocate 15 percent (or approximately \$50 million) of the remaining excise tax for the IRS Commissioner to grant to nonprofit organizations whose research, ratings, and evaluation efforts complement and augment the oversight functions of federal and state agencies.
5. Use another 15 percent of the excise tax for the generation of IRS statistics on the finances of foundations and charities comparable with the research IRS generates on other sectors of the economy.
6. Reserve the remainder of the excise tax revenues to support special initiatives of the Tax Exempt/Governmental Enterprises division of IRS and for additional research and data collection and dissemination.

The private foundation excise tax, originally set at 4 percent of foundation investment income when enacted in 1969, was intended to pay for IRS costs of overseeing tax-exempt organizations. Had the reduction of the foundation excise tax been enacted to start in 2004, \$144 million would have been potentially freed up for grantmaking in the first year and nearly \$200 million in the second year.

Oversight and enforcement of the nonprofit sector has changed since 1969, when Congress last implemented broad changes to rules pertaining to nonprofits and foundations. The responsibility is no longer just that of the Internal Revenue Service's Tax Exempt Division, but also the charity oversight offices of states attorneys-general, few of which were on the radar screen 35 years ago; their on-the-ground roles in monitoring foundations and nonprofits overall should be supported by the excise tax whose primary purpose was meant to bolster foundation and nonprofit accountability.

Bolstering philanthropic oversight is crucial, given the explosive growth in the number of private foundations, plus other kinds of grantmaking charities, while IRS audits of foundations plunged from 1,200 in 1990 to less than 200 in 1999 and considerably less today.

- Improve IRS forms 990PF and 990: The 990 needs to be radically overhauled to reveal important information about foundations (and public charities) for necessary review and oversight; foundations and nonprofits should be able to e-file; and there should be significant penalties for foundations that do not file their 990PFs on a timely basis. All publicly disclosed data should be available in a free, publicly accessible and searchable format.

Some of the recommendations below—such as disclosure of insider relationships between foundations and outside vendors providing services for hire—can be implemented through changes to the IRS Forms 990PF and 990. Institutions filing these forms should also be regularly required to state *in specific terms* how their grantmaking and/or programmatic activities further their tax-exempt purposes.

- Increase disclosure of corporate philanthropy: The bulk of corporate giving to nonprofits, whether above- or below-the-line, is not disclosed to the public due to the privacy of corporate tax returns and the unwillingness of the SEC to demand disclosure. The recent trajectory of corporate abuses including philanthropic misbehavior makes the need for enhanced disclosure clear.

Corporations undoubtedly have a variety of motives for giving to charity. Tax breaks, positive publicity, and a genuine concern for the public good could all encourage a company to donate its money, time, products, or services to charity. In more sinister cases, corporate charitable gifts could also be used as bribes to encourage

corporate directors to overlook financial improprieties, as in the case of Enron.

Corporations receive significant tax breaks for their giving—the money that they donate is in a sense “public,” since it is actually lost tax revenue for the government and the general public. Further, whether or not it is a motivation for giving, being seen as a good corporate citizen undoubtedly helps a company’s bottom-line. For example, in 1999 Philip Morris spent \$75 million on charitable contributions, and \$100 million to publicize these donations.<sup>2</sup> Corporate philanthropy, then, can be viewed in many cases as government subsidized advertising for for-profit corporations. Further, there is evidence that corporate philanthropy is being used to perpetrate and perpetuate scandals in corporate America—to the eventual detriment of shareholders, nonprofits, and citizens alike.

For these reasons, NCRP recommends that the SEC adopt disclosure requirements

for all corporate philanthropic donations—in-kind or cash, through a foundation or directly from the corporation. The amount donated, as well as the recipient of the funds, needs to be made public through paper and electronic means on an annual basis. Such a policy would help restore some faith in corporate America, as well as the recipients of its charity. It would also allow researchers and advocates to understand a significant piece of US private giving and work to make it more fair and responsive to the country’s neediest and most disadvantaged citizens.

- Disclose grantmaking by public charities: Private foundations are not the only charitable grantmakers. While some public charities such as community foundations routinely and completely disclose

<sup>2</sup> Michael E. Porter and Mark R. Kramer. “The Competitive Advantage of Corporate Philanthropy.” *Harvard Business Review*, 2002.

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their grantmaking, the grantmaking disclosure performance of public charities overall is spotty. The public deserves to know who receives how much of charitable grantmaking whether from public or private charities.

Current IRS regulations for both public charities and private foundations require the public disclosure—on IRS Form 990 or 990-PF—of grantees (including the organization's name and full contact information), specific purposes of grants made, and potential conflicts of interest. Based on our use of literally thousands of these documents for various research projects, only one foundation comes to mind that follows these requirements. More often than not, the only information offered is the name of the grantee organization and the grant amount. Contact information, a specific (or even general) description of how the money will be used, and conflict of interest information are rarely, if ever, provided.

- Disclose the grantmaking from donor-advised funds: Donor-advised funds (DAFs) are increasing rapidly, but there is virtually no disclosure of their grantmaking, much less oversight of their philanthropic probity. At a minimum, a comprehensive regime of DAF disclosure should be established.

In 2003 alone, nearly 70,000 new DAFs were established, according to the *Chronicle of Philanthropy*.<sup>3</sup> A private financial adviser has set up a website ([www.donoradvisedfunds.com](http://www.donoradvisedfunds.com)) to educate potential clients why they should set up DAFs instead of private foundations. According to this website: "Starting a private foundation can involve substantial start up costs and administrative expenses, such as the yearly filling of a Form 990-PF. But one of the most important differences is that Donor Advised Funds receive more

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<sup>3</sup> Leah Kerkman and Nicole Lewis. "Donor Funds Are on the Rise Again." *The Chronicle of Philanthropy*, May 27, 2004.

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favorable tax treatment than a private foundation. Donor Advised Funds allow donors to take a federal income tax deduction up to 50% of adjusted gross income (AGI) for cash contributions and up to 30% of adjusted gross income (AGI) for appreciated securities; versus 30% of AGI for cash contributions and 20% of AGI for appreciated securities for a private foundation. Donor Advised Funds also offer the ability to recommend grants anonymously, if desired."

Another perk, this site points out, is that donors receive all of these tax breaks, but do not have to make grants to any charitable organizations anytime soon--while the funds continue to grow. But it is recommended, however, that a DAF make a minimum grant contribution of \$250 annually.

If donors want to continue to receive significant tax breaks for "giving" through DAFs, then they must be held accountable in radically new ways. At a minimum, DAFs should have the same disclosure requirements that public charities and private foundations have, and they should be required to pay out at least 6 percent of their financial holdings annually to charities.

- Disclosure of all insider relationships with foundation vendors:  
 Foundations only list a small number of their outside vendors providing accounting, investment, consulting, and other services, without any obligation to identify which are related to foundation trustees or officers. Disclosure of vendors should include all firms with business relationships with foundation insiders, piercing the "doing business as" shield some insider vendors currently hide behind.

Stronger definitions of and restrictions against foundation trustee self-dealing also should be implemented, especially a standard that eliminates the practice of investing foundation assets through

foundation trustees' firms or funds. The Bielfeldt Foundation, in Peoria, Illinois, paid nearly \$3 million to three members of the Bielfeldt family for investment services. The foundation's assets were invested in risky futures trading, resulting in a 64 percent loss in value in just two years. These types of services should be outsourced on a competitive basis to companies that are qualified to invest what are largely public dollars.

- Foundation CEO and staff salaries: NCRP continues to advocate that foundation salaries and other foundation administrative expenses should be removed from calculations of qualifying distributions (payout). Removing administrative costs from foundation payout—while maintaining or increasing the required foundation payout rate—will result in more grant dollars going to nonprofits and provide funders with incentive to be more efficient when spending money on themselves as opposed to their grantees. NCRP does not advocate that there should be specific limits or caps on the salaries of foundation executive directors or staff, but that foundation trustees should review executives' salaries very carefully and include in their calculations pensions, stock options, and other perks. In addition, foundations should disclose the total compensation paid—including benefits, severance packages, and other payments—to senior staff members.

According to NCRP analyses of IRS data on private foundations, in 2000 \$2.5 billion in foundation administrative expenses were included in their payout calculations. On average, throughout the 1990s, each year nearly half of these payout-related administrative expenses—44 percent—was used for foundation executive, board of trustee, and staff salaries and related benefits. As a matter of principle, foundations should not be allowed to count a \$1 million severance package to an outgoing CEO as the legal and financial equivalent of a \$1 million grant to a nonprofit organization.

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Foundations receive tax breaks in exchange for their charitable purpose, which is to get their assets into the hands of nonprofit organizations. The constitution of foundation payout should reflect this legal reality.

- Limiting foundation trustees' compensation: In nearly all cases, foundation trustees should not be compensated for their board service. If trustee compensation is deemed necessary, NCRP calls for limiting compensation or fees for foundation trustees (not including reimbursement for reasonable travel and incidental expenses) to no more than \$8,000 per year from all sources (i.e., not only fees, but also compensation through contracts for services such as legal, accounting, and investment functions). Like salaries and other administrative costs, foundation trustee fees should be removed from foundations' qualifying distributions.

If a public charity paid its board members, most foundations would probably not even consider it for a grant. Ideally, all board service in the nonprofit sector should be thought of as volunteer work, not as a highly paid part-time job. And many board positions are highly paid. A recent study from the Center for Effective Philanthropy, for example, found that the median hourly compensation rate of foundation board trustees in its research sample was \$324.<sup>4</sup>

Ideally these rates should be reduced to a maximum of \$8,000 per trustee per year, and such payments should not count toward a foundation's annual grants payout.

- Foundation diversity: Despite some progress, the diversity of the philanthropic sector still needs improvement. Racial, ethnic, gender, and class diversity should be addressed and increased, particularly among private foundation board members who are still

<sup>4</sup> The Center for Effective Philanthropy. *Effective Governance: The CEO Viewpoint*. 2004.

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overwhelmingly white, male, and upper class. Information on the diversity of foundation board members, senior staff members, professional staff, and other staff should be publicly disclosed.

A semi-regular survey from the Council on Foundations tracks the racial and gender diversity of foundation board members. In 1982, 77 percent of all foundation board members in the survey were men. In 2000, some erosion of the gender divide occurred, but not much, with men representing 66 percent of all foundation board members. Similarly, in 1982, 96 percent of all board members in the survey were white, which fell to 90 percent in 2000.

Because foundations are using largely public dollars and many claim to serve minority and other disenfranchised populations, it makes sense that foundation staff and board members should reflect the citizens of the United States—or, at the very least, the communities the foundations strive to serve—in racial, gender, ethnic, and class terms.

#### **Maximizing Foundation Support for Nonprofits**

- Emphasize core operating support grantmaking: NCRP maintains that at least half of foundation grant dollars should be in the form of core operating support or flexible grants as opposed to restrictive, program- or project-specific grants. NCRP's research indicates that giving nonprofits flexible, unrestricted grant support leads to stronger organizations, better support for the communities they serve, and improved relationships between grantors and grantees. Unlike foundations, nonprofits cannot simply give themselves grants to cover their core administrative costs. Additionally, in program or project support, the full cost of nonprofits' reasonable related

administrative or "indirect" expenditures should be included in the foundations' grants.

According to the Foundation Center, in 2002 only 12 percent of the grant dollars given away by the 100 largest foundations—based on total giving—were for general/operating support. The next largest 900 foundations gave nearly 22 percent of their grants dollars through general/operating grants.<sup>5</sup> Time-series data from the Foundation Center show that most foundations in the past two decades have shifted more of their grantmaking dollars into project specific grants, away from general/operating support grants. The nonprofits we work with tell us on a regular basis that they are struggling to serve and represent their constituencies, in part due to the financial pressures and restrictions that this shift in foundation grantmaking has produced.

- Increase foundation grants payout: NCRP reaffirms its longstanding position that private foundation spending, or payout, should be a minimum of 6 percent annually, with all administrative and operating expenses excluded from the payout and qualifying distributions calculations.

Right now, private foundations are required to pay out 5 percent of their assets each year. Again, this 5 percent currently includes foundation overhead expenses, as well as grants to nonprofit organizations and program related investments. Many foundations pay out exactly 5 percent each year, effectively turning the 5 percent floor into a 5 percent ceiling. IRS data show that smaller foundations tend to exceed the 5 percent minimum much more frequently than larger foundations; smaller foundations also tend to have little—and in some cases, no—overhead costs.

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<sup>5</sup> The Foundation Center. *Foundation Giving Trends*, 2004.

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Interestingly, the foundations with the most overhead costs tend to also have the lowest payout rates, even when taking overhead costs into consideration. For example, the IRS analyzed the payout rates of the 50 largest foundations from 1985-1997, and found that only thirteen actually met or exceeded 5 percent. The other 37 foundations fall short of this legal requirement, sometimes by more than one full percentage point. Looking at the ratio of grants to assets, only four of these top 50 foundations met or exceeded 5 percent in 1997.

Many foundation leaders oppose increasing the foundation payout rate because they claim that any rate about the current 5 percent increases their minimum spending requirement to a level that is not sustainable, effectively drawing down foundation assets to nothing.

Most research on payout and returns on investments do not, however, substantiate the claims that these individuals have made. For example:

- Research that the Council on Foundations commissioned shows that foundations could have maintained a 6.5 percent payout rate from 1950 to 1998 and would have still increased their assets by 24 percent.
- A study conducted at Harvard University on the investment returns of 200 of the nation's largest foundations found that they earned an average return of 7.62 percent, while paying out an average of only 4.97 percent.
- A new analysis that US Bancorp's Piper Jaffrey presented at a recent meeting of Northern California Grantmakers found that an investment portfolio made up of 70 percent equity stocks and 30 percent government bonds earned nearly an inflation-

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adjusted 8 percent return from January 1980 through December 2002.

- Lincoln Investment Planning, Inc. reports that the S&P 500 earned an average annual return of 10.2 percent from 1926 through December 2002. Investments in small stock companies yielded an average return of 12.2 percent for the same period.

Further, IRS data show that many foundations annually receive new infusions of money beyond returns on investments, including new contributions from individuals and profits from real estate holdings. Assuming that the only source of revenue for foundations is returns on investments simply does not reflect the reality of the philanthropic sector. And considering that the foundation sector has more than quadrupled in size over the past 25 to 30 years, it is mathematically impossible that a percentage or two increase in foundation payout would drain foundation assets and bankrupt the sector.

- Donor-advised fund payout: There is currently no payout minimum for donor-advised funds. There should be a minimum grants payout from donor-advised funds, established at a 6% level comparable to the payout rate that should be required of foundations. Considering the substantial tax breaks that DAFs receive—and their recent proliferation—they must be required to provide some minimal return to society, as everyone is impacted by the lost tax revenue from these charitable vehicles.
- Philanthropic social equity: Foundations need to better address the needs of disadvantaged and disenfranchised populations—and the nonprofits that serve them. Toward that end, there should be more foundation grantmaking devoted to social justice organizing and advocacy, significantly higher proportions of grantmaking devoted to

racial/ethnic minorities, low-income populations, immigrant populations, the disabled, gay/lesbian/bisexual/transgender communities, and a willingness to make grants to smaller organizations as opposed to the current propensity of many foundations to make only a few large grants to a small number of large nonprofit recipients.

In 2002, civil rights and social action nonprofit organizations received only 1.7 percent of all foundation grant dollars. Minority populations in general are underserved by foundations. Grants designated for African Americans/Blacks amounted to only 1.9 percent of all grant dollars in 2002; for Hispanics/Latinos the figure was 1.1 percent; for the disabled, 2.9 percent; the homeless, 1 percent; single parents 0.1 percent; and gays and lesbians, 0.1 percent. These are the groups of people who have been hardest hit by discrimination in society, and they are entitled to receiving a greater share of philanthropic dollars.<sup>6</sup>

Despite the fact that the overwhelming majority of nonprofit organizations in the United States are financially small institutions, nearly half of all foundation grant dollars was given out in grants that were larger than \$1 million in 2002. Only 18 percent of all grant dollars were given through grants that were smaller than \$100,000. These data suggest that foundations are not supporting the countless small, community-based organizations that the nation's most disadvantaged communities and populations depend on for critical human services and political representation.

- Maintain and support small foundations: While some very small foundations may very well be economically impractical, NCRP does not believe that small foundations are any less accountable or probative than large foundations, and in many cases, because of their

<sup>6</sup> The Foundation Center. *Foundation Giving Trends*, 2004.

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smallness and localism, they are more responsive to disadvantaged constituencies than others. Therefore, NCRP calls for maintaining and working with small foundations—and resisting calls for establishing and raising arbitrary minimum capitalization levels for foundations.

The scandals and abuses in foundations that have been reported in the press are not exclusive to small foundations. Foundations in all parts of the country and of all sizes have been engaged in illegal and/or unethical behaviors, according to these press accounts and the foundations' IRS filings. It is irresponsible to pass blame for the recent foundation scandals from the entire foundation sector to just one segment of the sector, as some nonprofit and foundation leaders are attempting to do. Doing so is inaccurate, irresponsible, and unethical.

#### **Maximizing Foundation Support for Justice and Democracy**

- **Encourage democratic participation:** Foundations should be encouraged to support nonprofit public policy advocacy, community organizing, nonpartisan voter registration drives, and civic engagement. It is perfectly legal for them to do so, and these activities do more to advance a broad public interest agenda than most service organizations and programs that foundations currently support.
- **Foundation investment activism:** Foundations invest hundreds of billions in corporate shares, giving them the opportunity of voting their proxies on critical matters of corporate governance, corporate accountability, and other corporate policies. The failure of foundations to take these affirmative steps with proxy actions results in missed opportunities for social change. NCRP encourages foundations to use their powers as shareholders to promote social

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change. Unfortunately, the majority of foundations do not take advantage of this position of power that they currently hold.

- Promote mission-based investing: It makes social and economic sense for foundations to devote part of their investments to mission-based investment options such as community loan funds, equity funds, and other charitable instruments. Mission-based investing should be a standard component of a foundation accountability regime.
- Prevent portfolio concentrations: Foundations should not invest more than a very small proportion of their investments in any one particular corporation, as the law currently calls for, they should desist in asking for exceptions to that standard, and those foundations that have received approval to circumvent this standard should return to the philanthropic norm of preventing such investment concentrations.

The experience of the David and Lucille Packard Foundation is a great example of why foundations should avoid such concentrations. The majority of the foundation's investments was held in Hewlett-Packard company stock. The economic boom of the 1990s—fueled in large part by the technology sector—boosted the foundation's assets to around \$10 billion. Following the economic downturn in 2001—which hit the technological sector especially hard—the foundation's assets shrank by \$8.3 billion, forcing Packard to eliminate entire grantmaking program areas and lay off staff members.

#### Conclusion

Current regulations, laws, and oversight are clearly ineffective. The drumbeat of scandalous stories in the nation's newspapers will not stop anytime soon. But it is not the responsibility of the media to police the philanthropic sector. Responsibility rests with the government, at both the state and federal level. Not only do the

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current laws and regulations need to be actually enforced, but stronger and more relevant laws and regulations are needed to reflect the current realities that both foundations and the charities that they support are facing.

NCRP was created nearly 30 years ago, which was the last time the U.S. Congress took an active interest in holding foundations more accountable to their grantees and the general public. We are encouraged that the Senate Committee on Finance is returning to these very important issues, and look forward to an ongoing dialogue that we hope will strengthen philanthropy so that it can better serve the people and communities who need it the most, as well as remain true to the U.S. citizens who bear the brunt of tax breaks that support the philanthropic sector.

Thank you again for the opportunity to address the Committee. It has been an honor and a privilege.

**WRITTEN STATEMENT OF  
MARK W. EVERSON  
COMMISSIONER OF INTERNAL REVENUE  
BEFORE THE COMMITTEE ON FINANCE  
UNITED STATES SENATE  
HEARING ON  
CHARITABLE GIVING PROBLEMS AND BEST PRACTICES  
JUNE 22, 2004**

Thank you, Mr. Chairman, Senator Baucus, and distinguished members of this Committee, for the opportunity to explain the role of the Internal Revenue Service (IRS) in a number of issues relating to tax-exempt organizations. We can be proud of the vast majority of exempt organizations that are fully and effectively carrying out their important missions. I must emphasize that my remarks, which by necessity will focus on problems we have observed, should not be interpreted as an indictment of the tax-exempt sector. The vast majority of tax-exempt entities carry out their valuable role in full compliance with the letter and spirit of the laws.

As you know the Administration strongly supports efforts to encourage and support donations to our Nation's charities. The Administration's FY 2005 Budget includes a number of tax relief proposals designed to stimulate charitable giving. However, I share your concern that some entities are using their status to achieve ends that Congress clearly did not intend when it conferred the privilege of tax-exemption.

Before I begin, let me give you a few statistics on the population I am here to discuss. When the subject of tax-exempt organizations arises, we commonly think of charities. This is understandable, given the prominent and valuable role of charitable organizations. But the tax-exempt sector is far broader. The approximately 3,000,000 tax-exempt entities include almost 1,000,000 section 501(c)(3) charities and almost 1,000,000 employee plans. The other million entities include state and local governmental entities, Indian tribal governments, and other tax-exempt organizations such as labor unions and business leagues. This sector is a vital part of our nation's economy that employs about one in every four workers in the U.S. In addition, nearly one-fifth of the total U.S. securities market is held by employee plans alone.

As I will discuss, there are abuses of charities that principally rely on the tax advantages conferred by the deductibility of contributions to those organizations. Other abuses involve not only charities, but other exempt organizations that allow themselves to further purposes other than those for which tax-exemption is authorized. When abusive tax avoidance transactions are involved, the facilitators of those abuses include not only charities and other exempt organizations, but also employee retirement plans, state and local governments, and Indian tribal governments. While the abuse in this sector may still be

isolated, I share your view that we must quickly and effectively act now. If these abuses are left unchecked, I believe there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised.

I am committed to combating abuse in this area. We recently released our IRS Strategic Plan for 2005-2009. Along with improving service and modernizing our computer systems, one of our strategic goals is to enhance enforcement of the tax law.

The President has asked for an IRS fiscal year 2005 budget of \$10.674 billion, a \$490 million (4.8%) increase over the FY 2004 appropriation. Most of this increase, \$300 million, will be used to restore and reinvigorate our enforcement presence. If funded, we expect to increase our spending in the examination area with respect to tax-exempt and government entities by 17% in 2005. This funding is crucial, particularly with respect to charities. Historically, IRS functions regulating tax-exempt entities have not been well funded due to the lack of revenue they generated. This view is misdirected in light of the size and importance of the sector. With staffing in this area flat at best and with the number of charities increasing annually, our audit coverage has fallen to historically low levels, compromising our ability to maintain an effective enforcement presence in the exempt organizations community.

One of our four specific objectives is to deter abuse within tax-exempt and governmental entities, and misuse of these entities by third parties for tax avoidance or other unintended purposes. I will align my remarks today with this strategic objective. First, I will talk about IRS deterrence of abuses within tax-exempt and governmental entities. Second, I will discuss IRS deterrence of the misuse of these entities by third parties for tax avoidance or other unintended purposes. For the most part, I will focus my remarks on charities, but the abuse of tax-exempt organizations transcends charities. I believe it is important to give the Committee a comprehensive overview of the problems we face in this area.

I would like to start by highlighting the Administration's legislative proposals to address abusive tax avoidance transactions generally, including those that may involve tax-exempt organizations, and legislative proposals to address specific abuses involving tax-exempt organizations. The Administration's FY 2005 Budget contains a number of legislative proposals, originally announced by the Treasury Department in March 2002 to combat abusive transactions. These proposals include statutory changes that would create better, coordinated disclosure of abusive transactions by taxpayers and promoters, and would back these improved disclosure rules with meaningful penalties. Other proposals would increase promoter penalties, increase accuracy-related penalties for certain undisclosed abusive transactions, target egregious behavior, curtail frivolous submissions, and reinforce the disclosure rules for off-shore accounts that may be used in some abusive transactions. Under this Committee's

leadership, these proposals are closer to enactment. In March 2002, The Treasury Department also announced a number of administrative actions to combat abusive transactions, and virtually all of these actions have been completed. I will describe other administrative actions the IRS is taking to combat abuses in the tax-exempt area.

In addition, although the Administration is committed to encouraging gifts to charity, it also wants to ensure that taxpayers are accurately valuing property they donate to charity. As described below, the Administration's Budget includes proposals to address the problem of overvaluation of certain gifts of property to charity.

## **DETERRENCE OF ABUSES WITHIN TAX-EXEMPT ORGANIZATIONS AND GOVERNMENT ENTITIES**

### ***The Need for Enhanced Governance***

In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a corporation, its executives, its accountants and auditors, and its legal counsel. Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. We at the IRS also have seen an apparent increase in the use of tax-exempt organizations as parties to abusive transactions. All these reflect potential issues of ethics, internal oversight, and conflicts of interest.

### **Specific Examples of Failures in Governance and the IRS Response**

#### **Credit Counseling Organizations**

Over the past several years, we have seen an increase in applications for tax-exempt status from credit counseling organizations that are substantially different from their predecessors. The new breed appears to be more focused on marketing debt management plans than providing educational or charitable services, and they operate with a relatively high fee structure. Governance failures have been endemic, including conflicts of interest in service contracts. In one case we have seen a large number of individuals and business entities involved in a scheme to sell a fraudulent business plan to create credit counseling organizations as fronts for profit-making businesses. As a result, we have embarked on an unprecedented effort in this area.

We are focusing our audit resources on those organizations with the highest risk of noncompliance with tax law. We have selected 50 tax-exempt credit counseling organizations for examination; the majority of these examinations are currently underway. The balance will be assigned to agents by the end of this fiscal year. This summer, we will have 50% of the total revenues of those credit counseling organizations that file information returns under active examination. To date, we have initiated and will be pursuing the use of proposed revocations of exemption of credit counseling organizations in appropriate circumstances. We also plan to seek injunctions and penalties against both individuals and companies for promoting fraudulent tax schemes.

We also are focusing on slowing the proliferation of new credit counseling organizations that may not be serving charitable purposes. As with all tax-exempt organizations, our goal is to ensure that every credit counseling organization that applies for exemption meets all applicable standards before we recognize exemption.

Change is taking place, and the industry is starting to move in the right direction. However, what has happened thus far is only the beginning. There still is much to be done. We remain very concerned that the potent combination of exemption from income tax and from consumer protection laws is encouraging those who are motivated by profit rather than charity to seek tax exemption. To address that concern, we are continuing our broad-based approach that includes an enhanced examination program, stricter scrutiny in our application process, partnering efforts with the state attorneys general and the Federal Trade Commission (FTC), as well as warnings to consumers about our concerns. We will use all tools available to ensure that these organizations act lawfully, including revoking tax-exempt status where warranted.

### **Compensation Issues**

The issues of governance and executive compensation are closely intertwined. We are concerned that the governing boards of tax-exempt organizations are not, in all cases, exercising sufficient diligence as they set compensation for the leadership of the organizations. There have been numerous recent reports of executives of both private foundations and public charities who are receiving unreasonably large compensation packages.

Neither a public charity nor a private foundation can provide more than reasonable compensation. Reasonable compensation is determined with respect to the market value of the services performed and depends upon the circumstances of the case. In general, reasonable compensation is measured with reference to the amount that would ordinarily be paid for comparable services by comparable enterprises under comparable circumstances.

Section 501(c)(3) provides that the assets of an organization cannot inure to the benefit of private shareholders or individuals. If an organization pays or distributes assets to insiders in excess of the fair market value of the services rendered, the organization can lose its tax exempt status. Moreover, insiders of public charities and of private foundations are subject to excise taxes on any overpayments they receive. Although an overpayment to an insider of a public charity could result in a revocation of tax-exempt status, section 4958 of the Internal Revenue Code (Code) provides an intermediate sanction that ameliorates that result in many cases. Under section 4958, an excise tax can be imposed on the insider who received the overpayment and on certain managers who knowingly approved the overpayment.

The payment of excessive compensation to an insider of a private foundation likewise may give rise to excise taxes under section 4941 of the Code on both the insider and on certain managers who knowingly approved the overpayment. In addition, the foundation itself and its managers may be subject to tax on any overpayment under section 4945 of the Code. Although the private foundation rules permit the payment of reasonable and necessary compensation to foundation insiders, most other transactions between a private foundation and its insiders are prohibited outright, without regard to subjective factors such as the reasonableness of the amounts, fair market value of property involved, or whether the transaction benefits or harms the foundation.

***IRS Tax Exempt Compensation Initiative:*** This summer, we are launching a comprehensive enforcement project to explore the seemingly high compensation paid to individuals associated with some exempt organizations. This is an aggressive program that will include both traditional examinations and correspondence compliance checks. The purpose of the project is to enhance compliance by learning what practices organizations use to set compensation; learning how organizations report compensation to the IRS and the public; and creating positive tension for organizations as they decide on compensation arrangements. These organizations need to know that their decisions will be reviewed by regulatory authorities. This project also will have educational components.

We will be contacting hundreds of organizations. During the first stage, we will be looking at public charities of various sizes and private foundations. We will be asking these organizations for detailed information and supporting documents on their compensation practices and procedures, and specifically how they set and report compensation for specific executives. Organizations also will be asked for details concerning the independence of the governing body that approved the compensation and details of the duties and responsibilities of these managers with respect to the organization. Other stages will follow, and will include looking at various kinds of insider transactions, such as loans or sales to executives and

officers. We also will be looking at organizations that failed to, or did not fully complete, compensation information on Form 990.

This information will help inform the IRS about current practices of self-governance, both best practices and compliance gaps, and will help us focus our examination program to address specific problem areas.

***Private foundation market segment initiative:*** In the early 1980s, the IRS conducted an examination study of private foundations and concluded that there was a high level of compliance by these organizations. This led to lower audit coverage of private foundations, even compared to the decline in overall audit rates. That information is now dated. In addition, we are seeing a steady growth in what had been a fairly stable sector, now estimated as close to 100,000 entities. As a result, we have not only increased our coverage, we have developed a market segment initiative to learn about compliance issues raised by private foundations. Market segment initiatives are analogous to the National Research Program (NRP) in that they concentrate on a particular unique portion of the tax-exempt community to gauge its compliance with the tax laws. This project will study different categories of private foundations in several phases and ultimately will involve approximately 400 examinations. The goal is to measure compliance levels and ascertain whether anecdotal information, both good and bad, reflects foundation behavior generally. Depending upon what we find, we expect the results to allow us to develop improved enforcement mechanisms, a more focused educational effort, and improvements to Form 990-PF, the annual information return filed by private foundations. This market segment initiative will commence by November 2004.

#### **Terrorist Financing and Charities**

Obviously, a key concern is the financing of terrorism through the use of charities. Although that topic is beyond the scope of this hearing, we note that on March 4, 2004, we sent you a letter laying out our FY2005 initiative targeted toward this problem. We look forward to working with the Committee on this issue of national import.

#### ***Enhancing Governance--The Need for Better Coordination with the States and with Other Federal Agencies***

I believe that the various enforcement agencies, including the IRS, can achieve better enforcement results by partnering and coordinating our efforts. For example, we issued a joint consumer alert with the Federal Trade Commission (FTC) and the National Association of State Charity Officers (NASCO) on credit counseling abuses. Our ability to share information is governed by section 6103, and the flow of information to us in these relationships necessarily exceeds what we can offer in exchange. Nevertheless, we are taking the steps necessary to

ensure that we are able to work effectively with the states and other federal agencies to the extent permitted by statute.

#### **Coordination with States**

As Messrs. Josephson and Pacella will tell us, the states play an important role in the regulation of charities and private foundations. While the IRS's role is the administration of federal tax law, state law covers most other aspects of an exempt organization's existence, including issues involving contracting, fundraising, use of trust corpus, and consumer protection. State enforcement often can yield important information for federal tax administration.

To give an example, a number of states are actively looking at private foundations under state nonprofit corporation and charitable trust laws. The IRS has asked to monitor information arising from those efforts. What we learn may allow us to better focus our own enforcement efforts, and help identify areas where increased information sharing with the states is appropriate.

In fact, we have been working with NASCO to improve our coordination with the states not only with respect to private foundations, but with respect to public charities as well. Although we are limited by section 6103 in what we can provide to the states, there are some exceptions. Recently, we revised and streamlined our procedures for forwarding to state attorneys general and other authorized state officials copies of denial letters we have issued to applicants for charity status, and revocation letters we have issued to existing charities.

In addition, we have told NASCO we can provide better feedback on organizations they refer to us for examination. We have offered meetings to discuss areas of mutual interest and determine what kinds of information it would be useful for the IRS and states to share. We hope to schedule an annual IRS/NASCO strategic planning meeting to allow state officials input into our annual exempt organizations work plan. Finally, we have proposed piloting project teams in key compliance areas that include NASCO members.

To facilitate continued cooperation with the states, the Treasury Department believes Congress should authorize the IRS in appropriate circumstances to share returns and return information about tax-exempt organizations with state charity officials to the extent necessary to administer state laws governing the administration of charitable assets and the solicitation of charitable contributions, or to facilitate the resolution of issues relating to the organization's federal tax-exempt status. The Treasury Department believes any legislation that permits disclosure of additional information should be based on a balancing of the interests of state charity officials and concerns regarding taxpayer privacy and the impact on federal tax administration. In addition, such disclosure should be subject to the same confidentiality, recordkeeping, and safeguard provisions that

apply to information shared by the IRS and with state tax officials. The Treasury Department believes the approach taken in the CARE Act as passed by the Senate addresses many of these concerns.

#### **Coordination with Other Federal Agencies**

We work with other federal agencies in a number of areas. For example we continue to engage in information sharing with the FTC to learn more about the credit counseling industry, including joint meetings with the FTC with representatives from industries that provide business services to credit counseling organizations. We have established an expedited process through which FTC attorneys may request approved Form 1023 application files. Similarly, the FTC has established an expedited process through which we may obtain information we need for enforcement. We expect to continue this mutually beneficial relationship and find other ways to leverage our scarce resources.

#### ***Enhancing Governance--The Need for More Outreach***

As I discussed above, stronger governance procedures are needed for exempt organizations. The sanctions for serious lapses in governance are clear. There is the possibility of revocation of exemption, along with the various excise taxes against individuals that I mentioned before. But sanctions are a last resort. We need to publicize practices that will help and encourage these organizations and their officers to prevent abuses in the first place.

To help tax-exempt organizations, we are developing a plain-language brochure to set forth certain practices we believe will be useful in promoting good governance, ethics, and internal oversight. This brochure will be available this fall.

The publication will explore practices that are not necessarily required by law but that may elevate the standards, conduct, and workings of exempt organizations. Although the IRS does not have authority to require organizations to follow specific practices, organizations without effective governance controls are more likely to have compliance problems. The publication is intended to provide exempt organizations, and in particular public charities, with a list of practices that will help guard against abuses involving, among other things, inappropriate financial transactions and operations. Among the topics we expect to cover are standards of integrity; the role, selection and duties of the governing board; conflict of interest policies; record-keeping; checks and balances that help prevent abuses; and fundraising practices, to name a few.

We also are developing forms changes to focus more specifically on governance questions. We have asked for and received comments from the public on whether the annual information return for exempt organizations (Form 990)

should require disclosure of whether the organization has a conflict of interest policy or an independent audit committee, and whether additional disclosure should be required concerning certain financial transactions or insider relationships.<sup>1</sup> Our Form 990 revision team is working on a comprehensive overhaul of the form to provide better compliance information about these organizations to the IRS, the states, and the public.

In addition, we are revising Form 1023, *Application for Recognition of Exemption*, to provide new focus on governance issues, both in terms of questions that explore compensation setting practices and arrangements, and on conflict of interest questions. We are expanding the form instructions to include a sample conflict of interest policy, and other materials to help filers better understand good governance practices. We expect the revised Form 1023 to be available by the end of the calendar year.

#### **DETERRENCE OF THIRD PARTY MISUSE OF TAX-EXEMPT AND GOVERNMENT ENTITIES**

I am turning now from abuses involving failures of governance of certain tax-exempt entities to abuses of tax-exempt entities by third parties. Unquestionably, there is overlap. There is often complicity between the exempt entity and the third party abuser, and thus governance issues arise in these cases as well. What distinguishes this category of abuses is that the third party is seeking to exploit the entity's tax-exempt status.

##### ***Abuse Involving Tax-exempt Accommodation Parties***

I cannot overstate the seriousness of the involvement tax-exempt and government entities as accommodation parties to abusive transactions. We use the term "accommodation party" to describe the tax-exempt entity's involvement in a transaction that does not necessarily affect the entity's primary function, but is designed to provide tax benefits to a third party that is a taxable entity. This role served by tax-exempt entities has become increasingly significant as abusive transactions have evolved. Many of the earliest abusive transactions hinged on the use of partnerships and subchapter S corporations to facilitate transactions and thwart detection through the use of multiple entities and complex structures. As the IRS has responded and placed increased emphasis on the examination of those types of entities, we have seen an increased use of various tax-exempt entities--including charities private and government pension plans, Indian tribal governments, and municipal governments--to achieve equally abusive results.

Almost half of the transactions we have identified to date as "listed transactions" (i.e., tax avoidance transactions) under the return disclosure regulations may rely

<sup>1</sup> Announcement 2002-87, 2002-2 C.B. 624.

to some degree on the use of a tax-exempt party. In fact, five of the eight transactions we have listed in FY 2004 use a tax-exempt party. Although in many of the transactions the entity involved could be a foreign entity not subject to U.S. tax, in other cases the entity could be a tax-exempt organization. The S corporation transaction described below is an example of an abusive transaction that may involve a domestic tax-exempt organization.

We believe this is an area of major concern for your Committee. When taxpayers use artificial means to avoid their share of the tax burden, they not only shift the burden to all taxpayers, but also undermine the public's confidence in the integrity of our system. Further, for many tax-exempt entities, most notably charities, tax-exemption, the charitable contribution deduction, and other tax benefits constitute an indirect subsidy of activities Congress has determined are beneficial to society. However, when those entities engage in transactions that offer tax benefits not intended by Congress to third parties, there is a cost to society without a corresponding increase in social benefits.

The schemes are many. Here I will detail two examples of recently listed transactions that illustrate the abuse of the tax system and the challenges we face in dealing with the transactions. The first example is a transaction in which taxpayers donate offsetting foreign currency option contracts to a charitable organization to trigger a loss deduction while avoiding taxation on corresponding gain. The second example involves the purported transfer of S corporation nonvoting stock by a taxpayer to a tax-exempt entity in an attempt to shield income from taxation while allowing the taxpayer to retain the economic benefits of ownership.

#### **Offsetting Foreign Currency Option Contracts**

This marketed promotion exploits the Code's rules for recognizing gain or loss on foreign currency contracts. The taxpayer holds offsetting positions in contracts on a currency traded on a regulated futures exchange (these contracts are subject to section 1256 of the Code), and contracts on a currency that is not traded on a regulated futures exchange (these contracts are not subject to section 1256). Straddle positions are taken so that all gains are offset by losses.

Section 1256 of the Code requires a taxpayer to recognize the inherent gain or loss at the time of any assignment of a currency contract traded on a regulated futures exchange. However, assignments of contracts on currencies that are not traded on a regulated futures exchange are not subject to section 1256.

Before the close of the calendar year, a participating taxpayer assigns the offsetting section 1256 contracts and non-section 1256 contracts to a recognized public charity. Although this generates a small charitable deduction for the donor, the main feature is that the donor can recognize the loss on the section 1256 contracts without recognizing the corresponding gain on the non-section

1256 contracts. Rather, the charity, which is not subject to tax, recognizes this gain on the non-section 1256 contracts.

We have identified dozens of entities, both taxable and tax-exempt, that are involved in this type of transaction. Examinations are underway. Because we identified and began enforcement action on this issue early, we are still gathering data on the dollar impact of these transactions and we believe the revenue loss may have been minimized by early detection. However, preliminary data suggests the impact may exceed one million dollars per transaction. We listed this transaction in Notice 2003-81, 2003-51 I.R.B. 1223, which requires disclosure by participants.

#### **The S Corporation Transaction**

This abusive transaction is designed to shift income from the individual shareholder of an S corporation to an unrelated tax-exempt accommodation party that is either a municipal pension plan or a charitable organization with an unrelated business income tax net operating loss. Participants purport to donate S corporation nonvoting stock to the tax-exempt accommodation party while effectively retaining the economic benefits associated with ownership, either through stock options or repurchase rights. The purported donations generally represent 90% of the number of outstanding shares of S corporation stock. The transfer of the S corporation shares thus is designed to shift the pass-through of 90% of the S corporation taxable income from the original shareholders to the accommodation party, for purposes of deferring or avoiding taxes. The original S corporation shareholders retain voting control of the S corporation and thus retain control over the timing of corporate distributions (i.e., although the pass-through of taxable income occurs while the accommodation party holds the S corporation shares, the distribution of the underlying profit is controlled by the original S corporation shareholders). Not surprisingly, during the period that the accommodation party holds close to 90% of the outstanding shares, the S corporation distributes little or none of its profit. After a period of time, the original shareholders either cause the S corporation to repurchase the accommodation party's nonvoting stock at an artificially low value, or else the original shareholders themselves dilute the value of the shares held by the accommodation party to a small amount by exercising warrants to purchase additional shares of nonvoting stock vastly in excess of the number of shares held by the accommodation party. In either event, the original S corporation shareholders attempt to enjoy a lengthy tax holiday while retaining control and substantially all the economic value of the S corporation, including the retained profit.

We have identified dozens of S Corporation Transactions involving the reallocation of hundreds of millions of dollars from shareholders to tax-exempt accommodation parties. Examinations are underway. We listed this transaction in Notice 2004-30, 2004-17 I.R.B. 828.

## **Problems the IRS Faces in Addressing Area**

### **Disclosure**

Disclosure is an important way for the IRS to identify participants in abusive transactions. However, our disclosure scheme, which originally was developed to address the taxable sector, does not yet fit all tax-exempt participants because the method of reporting does not fit all tax-exempt entities well. For example, an organization must attach Form 8886 to its annual tax return for each year that the organization participates in a listed transaction. For this purpose, "tax return" includes information returns, so tax-exempt entities that file information returns are covered by the regulations. However, entities that are not required to file any return are not covered. This excepted category includes churches, small exempt organizations, state and local governments, state and local government retirement plans, and Indian tribal governments. Thus, these entities are not covered by the section 6011 disclosure net.

### **Lack of Sanction**

Another difficulty in addressing accommodation parties is that IRS has no sanctions comparable to those that can be imposed on promoters or investors. Currently, there is no sanction for a taxpayer's failure to disclose a reportable transaction under section 6011 of the Code. The Administration has proposed in its FY 2005 Budget legislation that would impose meaningful penalties on all taxpayers that fail to disclose reportable transactions, including listed transactions, on their returns. As noted above, however, not all tax-exempt entities are required to file a federal tax return.

In addition, the accuracy-related penalties imposed by the Code are not sufficient to deter a tax-exempt accommodation party, which neither invests in the transaction nor has taxable income to understate. Finally, IRS' compliance sanctions for exempt organizations do not fit these situations. Participation in the transaction as an accommodation party rarely will affect the tax status of a charity, qualified plan, or other tax-exempt entity. In the offsetting foreign currency options transaction, for example, the accommodating charity receives some net value. Its receipt of the asset has not changed the organization's purposes or activities, nor has the receipt of the asset caused the organization to engage in an excess benefit transaction. The abuse is that the transaction is structured to generate a tax benefit for the donor that far exceeds not only the amount authorized by the Code for charitable contributions, but also the net benefit received by the charitable organization.

***IRS Response to Accommodation Party Strategies***

*Accommodation parties in S Corporation Transactions designated as participants.* On April 26, 2004, we took an important step about the involvement of tax-exempt entities as accommodation parties in abusive tax transactions. In Notice 2004-30, we designated the S Corporation Transaction as a listed transaction and for the first time exercised our authority under the return disclosure regulations to designate specifically the tax-exempt accommodation party as a "participant" for purposes of those regulations. As a participant, the accommodation party must comply with the disclosure requirements. Thus, if required to file a return, the tax-exempt accommodation party must attach a Form 8886 to its return for the taxable year it received the donation from the S corporation, the taxable year of the reacquisition, and all intervening years.

*All filers will be required to identify accommodation parties involved.* At the same time we issued Notice 2004-30, we also announced<sup>2</sup> that we would revise Form 8886 to require all filers to identify the names of all parties to a listed transaction, including the names of tax exempt parties that facilitate the transaction. We have just released the revised Form 8886. Thus, a tax-exempt accommodation party to a listed transaction that is not itself required to file Form 8886 will be identified through the Forms 8886 filed by the other parties to the transaction. Although this information could be obtained through the examination process, requiring this information on the Forms 8886 that are filed will give us a better picture early of the tax-exempt entities that are facilitating the abusive transactions.

*Previously listed transactions will be reviewed.* We are reviewing transactions we have previously designated as "listed transactions" to determine whether we should treat tax-exempt accommodation parties in those transactions as "participants."

*Future listed transactions.* We will consider in all future listed transactions whether any tax-exempt accommodation parties should be designated as a participant.

There may be other actions necessary, in a regulatory context or otherwise. We look forward to working with your staff in this important area.

**Misuse of Tax-Exempt Entities by Donors and Investors**

We are facing a number of other current issues where donors or others are using or attempting to use tax-exempt organizations for private purposes, including sheltering assets for deferred personal use or claiming accelerated or inflated deductions. I will briefly discuss certain classes of cases in which we have found abusive behavior. It is important to note that although certain types of

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<sup>2</sup> Press release IR 2004-44.

organizations are being used inappropriately in particular instances, the abuses are not typical of these types of organizations, taken as a whole.

### **Section 509(a)(3) supporting organizations**

A supporting organization is a public charity that in carrying out its charitable purpose supports another exempt organization, in almost all cases another public charity. The phrase can cover a wide variety of organizations: endowment funds for universities; subordinate entities that provide essential services for hospital systems; and many others. The classification as a supporting organization is important because it is one method by which a charity can avoid classification as a private foundation. Because of the required relationship between the supporting organization and its supported organization, the supporting organization is classified as a public charity, even though the supporting organization may be funded by a smaller number of persons. Private foundations are subject to many more restrictions and to the above-referenced regime of excise taxes on certain behaviors.

Let me emphasize here that we believe the vast majority of supporting organizations are entirely legitimate and upstanding charities. However, some tax planners see the supporting organization primarily as a means by which an organization's creator can effectively operate what would ordinarily be a private foundation under the less restrictive rules applicable to public charities. Self-dealing and certain other transactions with substantial contributors to these organizations would be prohibited in the private foundation context.

However, some of the abuses and promotions we have seen clearly are not consistent with tax-exempt status. For example, in one promotion we have uncovered there is, almost immediately after a purported charitable donation to a supporting organization, an unsecured loan of all or a significant portion of the funds back to the donor and creator. A key part of this transaction is the effort by the promoter to ensure a lack of oversight of the supporting organization by the public charity it purports to support. While too technical to outline in this testimony, we are seeing several strategies that frustrate the ability of the supported public charity to oversee its supporting organization, clearing the way for abuses.

We have several promoters under investigation in this area and are examining dozens of organizations. More examinations are likely and we expect to be examining numerous individual returns shortly.

### **Corporations Sole**

First, let me say that corporation sole statutes are a historical artifact intended to allow church officers, such as bishops or parsons of a church, to be incorporated for the purpose of insuring the continuation of ownership of property dedicated to the benefit of a legitimate religious organization.

However, we have become aware that some promoters are urging use of corporation sole statutes for tax evasion. Individuals incorporate under the pretext of being a "bishop" of a religious organization or society. The idea promoted is that this entitles the individual to exemption from federal income taxes as an organization described in section 501(c)(3). Individuals are told that their income will not be reportable or taxable, that their assets cannot be reached by current or future creditors.

These promotions have no legitimacy, and we are taking vigorous action to stop them. We are conducting dozens of promoter investigations of corporate sole promoters. To deter potential customers from being lured into the scheme, we published Rev. Rul. 2004-27, 2004-12 I.R.B. 625, which clearly explains that a taxpayer cannot avoid income tax by establishing a corporation sole.

### **Donor Advised Funds**

A donor advised fund is a separately identified account maintained and operated by a section 501(c)(3) organization. These accounts have become very popular in recent years. Each account is funded with contributions made by a donor or a group of donors. For the payment to qualify as a completed gift, the charity must have legal control over the donated funds. While the donor, or individuals selected by the donor, may advise on the distribution of funds from the account and the investment of assets in the account, the charity must be free to accept or reject the donor's recommendations. For example, a donor may contribute \$1,000,000 to a donor advised fund and claim the whole amount as a charitable deduction for the year in which the contribution is made. In future years the donor may advise the fund as to desired distributions to qualified beneficiaries (e.g., other charities). In operation these funds allow considerable input from the donor but are not classified as private foundations. Again, in a legitimate donor advised fund, the charity must have legal control over the donated funds and must have the right to disregard the donor's advice.

We have seen abuses in this area, both in examinations and in applications for exemption from new organizations. A case in which the IRS denied exemption is pending in the Court of Federal Claims. In addition, we are aware that some promoters encourage clients to donate funds and then use those funds to pay personal expenses, which might include school expenses for the donor's children, payments for the donor's own "volunteer work", and loans back to the donor. We have over 100 individuals under audit in connection with such cases.

### **Certain Employee Stock Ownership Plans (ESOPs)**

Some ESOPs have been created for no purpose other than to circumvent statutory restrictions. For example, we discovered an abuse through our determination letter process that led to our publication of Rev. Rul. 2003-6, in which we stopped a strategy to market ESOPs on the basis that they would be eligible for the grandfathered (rather than the 2001) effective date of section 409(p). Rev. Rul. 2003-6 outlined a promotion where a person set up a series of ESOPs in advance of an effective date hoping to sell the plans later as part of the promotion.

### **In-Kind Donations to Charities—the Problem of Overvaluation and Other Issues**

With respect to gifts of both tangible and intangible property, we have seen overvaluation by some taxpayers to inflate the charitable contribution deduction at public expense. Valuation issues can be especially difficult. The Administration's FY 2005 Budget includes several proposals to address the problem of overvaluation of donated property. But there can be other problems as well.

### **Intellectual Property**

A key issue in intellectual property donations, as in all other property donations, is whether the property has been appropriately valued. In the case of patent and other intellectual property donations in particular, we have concerns about overvaluation, whether consideration has been received in return, and whether only a partial interest of property is being transferred. To address valuation concerns, the Administration's FY2005 Budget includes a proposal to limit the taxpayer's initial deduction for contributions of certain intellectual property to the lesser of the taxpayer's basis in the property or the fair market value of the property. Under the proposal, the taxpayer would be permitted to deduct certain additional amounts based on the amount of revenue, if any, actually received by the charity from the donated property. The Administration's Budget also includes a proposal to require all taxpayers (including C corporations) to obtain a qualified appraisal of property (other than inventory property and publicly traded securities) if the deduction claimed exceeds \$5000, and to attach a copy of the appraisal to the taxpayer's return if the deduction claimed exceeds \$500,000.

In addition to these legislative proposals, we have issued Notice 2004-7, 2004-3 I.R.B. 310, which is aimed at donors, promoters, and appraisers. The Notice reminds taxpayers that transfers of property are not deductible:

- If the transfer is of a partial interest in property.
- To the extent that consideration is received for the transfer.
- If the transfer is inadequately substantiated.
- To the extent the property is overvalued.

The Notice reminds taxpayers that the fair market value of a patent must take into account whether the patented technology has been made obsolete by other technology; any restrictions on the donee's use of, or ability to transfer the patented technology; and the length of time remaining before the patent's expiration.

#### **Conservation Easements**

Conservation easements placed on land or buildings have become a significant part of environmental and historic preservation movements. Some charities exist primarily to receive and hold land and easements in perpetuity to prevent development.

Although easements represent a valued part of philanthropy, let me briefly summarize some of the issues we have seen. As stated, gifts of partial interests in property are ordinarily not deductible. An easement, of course, is only a partial interest. However, section 170(f)(3) provides an exception to the partial interest rule for qualified conservation contributions such as conservation easements.

We have seen several abuses in this area. There have been cases where the easement being donated is overvalued. There are also cases in which the donor, or the donor's successor in interest, takes an action inconsistent with the easement without adverse consequences. The conservation easement rules place the charity in a watchdog role over the easements it possesses. If the charity fails to monitor these properties (another failure in governance), the potential exists for inconsistent use by the landowner of the property upon which the original deduction was premised. In other cases, taxpayers are claiming large deductions when they are not entitled to any deduction at all (e.g., when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements).

We have developed guidance to remind donors and charities the legal requirements for a conservation easement contribution. We expect that this guidance, examination in this area, and the forms changes and one of the compliance initiatives described below, will improve compliance in the area of easements donations.

### Vehicle Donations

For a taxpayer, donating a car to a charity has definite appeal. One can help a charitable cause, dispose of the car, and take advantage of tax provisions that are designed to support the generosity of Americans. Deductions are limited to the fair market value of the property.

In its recent study<sup>3</sup>, the GAO estimated that about 4,300 charities have vehicle donation programs. In its review of returns for tax year 2000, the GAO estimated that about 733,000 taxpayers claimed deductions for donated vehicles they valued at \$500 or more. Highly troubling is GAO's analysis of 54 specific donations, where it appears that the charity actually received less than 10% of the value claimed on the donor's return in more than half the cases, and actually lost money on some vehicles. While this study is important information for potential vehicle donors, it does not necessarily indicate that the charity is doing anything wrong. Most car donations result in small gains for the charity. From the charity's point of view, often a small gain is better than no gain. The GAO states that its sample of specific donations was too small to allow generalization to all vehicle donations. But we cannot ignore the clear implications of the study. The Administration's FY2005 Budget includes a proposal to curtail the problem of inflated deductions being claimed for donated vehicles by allowing a deduction only if the taxpayer obtains a qualified appraisal of the vehicle.

***IRS enforcement efforts with respect to donated vehicles:*** We are educating donors and charities on what constitutes a well-run donation program. In December 2001, we alerted the public to a series of nine steps that individuals should take when donating their vehicles to ensure that a gift is to a recognized and reputable charity, and that the appropriate deduction is taken for the make, model, and condition of the vehicle<sup>4</sup>. We have just released two plain language brochures regarding car donation programs, one for the benefit of the vehicle donors; the other for the benefit of charities. We will be partnering with the states to distribute the brochures to the fundraising community, as the states regulate fundraising activity.

On the compliance side, we have two programs. In the first, the IRS is focusing specifically on individuals who have taken deductions for vehicle donations. We are conducting approximately 200 correspondence examinations of vehicle donors to learn how donors are valuing their donated vehicles. In the second, the IRS is matching taxpayers' Forms 8283, which substantiate large deductions for donations of various kinds of property, against Forms 8282. We believe non-cash donations of property other than vehicles may be an equal or larger

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<sup>3</sup> Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight (GAO-04-73, November 2003).

<sup>4</sup> IR-2001-112, December 3, 2001.

problem. Based upon what we learn from these programs, we will decide what further compliance actions may be necessary.

We are also looking at how to improve our forms for reporting non-cash contributions. Taxpayers list their non-cash gifts of over \$500 on Form 8283. The IRS and Treasury are studying ways to improve the form to facilitate compliance with and enforcement of the substantiation requirements.

### **CONCLUSION**

In summary, let me assure you that this Administration understands just how important the exempt sector is to our nation and how important it is that we act against outliers before they do any further damage to the tax system and to the confidence of our citizens. That is why we have made this one of our four enforcement initiatives and have asked for additional funds to ensure that we are able to do what needs to be done. We are confident that if we focus both on the governance issues and the misuse of entities by others we will be able to address these problems effectively. Let me also say that the Administration commends this Committee for your recognition of the problems and your effort to get at the causes of and solutions for these abuses.

**QUESTIONS FOR THE RECORD*****Senator Snowe:***

Q: There are more than 60,000 private charitable foundations in the United States. Of these 60,000 plus foundations, the IRS has been said to audit, on average, only 120 per year. By my calculations that is roughly 0.2 percent of all foundations.

This seems to be an unusually small number of audits, but I understand that an April 2002 report by the General Accounting Office (GAO-02-526), entitled "Improvements Possible in Public, IRS, and State Oversight of Charities", concluded that the IRS lacked sufficient resources to conduct regular and thorough oversight of the country's tax-exempt organizations. As a result, the GAO supported improving charitable organization's reporting requirements in order to obtain more accurate data on the charitable sector, and strengthening state oversight of charities through improved cooperation with state officials and the IRS, particularly through data sharing.

Could you explain the progress the IRS has made to gather more accurate reporting data from foundations and trusts (beyond Form 990, if applicable) with special attention to charitable foundation expenses?

**A. With respect to reporting by tax-exempt organizations, the GAO in GAO-02-526 focused on Form 990, which is filed by public charities, rather than Form 990-PF, which is filed by private foundations. The GAO was concerned with the method used to report fundraising income and expenses, which would be particularly applicable to public charities because private foundations rarely engage in fundraising.**

Over twenty years ago the IRS studied private foundations and found a high level of compliance with the tax laws. This led to lower audit coverage of private foundations, even compared to the decline in overall audit rates. The study's information, however, is dated; we have seen what had been a fairly stable sector grow to over 100,000 entities. Our audit coverage has not kept pace with this growth, although we have lately increased the number of audits of private foundations from 119 in FY 2002 to 145 in FY 2003, and we have completed 155 audits through May 31, 2004 in this fiscal year.

To update our information about private foundations, we have begun a study that will measure the level of compliance by private foundations with the tax laws and that will determine whether the anecdotal information we have received reflects private foundation behavior generally. This study

will involve examinations of about 400 foundations which, by itself, will mean a stronger and more comprehensive IRS examination presence in this area. The results will allow us to develop improved compliance mechanisms, determine what educational steps we need to take, and what improvements to Form 990-PF are needed.

In a separate program, we will be looking at compensation paid by private foundations and public charities. Through examinations and correspondence contacts, we will obtain data from hundreds of organizations to determine not only how they set compensation but also how they report it to the IRS and to the public.

Finally, in connection with all of our examinations of private foundations, we have reminded our agents to check whether organizations have been filing Forms 990-PF accurately and completely, and to impose penalties when they have failed to do so.

Q. How is this data being used to conduct timely and comprehensive oversight, be it by the IRS or the state attorneys general, of tax-exempt organizations.

A. Quite simply, better data will allow us to identify and focus appropriate resources on problem areas. For example, in our compensation initiative, we are using executive compensation and organizational size data from Forms 990 and 990-PF to focus on which organizations appear to be providing compensation that might be excessive.

We also are becoming more innovative in the ways we find and use data. We have begun to use external databases to facilitate our searches. We are establishing a new Data Analysis Unit in the tax-exempt area that will use databases and information to investigate emerging compliance trends and improve the identification and selection of casework. The unit will use economists, statisticians, and research analysts to provide expert informational analysis.

The states use Forms 990 and 990-PF in their enforcement of state laws. While we cannot speak for the states, we know that at least some states are actively pursuing fundraising practices that violate state law or are investigating cases of possible misuse of charitable assets through overcompensation of officers or otherwise. Accurate information on Form 990 is important for these efforts.

We have been working with the National Association of State Charity Officials (NASCO) to improve our coordination with the states. We have revised and streamlined our procedures for forwarding to the states copies of our denial and revocation letters with respect to charities. We have

**offered meetings to discuss areas of mutual interest and to determine what kinds of information would be useful for the IRS and the states to share. We hope to schedule an annual IRS/NASCO strategic planning meeting to allow state officials to comment on our annual exempt organizations work plan and we have proposed teams in key compliance areas that include NASCO members.**

Q. Given concern over abuse of charitable organizations, do you think that more detailed accounting methods are necessary on tax filings to help break out expenses that may be tucked into umbrella titles; for example "travel" or "conferences, conventions, and meetings"?

**A. We understand the need to strike the appropriate balance between obtaining additional information for the enforcement of tax laws and the potential burden on taxpayers due to the time spent on additional reporting. We periodically review our forms that relate to exempt organizations to determine what additional information would be important for tax administration purposes. Also, given the fact that Form 990, Form 990-PF, and Form 1023 (the application a charity files for exempt status) are used by states to administer state laws that apply to these organizations, by nonprofit "watchdog" organizations, and by the general public, we have periodically offered the public (including the tax-exempt organizations affected) the opportunity to comment on what changes to these forms, if any, they recommend.**

For example, in the last two years we have asked the public for comments on how the Form 990 might be changed to request additional information on fundraising, on relationships between exempt organizations and section 527 political organizations, on foreign grants and other international activities, and on other matters. We have established a team that is considering these comments, as well as other changes, as they work on a comprehensive redesign of the form. Separately, we also have asked for comment on changes to Form 1023, including what additional changes might be desirable for better monitoring of international grant-making and other international activities. The revised Form 1023, with many new questions, will be available on our website by the end of this October.

**We believe that our internal reviews and enforcement experience, combined with comments from the states, watchdog organizations, and the public, help us identify those areas where information reporting by exempt organizations needs to be more specific.**

Q. In 1999, this Committee held hearings on restructuring and reforming IRS. Much of the testimony was about the then sometime draconian nature of IRS

enforcement and audits. At that time the IRS was encouraged to become more customer service oriented. I know your agency has worked hard to do just that, devoting a great deal of resources to making the IRS more friendly to the taxpayer. Now, I imagine, much of today's testimony will focus on how a lack of IRS enforcement has allowed for these charitable abuses to occur.

Do you feel that the abuses we will discuss today occurred because resources were redirected away from audits and enforcement to meet Congressional demands that the IRS be more consumer oriented?

How can the IRS balance the need for customer service with the need to dedicate resources and attention on tax fraud like the types of charitable fraud highlighted here today?

**A. The IRS needs to succeed with respect to both customer service and enforcement of the tax laws. It is not an either/or proposition. We must do both, and we need the resources to do both well.**

**Of all the functions within IRS, the exempt organizations area was actually one of the least affected by our recent reorganization. It is true, however, that our exempt organizations examination coverage rate has declined compared to where we were ten or twenty years ago. Historically, the competition for available funds within IRS has not favored exempt organizations tax law enforcement, in part because it has not been viewed as a particularly fruitful area for revenue generation. As the number of exempt organizations has grown, the number of our exempt organizations enforcement agents has remained level, at best. I think this best explains the decline in our coverage rate.**

**The trend needs to be reversed because abuses by or involving a small minority of tax-exempt organizations threaten public confidence in this important sector. We hope to increase the exempt organization audit-coverage rate substantially. One of our strategic goals in coming years is to enhance enforcement of tax law, not only with respect to exempt organizations but also across the board. The President has asked for an IRS fiscal year 2005 budget of \$10.674 billion, which is an increase of \$490 million over the FY 2004 appropriation. Most of this increase will be devoted to restoring and reinvigorating our enforcement presence, including a 17% increase in our spending on examinations activities in the tax-exempt and government entities area. I cannot stress enough the importance this funding has on our enforcement activities. Simply put, we need the resources proposed by the President.**

**Senator Santorum:**

Q. What percentage of charities are not complying with applicable laws?

**A. Currently, we do not have data that would yield a meaningful statistic. The section 501(c) exempt organization community is made up of many different kinds of charities and other exempt organizations, with diverse activities and needs and correspondingly diverse compliance challenges. To address this diversity, the IRS has divided the exempt organizations community into several dozen market segments, and in FY 2002 the IRS began to conduct market segment studies. Although the segments are broader than charities, among charities alone we have identified community trusts, social services organizations, religious organizations, colleges and universities, hospitals, supporting organizations, arts and humanities organizations, elder housing organizations, private foundations, and many more. Each market segment study will gather information about the segment, including compliance data from examinations and/or other means, through which we can determine industry compliance levels and shape targeted enforcement actions. With the exception of churches, which are not required to file with us and which under law we cannot examine unless we first have reasonable belief of a violation of tax law, we expect to gather compliance data that covers most categories of section 501(c)(3) organizations over the next several years.**

Q. Do you think that there are legitimate car donations programs and do you think that current car donation reform proposals will have a negative impact on legitimate charitable activity and fundraising efforts? (e.g., in 2000, \$228 billion (Giving USA report) was donated—approximately \$654 million (or roughly 0.29% of all giving) was deductions for vehicle donations.) Vehicle donation programs are a very small part of fundraising, but extremely critical for those charities that rely on such programs.

**A. The IRS has not done an independent study of the importance of car donation programs to the charitable community, and we defer to the work performed by the GAO in its study *Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight* (GAO-04-73). The GAO report raised concerns that the deductions claimed by taxpayers often substantially exceed the fair market values of the donated vehicles because taxpayers often use published values for cars in better condition than the donated vehicles. We have recently published two educational brochures on car donations that we hope will make charities and their donors better aware of sound practices and responsibilities with respect to vehicle donations.**

Q. The CARE Act, which passed the Senate more than 14 months ago 95-5 and is being prevented from going to conference, includes charitable transparency and disclosure provisions—including a provision to allow the Secretary of the Treasury to disclose to state officials certain documents and information about specific charities. Do you think that this would help improve coordination between federal and state charity regulators, and to what extent?

**A. The Treasury Department believes that Congress should authorize the IRS in appropriate circumstances to share returns and return information about tax-exempt organizations with state charity officials to the extent necessary to (i) administer state laws governing the administration of charitable assets and the solicitation of charitable contributions; or (ii) facilitate the resolution of issues relating to the organization's federal tax-exempt status. The Treasury Department believes any legislation that permits disclosure of additional information should be based on a balancing of the interests of state charity officials and concerns regarding taxpayer privacy and the impact on federal tax administration. In addition, such disclosure should be subject to the same confidentiality, recordkeeping, and safeguard provisions that currently apply to information shared by the IRS and with state tax officials. The Treasury Department believe the approach taken in the CARE Act as passed by the Senate addresses many of these concerns.**

***Senator Daschle:***

Q: Can you please tell me how the IRS monitors the Child Tax Credit beneficiary form?

**A: A taxpayer can claim the child tax credit for a qualifying child using Form 1040 or Form 1040A. On the tax return, the taxpayer must provide the name and identification number (generally a social security number) for each qualifying child. For tax year 2003, the credit was limited to \$1,000 per qualifying child and was reduced by the advance payment of the credit. The allowable credit generally depends on the amount of tax on the tax return, the taxpayer's modified adjusted gross income and filing status, and the amount of other credits claimed. The additional child tax credit is a credit taxpayers may be able to take if they were not able to claim the full amount of the child tax credit.**

**Generally, the taxpayer uses a worksheet in the tax return instructions to compute the allowable credit. Then, if the taxpayer cannot claim the credit in full, he or she uses Form 8812, Additional Child Tax Credit.**

Q: What does the IRS do to make sure two divorced parents do not simultaneously claim the credit?

**A:** In order to claim the child tax credits, the taxpayer must identify which dependent on the tax return is the qualifying child. The tax form instructions explain the rules for claiming a dependent and for the child tax credit. The instructions explain who is eligible to claim a child as a dependent in divorce situations. Because the qualifying child's name and identifying number (generally the social security number) must be entered on the tax return, the IRS can check for instances where the same child is being claimed by more than one taxpayer.

The IRS systematically checks for instances where two different individuals (including divorced individuals) use the same SSN(s) to claim the Education, Child Care or Child Tax Credits. A protocol was developed to select returns in this instance, and test audits were conducted on a sample of these returns in the later part of FY 2003. Analysis of the audit results is currently underway in order to refine parameters to select returns with the highest degree of non-compliance.

The IRS also utilizes the Dependent Database (DDb) to identify and select potentially non-compliant returns claiming Earned Income Tax Credit (EITC) and duplicate dependents. Any return claiming EITC or one or more dependents is processed through the DDb and is assigned a score based on a set of business rules. The amount of child tax credit claimed on the return is one component of the score computation. The child tax credit claimed on the return therefore contributes to the selection of returns for examination. Taxpayers, who are selected for dependency and/or EITC issues are required to verify that they are entitled the child tax credit, if applicable.



U.S. SENATE COMMITTEE ON

# Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

<http://finance.senate.gov>

Opening Statement of Sen. Chuck Grassley  
Hearing on Charitable Giving, Tuesday, June 22, 2004

Today the Finance Committee considers a very serious matter – ensuring that charities keep their trust with the American people. We will hear testimony today that is troubling. The testimony we will hear will suggest that far too many charities have broken the understood covenant between the taxpayers and nonprofits – that charities are to benefit the public good, not fill the pockets of private individuals. Too many well-meaning charities have fallen prey to the charlatans’ pitch about easy money. Some charities are blinded by their own mission and the need for additional dollars. These charities are willing to sign onto deals that provide dollars to promoters and insiders but only pennies to the charity. It is the taxpayers who are the losers.

In addition to well-meaning charities being led astray, we also have a growing number of individuals who knowingly set up a charity to evade taxes. Finally, we have charities – even big-name charities – that seem to just have the wheels fall off. Often problems at these charities can be traced back to poor governance or failure to abide to best practices. Since becoming chairman of the Finance Committee, I have been active in oversight in many areas, including charities. I have conducted investigations into such organizations as United Way, Red Cross and the Nature Conservancy. I’m please that my oversight has brought about good reforms at these organizations.

However, the Finance Committee is limited in its resources to perform this oversight. It’s clear that we need to look at more general reforms to address recurrent problems in the nonprofit sector. The staff of the Finance Committee, on a bipartisan basis, has produced a discussion draft that serves as a very useful beginning point to consider possible broad reforms. I welcome a dialogue about the best means of achieving the ends I hope we can all agree on – a vibrant and engaged charitable sector that enjoys the confidence of the American people that charitable donations are being used to meet charitable needs. Reforms to that end will benefit all charities – particularly the strong majority of charities that do their job and do it well and play such a vital role in our country. I view these much-needed reforms as a partner to the important efforts by President Bush to encourage charitable giving in the CARE Act -- championed by Senators Santorum and Lieberman. I continue to work to see the CARE Act brought to conference and signed into law.

Just as I’ve worked with the administration on encouraging greater contributions to charities, I hope the administration will work with the Finance Committee to bring real reform in the nonprofit sector.

--more--

Closing Statement of Chairman Grassley

This hearing has been very sobering. It's sad that in a hearing about charities we have to hear about million dollar insider contracts; middlemen who purposely cheat charities to make an extra buck; and the fact that over half of all new tax shelters used a tax-exempt party.

As I mentioned, this hearing is the beginning of a discussion about how to bring reforms to the charitable sector. I think that areas that we particularly need to think about are balancing the requirements that might be placed on charities, particularly smaller charities, and not overwhelming the ability of charities to achieve their important missions. Finding that balance will be the task in the weeks ahead. My hope is that Senator Baucus and I can look to introducing legislative reforms this fall – and even earlier for some provisions. I appreciate the nonprofit sector working with us to find that balance.

TESTIMONY OF MR. HOUSE – A CONFIDENTIAL WITNESS  
BEFORE THE SENATE FINANCE COMMITTEE  
JUNE 22, 2004

Testimony of Mr. House:

Mr. Chairman and Senators, thank you very much for inviting me to testify today.

I am a licensed financial professional with over 23 years of experience and I have been in the prime position to witness a non-profit run amuck. I will talk about how a seemingly good idea gets twisted and perverted in the hands of the wrong individuals. The story involves fraud, deception, waste and abuse – all cloaked in the shroud of a non-profit organization. The organization I am speaking about is Ameridream, Inc., a public charity and the largest home purchase, down-payment assistance non-profit in America.

I should make it clear before I begin that my story is about Ameridream as it was 18 or so months ago. Things have now changed at this organization for the better. It is a much different and a much better organization than the one I will describe today.

My testimony will focus on two key individuals, the founders of Ameridream, who I will call Mr. Red, and Mr. White – both who made millions from the charity they controlled.

First, though let me begin by describing what Ameridream does. Ameridream provides down-payment gifts to low and

moderate income families who cannot save enough to provide the down-payment themselves.

In the simplest of terms, the gift program works like this: a home seller has a buyer who has sufficient earnings to pay a monthly mortgage payment. For whatever reason, though, the buyer cannot scrape together enough money for a down-payment and the home seller through their real estate agent or potential mortgage lender, enrolls the property in the Ameridream gift program. In turn, Ameridream provides a down-payment to the buyer of up to 3% and receives a 3.75% "fee" in return from the home seller.

HUD requires that the home seller cannot give the buyer the down-payment directly. In order for HUD to insure the buyer's mortgage loan, HUD's regulations require a 501(c)(3) organization to act as a go between for the buyer and seller.

On the face of the transaction, everyone is a winner. The home seller sold his home, the buyer is now a new homeowner, the real estate agent receives a commission and the mortgage lender loans their money and receives "points".

Let me give you a typical example, Joe has a house he wants to sell that should sell for \$100,000. The selling agent knows about AmeriDream. The seller finds a buyer, Mary, who does not have the funds for a downpayment but can make the monthly

payments.

Then Joe's house is enrolled in the AmeriDream program. It is enrolled and the transaction goes forward. The price then is "massaged" for \$103,750. Or alternatively it is set for \$103,750 initially with an eye to the AmeriDream program and the fact that the \$100,000 will ultimately be the amount going to Joe as money back. The reason for this is as part of enrolling, Joe needs to pay AmeriDream 3.75% -- \$3,750.

So at the end of day, Mary buys the \$100,000 home for \$103,750. And of the \$3,750 -- it all goes to AmeriDream which then retains \$750 itself and reimburses itself for the \$3000 it paid the bank earlier for Mary's down payment.

Now let me talk to you about what the insiders, Mr. Red and Mr. White did at AmeriDream to fleece the charity from the revenues it got from this program (I estimate in the \$20 million range).

The founders and board members of AmeriDream, Mr. Red and Mr. White first set up along with Mr. Blue a marketing company called Synergistic Marketing, LLC (and now Inc).

Mr. Red and Mr. White ensured that Synergistic Marketing received a contract from AmeriDream. Synergistic's contract was to market to real estate agents, mortgage brokers and homebuilders.

According to Ameridream's Form 990 in 2002, Synergestic was getting \$1 million a month -- \$12 million for the year. Out of the million a month, approximately \$600,000 to \$700,000 would go to those three individuals or \$6 or \$7 million to those three for the year. The rest went to employee salaries and operating expenses at Synergestic.

At the same time, Mr. Red and Mr. White were getting a salary of \$175,000 approximately per year from AmeriDream. This inside deal where they got millions more in outside contracts was at best approved by a rubber stamp board that was dominated by Mr. Red and Mr. White.

This is only one example. At a time when Mr. Red and Mr. White had a desire for more cash they created a fake investment company, Valao Mortgage and transferred \$4 million from AmeriDream to Valao. Mr. Red borrowed a million dollars from Valao through – Avalar Properties, LLC . Mr. White, through his business partner, also borrowed a million dollars.

I understand Mr. Red and Mr. White used this money, in part, to pay \$250,000 each to become percentage owners in the Playboy golf scramble. Mr. Red defaulted on his loan.

In my limited time to speak, this gives you a general flavor of the situation at AmeriDream that I saw from the front row where insiders took advantage of a weak and absent board to enrich

themselves with the assets of a charity.

Let me end by noting, that while the good news is that Mr. Red and Mr. White are no longer at AmeriDream, unfortunately, to my knowledge there has been no actions taken against Mr. Red or Mr. White at either the State or Federal level.

Thank you Mr. Chairman.

**Embargoed until 12:00 Noon, Monday, June 21, 2004 - Dated June 18, 2004**



STATE OF NEW YORK  
OFFICE OF THE ATTORNEY GENERAL  
120 BROADWAY  
NEW YORK, NY 10271

ELIOT SPITZER  
Attorney General

(212) 416-8050

**UNITED STATES SENATE  
COMMITTEE ON FINANCE**

**HEARING ON**

**“Charity Oversight and Reform: Keeping Bad Things  
From Happening to Good Charities”**

**TESTIMONY OF**

**NEW YORK STATE ASSISTANT ATTORNEY GENERAL**

**WILLIAM JOSEPHSON**

**June 22, 2004  
Washington, DC**

Statement of William Josephson  
Assistant Attorney General-in-Charge, Charities Bureau  
New York State Department of Law  
Committee on Finance, United States Senate  
June 22, 2004

Mr. Chairman and Members of the Committee

Thank you for inviting me to testify here today on the Committee's proposals for reforms and best practices in the area of tax-exempt organizations.

I am accompanied by Assistant Attorney General Karin Kunstler Goldman, who has worked with your staff on these issues for the last five years. Karin and I applaud the Committee and particularly its most able staff for the time and effort they have devoted to preparation for these most important hearings.

Tax-exempt organizations contribute to countless aspects of our society. We all benefit from their services - developments in health care, education, culture, scientific advancement, helping our homeless and hungry citizens, improving our environment, caring for our children and much more. Most tax-exempt organizations are governed by dedicated boards of directors who properly manage the charitable assets with which they are entrusted.

However, as I will describe this morning, there are some boards that fail to fulfill their responsibilities because they are inattentive, ill-informed or self-interested. For example:

From 1990 to 1999, the six-member board of directors of the Grand Marnier Foundation's board awarded themselves \$3.4 million compensation. During the same period its asset value as reported to the Internal Revenue Service declined from a high of \$11,275,720 to \$6,699,487. The Attorney General's lawsuit against the six directors, including its lawyer, resulted in a settlement in which they agreed to repay to the Grand Marnier

Foundation a total of \$1,500,000 and to surrender control of the Foundation to five new directors.

The Urban League of Northeastern New York failed catastrophically in 2001 due to mismanagement of the organization by an unsupervised executive director, who failed to withhold payroll taxes, which resulted in a federal tax lien of \$525,830. The board did not exert appropriate oversight of the organization's activities, maintain an active committee structure, adopt budgets or retain an independent accounting firm to perform required annual audits.

Recently, a Texas jury decided that two former leaders of the Dallas-based Carl B. and Florence E. King Foundation, including the president and chief executive officer, had committed fraud against the charity and should repay \$7.5 million in excessive salaries, personal credit-card charges and attorneys fees. The jury also awarded \$14 million in punitive damages. The jury found that the salaries of these individuals, which included retirement packages of seventy-five percent of their salaries, had not been approved by the foundation's board of directors. According to the Texas Attorney General, the foundation spent more on compensation than it gave to charities in each of the last seven years as well as paying for defense of the defendants.

These examples, and others discussed, demonstrate a compelling need for reform. My remarks today will focus on recommended changes in the laws and practices in the following areas: exempt organization governance; IRS reviews of exempt organizations; improving IRS forms; cooperation between the IRS and state charity regulators; IRS and state resources; improved databases, electronic filing, revenue sharing between the IRS and the states, electronic filing; abuses by tax-exempt organizations, and ways to improve enforcement by the states.

A. Exempt Organization Governance and the IRS Exempt Organization Review Process.

At the beginning of the exempt organization application process, the Internal Revenue Service's organizational test review must pay far more attention than it now does to structures that will help to insure that improprieties such as these do not recur. Organizations

applying for exemption must state the qualifications of their directors and officers, their prior nonprofit experience and proposed training.

By analogy to the Securities and Exchange Commission's proxy rules, the exempt organization's Form 1023 should state: (1) whether the applicant requires standing audit, executive, compensation and nominating board committees and, if so, identify their director members; (2) the number of annual board and committee meetings contemplated; (3) whether the members of the audit and compensation committees, if any, are independent; (4) any compensation and benefits proposed for directors and executive officers; (5) who are the organization's independent accountants, if retained; (6) what conflict of interest policies have been adopted by the organization; and (7) what policies have been adopted for indemnification of officers and directors and for securing funds advanced to managers for their defense who are later found culpable. The written charter of the audit committee should be a required attachment to Form 1023. What policies protect whistle blowers?

B. Modification of Forms 990, 990-PF and 990-EZ and Their IRS Review.

Forms 990, 990-PF and 990-EZ (hereafter "990s") should be amended to enable the information described above to be easily tracked. If a director or executive officer has resigned or not been reappointed or removed because of disagreement on any matter relating to the organization's operations, policies or practices, that should be disclosed and the return flagged for IRS review, as the SEC requires for public companies. The same should be true for independent accountants and any management letters from them and for lawyers. Lawsuits, state audits and investigations should be disclosed.

Regulations promulgated by Attorney General Spitzer last year require the following information to be included in the registration statements of exempt organizations:

A statement as to whether, in connection with the solicitation or administration of charitable assets, the corporation, trust or other legal entity or any of its individual directors, officers, trustees or equivalent managers is or has been the subject of any disciplinary or legal action by any court or administrative body or been found to have engaged in unlawful practices and, if so, a detailed explanation of each such circumstance.

A statement as to whether the corporation, trust or other legal

entity's registration or license has ever been enjoined, suspended or revoked by any government agency and, if so, a detailed explanation of each such suspension and revocation.

Believe it or not 7,964 New York entities that file Form 990 with the Internal Revenue Service are not registered with the Attorney General's Charities Bureau: 5,955 public charities and 2,009 private foundations. Some may be exempt from registration (for example, schools, non-soliciting hospitals, etc.), but many will need to register. Form 990 filers should be required to represent to the IRS that they have filed with the states that require them to file, and there should be severe penalties for failure to do so. We are starting a project to bring these organizations into compliance.

C. Revision of Form 990.

Journalists and members of the public constantly complain about the user unfriendliness of the Form 990. The IRS's revision has been long pending. Perhaps the American Institute of Certified Public Accountants could help the IRS develop new Form 990 for public comment, in a form that is consistent with the financial statements prepared in accordance with generally accepted accounting principles, that are called for in the Committee's staff comments and recommendation.

D. Periodic Review of Exemptions.

Exemptions from federal income taxation should not be perpetual. They should be periodically reviewed by the Internal Revenue Service. The states charities regulators could provide helpful input into that review. We are closer to the scene. We generally know if there have been complaints, investigations or law suits, and we can add to the IRS's enforcement resources.

Prior to this year, because of the inadequacies of our data processing capability in New York, we had to use a catch-as-catch-can method for identifying delinquent filers. If we received a complaint or Freedom of Information Law request or saw a press story about a registrant that turned out to be delinquent in filing annual financial reports, we sent the registrant a delinquency notice.

One of our new incremental improvements to our data processing system has enabled

us for the first time to search our registration database for delinquent filers. At the beginning of this year, we identified roughly 12,000 registrants – 25 percent of our nearly 50,000 total registrants – that had failed to file an annual report for at least two years. In less than four months, we have brought roughly 2,000 organizations into compliance and have collected roughly \$250,000 in filing fees at a cost of less than \$50,000 to the taxpayers of New York State. We believe that half of the 12,000 delinquents will prove to be defunct. We have asked the State legislature for general authority to dissolve New York corporations that fail to file annual financial reports with the Attorney General. We do not have the resources to bring 6,000 individual dissolution proceedings.

The IRS and we need a speedy and efficient way to revoke their exemptions/registrations and dissolve them.

E. IRS-State Cooperation.

In the course of reviewing the financial reports of a private foundation registered in New York, our accountants learned that the foundation had not met its IRS section 4942 distribution requirements since 1997. For each year from 1997 through 2002, the foundation incurred excise taxes which totaled \$90,000. The amount required to be distributed through 2002 was \$267,000. In other words, the Foundation's managers elected to pay excise taxes rather than distribute money to charity. According to the foundation's treasurer, it distributed only \$50,000 in 2003. For whatever reason, the IRS has not invoked 100 percent second stage correction.

The foregoing is but one of many examples where the IRS and the states need to be able and willing to work together.

1. Law Enforcement.

Under current law, IRS employees are prohibited from sharing information with state charity regulators. That prohibition can have absurd results. Not too long ago, I received a call from an IRS agent who could not locate documents concerning a matter which we had referred to the IRS. He could not mention the name of the organization but expressed the hope that I could figure it out and send him the file. I could and I did.

After 9/11, when the IRS announced that it would audit 9/11 charities, we

offered to help since many were in New York. Such a cooperative effort, we thought, would use efficiently the resources of both offices and expedite the audits. However, under current law, such cooperation may be prohibited.

Attorney General Spitzer applauds the Committee and its staff for their repeated efforts to enact amendments to the Internal Revenue Code that will designate state charities regulators as state tax authorities, so IRS and the states can work together.

The Senate amended and passed H.R. 1528, which would remedy this absurd situation. The Senate version covers all of the Code section 501(c) exempt entities over which the Charities Bureau has jurisdiction. It is clearly preferable to the House's version that covers only (c)(3)'s. We would be happy to provide any assistance you might need to get this legislation enacted.

## 2. Public Education.

We believe that in addition to law enforcement, the IRS and the states should shoulder some of the responsibility for educating those to whom we entrust our charitable assets. To that end, we conduct symposia throughout New York State and publish information to assist fiduciaries of charitable assets. Our most recent publication, Internal Controls and Financial Accountability for Not-for-Profit Boards, was completed this month. Along with the other publications of the Attorney General's Charities Bureau, it is posted on our Internet site at [www.oag.state.ny.us/charities/charities.html](http://www.oag.state.ny.us/charities/charities.html).

This very morning, Attorney General Spitzer's Charities Bureau and the Internal Revenue Service Tax Exempt/Government Entities Division are, for the first time, conducting together a symposium in New York City for boards and managers of exempt organizations. The subject of the symposium is "Registration, Accounting and Tax Issues for Not-for-Profit Organizations." Karin and I will be at the repeat of this symposium in Albany tomorrow.

## F. IRS Resources.

Enhanced IRS reviews and improved IRS/state cooperation will not be meaningful unless the IRS has the resources it needs to do the job. We realize this is a complicated issue, but we strongly support allocation to the IRS of the proposed substantially increased user fees and penalties. We call to the Committee's attention, for but one example, section 6(b) of the

Securities Act of 1933, as amended. Since fiscal 2002 it has provided that no '33 Act registration fees shall be deposited and credited as general revenue of the Treasury, and it contains formulas to protect over time the SEC's resources. The New York State Banking Department has the same kind of financial arrangements with its regulatees. Those who benefit from federal income tax exemption, and surely those who abuse it, should pay for enforcement.

G. Improved Databases and Electronic Filing

Enhancing accountability of the non-profit sector depends on the availability of data on non-profit organizations. The IRS, state charity officials and other government agencies need up-to-date data to enforce the laws governing non-profits. For example, with searchable data on compensation from Form 990, we would be able to prioritize for review organizations that may be excessively compensating their directors and officers. Foundations, corporate giving programs and individual donors also need current data in an easy to use format to help them make informed choices about their charitable contributions.

We will not be able to take full advantage of available information without fundamental changes in the way it is collected, processed and disseminated. A key component is electronic filing, which is the most efficient, accurate and cost-effective way to collect data. Converting paper-filed 990s into usable data is a time-consuming, error prone and expensive process.

The IRS launched e-filing of the 990 and 990-EZ in February. The individuals at the IRS responsible for this achievement – as well as the people at The Urban Institute's National Center for Charitable Statistics and Independent Sector's Electronic Data Initiative for Nonprofits who assisted the IRS -- deserve everyone's thanks. The IRS also deserves the support necessary to ensure that it can stick to its schedule to implement e-filing of the 990-PFs in 2005 and the State Retrieval System in 2006.

We cannot overstate the importance of prompt implementation of the State Retrieval System, which will allow annual reports to be filed simultaneously with the IRS and one or more states. It will encourage more organizations to file electronically by providing a single-point filing system. It will also eliminate the need for states to reinvent the electronic filing wheel. GuideStar received a grant from the Commerce Department to work with the National

Association of State Charity Officials (NASCO) to develop NASCOnet, which will assist the states to prepare for electronic filing and, specifically, to participate in the IRS State Retrieval System.

Although electronic filing is necessary and should be mandatory, it is not sufficient. The IRS and state charity officials also need robust tools for searching and reporting on data. The ability to prioritize organizations for review would mean that scarce law enforcement resources could be allocated more effectively.

#### H. Revenue Sharing.

As Marion Fremont-Smith documents in her just published Harvard University Press Hauser Center book, Governing Nonprofit Organizations, some states have no registration and/or enforcement, and the capabilities of those that do vary widely. States should enact or have registration and minimum legal governance standards to qualify for revenue sharing as proposed in the Committee's comments. Then such qualifying states would be entitled to a share of revenue based on number of registrants or value of charitable assets registered. NASCO and we are ready and able to work with the Committee to develop those standards.

#### I. Abuses.

Attached for the record as Appendix A are thirty-two examples from New York of exempt organization abuses and the entire nation-wide Boston Globe series.

##### 1. Excess Compensation and Benefits.

Excess compensation and benefits cases, such as the Grand Marnier and King Foundation cases discussed earlier, are the most difficult state law cases to bring. And they often put additional charitable assets in jeopardy when they are used to fund the defense of such actions and perhaps provide indemnification to defendants, depending on outcomes.

Section 53.4941(d)(2)(f)(3) of the Treasury's private foundation self-dealing regulations should be amended. It appears to permit indemnification from charitable assets even if foundation managers are found culpable.

The so-called intermediate sanctions provisions of Code section 4958 and particularly the Treasury regulations thereunder are much more objective and detailed than either Code section 4941 and its regulations (self-dealing) or comparable state laws. Section 4958 should be

made applicable to private foundations as well as to the publicly supported charities to which it now applies. All that is required is repeal of the last sentence of section 4958(e).

The April Exempt Organization Tax Reporter indicates that section 4958 has had a salutary effect on publicly supported exempt organizations. I would expect the same effect on private foundations. Indeed, in drafting the Attorney General's pending state legislative proposals, we were gratified when the Nonprofit Coordinating Committee and the New York City Bar Association nonprofit committee suggested making IRC section 4958 applicable to interested director transactions as a matter of state law, as Attorney General Spitzer has proposed.

The examples contained in the attached summaries include a family foundation that allowed incentive fees of \$1.1 million to be paid to related parties during a two year period, a private foundation that paid for its attorney's trip to the Vatican and purchased a \$53,000 life insurance policy for the president of its board; a foundation that forgave a \$58,400 loan to its executive director; a foundation whose president purchased tickets to fundraising events of the foundation and was reimbursed by the foundation for the tax deductible portion of the payments; a foundation that in a two-year period paid \$1,850,000 in management fees to a company whose sole shareholder was a director of the foundation and also paid almost \$1 million to consultants for services, some of which were the same as those allegedly provided by the management company; a foundation whose management expenses of \$83,000 were expended to make charitable grants of \$71,000 and a family foundation that expended over \$2.5 million for the benefit of members of the family, including \$560,000 as compensation and \$140,000 in employee benefits for the secretary and \$963,000 as compensation and \$185,000 in employee benefits for the president.

One of the recent press stories as well as our internal private foundation review identified excessive compensation issues with respect to a charitable trust. This trust has four trustees (one bank and three individuals), who are each paid a full commission as calculated for trustees of a non-charitable trust (a declining schedule of rates applied to principal value) as opposed to a charitable trust (six percent of income). The grantor expressly

appointed these trustees, provided that they each receive a full commission, and that these commissions be calculated using the statutory schedule for non-charitable trusts. Consequently, the three individual trustees each received annual commissions of \$53,000, while the bank trustee received \$64,000, resulting in a total compensation of \$223,000 in years when the trust was valued at \$18 to \$23 million. The trust agreement also provides that this added compensation would not be effective unless approved by the IRS as having no impact upon the Foundation's section 501(c)(3) status. A May 19, 1992 private letter ruling from the IRS determined that this added compensation does not impact upon its section 501(c)(3) status. The states need preemptive federal legislation to deal with such abuses.

Opponents of this reform may argue that the Code section 4941 self-dealing provisions applicable to private foundations adequately cover this ground, but this is not true. In particular cases, there would be some overlap between sections 4941 and 4958. But they are not congruent. "Disqualified person" is much more broadly defined in section 4958(f)(1). Section 4958 separately taxes disqualified persons and organization managers. "Excess benefit" is much more objectively defined in section 4958(c) as "exceeding the value of the consideration" whereas under section 4941(d)(2)(E) the tests are slippery, "reasonable," "necessary," "not excessive". Section 4958 covers compensation and benefits from affiliated entities. As a consequence of Code section 508(e), the states have authority to enforce section 4941, but in fact those cases are difficult to bring because of its slippery standards.

We applaud the Committee's proposal to apply IRC section 4958 to private foundations.

## 2. Golden Parachutes.

Special attention should be paid to severance payments. By their terms Code sections 162M and 240G&H are not applicable to exempt organizations. I know of no good reason why the head of an exempt organization earning \$300,000 or \$400,000 a year should be entitled to a severance payment five times larger, even if he resigns or his service is terminated for cause.

## J. State Enforcement.

We applaud the Committee's proposal to expand the existing Code section 508(e) authority, which now enables the states charity regulators directly to enforce the Code's private foundation excise tax rules, just as the state tax authorities can enforce other provisions of the Code where state income taxes are based on federal filings.

Here is an example of state action with respect to excess business holdings as well as self-dealing. The Wilson Foundation initially was initially funded by contributions of Wilson Company stock. It later was required by the IRS to dispose of a significant portion of that stock as excess business holdings. The members of Wilson Foundation board were also officers or directors of the Wilson Company at the time. Instead of accepting generous independent offers for the stock which would have affected control of the Wilson Company, they authorized repurchase by the Wilson Company of Wilson Company stock at a lesser price. As a result of the Attorney General's investigation, the Foundation added independent directors and adopted a conflict of interest policy to ensure disinterested decision-making in the future. The Attorney General, the Foundation and the Wilson Company reached a settlement pursuant to which the company paid over \$1.3 million to the Foundation.

K. Abatements.

The Commissioner's authority to abate exempt organization excise taxes should be preserved, especially where these taxes fall on charitable funds. The Code should make clearer than it now does that abatement of taxes on foundation managers and other disqualified persons should be the exception rather than the rule, and abatement of taxes on innocent charities should be presumed. Our job is to protect charity.

L. Accountants and Lawyers.

The IRS has told us that 25 percent of 990s are filed incomplete, inconsistent or even false, and this is New York's experience as well. Yet many of these 990s are prepared and signed by paid preparers who are usually accountants, sometimes lawyers or both.

Accountants and lawyers have falsely claimed to us (and to their clients) that 990s

have been filed where they have not. A lawyer allegedly master-minded the scheme where the six directors of a \$10 million foundation, which made only grants to established public charities, took away \$3.4 million in compensation and pension benefits. A lawyer, who was a compensated executive of a charity, caused his law firm to bill its client, the charity, for nonlegal work. Accountants for private foundations, seemingly routinely, answer the 990-PF self dealing question no, and then schedule the compensation of paid directors and officers without filing form 4720. One paid preparer for a private foundation caused it to answer the 990-PF political contribution question "no" and then scheduled the political contributions on the contributions schedule. Needless to say, he did not file form 1120 POL. Virtually nobody files form 4720. There should be severe penalties on paid preparers who fail to file that form or form 1120 POL. We referred the matter to the IRS and the Federal Elections Commission.

Just as the Committee's comments recommend authority, for example, to remove directors and officers, there should be authority to require exempt organizations to change their lawyers and accountants, if they are not doing their jobs, and institute procedures to deny persistent offenders rights to practice before the IRS and the Tax Court.

M. Misleading and False Fund Raising.

Understatement or no statement of fund raising expenses is all too common in 990s. The public needs to know how much of their contributions are being spent to raise contributions. Amounts paid to professional fundraisers and other fundraising independent contractors should be separately disclosed in the 990.

Each year New York State Attorney General Eliot Spitzer's Charities Bureau publishes Pennies for Charity, a report of the amount raised by telemarketers registered to solicit contributions for charity. The figures are shocking. The 2003 edition shows that on average only 30 percent of the funds raised by charity telemarketers actually reach the charity. This is less than half the Better Business Bureau's best practice standard of 65 percent. California, Colorado and New Hampshire have done similar studies with approximately the same results.

Although the lion's share of contributions is paid to professional fund raisers, the Code currently permits donors to take a charitable deduction for the full amount. Since most telemarketing contributions are less than \$250, the Code section 170(f)(8) requirement of charity acknowledgment to sustain the deductions is inapplicable.

We recommend that the Committee amend little known and, as far as we are aware, never enforced Code sections 6113 and 6710. The Treasury has not promulgated regulations under either section, and we are not aware of any IRS enforcement or, indeed, what part of IRS is responsible to enforce. Section 6113 now provides that each fundraising solicitation by an organization to which contributions are not deductible under Code section 170(c) and which has annual gross receipts of more than \$100,000 shall contain an express statement that contributions are not deductible. There is an exception for fundraising solicitations by letter or telephone if no part of a coordinated campaign solicits more than 10 persons a calendar year. Section 6710 imposes a penalty of \$1,000 a day up to a maximum of \$10,000. The abuses at which this section are directed appear to be practiced most often, unfortunately, by organizations purporting to relate to law enforcement.

The proposed amendment, attached as appendix B to this statement, would require disclosure of deductibility or nondeductibility in all fundraising solicitations conducted by professional fund raisers, would require the charity to acknowledge all resulting contributions, regardless of amount, and would limit the deduction to the actual charitable gift. The amendment is limited to exempt organizations that pay outside entities to conduct fundraising on their behalf. It would not apply to in-house fundraising.

The proposed amendment would also close an apparent loophole in section 6113. We know of at least one fundraiser who forms section 501(c)(3) eligible organizations in many states, but never applies for income tax exemption. His organizations are arguably described in section 170(c), so they may evade section 6113. To close the loophole, the proposed amendments apply to all organizations that are described in 501(c) (other than paragraph (1) thereof) or (d), but exempt religious organizations, educational institutions and membership organizations.

The Internal Revenue Service unsuccessfully attempted in United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173 (7<sup>th</sup> Cir. 1999), to uphold its and the Tax Court's determination that a charity was a controlled extension of its telemarketer and not entitled to exemption, although Judge Posner did suggest that the Service could proceed on the theory that the charity operated for the private benefit inurement of the telemarketer. The case was subsequently settled, but the terms of the settlement are not public and cannot even be shared with state charity regulators who also have regulatory authority over United Cancer Council.

Because many charities contract with the same professional fundraisers year after year for the same meager results, we suspect that many are controlled extensions of the fund-raiser. We are now investigating a series of charities incorporated by the same lawyers who act as counsel to their professional fund raisers. The IRS needs the authority that it sought in the United Cancer Council case.

N. Extensions.

We applaud the Committee's concern to limit Form 990 extensions. In March, I attended a seminar for national journalists at the Western Knight Center, Annenberg Communications School, University of Southern California. One of their most important complaints was lack of current information on charities. The paid preparers rarely seem to file 990s on time. What with the four and a half months lag between close of year and the required filing date, two automatic IRS three month extensions and processing, data are nearly two years old before it becomes public.

Urban Institute's National Center for Charitable Statistics ("NCCS") has produced the following startling information concerning IRS forms 990 that are filed more than 5.5<sup>1</sup> months after the end of the fiscal year by IRC section 501(c)(3) charities:

- In FY 1998 69% of the 198,030 filing organizations filed late
- In FY 1999 71% of the 230,394 filing organizations filed late
- In FY 2000 65% of the 246,921 filing organizations filed late

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<sup>1</sup> Forms 990 are due to be filed within 4.5 months of the end of the fiscal year.

Linda Lampkin of NCCS recommend that if one applies for an extension, one then has to file electronically. That will effectively eliminate the processing time.

Another suggestion for addressing late filing of IRS 990s is to stagger the taxable years and filing dates of Form 990 filers to even out the paid preparer workload.

As the Committee knows, there are approximately 1.4 million charitable organizations. They hold approximately \$2 trillion in assets. They annually receive approximately \$240 billion in contributions.

9/11 highlighted how important the nonprofit sector is to the Nation. Most charities splendidly rose to the challenge. Some did not, and public confidence in the sector was damaged. We need not only to restore but to increase that confidence. The Committee's concern with these issues is timely and commendable.

As I have told the Committee's staff, after five years as the head of the Charities Bureau, I expect to leave before the end of the summer. But I am more than willing, and hope to continue to be able, as a private citizen to continue to work with the staff and the Committee on these important issues.

Thank you.

March 10, 2003

**EXAMPLES OF BOARD FAILURE - I  
IDENTIFIED BY  
THE ATTORNEY GENERAL  
OF THE STATE OF NEW YORK**

**Private Foundations**

**CASE 1: Grand Marnier Foundation** - The Grand Marnier Foundation was established in the mid-1980's by the president of a liquor importing company that was the exclusive importer of Grand Marnier liquor into the United States. The board of directors consists of the president and an employee of the importer, an attorney and three executives of the French company that produces Grand Marnier liquor. Starting at relatively modest levels, gradually their compensation grew, so that by 1990 each director was paid \$33,000 in exchange for attending one meeting per month. In 1992, in addition to a salary of \$42,000 the directors voted themselves a pension plan which accrued for a four year period. In 1995, the directors determined that the pension plan was not in the best interest of the Foundation and voted to end it. To do so, they funded the plan account and distributed to themselves \$746,364. For subsequent years, until the Attorney General began to investigate, each director took \$50,000-\$60,000 in compensation each year. In the ten years, 1990-1999, the six directors took a total of \$3,431,040 out of the foundation. During the same period, the foundation's asset value as reported to the Internal Revenue Service declined from a high of \$11,275,720 to \$6,699,487. The Foundation's reported asset value for 2000 was \$6,355,906.

**CASE 2:** This private family foundation invested in a related company and paid incentive fees to its general partner, which is owned by a former trustee of the Foundation and his children, one of whom is a current trustee of the Foundation. The incentive fees were \$514,480 in 1999 and \$612,360 in 2000. These transactions violate the self-dealing provision of New York's Not-for-Profit Corporation Law. In addition, the Foundation incurred substantial losses from high risk investment in 2000.

**CASE 3:** This private foundation had net asset with a market value of \$85,616,134 at April 30, 2001. Its 2001 annual report shows that there were over \$450,000 in legal fees to the law firm of which the foundation's president was formerly a partner. Included in the attorneys' invoices are bills for non-legal services including a visit to the Vatican. In 2001, the foundation also paid \$53,000 in premiums for life insurance policies of the board's president.

**CASE 4:** This private foundation incurred a loss of almost \$1 million on sales of \$2.4 million in securities during the fiscal year that ending on October 31, 1998. Its net assets decreased from \$850,000 to \$350,000 from November 1, 1995 to October 31, 1999, a decline of 59 percent. During the same period, it made charitable contributions of \$53,000, paid officers' compensation \$53,000 (investment fees) and incurred interest of \$56,000. The Attorney General requested information concerning the extent to which the foundation's losses were attributable to margin calls and was told that the foundation could not get the requested information.

**CASE 5:** This private foundation claimed to be exempt from filing annual reports with the Attorney General for 1997 through 2001 because it had income and assets of less than \$25,000. Its 2001 claim of exemption was marked "final return." Its 1994 financial report - the last one filed with the Attorney General - showed assets of \$127,000 and 1998 through 2000 reports filed with the Internal Revenue Service reported assets in excess of \$127,000 and claimed that its annual reports for those years had been filed in New York.

**CASE 6:** This Delaware private family foundation incorporated in 1948 and had of \$307,634 at market value as of December 31, 2001. All of the board members are related. In 1998, the Foundation entered into an investment management agreement with the husband of the Foundation president who is a director and the Treasurer. Under the agreement, he was to be paid a base fee of 1% of the value of the account payable on the anniversary of the agreement as well as an incentive fee of 20% of the account's gross investment return exceeding the first 5% each year. He was paid \$45,000 during 1999, although his fee, which was reduced, was almost \$98,000.

On December 31, 1998, the market value of the Foundation's assets was \$650,728. In 1999, the Foundation began engaging in trading on margin, options trading and speculative investments and used the margin account to meet grant payments when sufficient funds are not available and immediate liquidation of a portion of the portfolio is not appropriate. From 1999 through 2001, the Foundation made grants of \$105,002 and had total return on investment of \$193,169 and total investment expenses of \$192,763, for a net gain of \$406. Included in these expenses was \$76,967 in margin interest; \$70,796 in 990T taxes and the \$45,000 investment management fee. In the first third of 2002, the Foundation realized additional capital losses of \$157,725 in liquidating some of its positions held as of December 31, 2001. The Foundation's assets were \$252,477 on April 30, 2002. For the period January 1, 1999 through April 30, 2002, the Foundation had realized and unrealized losses of \$271,992, which represents almost 42 percent of its December 31, 1998 asset base. The Foundation was heavily invested in tech stocks during this period, and incurred most of its realized losses on such stock.

**CASE 7:** The board of directors of this private foundation, a husband and wife, made unsecured loans totaling almost one-half of the foundation's assets at below-market rates of interest to family members and entities controlled by family members. They also engaged and paid entities owned and managed by family members to ostensibly perform services for the Foundation.

**CASE 8:** - The problem of lack of independence among the members of the board of this private foundation created and funded by a for-profit business enterprise arose in the Attorney General's investigation of this foundation. At issue were decisions made by certain members of the Foundation's board of directors — who were also officers or directors of the for-profit company at the time — regarding the repurchase by the for-profit company of its stock owned by the Foundation. The Foundation, which was initially funded by contributions of stock in the for-profit company, was required by the Internal Revenue Service to dispose of a significant portion of such stock. The Attorney General had questioned the fairness of the consideration received by the Foundation from the for-profit company. As a result of the Attorney General's questioning the independence of the Foundation's board, the Foundation added directors who are independent of the business and adopted a conflict of interest policy to ensure disinterested

decision-making in the future. Following an inquiry into the governance of the Foundation, the Attorney General, the Foundation and the business reached a settlement pursuant to which the for-profit company contributed over \$1.3 million to the foundation.

This case demonstrates the risks arising from a director's competing loyalties to the charity of which the director is a fiduciary and to the commercial enterprise that employs the director and funds the charity. Such risks are best avoided by providing the charity with a governance structure that will ensure control by independent decision makers.

#### **Public Charities**

**CASE 1:** - This public charity failed catastrophically in 2001 due, in part, to its inattentive board. The board failed to address clear signs of fiscal distress, including repeated inability to meet payroll obligations and failures to pay employment taxes. Also, the board failed to adopt annual budgets, failed to maintain an active committee structure, failed to retain an independent accounting firm to perform required annual audits and failed to supervise its CEO adequately. To some extent, the board was held captive by its CEO who was reportedly ruthless with directors who questioned his performance. He systematically misinformed the board about the true condition of the charity's finances.

**CASE 2: Urban League of Northeastern New York, Inc.** - This publicly supported not-for-profit corporation failed in 2002 due, in part, to an inattentive board. It appears that the organization unduly relied upon lines of credit to finance basic operating expenses, despite the repeated counsel of its accountants. Also, the board was woefully inattentive or complicit in its CEO's charging of unreasonable travel and meal expenses. The CEO operated the entity as his own "kingdom" and was intolerant of dissenting directors.

**CASE 3:** The board members of this public charity are members of the local community and many are friends of the chief executive. None has any knowledge of fiduciary duties, some

attend meetings only rarely and some have profited personally from transactions with the charity. The charity has engaged in numerous self-dealing transactions with companies controlled by the chief executive, most of which have not been adequately disclosed to the board and the charity's fund and other resources have been used to support multiple political campaigns.

**CASE 4: The Martha Graham Center of Contemporary Dance and The Martha Graham School of Contemporary Dance** - These two publicly supported non-profit entities, both established before 1957, had identical Boards of Directors. The entities purposes are to preserve and foster the dance technique and the dances of the noted pioneer contemporary dancer and choreographer, Martha Graham. When Martha Graham died in 1991, her will left everything that she owned to the man who had served as her Assistant Artistic Director and as a longtime member of the boards. On Graham's death, he took her position as Artistic Director and exercised control over the entities. He took the position that he "owned everything" and consistently represented that to the other members of the boards. Neither he nor the boards took any steps to determine what he actually had inherited, and when his demands for licensing fees and artistic control grew overwhelming, the board was forced to close operations temporarily. The dispute ripened into a lawsuit over the rights to the marks "Martha Graham" and "Martha Graham Technique" and the copyrights to the choreography and the sets and costumes that go with the dances. During the two-part trial that ensued, numerous current and past board members testified that they simply believed the Artistic Director's claims to "everything" and feared his taking the life blood away from the organizations if they didn't cooperate with him. The non-profits have thus far prevailed in two trial court decisions and one appeal, but this long, expensive and emotionally draining dispute might have been short circuited had the directors not allowed themselves to be overwhelmed by one of their members.

**CASE 5: Green Hill Cemetery Association** - The Attorney General brought an action against the husband and wife directors of this cemetery association. The complaint alleges that the for defendants improperly withdrew \$128,000 from the cemetery's trust funds and deposited the funds into the cemetery's checking account from which they drafted checks to themselves and a corporation they control. The case is pending in Montgomery County Supreme Court.

**CASE 6: People V. Boyle** - In 2000, the Attorney General sued Robert Boyle, the former chairman of Hudson Valley Hospital Center (the "Hospital"), located in Peekskill. The complaint alleged that Boyle abused his position as the Hospital's chairman when he secretly arranged for Westchester real estate lawyer and developer, Albert Pirro ("Pirro"), to acquire a building in Croton-on-Hudson that the Hospital would be interested in acquiring for physicians' offices. A Pirro company then leased the building to the Hospital, which renovated the property at its own expense and ultimately purchased the property from Pirro at a substantial mark-up. For his services to Pirro, Boyle, unbeknownst to the Hospital, was compensated handsomely through Pirro's companies. Anticipating a statute of limitations defense, the complaint noted that the Hospital's annual financial reports did not disclose Boyle's self-dealing transaction. Boyle sought to distance himself from these reports, which he did not sign, by claiming that he was not responsible for ensuring their correctness. The 2001 settlement included an acknowledgment by Boyle that he concealed the self-dealing transaction from the Hospital and a \$50,000 payment.

**CASE 7:** This New York not-for-profit corporation is a type of public charity that is referred to as a supporting organization. The Foundation became involved in civil litigation initiated by one director (who is an officer of the primary supported charity named in the certificate of incorporation) against the two other directors for removal, an accounting and restitution. The lawsuit alleged, among other things, that the defendant directors: (1) refused to provide plaintiff with information concerning the finances, investments and operations of the Foundation thereby preventing plaintiff from taking an active role in its management; (2) improperly called for meetings of the board of directors; (3) failed to file tax returns and financial reports with the Internal Revenue Service and the Attorney General's Charities Bureau thereby jeopardizing the Foundation's charitable status, and (4) authorized distributions to organizations other than the two supported charities as directed by the Foundation's certificate of incorporation.

By way of settlement, and in order to ensure that the management issues that were raised in the litigation do not recur, we proposed that the Foundation be restructured so as to give control to the two supported charitable organizations. Alternatively, we proposed the dissolution of the Foundation based on deadlock with the assets being distributed to the two supported charities to

be held as restricted endowment funds.

**CASE 8: Hale House** - The Attorney General's investigation of this public charity revealed that it was operating without a functioning board of directors and solely under the direction of Lorraine Hale. Ms. Hale, Executive Director of the charity from 1996 through 2001, wrongfully used thousands of its dollars for personal and non-charitable expenses. She took funds directly from Hale House's bank accounts and diverted money raised under the Hale House name into an off-the-books checking account. With the help of the Attorney General, a fully functioning board of directors was installed at Hale House in May 2001. In July 2002, Lorraine Hale and her husband Jesse DeVore pled guilty to the felony charges of Grand Larceny in the Fourth Degree and Attempted Forgery in the Second Degree, respectively.

**CASE 9: Community Health Accreditation Program, Inc. ("CHAP")** - This New York not-for-profit corporation accredits home health care agencies. CHAP was founded in the 1960's as a division of the National League for Nursing, Inc. ("NLN"). In 1988, CHAP was separately incorporated, and NLN as CHAP's sole member had control over CHAP's board, activities and finances. As an illustration of such control, in 2000 NLN unilaterally transferred \$160,000 from CHAP's bank account to NLN's account, purportedly to satisfy debts that CHAP owed NLN for rent and administrative services, debts that CHAP's board had repeatedly disputed. In 2001, NLN entered into a contract to "sell" its membership in CHAP to a businessman, Melvin Lev. The contract was presented to CHAP's board as a *fait accompli* shortly before the closing, with a strong suggestion that NLN would retaliate against CHAP (for example, by spinning CHAP off to one of its competitors) if CHAP's board did not acquiesce. Upon becoming CHAP's sole member, Lev began to loot CHAP, and CHAP's former president (whom Lev had dismissed) and members of CHAP's board complained to the Attorney General. The Attorney General obtained a temporary restraining order barring Lev and members of his family from access to CHAP's property; and, a short time later, Lev and his family members resigned from CHAP and made restitution of the funds that Lev had misappropriated. The court ordered settlement with Lev provided that CHAP would amend its certificate of incorporation to make CHAP a non-membership corporation under the control - for the first time in CHAP's history - of a self-perpetuating board of directors. CHAP has since amended its certificate of incorporation in

accordance with the settlement agreement. (The Attorney General's and CHAP's claims against CHAP's former member, NLN, remain pending and are currently the subject of settlement discussions.)

**CASE 10:-** When the Attorney General began the investigation of this publicly supported corporation, the Chairperson of the Board of Directors and Chief Executive Officer (the Chair) picked board members, set the agenda, presided over board meetings, often prepared the boards' minutes and was in charge of all aspects of the organization's operations. The Chair was a required signatory on all bank accounts, had the final say on the payment of all of bills, including payments to the Chair and the Chair's associates. There was no oversight of the Chair's authority. The Attorney General's investigation revealed that the Chair was a paid consultant at a fee of over \$200,000 a year, for a vaguely described purpose and without the board's knowledge, and the Chair used the organization's funds to pay at least \$50,000 of personal expenses charged to her American Express card but paid by the organization but signed the organization's IRS Form 990s, under penalty of perjury, falsely claiming that no such income was received.

The organization commingled its funds with those of affiliates, in violation of restrictions on such funds, and used such funds for other purposes resulting in the failure of charitable projects. Millions of dollars were owed by the organization and affiliates for unpaid real estate taxes, payroll taxes, water/sewer charges and vendor debts.

**CASE 11:** This investigation was begun after the Attorney General received a complaint from a former member of this publicly supported organization's board of directors alleging mismanagement, including improper use of restricted funds, use of corporate assets to pay personal expenses, and failure to pay payroll tax obligations. Among the personal expenses at issue was apparently the satisfaction of board's president's own personal income tax obligations. Also claimed was the failure of the directors and management to follow legal advice and other professional studies regarding the implementation of proper oversight procedures and management practices. The board member reported that the organization had lost funding from corporations that supported its mission but which were concerned about its fiscal management.

**CASE 12:** This publicly supported organization had apparently been successfully operating an educational program for children for over twenty-five years when it announced, three years after receiving a foundation grant of over \$4 million (far in excess of any grant monies it had ever received), that it was seriously in debt and would be closing its doors. The Attorney General's investigation revealed that the board met not more than four times a year, it is not clear how often board subcommittees met, some board members of the board did not regularly attend meetings regularly and those who attended did not require management to account sufficiently. When it received the foundation grant, the organization began engaging in excessive spending and growth. The board claims that it was misled by management and that it was unaware of the organization's financial straits until it was too late to save it.

April 23, 2003

**EXAMPLES OF BOARD FAILURE - II  
IDENTIFIED BY  
THE ATTORNEY GENERAL  
OF THE STATE OF NEW YORK**

**CASE 1** - This private foundation's 2001 annual report showed notes and loans receivable due of \$50,000. Upon request, the president of the foundation provided the Attorney General's Charities Bureau with a copy of the note. The note was executed by the vice president of the foundation, doing business as his for-profit company. The note, dated 1993, provided for interest only payments to the foundation at a rate of six percent with payment of the principal upon demand. According to the foundation, it has regularly been paid monthly interest. Those parts of the note which refer to the collateral provided and the remedies available for nonpayment of the note have an "N/A" entered in the spaces provided. This loan represents half of the foundation's assets which, in 2001, were a little over \$100,00 at book and market.

**CASE 2** - In its report for the fiscal year that ended March 31, 2001, this private foundation noted that it forgave a \$58,400 loan to its executive director. In 1994, the foundation entered into a loan agreement with its executive director, secured by the borrower's real property. The agreement states that the loan matures the earlier of (a) April 1, 2024, (b) the sale of the real property secured by the note, (c) six months after the death of the borrower or (d) the termination of his employment with the foundation. The note provided for interest only payments to the foundation with interest of 6.35 percent. In early 1999, the foundation received an advanced ruling from the IRS identifying it as a non-private foundation for the sixty-month period beginning April 1, 1999 through March 31, 2004. At a 2000 meeting of the Board of Directors, the executive director announced his resignation as of December 31, 2000. At that same meeting, the board voted on a severance arrangement for the executive director, which included, among other things, forgiveness of his "housing loan", retention of a van as his personal property and the availability of up to \$15,000 of placement services. The foundation had net

assets at March 31, 2001 of \$14,000,000 at book and \$16,000,000 at market value.

**CASE 3** - In reviewing the report of this private foundation for the fiscal year ended October 31, 1998, it was noted that the foundation incurred a loss of \$998,000 on the sale of \$2,400,000 of securities while beginning the year with total assets at market value of \$1,600,000. The foundation began fiscal 1998 with \$510,000 in margin debt. By year end, the foundation had also sustained unrealized losses of \$197,000 while incurring interest expense of \$33,000. In 1998, the value of the foundation's portfolio dropped approximately 86 percent. From the beginning of fiscal 1998 through 2001, the foundation incurred realized losses of \$1,400,000 and was left with a portfolio of \$13,000 at market value as of October 31, 2001. During this same four-year period, the foundation made charitable contributions of \$53,000 while paying officer's compensation (investment fees) of \$53,000 and incurring interest expense of \$56,000. In correspondence, the president of the foundation said the foundation "has consistently made its investment selections relying substantially on outside advisors." A subsequent letter from the foundation's attorney identified the outside advisor as an out-of-state firm which employed the foundation's broker who was retained by the foundation prior to 1998 and remained its stockbroker while changing his business affiliations. Since fiscal 1996, the foundation's public notice concerning the availability of its annual report lists the offices of the broker as its principal office. The foundation's attorney advised the Charities Bureau that most of the acquisitions of securities for the account of the foundation were based on recommendations of the stock broker and that the foundation also relied heavily on the public assessments of market analysts, some of whom worked at the broker's firm. The foundation was unable to determine the exact amount of compensation earned by the broker but claims that commissions paid were in line with normal charges of a full service brokerage firm. The foundation's president claimed that during the four-year period that ended on October 31, 1999, the foundation's assets increased significantly in value despite realized gains and losses. In reality, on November 1, 1995, the assets were \$850,00 at fair market value and four years later the fair market value was \$350,000, a 59 percent decline in value.

**CASE 4** - In reviewing the report of this private foundation for the fiscal year ended September

30, 2001, it was noted that the foundation's charitable contributions consisted of what appeared to be tickets to dinners, luncheons, musical performances and gala events for charities. Upon inquiry, it was determined that the president of the foundation decides on the charitable events she wishes to attend, buys the tickets and receives reimbursement from the foundation for that portion of the tickets which is tax deductible. The foundation does not write the checks to the charities nor does the board decide on which contributions to make. The Charities Bureau asked for receipts from nine events over two fiscal years. None identified the foundation as the contributor. The foundation had net assets at September 30, 2001 of \$413,000 at book and \$356,000 at market. Query, does the president take the deduction and not declare the reimbursement from the foundation?

**CASE 5** - This private foundation reported legal fees of \$463,000 in fiscal 2001 and \$411,000 in fiscal 2000. The president of the foundation was a partner in the law firm that represents the foundation but is not currently a partner. The firm's invoices do not identify individuals who performed services but provide the total time for partners, special counsel, associates and a fiduciary accountant. In 2001, billing for partners' time ranged from \$525 to \$550 per hour and associates from \$195 to \$380 per hour. The billing for partners represented 74 percent of the amount billed. Not all of the items on the firm's invoices seem to be in the realm of legal work. One bill included a \$56,000 charge for a visit to Rome for meetings at the Vatican. The foundation's president has several life insurance policies through the foundation and documents suggest yearly premiums of \$54,000. On April 30, 2001 the foundation had assets of \$85,000,000.

**CASE 6** - In reviewing the file of this private foundation, it was noted that the foundation reported management fees of \$1,200,000 in 2001 and \$650,000 in 2000. The foundation's accountants identified the management firm as a company whose sole shareholder was a director of the foundation until his death in early 2002. His estate is now the sole shareholder. The management firm's duties included investment management and advice and the record keeping and accounting of the foundation's investment portfolio. However, the foundation also paid \$863,000 for investment counseling and custody fees and \$106,00 for consultants. Also, the

management firm provided administrative, record keeping and accounting service with regard to the foundation's operations and grant making. The foundation also paid accounting fees of \$92,000 and other salaries of \$36,500. The foundation reported that it had twelve directors, one who received a salary of \$67,000 and another who received \$45,000. The remaining nine directors each received at least \$7,500. In 2001, the directors received in aggregate \$190,000 and \$186,00 in 2000. The foundation had net assets at December 31, 2001 of \$105,000,000 at book and \$162,000,000 at market.

**CASE 7** - In reviewing the financial report of this Foundation for the fiscal year ended February 28, 2002, it was noted that it incurred expenses of \$83,000 while making charitable grants of \$71,000. Included as one of the four charitable contributions for fiscal 2002 was a grant of \$68,000 to a particular scholarship fund. The foundation made only three other grants during the year. The foundation's president received compensation of \$44,000 from the foundation and \$22,000 from the scholarship fund. Both the foundation and the scholarship fund have only two directors, although New York law requires three directors. The foundation provided a copy of its lease agreement and a letter evidencing a two year extension. The foundation's president and the foundation are identified as tenants and the use is listed as law practice as well as foundation use. The foundation's president acknowledged that the foundation and his law practice share the space. A schedule was submitted by the president identified the foundation's monthly rent payment as \$500 of the \$900 monthly rent. The scholarship fund's annual report for the fiscal year ended April 30, 2002 shows rent expense of \$4,800, or \$400 per month while reporting the same address. During the last six fiscal years the foundation and the scholarship fund reported in aggregate charitable contributions of \$726,000 and \$366,500, 50 percent of which was from the foundation to the scholarship fund. Therefore, during that period, the two entities incurred expenses of \$587,000 (including \$297,000 in compensation to the president and \$89,000 in occupancy expenses) while making net charitable contributions of \$409,000. The foundation, incorporated in New York in 1953, had net assets at February 28, 2002 of \$1,301,000 at book and \$1,387,000 at market. The scholarship fund was incorporated in New York in 1954 and had assets of \$7,000 as of April 30, 2002.

**CASE 8** - This private family foundation, a Delaware corporation incorporated in 1948, had net assets of \$308,634 at market value as of December 31, 2001. All of the foundation's board members are related. In 1998, the foundation entered into an investment management agreement with John Doe, a director and the treasurer of the foundation and husband of its president. Under this agreement, Mr. Doe was to be paid a base fee of one percent of the value of the accounts payable on the anniversary of the agreement and an incentive fee of 20 percent of the account's gross investment return exceeding the first five percent during each annual period. Mr. Doe was paid \$45,000 during 1999, although according to correspondence with the foundation's president, his fee was actually \$98,000, but was reduced by mutual agreement. He was a tax partner at a large New York firm. The foundation's assets were \$650,000 on December 31, 1998. At that point, the foundation began investing on margin in options and in other speculative investments. During the three years 1999 through 2001, the foundation had total return on investment of \$193,169 and total investment expenses of \$192,763, for a net gain of \$406. Included in these expenses was \$76,967 in margin interest; \$70,796 in 990T taxes and the \$45,000 investment management fee paid to Mr. Doe. During this period, the foundation also made grants of \$105,000. In addition, during the first third of 2002, the foundation realized additional capital losses of \$157,725 in liquidating some of its positions held as of December 31, 2001 and made grants totaling \$31,500.

As of April 30, 2002, the foundation's assets were \$253,000 which reflects an unrealized loss of \$115,000 from the 1998 value of its assets. Thus, for the period January 1, 1999 through April 30, 2002, the foundation had total realized and unrealized losses of \$272,000, which represents almost 42 percent of its asset base as of December 31, 1998. The Foundation was heavily invested in tech stocks during this period, and incurred most of its realized losses on such stock.

**CASE 9** - This private foundation was incorporated in New York in 1961. As of October 31, 2001 it had total net assets of \$862,000 at market value. From October 31, 1996 through October 31, 2001, the foundation had total revenues of \$577,000, expenses of \$298,000 and made \$243,000 in grants to charity. The biggest expense item was investment management fees of \$210,000. These fees were \$30,000 per year in 1996 through 1998 and \$40,000 per year thereafter.

In late 1996, the Charities Bureau corresponded with the foundation about its investment management fees and was advised by the foundation's vice president that the fees were paid to him. He stated that the fees include payment for investment, bookkeeping and administrative functions. He also said that the fees started in fiscal 1991 and were structured as "flat" to avoid potential conflict of interest. The annual fee was set at \$30,000 for both the increasing back office support anticipated and the investment functions. He justified the fee by stating that it was the long term growth trend in average net assets, not the asset base, that underlies the fee structure.

Over the last six years, the investment fee ranged from three percent to five percent of the market value of the net assets, normatively high, particularly since the vice president is a disqualified person and there does not appear to be a disinterested board in place. During 1999, the vice president granted himself a 33.33 percent annual raise .

The vice president utilizes margin trading as part of his overall strategy of asset growth. As of October 31, 2001, the margin account balance stood at \$291,000, which represented 25 percent of the assets of the foundation. The foundation has been fairly successful with this strategy and achieved an annualized total return of 10.95 percent per year during the past five years.

**CASE 10** - This private foundation, a New York corporation incorporated in 1976, had net assets with a book value of \$13,908,000 and fair market value of \$19,118,000 as of December 31, 2001. During the period 1996 through 2001, the Foundation had total revenue of \$8,959,303 (none from contributions), incurred expenses of \$3,141,000, and made grants of \$4,138,000 to charity.

More than \$2.5 million of the expenses were incurred for the benefit of members of the Smith family. Specifically, Jane Smith received \$560,000 as compensation for her services as secretary and \$140,000 worth of employee benefits and contributions to pension plans. John Smith received \$963,000 as compensation for his services as president/treasurer and \$185,000 worth of employee benefits and contributions to pension plans. The Foundation incurred payroll taxes of at least \$48,000 attributable to these salaries. During the same period, the Foundation paid investment consulting fees of \$397,000 to Michael Smith, the foundation's vice president who is

characterized in correspondence from the foundation as an independent contractor providing investment consulting services to the foundation. These fees were in addition to \$49,700 paid to him as an officer. The foundation also incurred expenses of \$22,000 for a dental plan, \$45,000 for life insurance premiums, and \$112,000 for a hospitalization plan. The Foundation did not appear to have any employees other than family members. Also, there were \$30,000 in vehicle related expenses during this period.

**CASE 11** - This private foundation was created as an inter-vivos trust in 1969. As of December 31, 2001 it had total assets of \$443,000 at market value. The Trust's primary assets are \$350,000 in notes receivable, which represent 79 percent of its assets at market value. The notes originated from loans made to a corporate borrower in the amounts of \$250,000 on March 4, 2000 and \$100,000 on September 21, 2000. A trustee is the owner of 33 percent of the voting shares of common parent of the affiliated group in which the borrower is a member.

The principal and interest on the notes were payable by their terms on May 31, 2000 and October 30, 2000, respectively. On January 1, 2001 an extension was granted by the trust for payment of both principal and interest until March 31, 2003. The interest rate on both Promissory notes is at 12 percent per year. The purpose of the notes was to generate a more significant amount of investment income for the trust and its charitable beneficiaries than was obtainable from more traditional sources in the economic climate of the period. The Trust continues to hold both of the notes, and the initial interest payments were to commence in April 2002. The principal and accrued interest on the notes total \$429,000 as of March 31, 2002.

**CASE 12** - This private foundation, incorporated in Connecticut in 1963, had net assets with a book value of \$1,005,000 and a fair market value of \$673,000 at the end of 2001. From 1996 through 2001, the foundation had total revenue of \$708,000, incurred expenses of \$1,619,000 and made grants of only \$316,000 to charity. While the level of expenses has remained fairly static, the level of contributions to charity has declined precipitously. A review of the grants made by the foundation during this period indicates that \$149,000 was paid to a school. This represents 47 percent of all the grants made during this period. An additional 40 percent of the

total grants went to just six additional entities. Thus, grants to seven entities accounted for more than 87 percent of the grants during this period. At least \$731,000 of the expenses were incurred for the benefit of officers and directors of the foundation. Specifically, A. Jones received \$300,000 as compensation for services as president and treasurer and \$28,000 worth of employee benefits and contributions to pension plans. B. Jones received \$353,000 as compensation for services as vice president and director and also \$50,000 worth of employee benefits and contributions to pension plans. On all the reports, A. Jones is listed as devoting 30 hours per week and B. Jones is listed as devoting 40 hours per week to foundation business. The foundation incurred occupancy expenses of \$283,000 and the address and phone number listed on the 990PF is the same as that listed in the telephone directory for C. Jones.. There were other employee salaries of \$273,000 and related employee benefits of \$82,000, travel expenses of \$66,000, general office expenses of \$50,000, accounting fees of \$50,000 and telephone expense of \$37,000.

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BEFORE THE COMMITTEE ON FINANCE  
UNITED STATES SENATE  
HON. CHARLES E. GRASSLEY, CHAIRMAN

JUNE 22, 2004

CHARITY OVERSIGHT & REFORM:  
KEEPING BAD THINGS FROM HAPPENING TO GOOD CHARITIES

Statement of:  
**JJ MacNab, CFP CLU QFP**  
Owner / Analyst  
*Insurance Barometer LLC*  
9224 Quintana Drive  
Bethesda, MD 20817  
Tel: (301) 767-1085  
Fax: (888) 918-9516  
jj@deathandtaxes.com

Mr. Chairman and members of the Committee, I thank you for inviting me to speak before you on the topic of tax schemes involving charities. My name is JJ MacNab, I'm a life insurance analyst in Bethesda, MD and I am the co-author of a professional trade book entitled Tools and Techniques of Charitable Planning. I count among my clients several high quality charities and many more wealthy individuals who are philanthropically minded.

#### **Introduction**

##### **The Problem**

In the past, charity has held a highly favored status, both in the Tax Code and in the hearts and pocketbooks of millions of American donors. Unfortunately, in recent years, that confidence has become eroded. Bad players have discovered that they can use small, hungry, or newly formed tax exempt organizations to conceal everything from Ponzi and affinity scams to high end corporate fraud and terrorism funding. And while there is a tendency among the charitable industry to simply ignore these bad players, the games and schemes are spreading at such a rapid pace, that even good charities are finding themselves sorely tempted to, if not sell their souls, at least rent them out to the highest bidder. Where the focus was once on fiduciary duty and preserving the public trust in their respective missions, a few well meaning charities are becoming blinded by the profits to be had from tax schemes. Instead of thinking, "Should we do this?" many charities are now ignoring the ethical and moral elements of the decision and are instead focusing on the bottom line of the program.

For example, when pitched a high end tax scheme by a donor's advisor, a charity might be faced with two choices: 1) turn down involvement in the scheme and receive \$0, or 2) agree to participate in the scheme and receive \$1,000,000. In many cases, the charity never actually sees how or how much the donor benefits from the plan, and so the decision is fairly simple. As

long as the charity thinks the risks in the program are manageable, that \$1 million can feed a lot of hungry children, buy numerous wheelchairs, or provide scholarship for many deserving students.

#### **The Reasons behind the Problem**

The last few years have been hard on charity<sup>1</sup>. Corporate donations are down, economic uncertainty has resulted in donors delaying or reducing their contributions, competition among charities has increased substantially, and charities have experienced losses in the market on their own investment portfolios. Any program that can successfully bring in a sizable donation is therefore given serious consideration even if, just ten years ago, the same scheme would have earned a resounding “no” from non profit executives.

Another important factor is the perceived lack of regulatory scrutiny. While many regulatory agencies (IRS, state attorneys general, SEC, FTC, state insurance and securities departments for example) can potentially attack charity abuses, most if not all of these agencies have strained budgets and have simply not made charity schemes a priority. In other industries where multiple regulatory bodies have jurisdiction, a turf war often emerges over who gets to shut down the scheme. In the charity industry, the opposite seems to be true – all of the various agencies generally seem to assume that one of the others will handle the problem.

And finally, risk of audits and sanctions imposed by the IRS have all but disappeared in recent years. Ten years ago, most charities would actively avoid schemes and plans that might subject them to taxes, penalties, or even loss of tax exempt status. Today, the only loss of exemption seems to occur when churches become involved in politics and the audit rate for tax exempts is so small that fear of the IRS has all but vanished. As of 2001, there were an

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<sup>1</sup> See “Surviving Tough Times,” by Brad Wolverton, the *Chronicle of Philanthropy*, October 30, 2003.

estimated 1.4 million<sup>2</sup> charities and foundations in the United States. Of these, approximately 285,000 filed Form 990 tax returns with the IRS<sup>3</sup>, but only 1,237 (.43%) charities had their returns reviewed by the Service and only 835 (.29%) charities faced an IRS examination. For a system of voluntary compliance to be effective, there has to be some form of real risk that an audit will occur. With IRS staffing at record lows and risk of government regulatory scrutiny practically non-existent, the bad players in the charitable industry are escaping unscathed while the otherwise ethical charities are engaging in schemes which are increasingly risky.

#### **So What Are the Schemes and Abuses?**

##### **Using tax exempt entities to shield or hide corporate and consumer fraud**

In recent years, a number of fraud and embezzlement stories have come out which show con artists and schemers using non-profit entities to enrich themselves at the cost of investors' money and public confidence in the charitable industry. While these stories in no way reflect the philanthropic community in general, they do show what happens when an industry has little or no regulatory supervision.

*Example:* After being banned for life from securities trading in 1992, Martin Frankel<sup>4</sup> almost got away with a \$215 million heist. With the assistance of Vatican officials, Frankel set up a scheme to purchase insurance companies through a non profit entity he founded called the St. Francis of Assisi Foundation. He promised high rates of return to his investors (many of them major churches) and described the charity as a benevolent foundation which assisted children's causes. Moneys raised would go to acquiring insurance companies, and profits (after paying his investors) would be used for charitable purposes. Instead of investing the moneys to

<sup>2</sup> Source: *The New Nonprofit Almanac and Desk Reference*, published in 2002 by the Urban Institute's Center on Nonprofits and Philanthropy.

<sup>3</sup> Source: GAO-02-526 *Oversight of Charities*, published April 2002.

<sup>4</sup> For further details, see Court TV's *Martin Frankel: Sex, Greed and \$200 Million Fraud* at [http://www.crimelibrary.com/notorious\\_murders/classics/frankel/1.html?sect=27](http://www.crimelibrary.com/notorious_murders/classics/frankel/1.html?sect=27)

pay those promised returns, Frankel siphoned cash from the insurance companies, diverted it to his own accounts, and fled to Europe when state insurance regulators discovered the theft. When fleeing the country, Frankel left behind a “to do” list in his home which included the entry “launder money”. Frankel has since been taken into custody, has pleaded guilty to 24 Federal charges and faces up to 150 years in prison.

*Example:* In 1999, the Baptist Foundation of Arizona<sup>5</sup> filed for Chapter 11 bankruptcy, owing more than \$600 million to 13,000 investors, most of them elderly and retired. In what turned out to be the largest fraud case ever involving a religious trust, thousands invested their life savings with the foundation, which promised high investment returns and charitable grants for Baptist causes, but turned out to be nothing more than a complicated pyramid scheme. Three foundation executives have pleaded guilty to defrauding investors and in May, 2002 the now-defunct accounting firm Arthur Andersen agreed to pay \$217 million in damages to investors for their role in helping executives cover up the scheme.

*Example:* In 1997, an insurance agent named Robert Dillie<sup>6</sup> owned a life insurance brokerage company called Mid America Financial Group. Dillie’s company worked closely as the marketing arm of a nonprofit called New Life Corp selling charitable split dollar programs and charitable gift annuities which paid insurance agents hefty commissions for the donations they raised. Recognizing that selling “charity” could be a lucrative business, Dillie decided to form his own non profit called Mid America Foundation which offered charitable gift annuities and donor advised funds through a sizable group of independent insurance agents and financial planners. Only four years later, the charity had raised almost \$53 million in donations through charitable gift annuity investments, but one week after publishing a financial statement showing

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<sup>5</sup> See the Arizona Corporation Commission’s website for additional information:  
[http://www.ccsd.cc.state.az.us/hot\\_topics/bfa.asp](http://www.ccsd.cc.state.az.us/hot_topics/bfa.asp)

<sup>6</sup> See the SEC’s website for additional details: <http://www.sec.gov/litigation/litreleases/lr17986.htm>

\$42 million in assets in October, 2001, Dillie closed the charity's doors and disappeared with the money. He had diverted almost \$20 million to a hidden account, had lost almost \$10 million in gambling debts, and had paid \$3 million in commissions to insurance agents. The charity had failed to file Form 990s with the IRS, and the financial advisors who had placed their clients with this non profit were shocked that the charity turned out to be nothing more than a Ponzi scheme. Dillie was indicted in 2003 on 193 counts of wire fraud, money laundering, and transacting in proceeds from a criminal activity. His trial is scheduled for October, 2004.

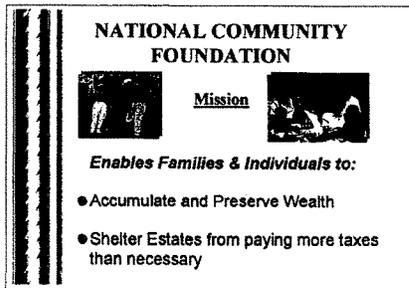
*Summary:* Martin Frankel could not have raised the moneys needed to fund his heist without a charity shell to hide his participation. The Baptist Foundation of Arizona could not have duped 13,000 elderly investors to trust it with their savings without the respectability of the charitable structure. Robert Dillie found that selling charity was much easier and more lucrative than selling life insurance. The charitable industry is attracting con artists and fraudsters simply because there is little or no regulatory scrutiny and because the general public places their trust in charity.

**“Accommodation” Charities, Operating Foundations, and Donor Advised Funds**

In the past decade or so, a small handful of charities have focused on building their organizations by catering to their donor's tax planning needs and by selling charitable “products” through an army of financial planners and insurance agents. Most of these organizations grew from small, fairly anonymous charities to very large entities as a result of selling large amounts of charitable split dollar life insurance in the late 1990s. When that program was shut down by a combination of Federal legislation, Tax Court opinions, and an IRS Notice, these organizations adjusted their marketing plans to “tax deductible annuity” sales (better known as charitable gift

annuities) and donor advised funds, both of which pay hefty commissions and trailing fees to the insurance agents which bring in the charitable donations.

In a 2001 slide show geared towards their insurance agent sales force, New Life Corp (doing business as National Community Foundation) declared their charitable mission to be as follows:



A second organization called National Heritage Foundation makes similar promises to donors:

*One of the most fundamental principles behind the National Heritage Foundation (NHF) is that you can set up and then work for your own foundation receiving taxable income – even if the only donations are those you provided.*

*Think of the retirement planning implications. Put money in a “Foundation at NHF” where it grows tax-free. Then during retirement, recover these funds as taxable income and nontaxable expenses for bona fide charitable activities.*

Source: [http://www.nhf.org/nacec/nacec\\_ch\\_employ.htm](http://www.nhf.org/nacec/nacec_ch_employ.htm)

And apparently, such promises combined with high commissions paid to the advisor who sets up the fund are effective. New Life Corporation currently has accumulated approximately \$189 million in assets, while National Heritage Foundation boasts \$200 million in assets, 7000 “foundations”, and more 3000 financial advisors.

*Example:* Set up an NHF Foundation to deduct adoption expenses that would ordinarily not be 100% deductible.

*We help adoptive parents throughout the United States that are currently working with adoption agencies to set up their OWN family foundation. Once the family foundation is in place, adoptive parents will pay for their adoption expenses through the new, tax-exempt Foundation. The National Heritage Foundation is the entity that will hold and disperse funds, and the Child Adoption Funds Organization is the facilitator of the process.*

*Source:* <http://www.childadoptionfunds.org/whatwedo.asp>

*Example:* Set up a corporate “foundation” with tax deductible money and pay yourself for “charitable employment” when you retire. The tax benefits are comparable to a qualified pension plan but there are no ERISA rules, no annual contribution limits, no penalty for early withdrawal, the plan can discriminate in favor of high compensated employees, and there are no annual IRS or DOL reporting requirements.

*Need Income During Retirement. Our society, at least here in America is facing a dramatic social change called “The Widening Retirement Gap.” Employees are both retiring earlier and dying later than they used to. Now, with funds saved up and growing tax free, they may be used, again with NHF approval, during retirement for bona fide charitable activities and employment.*

*Source:* [http://www.nhf.org/magic/magic\\_markets.htm](http://www.nhf.org/magic/magic_markets.htm)

*Example:* Donations to international charities are not generally tax- deductible, but checks distributed through an umbrella charity are. So before writing a check to a foreign country, just set up an account and you’ll be able to deduct it.

*As you know, a person seeking a deduction of a contribution to a charity or charitable project in another country, must make that donation to a U. S. based-charity like the National Heritage Foundation. A gift directly to the project is not deductible.*

*One of the objectives of NHF is to "touch lives in other countries". We support our "Foundations at NHF" when they desire to do so. 1. They may support charitable organizations in other countries, and 2. They may support charitable projects in other countries.*

Source: [http://www.nhf.org/foundation\\_services/ot\\_countries.htm](http://www.nhf.org/foundation_services/ot_countries.htm)

*Example:* Avoid self dealing rules when you sell inventory to your foundation by setting up an NHF fund rather than a "traditional" corporate foundation.

*Through an NHF foundation, any corporation can sell its goods or services to its foundation for distribution to charitable activities and organizations and still avoid any risk of self-dealing. That's because NHF administers the foundation and supervises and approves the activities. If ever a doubt arises, NHF files a Certificate of Independent Review to certify that prices are no higher than "normal" and that goods and services are actually received by the designated charities or charitable activities.*

Source: [http://www.nhf.org/nacec/nacec\\_corp\\_fndtn.htm](http://www.nhf.org/nacec/nacec_corp_fndtn.htm)

*Example:* Set up a foundation with an accommodating charity and use the tax deductible donations to pay for your children's education. In June, 2003 a CA insurance agent named a Tim Mosley was sentenced to five months in prison for tax evasion. Mr. Mosley made tax

deductible donations to his NHF “foundation” and then advised the charity to issue checks to his children’s private school to pay for their primary school education<sup>7</sup>.

*Example:* Run your insurance or other for-profit business through an NHF Foundation. A company called Elder Planners of Washington has established their insurance agency as an NHF Foundation, through which they offer Long Term Care insurance, reverse mortgages, senior mortgages, estate planning, and other financial products to seniors<sup>8</sup>. In May, 2003, the Attorney General for the state of Washington issued a consumer alert regarding the business practices of this insurance outfit<sup>9</sup>. The agent running the “foundation” had already lost his securities license in the state and had been fined \$10,000 by the state Department of Financial Institutions<sup>10</sup>.

*Summary:* The abuses in this field are too numerous to list. Family vacations, school tuition, Olympic size swimming pools, deferred compensation plans are all being funded through accommodation charities who are willing to often bend and sometimes break the rules.

#### **International Gifts and Concerns about Money Laundering and Funding Terrorism**

While most donations go to good charities that use the funds to provide important services, the recent focus on terrorism funding through non profit entities has grown sharply since September 11, 2001. A handful of charities have now been shut down and it would appear that finding and stopping such organizations have become a priority among US regulatory agencies. The situation, however, is potentially more complex when it isn’t the charity that is raising funds for terrorist groups but rather a charity that plays an unwitting role in funneling money to groups such as Al Qaeda.

<sup>7</sup> [http://www.usdoj.gov/usao/can/press/html/2003\\_06\\_20\\_mosley.html](http://www.usdoj.gov/usao/can/press/html/2003_06_20_mosley.html)

<sup>8</sup> <http://www.epwa.org>

<sup>9</sup> [http://www.atg.wa.gov/releases/alert\\_tax\\_050903.html](http://www.atg.wa.gov/releases/alert_tax_050903.html)

<sup>10</sup> “Seniors Warned About Tax Scam,” by Candace Heckman, *Seattle Post-Intelligencer*, May 8, 2003

Several US charities offer international grant making abilities to their donors, and while many claim that they investigate the foreign charity prior to making a grant, such due diligence is necessarily limited, especially in countries which have no charity structure and regulatory system comparable to ours<sup>11</sup>. While the US Treasury has recently released voluntary guidance<sup>12</sup> on this issue, most charities are unaware of these recommendations and the majority of charities who make international grants simply don't have the resources or the sophistication to perform the necessary due diligence. The voluntary guidance requires that the grant maker gather a significant amount of information about the international grantee, but it is fairly clear that such information will not prevent terrorism funding when the terrorist group exhibits flexibility and mobility. A legitimate orphanage in Afghanistan today could easily become a terrorist front next week, and by the time that organization is placed on the international watch lists, the terrorists have moved on to additional shell entities.

While the Treasury seems to be focusing on shutting down the worst offenders, good charities are likely being used to funnel at least some money to terrorist groups, and unfortunately, a significant percentage of that funding comes from US tax payers in the form of a deduction. Whereas donations made directly to foreign charities are not deductible, donations made to a US charity are, even if all they do is immediately cut a check to the foreign entity.

#### **Tax Shelters Involving Life Insurance and Dead Pools**

In the mid 1990s, some rather creative financial advisors devised a scheme whereby wealthy clients could purchase substantial amounts of life insurance for the benefit of their heirs using moneys "donated" to accommodating charities. The charity would end up with pennies on the dollar while the average donor saved tens of thousands in income and estate taxes. In the

<sup>11</sup> "Al Qaeda Skimming Charity Money", CBS News, June 7, 2004

<sup>12</sup> Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities, US Treasury

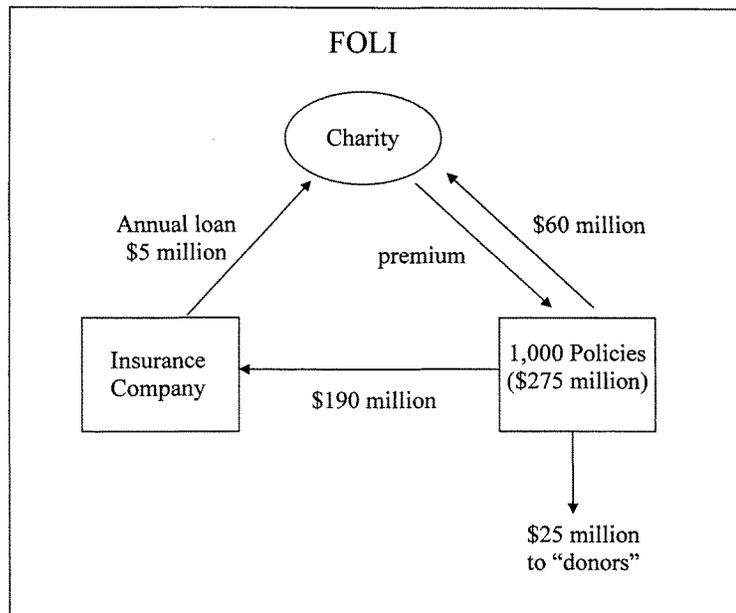
first couple of years, only a handful of charities were willing to participate in this charitable split dollar scheme, but when good charities saw that enough pennies on the dollar eventually added up to nickels and dimes, otherwise honest and ethical organizations began to accommodate wealthy donors too. In 1999, the IRS Released Notice 99-36, Congress passed legislation that added hefty penalties to charities that participated in these plans, and shortly thereafter, the Tax Court ruled in two different cases that the plan had never worked<sup>13</sup>. While the 1999 legislation effectively eliminated this particular scheme, many financial, legal, and accounting experts, struggling to replace the tax beneficial techniques that were being shut down in the corporate and offshore arenas started focusing their sales efforts on shelters involving tax exempt organizations.

**Foundation Owned Life Insurance (FOLI) and Charity Owned Life Insurance (CHOLI)**

Fundamentally, life insurance is a risk management tool. By design, it pays a lump sum benefit when someone dies. In certain circumstances, it may be appropriate for a tax exempt organization to purchase individual life insurance on the life of a donor, alumnus, or volunteer. There are also times when purchasing a group policy can also make sense for a charity. For example, a university may ask the Class of '50 to purchase life insurance to establish a scholarship fund or erect a building in their name. Unfortunately, a growing number of promoters have realized that buying large group policies can be profitable from a statistical gaming point of view. Using a technique called a "dead pool" such investors know that the more policies they hold in their portfolio, the more predictable the death rate becomes, enabling them to play the statistical odds. The gambling behind such an investment strategy is the reason why the state insurable interest laws exist; they ensure that life insurance is only purchased by someone who has a financial interest in the continued life of the insured.

<sup>13</sup> Addis v. Comm'r, 118 TC 32 (June 10, 2002) and Weiner v. Comm'r, T.C. Memo 2002-153 (June 18, 2002)

Institutional investors are actively looking for ways to fund life insurance pools as an investment. As outlined earlier in this report, many charities are also financially unsteady right now and are willing to engage in somewhat aggressive techniques in order to raise donations. Add these factors together, and the investors have found a willing – and cheap -- partner in charitable industry.



*Example:* In Southern California, a landscaper / dog catcher by the name of Robert Sandifer was approached by an insurance agent, who recommended that Sandifer start up a charity in order to establish a dead pool<sup>14</sup>. If Sandifer could find 1,000 people who would agree to have life insurance purchased on their lives, his new charity – a humane society – could

<sup>14</sup> "For Charities, a New Twist in Raising Money: Corporate Investors in Life-Insurance Policies", by Debra Blum, *Chronicle of Philanthropy*, August 12, 1999

borrow large sums of money each year, use it to pay life insurance premiums, and then keep any death benefits remaining after the loans were paid off. Since this charity had no donor list, Sandifer recruited insurance applicants at a local church and a motorcycle club, he ran advertisements in newspapers, and even signed up strangers in a car dealership.<sup>15</sup> While his motivation to fund a charity may have been good, the decision to start that charity with such a long term investment pool was faulty. The plan quickly collapsed and the charity has closed.

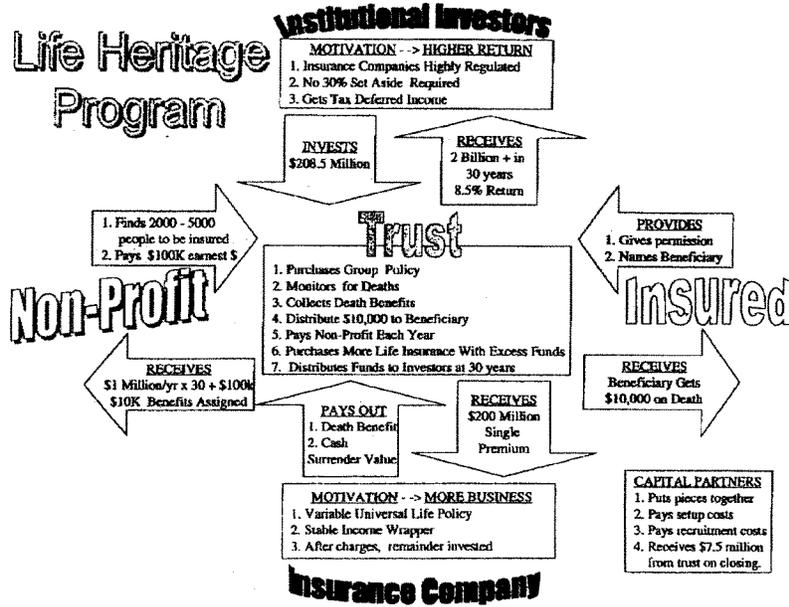
#### **Investor Owned Life Insurance**

While the FOLI dead pool was likely doomed from the start – the charity couldn't meet the public support test, and the size of the dead pool wasn't sufficient for death rates to be predictable – other more sophisticated plans have arisen which could turn a profit. It isn't the charity, though, who benefits most in the new schemes; it is an outside group of institutional investors (primarily insurance companies and hedge funds) who stand to gain the most.

As anyone familiar with the secondary life insurance market can attest, many investors would love to start an insurance pool insuring older, wealthy lives. For example, a life insurance company can only invest a small percentage of its reserves in the stock market, and the remainder must generally be invested in long term fixed income holdings. Since long term bonds are paying very low rates of return in recent years, insurance companies have been looking for creative ways to increase those fixed income yields. Buying a large pool of insurance policies would make a very good investment for this situation, but insurance companies don't have the ability to go out and buy 10,000 policies on the lives of targeted people. Charity, however, does.

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<sup>15</sup> "Dying to Donate: Charities Invest in Death Benefits", by Theo Francis and Ellen Schulz, *Wall Street Journal*, February 6, 2003

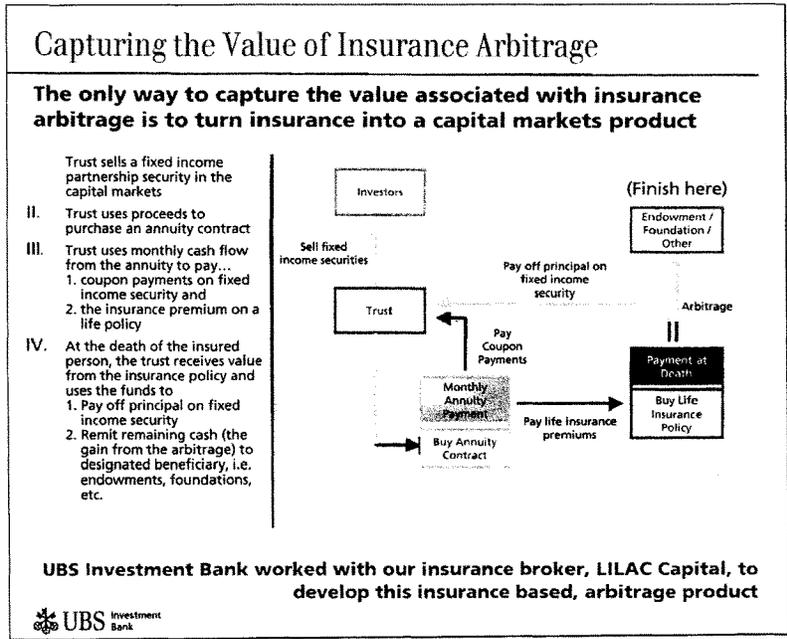


The L.I.F.E. Heritage plan diagram above provides the details for one such plan. The charity sets up a trust which sells either fixed income shares or debt instruments to the insurance company / investor. Using the money raised, the trust purchases 10,000 life insurance policies totaling \$2+ billion from a different insurance company on the lives of the charity's donors. The charity receives the first \$1 million in death benefits each year for 30 years, and the remaining pool (approximately \$2 billion) goes to the insurance company / investor. Each donor receives a small death benefit (\$10,000) as an enticement to have the policy purchased on his or her life. Charity's share in this plan (\$30 million) may seem enormous to the non-profits agreeing to enter into this arrangement, but it is nothing more than rent for the insurable interest they transferred to

the trust for the use of the institutional investors who benefit substantially more. While there are several variations of this plan, the promoter for the LIFE Heritage plan above claims to have already put together at least eighteen \$2+ billion pools for his institutional clients using a variety of charities<sup>16</sup>.

**Life Insurance Life Annuity Combination (LILAC)**

The newest Investor Owned Life Insurance (IOLI) scheme to hit the non-profit world is also the best funded in terms of marketing and lobbying budgets. The LILAC plan uses a structure which is similar to the LIFE Heritage Plan above, but adds an immediate annuity to the product mix.



<sup>16</sup> "Death dividends or creative financing?" by Tom Gascoyne, *Chico News and Reviews*, February 20, 2003.

To summarize briefly, the charity sets up a trust and sells fixed income securities interests in that trust to institutional investors (life insurance companies, hedge funds, and private banking clients). The moneys raised are used to purchase immediate annuities on the lives of the charity's donors. The income from these annuities is then used to purchase life insurance on the lives of the same donors. The charity benefits by receiving the "arbitrage" from the program – the annuity rates received are more favorable than the life insurance rates paid out – with the remainder going to the institutional investors. UBS has successfully put together several of these plans already (totaling \$2 billion) in their first year, and as they lobby to change the insurable interest laws in additional states, more and more plans are likely to fall into place<sup>17</sup>.

<b>Life Insurance and Life Annuities Based Certificates (LILACS)</b>				
<i>❖ Transaction Summary</i>				
	<b><u>LILACS 2003-I</u></b>	<b><u>LILACS 2003-II</u></b>	<b><u>LILACS 2003-III</u></b>	<b><u>LILACS 2003-IV</u></b>
Date of Closing	10-Jul-03	10-Oct-03	17-Dec-03	23-Dec-03
Series A Investor Certificate Amount	231,908,260	170,525,000	238,842,600	188,499,000
Total Death Benefit Amount	242,898,750	179,500,000	251,413,250	198,420,000
Distribution Rate	5.8594%	5.0456%	5.6460%	5.7750%
Number of Donors	15	10	15	17
State	Texas	Texas	Texas	Texas
Weighted Average Life	8.5	9.9	9.4	10.0
Targeted to Charities	10,990,490	8,975,000	12,570,663	9,921,000
Potential to Charities	13,139,579	10,680,250	14,707,675	11,607,570
Annuity/Life Insurance Provider	Two of the nation's leading insurers			
Upfront Annuity Premium	192,921,991	140,595,835	200,101,848	158,420,394
Upfront Life Insurance Premium	17,638,586	9,371,687	17,000,432	10,094,746
Rating (Moody's/S&P)	Aaa/AAA	Aa2/AA+	Aaa/AAA	Expected/AAA

The institutional investors (insurance companies and hedge funds) investing in this plan would be unable to purchase these insurance contracts on their own. They must borrow – or rent

<sup>17</sup> "Charities Look to Benefit from a New Twist on Life Insurance" by Stephanie Strom, *NY Times*, June 6, 2004.

- the charity's insurable interest. In exchange, the charity is receiving a very small percentage of the overall scheme. Once again, the charities are willing to sell their insurable interest for pennies on the dollar, simply because they reason that those are pennies they wouldn't have had otherwise.

Investing in life insurance dead pools clearly goes against public policy. The insurable interest laws pre-date the American Revolution and were put into place to prevent gambling on the lives of others. Under most state laws, the above transactions are already prohibited because while charity may have an unlimited insurance interest in the life of a donor, the trust funded by the institutional investors does not. For this reason, UBS and the promoters of this plan have been actively lobbying at the state level to get the insurable interests laws expanded, effectively gutting the purpose of these laws in order to arrange more LILACs for their institutional clients. Texas' and Virginia's laws were already sufficiently open to allow these plans, but the UBS lobbying efforts have recently resulted in Tennessee and Nebraska changing their laws to accommodate this program. Nine additional states currently have legislation under consideration which would allow charities to assign their insurable interest to outside investors, even when those investors have no reason – other than statistics gambling – to purchase such policies.

From a charity's point of view, participating in a scheme that enriches outside investors is bad public policy, even if the charity receives funds it would not ordinarily get. From an insurance industry viewpoint, this plan is equally problematic. If a person's death is allowed to become a commodity rather than a risk to be covered by life insurance, then the tontines and dead pools of the 17<sup>th</sup> and 18<sup>th</sup> centuries will return.

**Summary**

I have worked in and around the insurance industry for approximately eighteen years, usually as one of their harsher critics. The reaction to the investor insurance programs involving charity is the first time I've seen the two largest insurance agent associations -- Association for Advanced Life Underwriting (AALU) and the National Association for Insurance and Financial Advisors (NAIFA) -- jointly publish a statement warning their members away from a plan<sup>18</sup>. The lobbying efforts at the state level would do tremendous damage to the consumer protections that insurable interest laws are supposed to provide.

In the past year, I have spoken with literally dozens of people who were looking into variations of Investor Owned Life Insurance (IOLI) plans involving charity. The charities who have been pitched the program and agree to participate only see that they would have \$10 million if they do it and nothing if they don't. None knew how much the outside investors would get or even who those outside investors were. All appear to be caught up in the minutia of the plan - which arrow points where, which contracts pays what -- without stepping back and looking at the big picture. It is not the charitable mission to make wealthy investors wealthier by entering into complicated schemes.

**Conclusion**

Each of the examples above has one common theme: all of these schemes and arrangements allow people to do things that they couldn't do without the involvement of a charity. All receive a benefit that would be otherwise unavailable to them. A corporate raider is able to steal because a charity shell hides his identity and give him credibility. A terrorist group is able to raise tax deductible money from US supporters and can launder that money through non profit entities. A few thousand taxpayers are able to fund personal expenses using tax

<sup>18</sup> [http://www.naifa.org/frontline/20040615\\_nfl\\_1.html](http://www.naifa.org/frontline/20040615_nfl_1.html)

deductible “donations” to an accommodating non profit. And institutional investors are able to purchase sizable life insurance pools where ordinarily, the state insurable interest requirements would make such investment pools impossible.

I would really like to thank the Senate Finance Committee for holding these hearings and to commend the staff on their White Paper which thoughtfully addresses the myriad of concerns that the panel members have raised. Despite the horror stories told today, the charitable industry is still relatively clean, and it is my hope that shining a harsh light on the few abuses that do occur will have the effect of wiping out the bad practices before they have a chance to spread.

Statement of the  
National Association of State Charity Officials  
to the  
United States Senate, Committee on Finance  
*“Charity Oversight and Reform: Keeping Bad Things  
from Happening to Good Charities”*  
June 22, 2004

Mr. Chairman and Members of the Committee:

Good morning. My name is Mark Pacella and I am here today as the President of the National Association of State Charity Officials, or “NASCO” as it is more commonly known. NASCO is affiliated with the National Association of Attorneys General and serves as a forum for state charity officials to exchange views and experiences relating to the regulation of public charities as well as to foster interstate cooperation regarding charitable enforcement efforts.

On behalf of NASCO and its members, I thank the Committee for the opportunity to participate in today’s important proceedings as well as our NASCO members from New York for their hard work with the Committee.

Mr. Chairman, I respectfully request permission to submit this statement for the record.

State charity officials serve as the primary regulators over public charities and are the parties most likely to pursue breaches of the fiduciary duties of loyalty, care and good faith that our state and common laws impose upon the directors, officers and trustees of charitable assets. These actions include, but are not limited to, administering state registration and reporting requirements; correcting inaccurate and misleading financial reports; redressing fraudulent and deceptive charitable solicitations; recovering diverted charitable assets; imposing fines and penalties for violations of state law; and, most notably of late with respect to health care entities, overseeing corporate mergers, conversions, and asset sales.

Despite their broad authority over charitable assets and fiduciaries, many states lack the resources to effectively regulate the charitable organizations operating within their jurisdictions. Of our fifty states, less than half are able to be regular and active participants in NASCO's annual conferences and most do not have personnel dedicated to the exclusive regulation of charities.

Given the relative scarcity of enforcement resources, it is important that we make the most efficient use of the resources that we have. Toward that end, NASCO encourages reforms in three general areas: 1.) reporting and accountability; 2.) information sharing and cooperation among state and federal regulators; and 3.) exploiting technology in the areas of electronic filing and the internet.

1. Reporting and Accountability.

With regard to reporting and accountability, NASCO encourages the Committee to support reforms that strengthen the accuracy and timeliness of the IRS Form 990 that charities are obliged to file. The IRS Form 990 serves as the initial source of information for both the general public and regulators about a charity's finances. Unfortunately, the 990's submitted by organizations so often contain inaccuracies and in-completions that it is difficult to differentiate "bad actors" from the simply inept. Moreover, these returns are often filed one or more years after the fiscal period to which they relate, which frustrates the ability of state and federal regulators to identify problems on a timely basis.

Through an attachment to this statement, NASCO is offering a number of recommendations for specific changes concerning 990 reporting. These recommendations, too numerous to discuss here, propose substantive changes to the instructions for completing the form as well as to the form itself. They are intended to tighten the parameters within which charities report their financial activities to promote greater accuracy and consistency in 990 returns.

One material recommendation is to mandate that the information reported in an organization's IRS Form 990 be consistent with its financial statements. For larger organizations required to provide audited financial statements, the requirement will have the effect of subjecting the information reported in their 990's to the review of an outside, independent auditor, promoting greater accuracy and consistency. Conversely, for most smaller locally based organizations not required to have audited financial statements, the requirement will serve to enhance the accuracy and consistency of their financial statements.

These recommendations do not require changes to Generally Accepted Accounting Principals, nor are they intended to extend those principles blindly into Form 990 reporting requirements. NASCO's fervent belief is that the Form 990, with

appropriate reforms, can be the most effective vehicle driving improvements in the accuracy, consistency and usefulness of the financial reports submitted by charitable organizations. We believe such reforms are achievable within existing accounting principals and are optimistic that the accounting profession will welcome the opportunity to improve the accountability of our charitable community.

2. Information Sharing and Cooperation among State and Federal Regulators.

Concerning the sharing of information and cooperation among state and federal regulators, NASCO strongly supports the reforms contained in the Senate version of H.R. 1528. It is important that state charity officials and the IRS be able to share information pertinent to the regulation of charities. At the present time, the rules of confidentiality imposed on the IRS effectively preclude the service from any meaningful cooperative enforcement actions with state regulators. States are free to make referrals to the IRS, but the IRS is precluded from sharing any information as to what action, if any, it may take as a result of such referrals. Ironically, states pursuing an active investigation are far more likely to discover the extent of IRS activity through the target of the investigation rather than the agency

itself. The existing dynamic is regrettable since state charity officials and the IRS share many of the same enforcement interests.

As an example, pursuant to Section 6104(c) of the Internal Revenue Code, state charity officials receive final determination notices from the IRS when it has denied or revoked an organization's tax-exemption under Section 501(c)(3) of the code. State regulators can compare those notices to existing case files to see if they match any ongoing investigations as well as to see if organizations should have notified us concerning the disposition of the organization's assets upon termination. While an important example of how state regulators and the IRS can work together, these notifications barely scratch the surface of the benefits that broader information sharing and cooperative enforcement actions could yield.

### 3. Exploiting Technology in the Areas of Electronic Filing and the Internet.

With respect to technology and utilizing the potential of the internet to leverage regulatory resources, NASCO strongly supports the IRS's development of electronic filing of its Forms 990 as well as a state retrieval system which could serve as a single point filing system that would be available to all state regulators.

Charitable organizations are required to comply with a variety of registration and reporting requirements at both the state and federal levels. They have historically satisfied those reporting requirements by completing paper forms and submitting them separately to appropriate state and federal officials. Due to the ever increasing number of charitable organizations reporting information, however, regulators are finding it more and more difficult to effectively process the paperwork they receive. As a result, it is not uncommon for material omissions and inaccuracies in state registration materials and Forms 990 to go undiscovered unless circumstances draw attention to an organization's filings.

Since the software underlying electronic filing will, among other things, require the completion of requisite data fields and check for mathematical errors, electronic filing promises to materially improve the quality of nonprofit accountability. Charitable organizations will benefit from the efficiencies and cost savings inherent in electronic filing and the donating public and regulators will benefit from the increased accuracy, timeliness and access to information.

In order to further promote the effective use of the data that electronic filing will make available, NASCO has been working with Guidestar, a private, nonprofit

organization, to develop NASCO's web site into a national on-line charity information system. "NASCOnet" as the project is known, has been funded through a \$1.3M Commerce Department Technology Opportunities Program grant awarded to Guidestar in the fall of last year.

If the project is successful, state regulators will be able to efficiently post and share documents and information about their enforcement activities, enabling them to concentrate more time on substantive enforcement initiatives such as conducting data base searches to assess the reasonableness of executive compensation or identifying related parties among organizations. The site will also provide a convenient information source for the general public about what, if any, legal or administrative enforcement actions have been taken against an organization and how those actions have been resolved.

A resource such as NASCOnet, when used in conjunction with the IRS's electronic filing and state retrieval system, would extend the availability of "state-of-the-art" information technology and enforcement tools to all state regulators, including those lacking the financial wherewithal or technical expertise to develop such

capabilities on their own. NASCO and Guidestar hope to have certain aspects of the site functional by the end of this year.

Finding a way to sustain the financial viability of the project after the grant funding expires in the fall of next year is a critical matter yet to be resolved. As such, NASCO strongly supports restoring the use of funds generated through the 2% excise tax on the net investment income of private foundations on charitable oversight, and hopes that some of that funding can be dedicated to state regulators as proposed in the Committee's white paper. As set forth in our March 11, 2004 letter to Chairman Grassley, NASCO believes this additional funding would enable state charity regulators to become more effective in identifying, investigating and correcting the financial and other abuses becoming more prevalent in our nonprofit sector.

NASCO is a ready volunteer to assist the Committee with its important work in all of the areas being discussed today and greatly appreciates the opportunity to share some of our thoughts during today's hearing.

Thank you.

## ATTACHMENT

**A. REQUIRE 990 FORMS TO CONFORM TO FINANCIAL STATEMENTS.** As an “informational return,” the 990 should be conformed to an organization’s financial statements to promote consistency and enhance the usefulness of the form to the general public and regulators alike.

**1. Instructions for Form 990, Section G – Accounting Methods:**

Instructions for this Section should be changed *to require* that the information reported in 990’s conform to an organization’s financial statements (additions are underlined):

**Accounting Methods**

Unless instructed otherwise, the organization should ~~generally~~ must use the same accounting method on the return to figure revenue and expenses as it regularly uses to keep its books and records. To be acceptable for Form 990 or Form 990-EZ, reporting purposes, however, the method of accounting used must clearly reflect income. The Form 990 and Form 990-EZ revenue, expenses and balance sheet should be prepared in accordance with the financial statements prepared by the organization. The revenue, expenses and balance sheet items on a Form 990 for an organization having audited financial statements will be the same as the audited financial statements; for an organization having reviewed financial statements the revenue, expense and balance sheet items on Form 990 will be the same as the reviewed financial statements; and for organizations with compiled or other internal financial statements, the revenue, expense and balance sheet items on the Form 990 will be the same as these financial statements.

**2. Form 990, Part IV-A/IV-B – Reconciliation with Audited Financial Statements:**

Based on our general recommendation that the Form 990 be prepared using the same accounting method an organization uses to keep its books and records (*See Recommendation # 1*), this Section of the Form 990 should be changed to reconcile the organization’s financial statements figures (*i.e.*, the figures reported on Form 990) with a “Tax Basis” calculation.

If our *Recommendation # 1* is not adopted, this reconciliation should be changed to include the reconciliation of reviewed financial statements.

**3. Form 990, Part II – Joint Costs at variance with Financial Statements:**

At present, a substantial difference in joint cost allocation reporting between an organization's financial statements and Form 990 is permissible.

Absent adopting *Recommendation # 1*, how can the Form 990 instructions be improved to head off this tactic in the future?

**Example:** On a 2002 Form 990, Charity A allocated 65% of joint costs to program services although, due to the provisions of SOP 98-2, all joint costs were allocated to fund raising in its audited financial statements.

The organization eventually amended its return when threatened with denial of a state solicitation license, but its accountant found sufficient flexibility in the IRS instructions to feel that they were justified in preparing the Form 990 in this manner despite the substantial variation from the audit.

**B. TIGHTEN REQUIREMENTS FOR IDENTIFYING RELATED PARTIES.** Organizations are materially influenced by the personal relationships that may exist among other organizations. This is particularly true when smaller boards are involved that share a common director and/or when individual members of distinct boards are related by blood or marriage.

**4. Form 990, Part VI, Lines 80a/b – Related Parties:**

Change the criteria for identifying related parties to those organizations having one or more of the same individuals serving as officers or directors and delete the current requirement of *more* than 50% "commonality". Percentage assessments do not always reflect the **actual** control of the organization. A suggestion would be to use the GAAP standards for related party disclosures, which generally define a related party as an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be

prevented from pursuing its own interests. A related party may be any party the entity deals with that can exercise that control. Examples of related parties include (a) affiliates, (b) investments accounted for under the equity method, (c) trusts for the benefit of employees (for example, pension or profit-sharing trusts), and (d) principal owners and members of management and their immediate families.

**5. Form 990 Part V, Question 75:**

Change requirements to include payment arrangements to an officer/director/trustee/key employee by a related organization(s) *even if* the reporting organization did not pay any compensation directly to this individual, as long as the entities are related using the criteria detailed in *Recommendation # 4*.

**6. Schedule A, Form 990, Part II:**

Schedule A, Part II should include the reporting of payments over \$50,000 paid to related entities (including other non-profits) including, but not limited to, payments for administrative services (including shared services).

**7. Schedule A, Form 990, Part III:**

Schedule A, Part III should be changed to require the reporting of related party transactions that involve tax-exempt entities (*i.e.*, a charity could lease space to its (c)(3) affiliate at a "special" rate, Charity A pays or reimburses Charity B for administrative costs and Mr. Jones is the President of both Charity A and Charity B).

**8. Form 990, Part VI, Lines 80a/b – Related Parties:**

If changes cannot be made as discussed in *Recommendation # 4*, the existing instructions need to be clearer, with real world examples given, including those types of relationships that are set-up to avoid disclosure.

**C. STRENGTHEN THE INFORMATION PROVIDED REGARDING THE IDENTITY AND COMPENSATION OF EXECUTIVE MANAGEMENT.**

**9. Form 990 Part V:**

- a. Require the city and state that the officers/directors/trustees/key employees reside in, so that information can be found easier on these individuals for the service of law suits, civil investigative demands and other kind of legal papers;
- b. For compensation of officers, directors, trustees and key employees, require that the organization indicate whether it has complied with the "safe harbor" provisions of the Internal Revenue Code.
- c. Require the disclosure of the existence of any contracted labor agreements/arrangements for all individuals, or at least the officers, directors, trustees and key employees and require detail of these agreements/arrangements; and
- d. Add a column that requires the disclosure of the dollar amount of all loans to/from each of the officers/directors/trustees/key employees listed.

**D. MISCELLANEOUS REVISIONS TO THE INSTRUCTIONS TO FORM 990.**

**10. Instructions - General Issues:**

- a. Instructions should make clear all potential penalties that could be assessed against the reporting organization related to the Form 990 (i.e. filing a false tax return);
- b. Instructions should clearly indicate the procedure for reporting all aspects of a thrift-store's transactions – to assure uniform reporting.

- c. Instructions should include a simple-to-follow “check-list” of items that must be completed or the Form 990 would be returned with a processing/penalty charge. These items should include:
  - i. Form 990, Page 6, Signature of Officer;
  - ii. Form 990, Page 1, Line 9, special events with detail must be attached if more than zero;
  - iii. Form 990, Page 2, Line 22, Grants & Alloc., detail must be attached if more than zero;
  - iv. Form 990, Page 4, Part V – if organization answers any question by referring to an attached list or statement and it is not attached.

**11. Form 990, Line 1a – Direct Public Support:**

If our general *Recommendation # 1* is not adopted, the instructions for this Line should be rewritten to include the IRS’s position on the reporting of:

- a. Agency Transactions -- the general accounting rule is that an agency transaction occurs when resources received via transactions in which a non-profit organization is acting merely as an agent, trustee or intermediary for another organization. These resources (i.e., cash, non-cash goods) are generally not considered as revenue or expenses to the non-profit, but an increase to its assets and liabilities.
- b. Non-Agency Transactions -- With regard to resources received from another nonprofit, the general accounting position is that the decision to report the transfers (i.e., the receipts and the subsequent distributions of resources) as an increase to the non-profit’s assets and liabilities (an agency transaction) or an increase to its contribution revenue and expenses depends on the extent of the discretion the reporting organization had over the use or subsequent disposition of the assets.
- c. Sales Transactions -- Sales revenue used to support the charitable mission of the organization should be reported as revenue on Line 2 or Line 10. Sales revenue not used to support an organization’s

charitable mission should be reported as unrelated business income on Line 78a.

**12. Form 990, Line 1c - Government contributions (grants):**

It is unclear whether Line 1c includes grants from foreign governments or just U.S. governmental grants. The instructions should clearly state whether or not foreign government grants should be included on Line 1c. If foreign grants do not get reported on Line 1c, the instructions should indicate where they should be reported.

**13. Form 990 Part V:**

Instructions should be modified to reduce the underreporting of deferred compensation arrangements. Examples in the instructions should include:

- a. A nonqualified deferred stock plan and how to value it;
- b. When large bonuses are spread out over a number of years – how should they be prorated, how should they be valued (i.e. present value);
- c. An arrangement where there is a significant potential for forfeiture (no legal right to money);
- d. Examples of different methods for valuation or suggest a method and require disclosure if it varies from the IRS suggestion;
- e. Require disclosure if changes in valuation occur from a prior year.

**14. Schedule A, Form 990, Part III, Line 2d:**

Instructions should indicate the exclusion of amounts already reported in Form 990, Part V.

**15. Form 990 – General Issues:**

- a. Disclose aggressive tax positions taken (similar to the disclosures required by Form 8275);

- b. Require more types of organizations filing Form 990 to submit Schedule A (*i.e.*, 501 (c)(4)'s);
- c. Require all organizations filing Form 990 to fill out all sections of Part II and Page 1, Lines 13-15; and
- d. Require all organizations to report their gross professional fundraising fees on Line 30.

**E. GENERAL RECOMMENDATIONS REGARDING FORM 990.**

- 16. Amended returns and Guidestar.** At times, a state may require an organization to amend its Forms 990 to be compliant with IRS instructions. Sometimes the amended return may be required to correct potentially misleading accounting information or it may involve providing meaningful disclosure of information that had not been made. However, in most, if not all, cases, these amended returns do not appear on the Guidestar website thus leaving open the possibility that the public viewers of the returns at the website may either be misled or not have pertinent information. We recommend that a procedure be instituted with Guidestar to expeditiously post amended returns on Guidestar's website.

**17. Form 990, Line 1c - Government contributions (grants):**

Change Form 990 to require a list of government grants received. This would insure that the contributions are from actual governmental agencies and not just "grant money" from private foundations or other entities, like the Combined Federal Campaign, erroneously reported as government grants.

**18. Form 990, Line 9a/b – Special Events Reporting:**

Form 990 should have separate lines for reporting gambling income and expenses.

**19. Form 990, Part II, Line 25a (Proposed New Line):**

Require disclosure of any cash benefits (or the value of any non-cash benefits) paid to individuals that were for the "convenience" of the employer (excluding de minimis fringes). This could reveal anything that could potentially be taxable income to the individual (*i.e.*, employer-

provided housing or meals) and reportable elsewhere on Form 990 (i.e. as compensation on Part V).

**20. Form 990, Part VI, Question 90a – States with which a copy of return is filed:**

- a. In addition to, or instead of this question, require a list of states and governmental agencies that have conducted investigations, audits or reviews of the filing organization and require the organization to attach a description of the results and any action taken;
- b. In addition to, or instead of this question, ask for a list of states and federal governmental agencies with which amended Forms 990 were filed during the last 3 years;

**21. Form 990, Part II - Proposed New Line:**

Require the disclosure of any fraud, misappropriation, and /or embezzlement found by an organization (or its agent), perpetrated by any of the organization's officers, directors, trustees, employees, or independent contractors;

**22. Form 990, Page 6, Signature:**

Incorporate some of the accountability requirements of Sarbanes-Oxley to send a warning signal that certain individuals within the reporting organization have fiduciary responsibilities.

For example:

- a. Require the Form 990 to be signed by the chairperson of the board and the highest officer;
- b. Include an affidavit section indicating that the chairperson and officer have personally reviewed the tax form and supporting financial information and personally verify its accuracy; and
- c. Include a provision that makes them personally responsible for the content, and makes them personally responsible for due diligence in verifying the content.

23. Do not accept Forms 990 using the phrase "Available Upon Request" or similar phrases.
24. Have an identification number assigned to each state by the IRS so when the state representative calls the toll free tax exempt #1-877-829-5500, the IRS Agent would be allowed to give some public information, but it wouldn't require 6-8 weeks of waiting for a copy of the 990, Form 1023, determination letter, etc.
25. Make it mandatory for an organization to respond in writing (e.g. a small postcard already formatted by the IRS) stating that the organization is under \$25,000 in gross receipts for a particular year and therefore is not required to file a 990 or 990-EZ.

Testimony of Mr. Rock Ringling  
Managing Director, Montana Land Reliance  
Before the United States Senate Committee on Finance  
Tuesday, June 22, 2004

MR. CHAIRMAN and members of the Senate Finance Committee I appreciate the opportunity to share with you my perspective as a Managing Director of The Montana Land Reliance on the future direction of the conservation easement program.

In my limited time this morning, I would like to accomplish three things.

First, I would like to give you a brief introduction to The Montana Land Reliance, our mission and our values.

Second, I would like to share with you some of my views regarding the potential for reform that would both protect taxpayers and put this program within reach of average farm and ranch households in America.

And third, I would like to answer any questions you may have in this regard.

The Montana Land Reliance was founded by a group of forward-thinking Montanans in 1978. Today, some 26 years later, the mission of our organization remains the same as when it began – to provide protection for private lands that are ecologically significant for agricultural production, fish and wildlife habitat and open space.

In those 26 years, Montana private landowners have protected the unique Montana heritage of 537,000 acres. To put that in perspective, even though we restrict ourselves to working only with Montana landowners, The Montana Land Reliance holds an estimated 15% of the easement acreage granted to local and regional land trusts in the United States.

We accomplish this work through a strict adherence to a number of important principles.

First, we have a strong, independent Board of Directors, two of whom have testified before this committee. The Board has hands-on oversight over organizational policy and takes an active role in reviewing easement agreements.

Second, we have as an operating policy a strict adherence to accounting and legal standards. In addition to adopting the national standards and practices developed by the Land Trust Alliance, we have in place a set of policies that constitute what we believe to be a conservative but appropriate approach to proper utilization of the conservation easement program.

Third, we create a personal relationship with each easement donor. This allows us to understand their motivation for wanting to join with us in creating an easement agreement and to determine how best to craft an agreement that meets their objectives as property owners, that is in keeping with the public benefit requirements of the conservation easement law and is consistent with our mission at The Montana Land Reliance.

Mr. Chairman, these operational values are at the core of everything we do at The Montana Land Reliance and I believe similar values are at the core of the work done by the vast majority of our fellow members of the land trust community in your states and throughout America.

Before I close, I would like to take just a moment to discuss potential reforms to the conservation easement system.

As you know, we have engaged very directly in this discussion with committee staff and we hope our observations have been helpful.

We believe there are a number of reforms you can enact that would help protect the integrity of the conservation easement program. Let me touch on a few.

First, encouraging land trusts to meet accreditation standards would be a step forward and can be done without creating additional bureaucracy. In Montana, we have taken the initiative by putting together a Montana Association of Land Trusts that will provide independent oversight and accreditation for Montana's land trust community.

Second, requiring that appraisals meet uniform, national requirements could be a useful tool as long as the proper standard is determined. More specifically, mandating the use of Uniform Standards of Professional Appraisal Practice would, we believe, be an appropriate reform.

Third, making it easier for the IRS to review easement donations is consistent with current Montana Land Reliance policy. As a matter of practice, we recommend landowners attach the easement agreement, the appraisal and a letter from the land trust detailing the public benefit of the easement. Codifying this practice would, in our view, make good sense.

Fourth, increasing existing fines and penalties will be of no concern to most land trusts like ours who already insist on the highest legal and accounting standards.

Last, I want to touch on what we believe is the most important reform, which is to level the playing field in the conservation easement arena. For the past three years, The Montana Land Reliance has been proud to work with Chairman Grassley, Senator Baucus and over 200 endorsing land trusts in proposing legislation to allow working farmers and ranchers equal access to the conservation easement program.

This legislation, S. 701, passed by this Committee last year as part of the CARE act, would help remove inherent inequities in the current system that favor landowners with high personal incomes over the bulk of working farmers and ranchers in America for whom the current system does not work.

Mr. Chairman, we are proud to be a part of the land trust community and are honored to have been asked to visit with you today. We believe that by leveling the playing field through passage of S. 701, and by consideration of additional technical reforms, the current, successful conservation easement program in America can be improved to work better for all of us. We at The Montana Land Reliance and in the land trust community stand ready to work closely with you and this committee in that important work.

Thank you.

**Statement**  
**Sen. Rick Santorum**  
**Senate Finance Committee Hearing**  
**June 22, 2004**

Mr. Chairman, I would like to thank you for your commitment to making sure that the charitable sector is a responsible steward of the public's trust and functions in compliance with the tax laws of this country. It is my strong conviction that the overwhelming majority of charities in this country seek to improve their communities in concrete and sacrificial ways—often one person, one family, and one neighborhood at a time.

One of the things that makes American unique around the world is the philanthropic tradition and spirit of this country. We believe that individuals, families, churches, synagogues, mosques, and community groups have a critical role to play in the betterment of our society and in helping those in need. In many cases this includes partnerships with local, state, and the federal government.

**FREE THE CARE ACT: HELPING THOSE IN NEED**

The CARE Act, the Charity Aid, Recovery, and Empowerment Act of 2003, S. 272/S.476, will help people in need by encouraging GIVING, SAVING, and FAIRNESS. The legislation, the first order of business for the Senate Finance Committee in this Congress, overwhelmingly passed the Senate. The CARE Act also included commonsense charitable reforms on transparency and disclosure. Like several of today's witnesses I want to express my concern that we not take steps with unanticipated, unintended consequences for the many charities being responsible in their charitable endeavors because of a few dramatic bad examples – when existing laws and regulations merely need to be enforced at the state or federal level to prevent such abuse. It is also appropriate to look at whether there are sufficient resources to adequately do so. I look forward to the testimony of the witnesses and welcome Mr. Pacella, President of the National Association of State Charity Officials, from Pennsylvania.

The CARE Act is important unfinished business since the charity crisis continues as a result of increased social needs and lower charitable giving. Representing part of the President's Faith-based Initiative, the CARE Act will spur charitable giving and assist faith-based organizations who serve the needy. More than 1,600 small and large organizations from around the country have endorsed the CARE Act and 23 bipartisan senators are cosponsors. The CARE Act passed the Senate on April 9, 2003, by a vote of 95-5. The House of Representatives passed companion legislation, the Charitable Giving Act, H.R.7, on September 17, 2003, by a vote of 408-13.

Eight unanimous consent requests have been tried since October 17, 2003, to go to conference on the House and Senate charitable bills but Senate Democratic leaders led by Sen. Daschle have objected repeatedly—even though his staff was involved with the original bipartisan negotiations, he wrote an op-ed in South Dakota strongly endorsing the bipartisan bill one week after the bill was introduced, and there was an agreement to go to conference once the House passed its bill without explicit faith-based language more than nine months ago.

Sen. Daschle wrote in the *Rapid City Journal* on February 15, 2002, “**The CARE Act isn’t a Republican or Democratic plan. It is a bipartisan proposal** that strikes the right balance between harnessing the best forces of faith in our public life without infringing on the First Amendment. ... **Most importantly, it is representative of what we can accomplish in Washington when we put partisanship and politics aside and focus on what matters. I look forward to working with President Bush to get this proposal signed into law.**”

CARE was the first bill prevented from going to conference last October by the Democratic leadership-since then the pensions bill and now the transportation bill have been allowed to go to conference, because of the political clout of those who support them-even though the same assurances have already been provided to enable a charitable conference. Democratic leaders also continue to hold up other social policy and resources focused on low-income individuals including the Workforce Investment Act (WIA) (job training), Community Services Block Grant (CSBG) (community services), Temporary Assistance to Needy Families (TANF) (welfare and child care) and other social services bills by preventing them from going to conference or being considered at all. Charities around the country have been struggling for several years. The CARE Act would provide billions of dollars in private and public sector assistance for those in need.

What does the CARE Act do?

**GIVING:** The CARE Act seeks to address these needs through a number of expanded tax incentives. The bill restores a charitable tax deduction for the 86 million Americans who do not itemize, for a maximum deduction of up to \$250 for individual taxpayers and \$500 for couples for charitable giving beyond a base level of \$250 for individuals and \$500 for couples. To encourage larger donations, Individual Retirement Account (IRA) holders will be allowed to make charitable contributions without tax penalties. It provides incentives for an estimated \$2 billion worth of food donations from farmers, restaurants, and corporations to help those in need (America’s Second Harvest estimates that this is **the equivalent of 878 million meals for hungry Americans over 10 years**). This is strongly supported by food banks, farm bureaus, and hunger advocacy groups around the country. A deduction is also provided for contributions of books to schools.

**SAVING:** The CARE Act also attempts to narrow the gap between the rich and the poor. Through Individual Development Accounts (IDAs), low-income Americans are encouraged to save and build assets and provided training in financial education. These special savings accounts offer matching contributions from the sponsoring bank or community organization reimbursed through a federal tax credit of up to \$500 a year, on the condition that the proceeds go to buying a home, starting a business or paying for post-secondary education. Low-income Americans are now being given the possibility of sharing in the American dream. The provision would provide for a phased-in 300,000 savings accounts for a national demonstration.

**FAIRNESS:** The CARE Act helps smaller faith and community-based organizations. Through the Compassion Capital Fund, it provides these community healers with additional resources for technical assistance such as enabling incorporation, grant writing and accounting skills,

authorizing \$150 million a year. It also allows social service agencies with experience in administering government contracts to play an intermediary role between government agencies and smaller charities. These provisions will help smaller faith-based charities to survive and to grow into viable charitable organizations. The legislation also expands resources through significant increases in the Social Services Block Grant (SSBG) funds of more than \$1.3 billion. It also authorizes \$33 million a year to assist the important efforts of maternity group homes.

This bipartisan consensus bill seeks to harness the potential of charitable organizations in order to better serve the most needy members of our society in partnership with government efforts. A coalition of more than 1,600 national and grassroots charitable organizations helping those in need endorsed similar legislation last year. The bill offers incentives to individuals and corporations to increase charitable giving, rewards low-income citizens who choose to save, and encourages fairness for smaller faith-based organizations by providing resources to expand their capacity to serve those in need.

Throughout our country many social entrepreneurs and community healers are making a difference in the lives of those who are struggling and in the neighborhoods and communities seeking to revive themselves in the face of poverty, crime, failing schools, and unemployment. Many of these heroic individuals and organizations are also motivated by faith. Because of this reality, many of the provisions of the CARE Act will result in significant benefits for faith-based organizations around the country. For example, more than 75% of the food banks across our nation have a religious affiliation. Moreover, much of the charitable giving in this country is directed toward faith-based organizations serving their communities and those in need. Many maternity group homes have faith affiliations. Some faith-based organizations are partnering to provide Individual Development Account demonstration programs around the country.

A successful war on poverty at home requires the concerted efforts of government, community and faith-based organizations, and citizen heroes from around this country. The reality is that many community and faith-based organizations are located in the same zip codes of these distressed communities where the needs are the greatest. They know the names of the people and families in need and care for them compassionately one at a time. In some cases, they also willingly put their lives on the line in order to provide a safe place for a child and hope for his or her tomorrow. The CARE Act, one of the largest charitable legislative packages in decades, seeks to expand the capacity of the voluntary and charitable sectors in this country, which is one of the greatest strengths and traditions of our country.

I would like to thank the thousands of charities and millions of Americans who represent the power of compassion through charitable service which is transforming their communities. The CARE Act advances our common interest in turning the immense spirit of volunteerism and civic duty in our country toward building strong communities. The Act's ultimate goal is to help those most in need in our society--the poor, the hopeless and the destitute. The time has come for this important legislation to be freed and allowed to go to a bipartisan conference so that it can be signed into law to the benefit of those in need around this country.

**Testimony of H. Art Taylor, President & CEO**  
**BBB Wise Giving Alliance, 4200 Wilson Boulevard, Arlington, VA 22203**  
**before the**  
**COMMITTEE ON FINANCE, UNITED STATES SENATE**  
**on**  
**Charity Oversight and Reform:**  
**Keeping Bad Things from Happening to Good Charities**  
**June 22, 2004**

Mr. Chairman and Members of the Committee, I am Art Taylor, President and CEO of the BBB Wise Giving Alliance. I appreciate the opportunity to appear before this Committee to share with you our perspective on charity accountability.

At the outset, I want to stress that our aims, as a nonprofit organization, both resemble and differ from those of government. An objective we share is the fostering of ethical conduct. Both of us work toward that end through activities designed to educate charities about good governance and fund raising practices. While government seeks to identify and prosecute fraud, abuse of tax-exempt status, and financial improprieties in the charitable sector, the BBB Wise Giving Alliance works to help donors make informed judgments, based on ethical and other considerations, about the charities that seek their support. I believe the distinct characteristics of a charity monitoring program will become more evident as I describe our work—and the imminent expansions of our capacity.

The BBB Wise Giving Alliance (the Alliance) is a monitoring organization that sets voluntary accountability standards for charities. We are a charitable affiliate of the Council of Better Business Bureaus (CBBB), formed three years ago through a merger of the National Charities Information Bureau and the CBBB Foundation's Philanthropic Advisory Service. Our mission is to help donors make informed giving decisions. Between the two merger partners, we have more experience—over 100 years—in reviewing and reporting on charities than any other charity monitoring service in the nation.

Our national scope, the breadth of our standards, the public availability of our evaluations, and our practice of identifying organizations that do not meet our standards, as well as those that do, have together given the Alliance a distinctive reputation. Our association with the Better Business Bureau, a name familiar to virtually the entire public, lends it high credibility. We have extensive contact with the public through our website, [www.give.org](http://www.give.org). Over 2 million people visited our website in 2003 to access our charity reports. The Alliance also reaches out to the public and charity community through its everyday work with media and through participation in major national charity conferences.

### **Assessing and Serving Donor Needs**

The donor is our primary constituent. The generosity of American donors is well known. How seriously they take giving, and the problems they have in making choices are perhaps less familiar. In 2001, the Alliance commissioned Princeton Survey Research Associates International to conduct a major donor expectations survey, the results of which are available on the [www.give.org](http://www.give.org) website. Among the key findings:

- 70% of respondents say it is difficult to know whether a charity is legitimate;
- 44% say it is difficult to find the information they want in making a giving decision;
- 50% say they would be “very likely” to get information they wanted from the charity itself, although only 50% think that the charities provide enough information about their activities to help them decide about giving;

Clearly, donors are not sure what information they need or where they should get it, or in some cases, how to assess the information they have. They are looking for help in finding accountable charities. The Alliance dedicates itself to providing that help, primarily through evaluations of individual national charities based on our recently revised voluntary *Standards for Charity Accountability*. Developed over three years in an open process involving leaders from national and local charities, the accounting profession, grant-making foundations, research organizations and the Better Business Bureau system, with input from the public as well, the present *Standards* encompass not only how a charity spends its money, but its governance, fund raising practices, and solicitations and informational materials.

- The Alliance produces reports on national charities that specify whether or not an organization meets or does not meet the *Standards for Charity Accountability*.
- Our reports do not rank or grade charities but rather seek to assist donors in making informed judgments about charities soliciting their support.
- In addition, the Alliance goes beyond standards to issue special alerts and advisories for individuals on topics related to giving. These include tips on donating cars, as well as tips on charity telemarketing, police and firefighter appeals, and charitable responses to disasters.

### **Standards for Charity Accountability**

The *Standards for Charity Accountability* (see attachment for full text) address four major areas:

Governance and Oversight: This section seeks to ensure that the volunteer board is active, independent and free of self-dealing.

Measuring Effectiveness: This section seeks to ensure that the organization has defined, measurable goals and objectives in place and a defined process in place to evaluate the success and impact of its program(s).

Finances: This section seeks to ensure that the charity spends its funds honestly, prudently and in accordance with statements made in fund raising appeals.

Fund Raising and Informational Materials: This section seeks to ensure that a charity's representations to the public are accurate, complete and respectful.

#### **The Alliance's Charity Reporting Process**

To illustrate the nature of our charity evaluations, I think it helpful to describe briefly the contents of the Alliance's reports and key points in the reporting process.

From a national charity being evaluated, the Alliance requests, among other things:

- annual financial statements
- annual report
- articles of incorporation
- board roster
- budget
- bylaws
- cause-related marketing promotions
- conflict of interest policy
- fund raising contracts
- IRS Form 990 (if applicable)
- scripts of telephone appeals
- solicitation materials
- tax-exempt status determination letter

Providing this information to the Alliance is voluntary on the part of charities, but 80% of the organizations that we ask for information provide it.

Alliance staff review this material in relation to the Alliance's charity standards to determine whether the organization meets or does not meet each standard. In some cases, the Alliance finds that the charity either did not provide all the requested information or that the information provided was not sufficient to reach a conclusion on the cited standard.

#### **Results of National Charity Evaluations**

Keeping in mind that approximately 68% of the organizations we report on meet all our standards, let me highlight some of the problem areas we see.

Of all instances of charity noncompliance summarized in the current edition of our *Better Business Bureau Wise Giving Guide* magazine:

53% relate to financial matters, including ways in which charities report or present their finances. The prevalence of problems in this area correlates with donors' focus on financial matters as their primary concern.

29% relate to the public's access to basic facts about the charity's programs, finances and/or fund raising.

18% relate to some area of governance, such as the oversight responsibilities of the charity's governing board.

The Alliance's reports not only state whether or not the subject charity meets the *Standards*, but also include information on program service activities, fund raising practices, governance, executive compensation, sources of funds, and how the organization spends its money. Organizations under review are sent the preliminary report and have an opportunity to respond to the Alliance's draft conclusions.

The Alliance reports whether a charity meets or does not meet the referenced standards. It does not comment on a charity's worthiness or approve or disapprove of any cause. Our aim is not to direct or inhibit donor choice but to provide facts, measured against widely accepted standards, that can inform that choice. Our evaluation results are available directly through all 120 local Better Business Bureaus in the United States and on our website, [www.give.org](http://www.give.org). As a service to individual donors across the country, we also issue a quarterly magazine, the *Better Business Bureau Wise Giving Guide* that summarizes our evaluation findings and reports on other topics of interest to charity contributors.

#### **The Alliance Introduces a New Charity Reporting and Evaluation System**

The Alliance will shortly announce an important innovation in its reporting program, an *online* charity reporting and evaluation system.

This innovation is the Alliance's response to a rapidly changing charitable environment. Over 900,000 organizations have received charitable tax-exempt status; about 250,000 of them file either the IRS Form 990 or 990-EZ. Donors and potential donors want ready access to information that will help them learn which of the vast number of charities that solicit them are responsible, accountable, and well-governed. The Alliance's new reporting and evaluation system will produce that information on a greatly expanded scale. Currently we report on hundreds of national charities; our goal is report on thousands.

The new system will enable participating charities to submit information directly online. A computer program will, based on criteria of the BBB Wise Giving Alliance,

automatically evaluate the information, making an initial assessment as to whether the subject charity meets or does not meet the *20 Standards for Charity Accountability*.

This new reporting system also will alert us to problem areas that require individual scrutiny and possibly further clarification from the reporting charity. Staff will also review portions of information reported online against basic documents such as financial statements, the IRS Form 990, and annual report. We expect that the efficiencies created by the system will vastly expand our coverage of national charities and facilitate both the filing and the analysis of information so that we can provide information about more charities to donors more quickly.

To launch this online reporting and evaluation system, the Alliance will hold an event on July 13, 2004 at the National Press Club in Washington, DC. Media representatives, including those well acquainted with charity issues, will be able to see a demonstration of the system. Shortly afterwards, national charities will also be able to review the system through a web cast. We want to reach national charities across the country and acquaint them with this new evaluation tool.

In addition, this system will be shared with local Better Business Bureaus nationwide to assist them in reporting on local and regional charitable organizations. Through this expanded effort, we intend that national and local BBB charity reporting will become the primary accountability resource for the donating public.

#### **BBB Wise Giving Alliance National Charity Seal**

To call additional public attention to charities that meet the Alliance standards, we have also recently developed a national charity seal. National charities that meet the *Standards for Charity Accountability* may now apply to display this BBB Wise Giving Alliance seal. By signing a licensing agreement and paying an annual fee to help support this program, they are authorized to show the seal in their solicitation materials, on their website and in other authorized venues. A number of local Better Business Bureaus are beginning to offer participation in the seal program to local charities that have met the same standards.

The seal informs the public instantly that the charity using it meets the Alliance's standards, but it has other important functions, too. It gives participating charities a means to increase donor confidence and strengthen public trust; it extends public awareness of the Alliance's work in charity accountability, and it helps draw attention to the fact that charities are actively addressing issues, income some *beyond what government regulations require*—and this is what our standards are about.

#### **The Voluntary Approach to Accountability**

This description of the work of the Alliance suggests some valuable assets of voluntary organizations that focus on strengthening the charitable sector. One is flexibility, the ability to re-visit standards, to establish new criteria or re-define former ones as

circumstances change. Voluntary standards also offer elasticity, being broad enough to take into account the multiple creative and productive ways in which charities operate.

Sometimes voluntary standards do what the law explicitly cannot do. Notably, a voluntary monitoring organization can have a standard that calls for fund raising expenses not to exceed a certain threshold. By contrast, several U.S. Supreme Court decisions do not allow the states to set across-the-board fund raising cost restrictions for charities.

On the whole, the high level of compliance we find in the charities we evaluate suggests that disregard of accountability is by no means rampant. We are well aware, however, that there are problems within the sector. And we expect that scandals are going to gain increased attention as the number of charities continues to grow and government action is limited by inadequate resources.

We are proud of our work but also know that we alone cannot deal with persistent problems in the charitable sector. Other organizations have also recognized the needs for betterment. Charities have become increasingly sensitive about responsiveness to their donors. We have seen the growth of nonprofit organizations formed to make information available to donors. Philanthropic Research, Inc. (commonly known as Guidestar), for example, provides the IRS Form 990 and other information at its website, enabling donors and others to access important charity facts. And we have seen organizations develop programs to help charities demonstrate their accountability and commitment to ethical behavior. Both the Evangelical Council for Financial Accountability (ECFA) and the Maryland Association of Nonprofit Organizations offer their own charity seals based on comprehensive standards. The National Committee for Responsive Philanthropy encourages greater philanthropic openness and engages in other activities important to the infrastructure of the nonprofit sector.

#### **Government and Charity Monitoring**

There is no question that governmental agencies have vital roles in assuring that charities merit the special advantages given them by law. In particular, that role is to fight fraud and abuse of tax-exempt status. The IRS Form 990 and the requirement that organizations make it available are extremely important in that effort. IRS has begun implementing regulations addressing excessive compensation and private inurement.

Only on rare occasions does the Alliance involve itself in governmental action: we presented an *amicus* brief in the recent case of *Madigan v. Telemarketing Associates* before the U.S. Supreme Court because we believed the voice of donors needed to be considered. The case involved a subject very close to donors—what telemarketers say and sometimes don't say when they solicit contributions. The U.S. Supreme Court, reversing an earlier decision of the Illinois Supreme Court, held that States have the right to bring fraud actions “when fundraisers make false or misleading representations designed to deceive donors about how their donations will be used.”

The Alliance is supportive of several possible government actions that have been suggested:

- Efforts to increase accuracy and completeness of the IRS Form 990;
- Additional funds for the Tax-Exempt and Government Entities Division of the IRS and the state regulatory offices, to increase their ability to address concerns about charities;
- Federal government fees received with applications for tax-exempt status as well as excise taxes paid by private foundations could serve as sources of funds for both government and private efforts to strengthen the charitable sector;
- Government encouragement of private foundation funding of efforts to strengthen the overall infrastructure of the charitable sector. This could include efforts designed to address, among other things, nonprofit management, accountability, governance, and effectiveness.
- Government encouragement of charities to participate in various available accountability programs.

In our view, the latitude of operation granted to charity in America is fundamental to its strength. I am convinced that the giving public prizes the voluntary nature of charity and the variety and creativity that voluntarism fosters. I believe that what donors want to see is that charities are ready, voluntarily, to show their commitment to openness and ethical conduct and to demonstrate that their efforts are sharply focused on their missions.

Donors should be wary about giving their support to a charity that simply attests that it obeys the law.

Inevitably, donors' choices will sometimes benefit less effective and/or poorly managed charities. Charities must be helped to understand and observe standards of accountability so that they can earn the support of donors—individual and institutional—who are also acquainted with those standards and insist upon adherence to them.

We realize that there is an interest in strengthening both federal and state oversight of charitable activities. We agree that there are concerns that government needs to address. We also believe that there is an essential and complementary role for voluntary charity monitoring, a role in promoting good practices that go beyond what government should seek to regulate.

We can say with assurance that whatever steps government decides to take, the Alliance will continue and expand its work at the front line of accountability, promoting openness and ethical conduct throughout the charitable sector and providing a way for charities to demonstrate their adherence to accountability standards that go beyond the law.

## BBB WISE GIVING ALLIANCE STANDARDS FOR CHARITY ACCOUNTABILITY

### PREFACE

The BBB Wise Giving Alliance *Standards for Charity Accountability* were developed to assist donors in making sound giving decisions and to foster public confidence in charitable organizations. The standards seek to encourage fair and honest solicitation practices, to promote ethical conduct by charitable organizations and to advance support of philanthropy.

These standards replace the separate standards of the National Charities Information Bureau and the Council of Better Business Bureaus' Foundation and its Philanthropic Advisory Service that were in place at the time the organizations merged.

The *Standards for Charity Accountability* were developed with professional and technical assistance from representatives of small and large charitable organizations, the accounting profession, grant making foundations, corporate contributions officers, regulatory agencies, research organizations and the Better Business Bureau system. The BBB Wise Giving Alliance also commissioned significant independent research on donor expectations to ensure that the views of the general public were reflected in the standards.

The generous support of the Charles Stewart Mott Foundation, the Surdna Foundation and Sony Corporation of America helped underwrite the development of these standards and related research.

Organizations that comply with these accountability standards have provided documentation that they meet basic standards:

- In how they govern their organization,
- In the ways they spend their money,
- In the truthfulness of their representations, and
- In their willingness to disclose basic information to the public.

These standards apply to publicly soliciting organizations that are tax exempt under section 501(c)(3) of the Internal Revenue Code and to other organizations conducting charitable solicitations. The standards are not intended to apply to private foundations, as they do not solicit contributions from the public.

The overarching principle of the BBB Wise Giving Alliance *Standards for Charity Accountability* is full disclosure to donors and potential donors at the time of solicitation and thereafter. However, where indicated, the standards recommend ethical practices beyond the act of disclosure in order to ensure public confidence and encourage giving. As voluntary standards, they also go beyond the requirements of local, state and federal laws and regulations.

In addition to the specific areas addressed in the standards, the BBB Wise Giving Alliance encourages charitable organizations to adopt the following management practices to further the cause of charitable accountability.

- Initiate a policy promoting pluralism and diversity within the organization's board, staff and constituencies. While organizations vary widely in their ability to demonstrate pluralism and diversity, every organization should establish a policy, consistent with its mission statement, that fosters such inclusiveness.
- Ensure adherence to all applicable local, state and federal laws and regulations including submission of financial information.
- Maintain an organizational adherence to the specific standards cited below. The BBB Wise Giving Alliance also encourages charities to maintain an organizational commitment to accountability that transcends specific standards and places a priority on openness and ethical behavior in the charity's programs and activities.

### GOVERNANCE AND OVERSIGHT

**The governing board has the ultimate oversight authority for any charitable organization. This section of the standards seeks to ensure that the volunteer board is active, independent and free of self-dealing. To meet these standards, the organization shall have:**

**1. A board of directors that provides adequate oversight of the charity's operations and its staff.** Indication of adequate oversight includes, but is not limited to, regularly scheduled appraisals of the CEO's performance, evidence of disbursement controls such as board approval of the budget and fund raising practices, establishment of a conflict of interest policy and establishment of accounting procedures sufficient to safeguard charity finances.

**2. A board of directors with a minimum of five voting members.**

**3. A minimum of three evenly spaced meetings per year of the full governing body with a majority in attendance, with face-to-face participation.** A conference call of the full board can substitute for one of the three meetings of the governing body. For all meetings, alternative modes of participation are acceptable for those with physical disabilities.

**4. Not more than one or 10% (whichever is greater) directly or indirectly compensated person(s) serving as voting member(s) of the board. Compensated members shall not serve as the board's chair or treasurer.**

**5. No transaction(s) in which any board or staff members have material conflicting interests with the charity resulting from any relationship or business affiliation.** Factors that will be considered when concluding whether or not a related party transaction constitutes a conflict of interest and if such a conflict is material, include, but are not limited to: any arm's length procedures established by the charity; the size of the transaction relative to like expenses of the charity; whether the interested party participated in the board vote on the transaction; if competitive bids were sought and whether the transaction is one-time, recurring or ongoing.

#### MEASURING EFFECTIVENESS

An organization should regularly assess its effectiveness in achieving its mission. This section seeks to ensure that an organization has defined, measurable goals and objectives in place and a defined process in place to evaluate the success and impact of its program(s) in fulfilling the goals and objectives of the organization and that also identifies ways to address any deficiencies. To meet these standards, a charitable organization shall:

**6. Have a board policy of assessing, no less than every two years, the organization's performance and effectiveness and of determining future actions required to achieve its mission.**

**7. Submit to the organization's governing body, for its approval, a written report that outlines the results of the aforementioned performance and effectiveness assessment and recommendations for future actions.**

#### FINANCES

This section of the standards seeks to ensure that the charity spends its funds honestly, prudently and in accordance with statements made in fund raising appeals. To meet these standards, the charitable organization shall:

*Please note that standards 8 and 9 have different denominators.*

**8. Spend at least 65% of its total expenses on program activities.**

Formula for Standard 8:

$$\frac{\text{Total Program Service Expenses}}{\text{Total Expenses}}$$
 should be at least 65%

**9. Spend no more than 35% of related contributions on fund raising.** Related contributions include donations, legacies and other gifts received as a result of fund raising efforts.

Formula for Standard 9:

$$\frac{\text{Total Fund Raising Expenses}}{\text{Total Related Contributions}}$$
 should be no more than 35%

**10. Avoid accumulating funds that could be used for current program activities. To meet this standard, the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher.**

An organization that does not meet Standards 8, 9 and/or 10 may provide evidence to demonstrate that its use of funds is reasonable. The higher fund raising and administrative costs of a newly created organization, donor restrictions on the use of funds, exceptional bequests, a stigma associated with a cause and environmental or political events beyond an organization's control are among factors which may result in expenditures that are reasonable although they do not meet the financial measures cited in these standards.

**11. Make available to all, on request, complete annual financial statements prepared in accordance with generally accepted accounting principles.**

When total annual gross income exceeds \$250,000, these statements should be audited in accordance with generally accepted auditing standards. For charities whose annual gross income is less than \$250,000, a review by a certified public accountant is sufficient to meet this standard. For charities whose annual gross income is less than \$100,000, an internally produced, complete financial statement is sufficient to meet this standard.

**12. Include in the financial statements a breakdown of expenses (e.g., salaries, travel, postage, etc.) that shows what portion of these expenses was allocated to program, fund raising and administrative activities.**

If the charity has more than one major program category, the schedule should provide a breakdown for each category.

**13. Accurately report the charity's expenses, including any joint cost allocations, in its financial statements.**

For example, audited or unaudited statements which inaccurately claim zero fund raising expenses or otherwise understate the amount a charity spends on fund raising, and/or overstate the amount it spends on programs will not meet this standard.

**14. Have a board-approved annual budget for its current fiscal year, outlining projected expenses for major program activities, fund raising and administration.**

#### FUND RAISING AND INFORMATIONAL MATERIALS

**A fund raising appeal is often the only contact a donor has with a charity and may be the sole impetus for giving. This section of the standards seeks to ensure that a charity's representations to the public are accurate, complete and respectful. To meet these standards, the charitable organization shall:**

**15. Have solicitations and informational materials, distributed by any means, that are accurate, truthful and not misleading, both in whole and in part.** Appeals that omit a clear description of program(s) for which contributions are sought will not meet this standard.

A charity should also be able to substantiate that the timing and nature of its expenditures are in accordance with what is stated, expressed or implied in the charity's solicitations.

**16. Have an annual report available to all, on request, that includes:**

- (a) the organization's mission statement,
- (b) a summary of the past year's program service accomplishments,
- (c) a roster of the officers and members of the board of directors,

**(d) financial information that includes:**

- (i) total income in the past fiscal year,
- (ii) expenses in the same program, fund raising and administrative categories as in the financial statements, and
- (iii) ending net assets.

**17. Include on any charity websites that solicit contributions, the same information that is recommended for annual reports, as well as the mailing address of the charity and electronic access to its most recent IRS Form 990.**

**18. Address privacy concerns of donors by**

**(a) providing in written appeals, at least annually, a means (e.g., such as a check off box) for both new and continuing donors to inform the charity if they do not want their name and address shared outside the organization, and**

**(b) providing a clear, prominent and easily accessible privacy policy on any of its websites that tells visitors**

- (i) what information, if any, is being collected about them by the charity and how this information will be used,
- (ii) how to contact the charity to review personal information collected and request corrections,
- (iii) how to inform the charity (e.g., a check off box) that the visitor does not wish his/her personal information to be shared outside the organization, and
- (iv) what security measures the charity has in place to protect personal information.

**19. Clearly disclose how the charity benefits from the sale of products or services (i.e., cause-related marketing) that state or imply that a charity will benefit from a consumer sale or transaction. Such promotions should disclose, at the point of solicitation:**

- (a) the actual or anticipated portion of the purchase price that will benefit the charity (e.g., 5 cents will be contributed to abc charity for every xyz company product sold),
- (b) the duration of the campaign (e.g., the month of October),
- (c) any maximum or guaranteed minimum contribution amount (e.g., up to a maximum of \$200,000).

**20. Respond promptly to and act on complaints brought to its attention by the BBB Wise Giving Alliance and/or local Better Business Bureaus about fund raising practices, privacy policy violations and/or other issues.**



## COMMUNICATIONS

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### STATEMENT OF THE AMERICAN ASSOCIATION OF HOMES AND SERVICES FOR THE AGING (AAHSA)

Dear Chairman Grassley:

The American Association of Homes and Services for the Aging has reviewed the Staff Discussion Draft, proposing reforms in the regulation of tax-exempt organizations. On behalf of the 5,600 not-for-profit aging services providers we represent, we hope that the following comments may be taken into consideration as your committee continues its work on this issue.

We certainly understand your concern that charitable organizations must operate according to the mission for which they originally received tax-exempt status, not for the enrichment of insiders. We completely agree with several witnesses at your committee's June 22 hearing, who called for streamlining the Form 990, providing more resources for the Internal Revenue Service to ensure tax compliance among charities, and strengthening rules against self-dealing.

We hope, however, that the law of unintended consequences will be heeded and that any legislation that develops on the basis of the staff draft will not impose too heavy an administrative burden on legitimate not-for-profits. Several witnesses at the June 22 hearing pointed out that small, local charities do not have the same financial and human resources that larger, national charities do. As described in the staff draft, the proposed five-year review of tax-exempt status would be particularly onerous for small non-profits that have limited administrative staff and could also make it extremely difficult for such organizations to secure long-term financing. Accreditation also might well be beyond the means of smaller tax-exempt organizations. AAHSA has extensive experience with accreditation of long-term care providers through the Continuing Care Accreditation Commission, and we understand the financial and administrative burden that a meaningful accreditation program can represent for many organizations. While electronic filing of Form 990s is now permitted, a longer timeframe than the one proposed in the staff draft would be needed to enable all organizations to adapt to the IRS system. Any requirement that performance goals and measures for meeting them be disclosed would also have to be carefully drawn to ensure that non-profits with expansive, long-range and potentially unachievable goals were not penalized.

The Honorable Charles E. Grassley  
July 6, 2004  
Page two

As legislation is drafted, it would be useful for the committee to distinguish between small non-profits and larger, national organizations in which most of the recently-reported abuses have taken place. Possibly this distinction could be made on the size of a non-profit organization's annual revenues.

We continue to analyze the staff draft, and we will forward you more in-depth and detailed comments and recommendations. We look forward to working with you and your staff to ensure that charities are held to high standards of tax compliance without the imposition of undue burdens on organizations that truly operate for the public good.

Sincerely,

A handwritten signature in black ink, appearing to read "William L. Minnix, Jr.", written in a cursive style.

William L. Minnix, Jr., D.Min  
President and CEO



WRITTEN STATEMENT OF

AMERICAN ASSOCIATION OF MUSEUMS

For the

June 22, 2004 Hearing

Of the

COMMITTEE ON FINANCE

U.S. SENATE

Concerning

Charity Oversight and Reform

Chairman Grassley, Senator Baucus, and members of the Committee, the American Association of Museums thanks you for the opportunity to submit written testimony in connection with the Committee's June 22, 2004 oversight hearing on charity activities. We particularly appreciate the receptiveness of the staffs of the Senate Finance and Joint Tax Committees to meeting with representatives of the museum and cultural community, as well as with other nonprofit representatives, both before and after the hearing, for substantive exchanges of views about how to address most effectively the concerns that have arisen as a result of the Senate Finance Committee's oversight process.

As a national service organization representing the full range of American museums, including history, art, natural history, and children's museums, as well as science-technology centers, zoos, aquaria, and specialized museums, the American Association of Museums addresses the needs of museums to enhance their ability to serve the public. AAM disseminates information on the current standards and best practices and provides professional development for staff to ensure that museums contribute to public education in its broadest sense and protect and preserve our cultural heritage. Since its founding in 1906, AAM has grown to more than 16,000 members, including more than 10,500 individual members, 2,500 corporate members, and nearly 3,000 museums.

In preparing this written testimony after the June 22 hearing, AAM has had the benefit both of being able to review the Senate Finance Committee staff's White Paper issued on June 21 and of observing the oral testimony of witnesses at the June 22 hearing. In that context, it is clear both that some significant problems relating to abuse of charities by unscrupulous persons through tax shelters and other means have arisen, and that such abuse appears to be confined to a fairly small number of charities.

As in the past, AAM, with other national service organizations of charities, is eager to continue to work with the Committee and its staff to correct problems within the charitable sector. As oral testimony at the hearing made clear, one of the most important assets of the charitable sector is its reputation; without good standing in their communities, museums and other charities would be thwarted in fulfilling their nonprofit missions.

In this work to end abuses, the museum community has two particular concerns, both of which are discussed in the White Paper. One of these—governance and general operations of nonprofits, including reporting requirements—is a concern for all nonprofits. The second, the valuation of gifts to museums and other charities, is a particular concern for museums. Gifts are one of the important sources of support for the work of many museums, including for operating expenses and endowments. In particular, gifts in the form of objects of artistic, historical, or other cultural value, often unique, are the basis for the continued growth of museum collections. Indeed, one of the distinctive features of the American museum community is that in this country, unlike any other, museum collections are very largely the result of gifts rather than purchases.

More specifically:

General Accountability, Coordination, Governance, and Reporting Reforms. The bulk of the Committee staff's June 21<sup>st</sup> White Paper (pp. 1-17) offers suggestions to improve charity accountability, governance, and reporting to the IRS, along with greater State/Federal coordination. There are many recommendations here that require the kind of further study and consultation between the Committee and charities that the remarks of the Chairman and other Committee members at the hearing seem to invite. AAM expects to work closely with the Association of Art Museum Directors and other national museum service organizations, as well as Independent Sector, the American Society of Association Executives, and other interested parties in the charitable sector, to respond to these suggested reforms in more detail. In general, however, we hope that the Committee would seek to balance the expected return of greater compliance and abuse prevention of a given solution against the greater costs in time and funds that any such method would entail. In this regard, AAM notes the testimony of Willard Boyd at the hearing, who rightly urged consideration for the effect of new strictures on the financially marginal operations of many smaller, local charities. We strongly support the Chairman Grassley's remarks at the hearing recognizing the importance of not overburdening smaller charities.

Valuation of gifts. Given the particular importance of this issue to the museum community as a whole for the reasons noted above, we are pleased both that Committee staff was willing to meet with representatives of AAM and others on this issue, and that the White Paper's proposal for a "baseball arbitration" approach seems, on first consideration, to be a reasonable basis for further discussions. This approach has the advantage of avoiding the most important pitfall in this area, namely putting a museum or other donee institution between the donor and IRS and compelling the donee—an interested party to the gift transaction—to enter in some way into the valuation process. That, of course, is the very problem that the 1984 tax reform act rectified. If the donee were to be reinserted, it would reinstate the practice the 1984 law reformed. Thus we are very pleased that the staff recognized the seriousness of this problem and proposed a solution that would address concerns about possible overvaluations of gifts via another route.

AAM appreciates the Committee's recognition, at the hearing and elsewhere, that most charities, by an overwhelming margin, continue to serve their nonprofit missions and are very conscious of acting in both a legal and ethical way that merits community respect. At the same time, we also believe strongly that where abuses have arisen, museums and the whole charitable sector should work in full cooperation with the Congress and IRS to counter those abuses. We look forward to continuing discussions with the Committee over coming months to that end.

June 22, 2004

Advancing Your Success

Senate Committee on Finance  
Attn. Editorial and Document Section  
Rm. SD-203  
Dirksen Senate Office Bldg.  
Washington, DC 20510-6200

Re: June 22, 2004 committee hearing on "Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities." Testimony submitted by John H. Graham IV, President and CEO, American Society of Association Executives, 1575 I Street NW, Washington, DC 20005.

**American Society of Association Executives.** The core purpose of the American Society of Association Executives ("ASAE") is to advance the value of voluntary associations to society and to support the professionalism of the individuals who lead them. ASAE membership consists of professionals who manage or work for virtually every kind of tax-exempt nonprofit organization, including trade associations, individual membership organizations, and charities. Nonprofit organizations can be broken down into various subsections, including religious, social welfare, fraternal, business leagues, and philanthropic, but all exist to serve and provide value to their members and other constituencies, including the greater society. Tax-exempt nonprofit organizations represent more than 12 percent of the United States' Gross Domestic Product ("GDP"), and employ some 19 million full-time workers. The size and scope of the nonprofit community continues to grow, along with its role in American life. The nonprofit community acknowledges the increasing attention paid to the governance and "best practices" of their organizations and is committed to assuring strong fiduciary controls and accountability to members, donors, grantors, and other stakeholders.

**Introduction.** ASAE believes that disclosure and transparency benefit both nonprofit organizations and the communities they serve. By their very nature, tax-exempt nonprofit organizations are organized for a "higher purpose," often to provide a valuable role or function that might otherwise fall to the government.

The ASAE Building  
1575 I Street, NW  
Washington, DC  
20005-1103  
202-626-ASAE (2723)  
fax 202-371-8825  
www.asaenet.org

The performance and long-term survival of these organizations is, typically, highly dependent on a measure of confidence. While not untouched by isolated instances of fiscal mismanagement or ethical abuse, the vast majority of nonprofit organizations have embraced their responsibility to institute governing practices that ensure public trust.

The “American Competitiveness and Corporate Accountability Act of 2002,” also known as the Sarbanes-Oxley Act, has become a frequently studied model for nonprofits seeking to take measure of their existing governance structures and fiduciary practices. While only two provisions of Sarbanes-Oxley, dealing with document destruction and whistle-blower protections, explicitly demand compliance by nonprofit organizations, the Act explains many processes and practices that have relevance for some nonprofits.

According to ASAE counsel, two areas in particular are demanding considerable attention from nonprofit executive and volunteer leadership: financial monitoring and disclosure, and codes of ethics and conflicts of interest. Nonprofit leaders are seeking to replicate the Audit Committee feature of Sarbanes-Oxley to the extent feasible – a board committee whose principal function is to ensure that appropriate financial controls are in place and that reliable accounting and auditing are conducted. Some organizations are also asking their CEOs and CFOs to personally certify that financial reports are accurate and complete. Many nonprofit organizations, especially professional societies, already have codes of ethics, but these tend to provide direction for the conduct of members, not for executive and volunteer leadership. More organizations are now considering whether to establish codes, policies, standards, or guidelines to address financial management and disclosure, as well as leadership authority and responsibility. Conflicts of interest are typically addressed not only with general policies but also with detailed written enforcement procedures in order to help “de-personalize” conflicts when they arise.

ASAE and its members considered these and other governance principles at the first-ever National Consensus Conference on Nonprofit Governance in New York, Jan. 12-13, 2004. The discussion among the roughly 150 nonprofit executives focused on how, and to what extent, nonprofit organizations can voluntarily strengthen their governance principles and practices. The conference proved to be a good starting point for developing and disseminating guidelines for nonprofit governance. Among the principles considered were: the role of the nonprofit organization’s governing board in setting policy and providing oversight; the independence of the governing board from management; the presence, composition and role of an audit committee, or at least a committee

fulfilling the audit committee function; codes of organizational conduct for nonprofit governance; chief executive compensation review; accurate and complete financial disclosures; policies and procedures for investigating complaints; and policies and procedures for document destruction. Independent Sector, which works to empower foundations and philanthropic organizations, has convened similar conferences to enhance compliance and oversight in the nonprofit sector.

In considering the applicability of Sarbanes-Oxley provisions to nonprofits, however, it is important to note the diverse nature of the tax-exempt community, and recognize that Sarbanes is not a "one size fits all" blueprint for nonprofit governance standards. The Internal Revenue Service's (IRS) Exempt Organizations (EO) Division has just this month reported that there are now over 1,640,949 exempt organizations in the U.S., with the number of exempt organization applications steadily increasing each year. These organizations range from fraternal societies and small social clubs, to charities and scientific societies to trade associations and chambers of commerce. The size and resources of various nonprofit organizations impact the necessity for, as well as their ability to implement, certain governance practices mandated for large businesses by the Sarbanes-Oxley Act. Hence, Congress's wisdom in applying the new law only to publicly traded, Securities and Exchange Commission (SEC)-regulated companies.

Despite their complexity, tax-exempt organizations are not precluded, nor should they be excused, from responsible governance. ASAE's argument is merely that a set of rigid "best practices" for nonprofit governance requires some realistic cost-benefit analysis, and careful attention that the essential work of these exempt organizations, and the value they bring to society, continue unabated by unnecessary and burdensome compliance measures.

**IRS oversight.** Organizations with tax-exempt status and \$25,000 or more in gross receipts file an annual Form 990 exempt organization information return with the Internal Revenue Service (IRS). The Form 990 is the key document used by both state and federal regulators to oversee and monitor the operations of exempt organizations. All nonprofit organizations must make their last three Form 990s widely available for public inspection as well, either in person or through posting on a Web site. Although a useful reporting tool, caution is warranted in relying on the Form 990 data to make definitive conclusions about an exempt organization's expenses and operations.

As mentioned earlier, the number of exemption applications filed with the IRS Exempt Organization Division has steadily increased each year, and reached an all-time high of 91,439 in 2003. Despite this growth, EO staffing levels have not kept pace and, by the IRS's own admission, are insufficient to maintain adequate oversight of the exempt sector. There appears, however, to be a renewed commitment this year to enhance EO enforcement and compliance efforts to increase public confidence in both the EO Division and in the exempt sector itself.

The Internal Revenue Service's (IRS) Advisory Committee on Tax Exempt and Government Entities (ACT) held its annual public meeting June 9, during which five project teams presented recommendations to the Commissioner and leadership of the IRS's Tax Exempt and Government Entities Division. The recommendations of relevance to exempt organizations strongly emphasized enhancing EO enforcement and compliance.

IRS Commissioner Mark Everson said targeting abuse of charities, in particular, is one of his top enforcement priorities. Among the recommendations made in the ACT report: the IRS should follow through on its commitment to hire 72 additional EO examination agents by the end of Fiscal Year 2004 and improve its current training for agents and examiners; the EO Division should establish a standing Form 990 review committee to continuously evaluate the quality and utility of the information being submitted on Form 990; the EO Division should increase the number of "limited scope" audits it performs as well as the number of "soft" contacts it makes each year, to increase the number of organizations examined; the EO Division should consider making electronic filing of Form 990 mandatory for organizations with assets and/or annual revenue over a certain amount; the EO Division should more regularly issue technical and precedential guidance for the exempt community; and the EO Division should vigorously support an amendment to the Internal Revenue Code permitting the EO Division to share information and coordinate enforcement efforts with various state regulatory agencies also responsible for exempt organization oversight.

ASAE is supportive of the recommendation to hire additional EO agents this year, and encourages the EO Division to consider it a resource on issues of relevance to the exempt community. In particular, ASAE would offer its assistance should EO move forward with creation of a standing Form 990 review committee. ASAE is appreciative of the work conducted by the Advisory Committee on Tax Exempt and Government Entities (ACT) and believes there is good representation on the advisory group of individuals who understand and are working in the best interests of the exempt sector.

ASAE is also supportive of the IRS making public its market segment studies of the exempt sector, first initiated in 2002. Between 100-150 501(c)(6) trade associations, 501(c)(5) labor unions and 501(c)(7) social clubs were randomly chosen by the IRS in 2002 to provide detailed information about their compliance and their use of IRS resources, and other organizations within the exempt sector have since been examined as well. The IRS had clarified last year that the market segment studies were not in response to any perceived noncompliance on the part of the exempt community, and should not be considered formal audits, but were necessary to capture a current snapshot of the activities and compliance levels of the organizations mentioned. Our understanding is that the shortage of trained staff and resources has prevented EO from completing any of these studies to date. ASAE believes this type of guidance, when published, will enhance voluntary compliance within the exempt sector.

**Conclusion.** Accountability, transparency and responsible governance are the orders of the day in the nonprofit sector. It is clear that Chairman Grassley and the Committee have made charitable and foundation oversight a priority, and the tax-exempt community will benefit from the Committee's actions to the extent that the few charities abusing the public trust can be singled out and forced to uphold the integrity of the sector. IRS is also working to enhance enforcement of exempt organizations and is seeking to move toward data sharing with state agencies that also oversee charities and other nonprofits.

While appreciative of efforts to measure the quality and utility of information reported by exempt organizations, ASAE would again caution the Committee and the IRS not to become overly dependent on the Form 990 return for investigative activity and oversight. While a valuable snapshot of exempt activity, the Form 990 alone is not adequate for making judgments about an exempt organization's fiduciary practices and controls. The U.S. General Accounting Office (GAO) has voiced the same concern in a 2002 report to this Committee entitled "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities," stating that "charities have considerable discretion in recording their expenses in the program services, general management, and fundraising categories. Different approaches for charging expenses as well as different allocation methods can result in charities with similar types of expenses allocating them differently among the three categories."

ASAE urges the Committee, the IRS, state agencies, and other oversight entities to utilize the expertise and knowledge that exists in the nonprofit world to find solutions to current and future problems in the exempt sector. Congress first

gave nonprofits favored tax treatment largely in recognition of the public benefit derived from their activities – the theory being that the government is compensated for any loss of tax revenue by its relief from the financial burden of undertaking standards-setting, skills training, community service, research, and other essential functions met by nonprofits. In other words, associations and other nonprofits earn their exempt status by meeting needs of the general public that the government would otherwise be forced to meet. Leaders of the exempt community fully understand the negative impact instances of abuse have on the public trust that is essential to our good standing and the fulfillment of our respective organizational missions. We respectfully offer our insights, knowledge and expertise for the purpose of maintaining the importance of the nonprofit sector to the nation.

Sincerely,

A handwritten signature in black ink, appearing to read "J. H. Graham IV". The signature is written in a cursive style with a distinct "IV" at the end.

John H. Graham IV  
President and CEO



**Association of Art Museum Directors**

**Head Office**

41 East 65th Street  
New York, NY 10021  
Tel: 212-249-4423  
Fax: 212-535-5039  
aamd@amn.org

**Washington Office**

1319 F Street, N.W., Suite 707  
Washington, D.C. 20004  
Tel: 202-638-4520  
Fax: 202-638-4528  
aamddc@amn.org

**UNITED STATES SENATE  
COMMITTEE ON FINANCE**

**HEARING ON  
June 22, 2004**

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

Testimony of

**ASSOCIATION OF ART MUSEUM DIRECTORS**

Suite 201  
1319 F Street NW  
Washington, DC 20004

Mr. Chairman, our thanks to you and Senator Baucus and your Committee for giving nonprofit organizations the opportunity to share with you the best practices in our community and our concerns for the future

The Association of Art Museum Directors, established in 1916, represents 175 art museums which collectively hold in trust for the American people over 15 million works of art representing a significant portion of our nation's artistic and culture heritage. Museums bestow loving care and attention on the works in their collections whether they are thousand year old masterpieces or works less than a year old; they are preserved for future generations to enjoy, study and reflect upon.

Many of America's great museums owe their inception to the generosity and far-sightedness of donors whose collections formed the basis of the museums we know today. Would there have been a National Gallery of Art without Paul Mellon, a Phillips Collection without Duncan Phillips, or the Art Institute of Chicago without Mrs. Palmer Potter? The munificence shown by early collector/patrons is as strong today, as many serious collectors, as well as ordinary citizens, generously give gifts of art to the nation encouraged by enlightened tax policy that allows them to take fair-market value deduction for their gifts.

We know from studies that Americans by nature are generous and give because they believe in the institutions which they support, but we also know that favorable tax policy encourages them to give more and to give sooner. As a result, the philanthropy of Americans is the envy of the world -- international representatives from nongovernmental organizations travel to the US to learn about our system of philanthropy and how they can replicate it in their own countries.

As the Senate Finance Committee addresses the issues of nonprofit oversight, we urge that you not create solutions that are more complicated and vexing than the issues themselves. It is especially important to the success of nonprofit organizations that donors not be discouraged or burdened with unmanageable regulations -- particularly given that the overwhelming majority of donors to mainstream nonprofits give from their heart. They are not seeking tax shelters or tax avoidance. They give because they believe in the charity and its mission. And while there are unquestionably a few bad apples, they do not represent most nonprofit organizations -- or most donors. This is particularly true of those who give works of art, regardless of the tax advantages; donors of works of art always experience a financial loss over what they would have gained had they sold the work and paid the tax.

These gifts of works of art go not only to large institutions in big cities; they also go to small art museums that dot the country forming the national fabric of our artistic and cultural heritage. The artistic and cultural heritage of the nation is not established by date

*Association of Art Museum Directors Testimony*

-- it is not a fixed period, rather it is a constantly moving continuum; and museums, true to their charge of preserving the nation's heritage, must have access to the works that represent that ever-growing heritage. Countless of those works are donated to art museums, many of which do not have funds to purchase works of art. And while it is true that museums generally refuse over 90% of the gifts offered to them, the gifts they do accept allow their collections to continue to grow while our heritage continues to be preserved.

At the same time that they carry out the daunting task of protecting, presenting and preserving America's treasures, art museums make heroic efforts to balance their books. It is not easy; government funding is down, foundation spending often is targeted to special programs, and corporations are giving less, not more. Meanwhile museums are called upon to do more in their communities with fewer resources -- more after-school art programs, more art-in-the-schools programs, and programs for life-long learners, all the while caring for the art.

As public, nonprofit institutions, art museums that are part of the Association of Art Museum Directors are guided by a strict code of professional ethics that cover all aspects of museum governance including collection management, public programs, fiduciary responsibilities, fundraising and earned income. The museums themselves have bylaws that reflect their public obligations and mission and are governed by community-minded boards of trustees who volunteer their time and, who, along with the director of the museum, are responsible for the institution. Museums make every effort to be as transparent as possible in dealing with donors and the public in order to retain their trust.

They take seriously the public trust they hold and look forward to working with you and your staff to ensure that the public's interests continue to be served. To that end, we urge the committee to:

- Strengthen the IRS Art Advisory Panel, by providing sufficient resources for the Panel to examine a more representative sample of individual gifts given to museums.
- Continue to have the IRS Art Advisory Panel serve as the government's advocate in a dispute with the taxpayer.
- Require that appraisals meet uniform standards.
- Dramatically increase penalties against appraisers who willfully under or overvalue a gift of appreciated property.

In the draft white paper issued June 21, 2004 by the staff of the Senate Finance Committee there are several recommendations that could impact museum governance. We will study those issues and consult with the membership and then look forward to communicating with the committee staff.

Thank you again, Mr. Chairman.

## Statement of the Center for Science in the Public Interest

RE: Hearings on "Charity Oversight and Reform:  
Keeping Bad Things From Happening to Good Charities"

On behalf of the almost 800,000 U.S. members and supporters of the Center for Science in the Public Interest (CSPI), a nonprofit, tax-exempt public charity under Section 501(c)(3) of the Internal Revenue Code, I am writing to express our general comments on the staff discussion draft, related to the above hearing.

CSPI is, in general, in favor of greater public disclosure by tax-exempt public charities of their finances, operations, investments, goals, conflicts of interest, related organizations, insider transactions, and independent audits, as specified in the staff draft. Greater consistency and conformity in the information provided on Form 990 should also be encouraged. It is likewise in the public's interest for Congress to provide more funding for a woefully underfunded Internal Revenue Service (IRS) to meet its current obligations and mandated oversight with respect to tax-exempt charities.

Our concern with the staff draft proposal is two-fold: 1) its major, new thrust towards federalizing governance standards for charities, and 2) the concomitant inability of the IRS to adequately, fairly and consistently enforce these new mandates.

Traditionally, each state has established corporate and governance standards for nonprofits and has enforced them. The Senate Finance Committee staff proposals would move the federal government into this area in a major way and at least informally preempt state authority. For example, establishing a "federal liability for breach" of director's duties, is arguably duplicative of state laws and unnecessary.

The draft suggests a comprehensive list of director's duties, the breach of which would be subject to federal enforcement and prosecution (including making directors with special skills, such as lawyers or investment professionals, bound to use those skills as board members, or face discipline). It also gives the IRS authority to remove nonprofit directors under certain limited circumstances. All of this seem to be overreaching by the federal government into an area already subject to state regulation and enforcement. And it may also make talented, valued professionals less willing to serve on the boards of nonprofit charities.

It is also highly questionable whether the already underfunded IRS will be capable of administering these new mandates, which could exacerbate any problems which the staff proposals purport to address. In any case, many observers believe the IRS already has sufficient authority to correct any of the major concerns about public charities raised in congressional hearings. What the IRS does not have is the personnel or funding to enforce even current law, much less any new mandates.

In summary, CSPI, while supporting increased public disclosure of important information about nonprofits, is very skeptical of Congress enacting new federal duties and liabilities when the states have always borne this responsibility and when the federal government shows no indication of providing the resources for the IRS to fairly and consistently enforce these new duties and liabilities.

Thank you for considering our views on this issue.

Sincerely,

Michael F. Jacobson, Ph.D.  
Executive Director  
Center for Science in the Public Interest  
1875 Connecticut Ave. NW #300  
Washington, DC 20009

(o) 202-777-8328  
(f) 202-265-4954  
e-mail: [mjacobson@cspinet.org](mailto:mjacobson@cspinet.org)  
CSPI web site: [www.cspinet.org](http://www.cspinet.org)

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

**U.S. Senate Committee on Finance**

**Written Statement for the Record**

**Dorothy S. Ridings  
President and CEO  
Council on Foundations  
1828 L Street, NW  
Suite 300  
Washington, DC 20036**

**June 22, 2004**

The Council on Foundations is a membership association of more than 2,000 grantmaking foundations and corporations worldwide. For 55 years, the Council has served the public good by promoting and enhancing responsible and effective philanthropy. The Council is home to all kinds of grantmakers, from the largest private foundations to those with less than \$1 million in assets. Family foundations, independent foundations, operating foundations, corporate foundations and giving departments, community foundations and public charities that focus on grantmaking all have a place in the Council. Marshalling private resources for the public good, Council members have helped create stronger societies in the United States and in the world.

Grantmaking foundations in the U.S. have a proud history of being created with honorable motives and operated with unquestionably high standards – standards that reflect the honor, respect for society and philanthropic impulse of their founders. Past studies by the IRS and our own experience lead us to believe that most foundations continue to adhere to these high standards. Sadly, however, media reports, and this committee’s investigation, document the presence of greed and aggrandizement in the ranks of the foundation sector. It isn’t enough to characterize these illegal practices as applying to only a minute portion of our field. Even if this were true, it matters when even a single incident of abuse is uncovered.

Tax exemption and the ability to receive tax-deductible charitable contributions are tremendous and important privileges that this country accords foundations. Members of the Finance Committee and committee staff have devoted substantial time and resources to investigating areas of abuse in foundations as well as in other kinds of charitable organizations. The Council shares the committee’s concerns about abuse and we are committed to doing our part to put an end to illegal and unethical behavior on the part of those who are charged with the governance of the country’s foundations. The Council has called for numerous reforms such as increased funding for the Exempt Organizations Division of the Internal Revenue Service and for process reforms such as permitting the Internal Revenue Service to communicate openly with state charity officials about pending matters involving tax-exempt organizations. In addition, the Council has

supported, indeed suggested, an increase in the penalty excise tax to 25% for acts of self-dealing by private foundations. We look forward to the opportunity to review the committee's discussion paper with the expectation that we will add our support for many of the reforms it will suggest.

To carry out this commitment, the Council has launched a major initiative aimed at governance and stewardship entitled "*Building Strong and Ethical Foundations: Doing It Right.*" This multi-faceted initiative is designed to take the lessons of good philanthropy and moral suasion to grantmakers, their advisors, foundation executives and trustees across the country, and to pioneer in partnerships with state and federal regulators to call a halt to bad practices through legal means while educating regulators about the appropriate role and functions of foundations.

Some of this has already begun, for the needs are urgent. Several years ago the Council's community foundation members drafted definitional standards to distinguish themselves among all those offering donor-advised funds. Last year, our family and corporate grantmaking members told us they wanted more guidance, and they have drafted respective sets of aspirational Stewardship Principles and Practices that are currently in draft form after a recently completed nationwide "listening tour." While we engage in a more sweeping look at standards and practices in our field, the Council on Foundations is also strengthening its internal process for dealing with instances of bad behavior should they occur among our members.

This initiative calls for intensified professional development and outreach about strong legal and ethical governance practices, to foundation professionals, foundation advisors and federal and state charity officials. The Council has begun a series of regional meetings that will take place over the next two years, to learn from regional leaders on these issues while educating Council and non-Council members about the legal and ethical practices endorsed by the Council on Foundations.

The Council will help educate and improve the capacity for state Attorneys General to improve enforcement of existing laws. The Council also will work with federal regulators and the Internal Revenue Service to help them better understand our field and penalize offenders when appropriate and merited by the facts. Last week's \$21 million verdict of a Texas jury against the former CEO and some former members of the board of the King Foundation illustrates the power of an attorney general, when combined with the dedication and commitment of the foundation's new board, to remedy abuse. Not long ago, the Council welcomed the King Foundation, under its new leadership, to membership in the Council on Foundations.

Senior practitioners of principled philanthropy will engage in consultations with current practitioners on issues of accountability and good practice. The Council's curriculum for new grantmakers, CEOs and board members will focus on ethics and accountability. We also have begun outreach to professional groups such as those serving lawyers, accountants and financial advisors, to help improve their overall ability to advise and serve philanthropic institutions and individuals. We will reach out to new foundations

entering the field, to help them get off to a good start in terms of ethics and accountability.

For some in our field and in the public at large, none of this is enough. For others these efforts go too far. But the Council on Foundations is strongly committed to this path, even should we lose some members because of it, as the Council did about 20 years ago when our Principles and Practices for Effective Grantmaking became a condition of membership.

The Council on Foundations will become a hallmark for legal, ethical and moral practice in philanthropy. To be sure, the path the Council is embarking upon is a most difficult one, and the number of grantmakers we can hope to influence directly is only a portion of the field. However, the goal is clear: the Council on Foundations will not be a home for anyone who would use a charitable dollar for personal benefit.

The Council's commitment to the highest standards of ethical practice and clear communications comes with a strong sense of urgency, but without a final deadline. We expect this to be a path the Council will be taking for years into the future, perhaps forever. It will not be easy. It will not come quickly. But we are determined to ensure that philanthropy is recognized as the honorable practice it is, and as the cornerstone of a healthy democracy we know it to be.

Finally, the Council would like to thank Chairman Grassley and Ranking Member Baucus for their care and concern about the health of this country's independent sector. We applaud their commitment to a future that is as innovative, independent and vital to American democracy as it has been in the past. We look forward to working with them to find solutions to the abuses that harm us all and erode the public confidence in our sector.



500 WOODWARD AVENUE, SUITE 4000  
 DETROIT, MICHIGAN 48226-3425  
 TELEPHONE: (313) 223-3500  
 FACSIMILE: (313) 223-3598  
 http://www.dickinsonwright.com

DENNIS W. ARCHER  
 DArcher@dickinsonwright.com  
 (313) 223-3630

July 12, 2004

**Via Federal Express**

Senate Committee on Finance  
 Attn: Editorial and Document Section  
 Room SD-203  
 Dirksen Senate Office Building  
 Washington, DC 20510-6200

**Re: *Statement to the Record--  
 Charity Oversight and Reform: Keeping Bad Things  
 from happening to Good Charities***

Our communities and, indeed, our nation are stronger because of the presence of nonprofit charitable organizations. It is hard to imagine any aspect of our lives that have not been enriched and shaped by this amazing collection of nonprofit organizations supported by the giving of both organized philanthropy and individuals. While the greatest asset of this nonprofit sector is the trust of the public, the actions by a few have now called that valued trust into question.

Therefore, I support the decision by the Senate Finance Committee to examine the governance and accountability of nonprofit and philanthropic organizations. The oversight capacities of the Internal Revenue Service and complementary state regulatory officials have not kept pace with the rapid growth in the number of charitable nonprofit organizations. I encourage the Committee to explore how the IRS's Tax Exempt and Government Entities Division can be given the resources to insure the application of appropriate consequences for those violating the law. I also support the efforts to reform the Forms 990 and 990-PF to make them easier to complete, clearer and more useful to IRS auditors and the public.

The hearing of June 22 was an important call to nonprofit leaders to unify the patchwork of standards being offered by local, regional and national nonprofits and to, in fact, demonstrate that self-regulation can be effectively accomplished by this very diverse field. In recognition of the great diversity of the nonprofit sector, I feel that it is vital to be cautious in considering general regulatory measures that could result in higher administrative burdens and limits on charitable giving.

As the former Mayor of the City of Detroit (1994-2001) and as Chairman of Dickinson Wright, I value the great contributions of the nonprofit sector. Regional and national nonprofit leaders will receive assistance in their important efforts on effective governance and good practice that will result in continued benefit to communities across the nation.

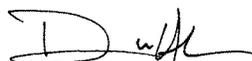
**C o u n s e l l o r s   A t   L a w**

DETROIT   BLOOMFIELD HILLS   LANSING   GRAND RAPIDS   ANN ARBOR  
 WASHINGTON, D.C.

DICKINSON WRIGHT PLLC

Senate Committee on Finance  
July 12, 2004  
Page 2

Very truly yours,



Dennis W. Archer

DWA/bf

DETROIT 99998-170 822166

Counselors At Law

DETROIT BLOOMFIELD HILLS LANSING GRAND RAPIDS ANN ARBOR  
WASHINGTON, D.C.

**U.S. Senate Committee on Finance**

“Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities”  
Tuesday, June 22, 2004

**Statement to the Record from:**

The Forum of Regional Associations of Grantmakers  
1111 19<sup>th</sup> Street, NW, Suite 650  
Washington, DC 20036  
Alison Wiley, President and Martin Lehfeldt, Chair

The Forum of Regional Associations of Grantmakers adds its collective voice to those representing the 62,000-plus foundations and other grantmaking institutions that daily invest private assets in improving communities in full commitment to the public trust. The Forum is a network of 30 regional associations of grantmakers, which are also nonprofits, serving more than 4,000 corporate and nonprofit funders and representing most of the philanthropic assets in cities, states or multi-state regions across the country. Working together, these regional associations provide grantmakers with the skills, knowledge and connections that will maximize their effectiveness. They also provide other leaders, including policymakers and the media, with information about charitable giving and the nonprofit sector in your states.

The Forum and its network have long been committed to maintaining a strong philanthropic sector and preventing abuses of charitable resources. This is mission-level work for all of us.

- We share the concern of the Senate Finance Committee – and of the public – when nonprofit organizations abuse their tax-exempt status by engaging in illegal or unethical activities.
- We support public policies that ensure effective management of charitable resources and support values of openness and ethical conduct, responsible philanthropy and corporate giving, and reasonable public access to information.
- And we support more active exercise of the Internal Revenue Service’s oversight authority of existing rules governing the nonprofit sector.

Grantmakers everywhere recognize that they play an important role in their communities; that their role is sustained by the public trust; and that certain obligations follow from that trust. Regional associations understand the role they play in helping these grantmakers comply with their legal and fiduciary responsibilities; many associations either have, or are in the process of, developing locally agreed-upon principles that reflect those obligations and to which their grantmaker members subscribe.

Additionally, at the national level, the Forum board of directors has passed a set of overarching tenets that are recommended as the basis for those locally developed principles. These tenets set expectations that *every* grantmaker who is a member of a regional association will:

- Adhere to the highest standards of ethical behavior in all foundation actions.
- Operate with an identifiable, active governing board.
- Have basic grantmaking information readily available to the public.
- Maintain constructive relationships with applicants, grantees, donors and the public, based on mutual respect, candor, and confidentiality.

- Strive to include the perspectives, opinions and experiences of the broadest possible cross-section of people to inform the foundation through its grantmaking, governance/staff structure and administrative practices.

A core emphasis of our work is on legal and ethical accountability. All regional associations provide regular training and information on those issues for their members and other area grantmakers. For example, this spring in preparation for the IRS 990PF filing deadlines, regional associations across the country linked their areas' private foundations into national teleconference trainings on correctly completing the most challenging sections of that form. They also joined with PricewaterhouseCoopers to provide web-based instruction guides for tax preparers and signers. For one example of these tools, see the Donors Forum of Chicago website at: <http://www.donorsforum.org/resource/990tips.html>.

A few examples of how regional associations are working to improve accountability include:

- For the past two years, the Indiana Grantmakers Alliance has focused their efforts on accountability and ethics, starting with their 2002 conference on "Accountability in Grantmaking" to their current proposal of guiding principals and conflict of interest policies being discussed this week at their board meeting.
- The Southeastern Council of Foundations is holding "Conversations on Foundation Responsibility and Oversight" throughout their region with the goal of adopting a code of principles or values by early 2005.
- In addition to offering to its members regular education programs on governance, compliance, and transparency, Delaware Valley Grantmakers drafted a set of *Values, Guiding Principles & Best Practices* for members to be adopted by their board this July.
- The Minnesota Council on Foundations has been one of the leaders, having adopted 8 years ago their *Principles for Minnesota Grantmakers*, which define a code of ethics and accountability for the field as a condition of membership. Over the past year the Council ran a series in the newsletter educating members on key legal and ethical issues and launched an online Legal FAQs Guide, which is a comprehensive resource to help private, corporate and community/public foundations understand their legal requirements and obligations.
- In May, the Southern California Grantmakers Board of Directors adopted a set of Guiding Principles. At its June Annual Members Meeting, the Board led discussions with members about these principles. SCG also initiated a series of Leadership Dialogues and James Canales, President and CEO of the James Irvine Foundation spoke on the topic of "Foundation Accountability and Lessons Learned."

The abuses by a few foundations and nonprofit organizations compromise all foundations and nonprofits. The Forum is committed to addressing this challenge and is expanding its nationwide initiatives and devoting significant new resources to:

- Provide regional associations with tools for educating foundations on ethics, the law, accounting, and improved 990PF reporting.
- Assist each regional association with the process of adopting guiding principles.
- Enable ongoing relationship building with state charitable officials and state and federal policymakers.
- Effectively and proactively convey the known positive impact of organized philanthropy, through a regionally based communications and information program.

Nationally and regionally, the Forum also helps introduce new people and organizations to charitable giving and connects them to existing communities of practice. This initiative, New Ventures in Philanthropy, has over the last 6 years worked with 41 regional coalitions and yielded approximately \$570 million in new community endowments with thousands of new donors. Linking those emerging groups to existing communities of practice like regional associations enables us to make them cognizant early on about all legal and ethical requirements, and thus cast a significantly broader net in our field in responding to issues of accountability and the public trust.

As a place to lodge your concerns about specific troubling reports related to the philanthropic community – and to learn more about the details – your regional association of grantmakers can be an invaluable resource. Virtually all Senators and Members of Congress have regional associations covering their geographical areas. For public policymakers, these associations are rich and unbiased sources of "on-the-ground" information about philanthropy in your region, and about the social issues affecting your communities. Like you, their member grantmakers are *servicing your constituents*, making positive change on education, community revitalization, children and families, and myriad other issues important to you.

Find your regional association at <http://www.givingforum.org/ralocator.html>.

And see examples of ways you can utilize or collaborate with them at <http://www.givingforum.org/policy/factsheet.html>.

Our locally based network works closely with national colleague organizations such as the Council on Foundations and Independent Sector, collectively ensuring that funders are armed with the tools, training and grantmaking practices to fully realize their strong commitment to the public trust. We appreciate this Committee's interest in working toward that same goal.

**FOUNDATION SOURCE PHILANTHROPIC SERVICES INC.****20 GLOVER AVENUE  
NORWALK, CT 06850**Comments on the Discussion Draft of the Senate Finance Committee  
For Reforms and Best Practices In the Area of  
Tax-Exempt Organizations**Introduction**

Foundation Source applauds the work of the committee in its commitment to improving the accountability of tax exempt organizations. By way of introduction, we are the leading provider of outsourced services for private foundations. Since 2000, Foundation Source has provided complete back-office administration, transaction processing, tax preparation and filing and monitoring services aimed at providing private foundations with the tools, technology and support services they require to remain in regulatory compliance. We currently administer over 170 nonoperating foundations, ranging from \$100,000 to over \$60 million in assets.

Foundation Source provides each client with a secure website to transact their foundation activities online. Each such website is an extension of our proprietary operating platform for operating and managing private foundations. We have programmed into this operating system our interpretation of many of the rules and regulations that define the proper operating parameters for foundation management. We now have a highly advanced, automated system that, coupled with related support services, provides private foundations with the knowledge, expertise and general guidance they need to effectively self-regulate.

We are aware that some organizations have engaged in inappropriate practices and that some individuals connected with exempt organizations have crossed the line of acceptable ethical behavior. Based on our experience, though, we believe that these cases represent the exception rather than the rule. Most organizations and their executives are committed to carrying out their exempt purposes. We find that the majority wish to remain in compliance and endeavor to do so, and are worried lest they unknowingly violate the regulations. Indeed, they engage our services as a first line of defense so that we can screen their activities and actively warn them prior to making an inadvertent mistake.

In our view, the current rules that are in place are quite adequate to prohibit the errant transactions of a decided minority. We do not believe that new limitations are needed. Rather, we believe that better guidance and enhanced clarity would enable better self-regulation, which most foundations desire. In this vein, as discussed below, we provide our clients with meaningful tools to enhance their ability to self-regulate and meet their existing obligations under the law.

**Proposal C.4. – Limit amounts paid for travel, meals, and accommodation**

In the context of travel, meals and accommodation, each foundation under our administration makes all requests for expense reimbursements online by means of its secure website. When entering an expense request, the individual requesting reimbursement is asked to provide (1) the amount of the expense; (2) the type of expense (accommodation, meals, etc.); (3) a description of the expense; and (4) a written explanation of how each expense advances the mission of that particular foundation. No expenses are paid until original receipts for all expenses have been submitted to Foundation Source.

To provide our clients with guidelines for expense reimbursement, we have instituted two basic caps:

The first cap, the “Individual Daily Expense Cap,” is applied at the level of the individual and is equal to the per diem rate for the continental United States that is in effect at the time a given expense is incurred. The Individual Daily Cap applies the “high-low” method described in Revenue Procedures periodically issued by the Internal Revenue Service to an individual’s daily expenses. The Individual Daily Expense Cap applies only to lodging, meals and incidental expenses incurred by a foundation officer or director while away from home attending to foundation-related business. Our operating system requires the client to enter the state where the expense was incurred. If the amount entered is greater than the low cost area rate, the system will provide a list of the high cost areas in the designated state and ask the person if the expense was incurred in any of those areas. In any event, the system will advise the client of the applicable rate, high or low, for the area where the expense was incurred.

The second cap, the “Foundation Annual Expense Cap,” tracks all year-to-date expenses paid for travel, meals and accommodation and is applied at the level of the foundation. The Foundation Annual Expense Cap is calculated by multiplying .005 times the average value of the foundation’s assets for the three months immediately preceding the date of the expense. This overall limit suggests the maximum amount that the foundation should reimburse in any given year for all expenses incurred, except for those expenses noted in the following sentence. The Foundation Annual Expense Cap does not apply to the purchase of supplies and materials necessary for the foundation’s operation or professional services rendered to the foundation, such as legal, accounting and consulting fees. When an individual enters an expense that comes within \$5,000 of the Foundation Annual Expense Cap, he or she is advised how much the foundation has spent on travel, meals and accommodation expenses to date and further advised how close the foundation is to reaching the Foundation Annual Expense Cap. As above, the system will warn the individuals requesting reimbursement if the expense exceeds the Foundation Annual Expense Cap.

Comments from our clients indicate that they appreciate having clear guidelines against which to benchmark their expense limits. To date, no one has exceeded these limits. Based on our

experience, we recommend that better guidelines be provided to enable foundations to more effectively regulate themselves.

Respectfully submitted,

Daniel M. Schley  
Chairman & CEO,  
Foundation Source Philanthropic Services Inc.

## Free Speech Coalition, Inc.

8180 Greensboro Drive, Suite 1070  
McLean, VA 22102-3860  
Phone: (703) 356-6912  
Fax: (703) 356-5085

July 6, 2004

**Free Speech Coalition, Inc.**  
**Post-Hearing Comments relating to**  
**U.S. Senate Committee on Finance Staff Report and June 22, 2004 Hearings on**  
**“Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities”**

The Free Speech Coalition, Inc. (“FSC”) is a broad nonprofit alliance of nonprofit organizations and for-profit companies which help nonprofits raise funds and carry out their programs. FSC is particularly concerned with the preservation of the rights of nonprofit advocacy organizations. This diverse group was established in 1993 to defend the interests of Americans who want to participate fully in the formation of public policy in this country without undue governmental interference and restriction.

The Senate Finance Committee, which oversees the Internal Revenue Service's regulation of tax-exempt organizations, released a staff draft report in connection with the above-captioned hearing. That report suggests many dramatic changes in laws governing charities and other exempt organizations, including virtually all members of FSC, which are directly engaged in educating the general public on matters of direct importance to the communities they serve. Some of these groups are 501(c)(3) public charities, while others are 501(c)(4) social action groups. Both of these types of organization are now heavily regulated at the Federal, State, and, in some cases, local levels. Compliance costs for these groups have steadily risen over the past 35 years. Indeed, it is ironic that the very government entities that impose and enforce these rules object to the increasing percentage of total revenues nonprofits must spend on non-program activities, including registration, recurrent filings, and responding to government and watchdog inquiries. Every dollar spent on salaries, accounting fees, legal fees, and registration fees to comply with these laws is a dollar less for the core missions of tax-exempt organizations.

Yet, despite the constantly increasing regulatory burden of mandatory filings, disclosures, and compliance with new rules and regulations at all levels, there is no indication that governmental involvement has had any significant beneficial result. Indeed, rather than the imposition of additional requirements, burdens, regulations, and penalties, this Committee's attention should be focused on lessening currently existing burdens on nonprofits. If Congress believes that something must be done, Congress should focus on enforcing laws currently on the books, as recommended in the June 9, 2004 Report of the Advisory Committee on Tax Exempt and Government Entities (ACT) at page 9, not passing new laws.

In these comments, FSC points out the shortcomings of many of the proposed solutions contained in the discussion draft, numbered to correspond to the sections of that document.

#### A. Exempt Status Reforms

**1. Five-year review of tax-exempt status by the IRS.** The draft proposes a five-year review of tax-exempt status. Such a proposal is ill-conceived and would produce absurd results. First of all, there is no demonstrated need for such a pervasive, burdensome requirement, whose benefits to the public are not even apparent. In addition to the costly, unnecessary burdens it would impose on tax-exempt organizations, it would overtax the regulators themselves. The Service is already unable to respond in a timely fashion to applications for recognition of exemption (Forms 1023 and 1024). Field offices send many of these applications to the National Office without even opening a case file in order to reduce their swollen caseload, and in return the National Office is reportedly returning these applications because it does not have the resources to review them. This proposal would increase the number of such renewal applications to be considered each year by hundreds of thousands! Without significant added resources, it is highly unlikely these applications actually will be reviewed by the Service. Requirement that these also be made available to the public, as Forms 1023 and 1024 now must be, would kill plenty of additional trees, consume lots more time of an organization's staff, and help to make accountants and lawyers rich, but would not result in any perceptible benefit to the public.

**2. Donor advised fund reforms.** Eleven new rules are suggested for DAFs, primarily focused on for-profit investment houses that create the charities housing them, and then manage their funds. Again, it is not clear why such intricate and comprehensive changes should be necessary in view of the statutes and regulations currently in force. Perhaps one constructive suggestion would be for the IRS to publish a list of approved foreign charities to which grants could be made, not only by DAFs, but also private foundations and other public charities without having to exercise the equivalent of expenditure responsibility over them. This proposal could actually *cut* overhead for many charities and get *more* money out for mission. Private foundations should also be allowed to discharge the charitable pledges of their creators, as they are no less worthy than DAFs and their creators in this respect.

**3. Supporting organizations.** Eliminating Type III (Code Section 509(a)(3)) support organizations is an extremely bad idea. If specific problems concerning manipulation of Section 509(a)(3) organizations have been discovered, that specific conduct should be addressed. This proposal would make it very difficult for many charities, social action groups, unions, agricultural and horticultural organizations, and trade and professional associations to conduct their legitimate, educational, and other ancillary activities through subsidiaries that would qualify for tax exemption. For example, a trade association that wishes to conduct educational programs may want to do so through a public charity. If, however, those educational activities cannot pass the public support tests of Code Section 509(a)(1) and (2) — for example, where more than one-third of the subsidiary's support comes from passive income and the rest of its revenue comes from conference registrations — the entity would be treated as a private

foundation. This was just the sort of foolish result that Code Section 509(a)(3) was enacted to prevent. The Committee should reject “throwing out the baby with the bath water,” which is what repeal of Code Section 509(a)(3) would be.

**4. Revise exemption standards for credit counseling organizations.** These proposals apparently were made in response to particular abuses that have been discovered among some organizations in the debt counseling field. The Service is now engaged in auditing over half of this industry, and there is no reason to believe that the Service lacks the tools to deal with each of the abuses reported to date. If more definite rules are required, these can be issued by the Treasury Department in regulations and rulings, and enforced by the courts. Statutes that attempt to micro-manage complex business and financial relationships almost always end up creating unintended consequences that can only be remedied by more legislation. The results of the credit counseling audits in progress by the IRS will demonstrate whether proceeding by regulation is inadequate, but there appears to be no indication of this at the present time.

**5. Revoke charitable status for accommodations to tax shelters.** Active participation by a charity in tax evasion is certainly illegal, and in the appropriate case could justify revocation of the organization’s exemption. Imposing the tax in appropriate cases would also make sense, as it presumably will steer charities away from such schemes. A requirement for advance approval, however, would require organizations to come to the Service with every new idea proposed in connection with planned giving, partnerships with for-profit companies, and the like — or risk the possibility that the proposed activity is substantially similar to a listed transaction. Further, the IRS likely will be unable to respond to these requests in a timely manner. If more regulation is needed here, it should follow the path of other tax regulation, and include appropriate standards by which the conduct in question could be evaluated.

## **B. Insider and Disqualified Person Reforms**

**1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules.** There should be a compelling evidentiary record to justify extending the self-dealing regulations, as proposed, to public charities. This would amount to extremely expansive regulatory change which has not been considered necessary in the past. Furthermore, this proposal points out an existing unfairness in the law that Staff proposes to extend further. Social action organizations, contributions to which are *not* tax deductible, were subjected to intermediate sanctions in 1996. There was no apparent justification for imposing those rules upon 501(c)(4) organizations, beyond the fact that such groups inform constituents about the actions of legislators and rally them to contact their representatives — obviously an uncomfortable prospect for those in positions of legislative power. Prior to that time, the basic difference between charities and these groups had been recognized by Congress, the Service, and even by the Supreme Court as a healthy safety valve, permitting lobbying and even political activity to be conducted by organizations related to charities that did not receive tax-deductible contributions. Regan v. Taxation with

Representation of Wash., 461 U.S. 540, 544 and fn. 6 (1983). Staff now proposes to treat these organizations as private foundations.

This proposal is truly odd, since trade and professional associations which *do* receive tax-deductible contributions from their members are omitted, as are fraternal and beneficiary organizations, veterans groups, and social clubs. Organizations that have more in common with charities than do social action groups are given a free ride, while social action groups, which deal directly with the public and serve a recognized, constitutionally-protected function, are discouraged by ever more burdensome regulation. It is doubtful that Congress could field a reasonable basis for this discrimination between social action groups and these others classes of entities. The proposal to apply private foundation rules to social welfare organizations should be rejected, even if it is ultimately decided to extend the private foundation self-dealing rules to public charities.

**2. Expand definition of disqualified person.** See comments to section B.1.

**3. Increase taxes for self-dealing, jeopardizing investments, and taxable expenditures.** See comments to section B.1.

**4. Compensation of private foundation trustees.** This Staff proposal appears to ignore the realities of the non-governmental world. First, not paying directors would not necessarily result in better directors. If directors would not serve on the boards of publicly-held corporations without compensation, why disadvantage nonprofits in seeking qualified directors using compensation? Further, private foundations that do not pay trustees may attract trustees who seek to obtain compensation indirectly, such as through dealings with grantees or in other relationships to the organization.

There must be some understanding of real-world concerns of those who would otherwise like to serve on nonprofit boards. Intelligent people rarely choose to expose themselves to personal liability, public criticism, and governmental attack, for the time-consuming and costly work associated with meeting the existing standards of trustee responsibility, let alone the more stringent proposed rules. Such a proposal would result in only the wealthy (such as creators of the private foundations who have sufficient assets of their own to deflect these concerns), or those with nothing to lose, to serve as directors of private foundations. This could result in the pool of potential directors becoming shallow indeed, leading to more, not fewer, abuses.

**5. Compensation of disqualified persons.** Limiting the compensation of disqualified persons to government levels artificially limits the ability of nonprofits to recruit talented personnel. Such a proposal is unrealistic, and actually would be self-defeating. Over the past 25 years, some government salaries have failed to keep pace with those available out of government, and some public servants have left public service to put their children through college and otherwise pursue the American dream. To restrict the ability of nonprofits to recruit qualified leadership will deprive the nonprofit sector of those individuals it needs. Moreover, requiring for-profit companies to make executive compensation data publicly available did

nothing to stem the excesses evident in the Enron and Tyco cases, let alone to eliminate the disparity between workers' wages and executive salaries in certain for-profit companies. There is no reason to believe it will do better in the nonprofit sector. It makes no sense to harm the capabilities of the nonprofit sector to do its job so that its reputation in the eyes of some in government is preserved.

### C. Grants and Expense Reforms

**1. Treatment of administrative expenses of nonoperating foundations.** As noted above, more filings and reviews will require added government staff, not to mention added non-grant expense for the foundations, which would itself trigger these requirements more often. Failure to either review the filings or follow them up with audits would cause this to be an empty exercise. This proposal actually reinforces arguments already made above that requiring additional filings is not the answer for anyone.

**2. Encourage additional grant-making by private foundations.** It is not clear that this incentive would be enough to accomplish its goal; dropping the payout figure needed to obtain exemption from the 2 percent tax to 7 or 8 percent might be successful to some degree. In times of low investment return, however, such an approach would encourage speculative investment, which could not be thoroughly controlled by stiffening the Jeopardy Investment provisions of Code Section 4944.

**3. Prohibit foundation grants to donor advised funds.** The Service has already informally proposed this rule, which most DAF sponsors are already following.

**4. Limit amounts paid for travel, meals, and accommodation.** Abusive perks are always an easy target, and setting a bright line test such as government per diem rates has a certain superficial appeal. However, nonprofits are not able to take advantage of deeply discounted government airline and hotel rates. Furthermore, travel, meals, and accommodation coverage is no less an element of director, officer, and staff recruiting than other forms of compensation. To arbitrarily limit these small cost items clearly would result in limiting the pool of those willing to serve charity. Current rules, properly enforced, would in fact achieve the desired goal; more enforcement, not more arbitrary rules, is needed.

### D. Federal-State Coordination of Actions and Proceedings

**1. Establish standards for acquisition/conversion of a non-profit.** This is a subject that has received much attention in connection with the purchase of nonprofit health facilities by for-profit organizations. The proposal raises important, difficult questions of federalism. Any legislation should clearly establish the lines of Federal versus State authority, and specify the extent of preemption intended by Congress. Failure to do so will likely result in conflicting rules at each level, turf wars over enforcement and uncertainty for charities that seek to "do right" by the public interest.

**2. Provide States the authority to pursue federal actions.** This proposal highlights the risks associated with unlimited cooperation and information sharing between Federal and State authorities. It would almost certainly require the sharing of audit materials between the Federal and State enforcement arms, which is something that has traditionally raised issues of personal privacy, freedom of association, and abuse of power. If State and Federal enforcement authority is to be integrated in this way, information that is provided for one purpose could well be used for another, even though to do so would violate constitutional protections. The Federal government should gather only that information which it needs, and use it only for its own purposes. The same is true for States. If wrongdoing is found, the agency uncovering it should deal with it, rather than some type of Federal-State consortium threatening to exponentially increase the consequences of a misstep. Federalism issues must be carefully considered before any regulatory measure of this type is established.

#### **E. Improve Quality and Scope of Forms 990 and Financial Statements**

The comments noted above concerning the cost of compliance are particularly important here. Thirty-five years of ever-increasing reporting on Form 990 have few demonstrated benefits, but clearly have increased administrative costs. There is no reason to believe that asking more questions will produce anything more than higher administrative costs with less money going to charity and more complaints about dropping percentages of funding going to mission.

**1. Require signature by Chief Executive Officer.** This proposal is unnecessary at best. Such a change would make it impossible for a CEO to delegate this responsibility to a CFO, who presumably has superior personal knowledge.

**2. Penalties for failure to file complete and accurate 990.** Government at all levels usually assumes malice and fraud by citizens. Honest mistakes are sometimes made by nonprofit officials and accountants, just as they are made by Congressmen and Congressional staffers. Intentional misrepresentation should be required before substantial penalties are threatened or imposed.

One hallmark of the Exempt Organizations function at the Service since its inception has been its commitment to ensuring organizations acted properly, regardless of whether it produced tax revenue. To incentivize the Exempt Organizations function by giving it the ability to benefit from tax collections would fundamentally change this from a function that does the right thing, to one that "follows the buck." This would be a dangerous development. In times of rising deficits, this would likely trigger the institutional self-preservation response to assert claims even where not justified, especially in view of the adverse publicity that such claims would bring.

**3. Penalty for failure to file timely 990.** Many times, apparent inconsistencies on Forms 990 are due to differing interpretations of the instructions or simple human error. Putting such heavy burdens on the organization for inadvertent error is unrealistic, and undoubtedly unfair. There are frequently genuine reasons that Forms 990 are filed late, most often to allow

correct information to be gathered. Accounting firms or other return preparers, many of whom answer the call when asked to perform these audits at reduced rates or entirely for free, require the allowable period of time for filing, with occasional extensions, in an attempt to do their job properly. Creating such a deadline would merely encourage rapid filing of incorrect information, with nonprofits playing the audit lottery.

**4. Electronic filing.** This more efficient way of providing ready information to the Service is a good idea. Making all filed information available to the States is a bad one. In NAACP v. Alabama, 357 U.S. 449 (1958), the Supreme Court recognized that donor and membership lists could be used by government or those gaining unauthorized access to government data bases to harass persons affiliated with unpopular groups. Sharing donor contribution information with State authorities, as well as with elements of the federal government outside the Service, would be a dangerous step.

**5. Standards for filing.** If the Committee and Treasury can develop reasonable rules relating to the accurate reporting of nonprofit finances, this would be a heroic feat, and could bring order out of chaos. When undertaking this step, the Committee should be aware that the costs associated with capturing information, reporting in greater detail and otherwise complying with the added rules called for in the discussion draft are often used by large charities to keep out new and smaller charities that cannot afford the administrative costs. Care should be taken to require expensive compliance actions only from groups whose gross receipts are large enough to absorb them without having to give up a substantial portion of their revenue. In other words, perhaps there should be a policy that limits the costs that government, at all levels, can impose upon nonprofits (say the same 10 percent mentioned by the discussion draft as the limit on acceptable administrative expense).

**6. Independent audits or reviews.** In addition to being unnecessarily burdensome, the proposed requirement that a tax-exempt organization with over \$250,000 in annual gross receipts change its independent auditing firm every five years would result in substantially higher auditing fees for the exempt organization. It always takes a new auditing firm significant time to become familiar with a new organization when it conducts an initial audit, *e.g.*, reviewing the organization's accounting system, computer programs, and internal controls. Curiously, a new auditing firm probably would be less able to spot problems than one which had experience with the organization. See comments to section E.5., *supra*.

**7. Enhanced disclosure of related organizations and insider transactions.** Requiring organizations to give up their confidentiality in seeking legal advice would discourage both boards and management from seeking advice. As often as not, requests for legal advice reveal that what is contemplated cannot and should not be done, normally leading to abandonment of the suggested course and adoption of an acceptable approach. If an organization wishes to rely upon opinion of counsel to protect it or its leaders from penalties, the opinion letter is expected to be shown to third parties, and will be drafted with that in mind. Not all opinions, however, are sought for this purpose, and only those designed to support exemption from a penalty should be subject to view even by the Service, let alone the public.

**8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements.** This suggestion infringes upon the existing State governmental regulatory role of internal management of nonprofits; for more of the same, see comments to section G, *infra*. There is no reason to believe that donors would rely upon this information in making decisions about giving; if they wanted this, they would let nonprofits know about it by refusing to give donations until this information were forthcoming. The only thing sure to come from this proposal would be more expense for more data that will either go unused or be manipulated by groups opposing or supporting a nonprofit to their own ends.

**9. Disclose investments of public charities.** It is not clear what, if any, legitimate goal this additional requirement would further.

#### F. Public Availability of Documents

**1. Disclosure of financial statements.** Curiously, this could put more pressure on auditors to “bend the rules,” much as they did during the bull market of the 1990’s; at the same time, it could open public accounting firms to private suits, thus further increasing the cost of audits.

**2. Web-site disclosure.** This would be a good suggestion only if it (a) were inexpensive to post such materials — as where Guidestar or the federal government agreed to do the publication — and (b) did not disadvantage the electronic medium by imposing required speech while printed media were exempt. Even if all media were to be subject to such a rule, it is not clear that such a mandatory speech requirement is supported by sufficiently strong government goals that could not be achieved by other means, such as requiring those who want the information to request it.

**3. Publication of final determinations.** Giving the Service the ability to disclose audit results would give them the ability to intimidate nonprofits into agreeing with their position or doing anything else the Service wished them to do under threat of publishing unfavorable conclusions to damage the nonprofit’s image. If one believes such abuses cannot occur, the record of the SSS (“Special Services Staff”), which allegedly compiled the nonprofit enemies list under the Nixon Administration, should be researched.

**4. Require public disclosure of Form 990-T and affiliated organization returns.** It is clear the Staff believes that nonprofits must have absolute transparency in all matters to be accountable. Thus, mistakes in judgment, such as investing in poorly performing assets, or trying to start a new program that requires lots of start up capital but provides few returns, will be done in full public view. The criticism this would produce may discourage innovation. It would be simple to reduce the consequences for this type of mandatory disclosure to absurdity. For example, tax returns of public companies and private individuals, even of elected officials, are not subject to public scrutiny to avoid such embarrassment; why should the tax returns of nonprofits be different? Extending such forced disclosure to affiliated organizations (depending

upon the definition of that term) could make contractors think twice about providing services to nonprofits. Would this be in the public interest?

**5. Require public corporation filing of charitable giving return.** Corporations already get little benefit from charitable contributions, their deductions for which are limited to 10 percent of taxable income; most use their advertising budgets for charity for this reason. To create yet another disincentive to corporations to support charity would give them another excuse to shirk their responsibility to the community in which they operate.

#### **G. Encourage Strong Governance and Best Practices for Exempt Organizations**

This entire section would preempt the role of State Attorneys General in setting the performance standards of nonprofit boards. But would the IRS even make the key determinations in this process? No. The discussion draft would farm the governmental duty of determining whether a nonprofit were tax exempt and properly run to “accredited” watchdog groups. Government agencies would also give preference to these private determinations in granting government contracts. This unprecedented preemption and delegation of government responsibility and authority to private institutions and individuals would be an unconstitutional arrogation of power to the Federal government, would constitute a denial of due process, and would delegate non-delegable government functions.

#### **H. Funding of Exempt Organizations and for State Enforcement and Education**

Payment for the government’s costs under the discussion draft would be laid at the doorstep of private foundations, the group least frequently in the news lately and, until recently, hailed by the Service as the most compliant segment of the nonprofit community. In the alternative, filing fees would be imposed that would further exacerbate the administrative cost problems faced by nonprofits under the proposals. Aside from the basic unfairness of either approach, the dollars it is estimated to raise would fall far short of what an active enforcement program would require. Even these costs, however, pale into insignificance next to the costs that compliance with these rules would place on nonprofits. In short, the resources to be extracted from the nonprofit community to provide added information and see to its proper use would far exceed any benefit that community or the public at large could reasonably expect to gain from the exercise. Were all of the funds to be raised by this proposal dedicated to enforcing current rules without imposing further costs of the nonprofit sector, the public would be far better served.

#### **I. Tax Court Equity Authorities, Private Relator and Valuation**

**1. Tax Court Equity Authorities.** The proposal to invest the Tax Court, an Article I Court, *i.e.* a court of law (Freytag v. Commissioner, 501 U.S. 868 (1991)), but not necessarily

a court of equity, with injunctive powers may be unconstitutional. Any such authority would be more appropriately placed with district courts, which clearly have equitable powers under our combined American system of jurisprudence.

**2. Private Action - Directors.** Aside from providing another avenue for litigation attorneys to ply their trade, there is little to recommend using overburdened courts to deal with internal director disputes. Directors already have the right and duty to litigate such actions in local court if they believe it would help. If they merely wish to resign and walk away, this new procedure is unlikely to convince them to take the chance of having to pay defendants' fees if they lose. If a resigning trustee or director sent a letter to the IRS, it likely would result in an old-fashioned audit, the remedy most sadly lacking any attention in the discussion draft.

**3. Private Relator Action - Individual.** The law has long denied standing to private citizens seeking to hold charities to account for violating federal tax exemption provisions (*see Catholic Conf. v. Abortion Rights Mobilization*, 487 U.S. 72 (1988)), and for good reason. This is the role of the Service, and opening enforcement of these public rules to private attorneys general will produce far more mischief than it would true oversight. This is regulation on the cheap until you consider the administrative and judicial resources that would be consumed, not to mention the cost to the nonprofit. The most likely result that would flow from implementing this proposal would be abuse of process, and even \$10,000 fines would not prevent the use of this provision to punish or occupy the resources of a nonprofit with which well-funded interests, on either side of a heated issue, disagree.

**4. Valuation Resolution.** The proposal to use "baseball arbitration" techniques to resolve valuation issues in charitable contribution cases is irrational. Taking the appeals office out of negotiations with the taxpayer, when the relative strengths of their positions on valuation is often the most significant litigation hazard in the case, is at odds with the essential role of Appellate, namely to sort out weaker cases that are factually driven so as to avoid wasting court time on often imponderable issues, such as value. Making the auditor the taxpayer's only chance to compromise is contrary to the very essence of the appellate process at the Service.

Respectfully submitted,

Mark B. Weinberg  
Weinberg & Jacobs, LLP  
Co-Counsel to Free Speech Coalition, Inc.  
paladin@wjlaw.com  
301-468-5500

William J. Olson  
William J. Olson, P.C.  
Co-Counsel to Free Speech Coalition, Inc.  
wjo@mindspring.com  
703-356-5070



July 6, 2004  
*Delivered by fax July 6, 2004 to 202.228.0554, 202.228.1831*  
The Honorable Senator Charles Grassley, Chair  
The Honorable Senator Max Baucus, Rnk.Mem.  
Senate Finance Committee  
Room SD 203  
219 Dirksen Senate Office Building  
Washington, D.C. 20510-6200

*Attn: Editorial and Document Section: Public Input: Hearing: "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities", June 22, 2004, Dirksen Senate Office Bldg.*

Dear Senator Grassley and Senator Baucus:

I am writing you to thank you for holding your June 22, 2004 hearing on charity oversight and reform. Your hearing raised important and timely issues that greatly concern those of us who serve on foundation boards and oversee their operations for the benefit of the public.

As President of the Gilbert M. and Martha H. Hitchcock Foundation since 1984, I have witnessed firsthand some of the serious problems that arise in the tax-exempt world when regulatory agencies, the IRS and States AG offices fail to enforce the law and foundation self-policing and governance are ignored by individuals and groups of individuals on foundation boards or managing foundations bent on engaging in self-dealing in order to use the tax-exempt world to their own economic benefit. Foundations tainted by these conflicts of interest find themselves increasingly in the media, and for good reason. These patterns threaten the public's faith in the tax-exempt corporate world, and threaten to keep good honest people from ever serving on a board due to fear of what may happen if a board would start to resemble the Enron board in its decisions of where to give money, and to whom, and for what purpose.

I believe your committee and the U.S. Senate as a whole should take an interest in the Hitchcock Foundation case because Gilbert M. Hitchcock was a U.S. Senator from Nebraska and the Foundation is his legacy. I have managed the assets of the foundation for 42 years as it has grown from \$200,000 to over \$19 million dollars benefiting donees in Nebraska, Iowa, Florida, New York, Texas, Massachusetts, South Dakota primarily, among other states.

The Hitchcock Foundation controversy has been extensively covered by the New York Times (*Jan 9, 2004*), Associated Press, and other publications (see attached articles) but we are no closer to resolving the problems than 2002, when significant self-dealing issues were uncovered by an independent investigation of the board and its terminated manager. In addition, that time period saw the collapse of Enron (foundation bonds are separately managed by First National Bank Omaha) costing the foundation \$188,000 in corporate bonds (Enron) which has never been recovered by the foundation.

Our efforts at "Voluntary Compliance" are included with this letter, as we go forward to preserve a U.S. Senator's legacy. The Foundation, and the Hitchcock Fellowship at Columbia University in New York, established in 1934, and which the foundation was primarily established to fund, are both endangered by a willful determined group who seek to take over the Senator's money by whatever means necessary in order to paper over their history of self-dealing and insider trading and the exposure to excise taxes that such acts bring to all boardmembers. Trustees and Boardmembers should not have to use their own funds to defend such distinguished organizations without governmental oversight. Without such oversight, the tax-exempt world will sink into a cesspool of unethical practices and the public faith in charities and foundations may never recover.

We thank you for this important and timely hearing. Please do not hesitate to call me at my home number, 239-649-0818, and thanks to all of the distinguished Senators on the Finance Committee.

Sincerely,



Denman Kountze  
President: Gilbert M. and Martha H. Hitchcock Foundation  
PO BOX 578  
Naples, Fla. 34106

Attn: Debbie Steward, Senate Finance Committee: fax: 202-228-1831  
Kolan Davis, Russ Sullivan

July 6, 2004

*Delivered by facsimile to 202.228.0554*

The Honorable Senator Charles Grassley  
The Honorable Senator Max Baucus  
Senate Finance Committee  
Room SD 203  
219 Dirksen Senate Office Building  
Washington, D.C. 20510-6200

*Attn: Adam Freed, Staff, Senate Finance Committee*

*Attn: Editorial and Document Section: "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities" June 22, 2004, Dirksen Senate Office Bldg.*

Dear Senator Grassley and Senator Baucus:

Thank you for holding the June 22, 2004 hearing on charity oversight and reform. Your hearing raised important issues in the tax-exempt world, and it greatly concerns those of us who have long experience (13 years) on foundation boards.

In my case, this is the legacy of U.S. Senator Gilbert M. Hitchcock from Nebraska. Since 1934 the Foundation has funded one of the oldest fellowships at Columbia University in New York. It has given away over \$16 million in recent years in Iowa, Nebraska, New York, Florida, Texas, and Massachusetts, all with the mandate the Senator (and the Senator's wife, Martha H. Hitchcock) began with the Fellowship at Columbia in 1934.

While doing 'due diligence' and working to maintain a high level of corporate governance, I have also discovered activities that threaten to end the Senator's legacy, and its tax-exempt status.

In 2001 independent investigators informed Foundation President Denman Kountze and myself of long-term "questionable insider self-dealing transactions" that had occurred in a repeated pattern, which was then covered up by the Foundation's manager in concert with the self-dealing trustees. When this conspiracy was uncovered, one board member, a retired Merrill Lynch executive, resigned in disgust, and the 'self-dealing' trustees began a hostile takeover attempt, along with the Foundation's manager, who had by then resigned, but still aided and abetted the coup attempt.

To date, the Foundation's President and myself have spent nearly half a million dollars out of our own personal funds to see that Senator Hitchcock's will be done free of IRS prohibited transactions, and to see that transgressors be removed from the board. We have contacted the Nebraska AG's office, New York AG's Charity Bureau (Mr. Josephson), informed both IRS Commissioner Everson and Tax-Exempt head Ms. Johnson.

The story of our battle has been widely reported in the press (*New York Times* 1.13.04; *Associated Press* 12.06.03, *et.al.*) Mr. Rick Cohen of the National Center for Responsive Philanthropy also met with us in 2003 and was enormously helpful in his advice.

Our efforts to self-police and “voluntarily comply” with IRS code to preserve this \$19 million U.S. Senator’s legacy for the ‘general public’ is our fiduciary duty - and one that is far harder without governmental oversight.

We thank you for this hearing, that it may help make this struggle easier, discourage malfeasance, and remove any taint from the tax-exempt world, so that we may return to benefiting those who are the truly needy in this world, as was intended when the tax-exempt world was created.

Please do not hesitate to contact me at my home number, 303-415-9286. I look forward to hearing from you soon. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "Edward Kountze". The signature is fluid and cursive, with a large, sweeping initial "E".

Edward Kountze  
Secretary, Gilbert M. and Martha H. Hitchcock Foundation  
P.O. Box 231  
Boulder, CO 80306

**VIA FED/EX AND FACSIMILE** 2.6.04

Ms. Rosie Johnson  
 Director, EO Examinations  
 Exempt Organizations Division  
 Internal Revenue Service  
 1100 Commerce St  
 Dallas, TX 75242

Mr. Mark Everson, Commissioner, IRS  
 Washington, D.C.

**RE: Gilbert M. and Martha H. Hitchcock Foundation (EIN: 47-6025723)**

Dear Ms. Johnson,

On behalf of the Gilbert M. and Martha H. Hitchcock Foundation (the "Foundation"), I am writing to inform you of several developments that could give rise to excise tax liability under Chapter 42. In the context of recent litigation involving the Foundation, the Trustees have learned of several instances of potential self-dealing, taxable expenditures, and governance decisions tainted by conflicts of interest that warrant your careful consideration. Although the statute of limitations for tax matters may have expired on some of the instances, they appear to reflect a pattern of insider transactions that may be reflected in subsequent financial arrangements involving disqualified persons and the Foundation.

As you may already know, the controversy involving the Foundation, an Omaha, Nebraska-based family foundation, has been highly visible in the community, and has been highlighted in the national press in recent months.<sup>1</sup> The case, Hitchcock Foundation v. Kountze, involves the Kountze family, descendants of Gilbert and Martha Hitchcock, and issues regarding management and control of the Foundation. Plaintiffs in the principal case are Neely Kountze, his wife Mary Kountze, his lawyer Tyler Gaines and John Webster, as Trustees on behalf of the Foundation. Defendants Denman Kountze (Neely's uncle) and his sons Edward H. and Charles D. Kountze, also Trustees of the Foundation, filed a counterclaim against the Foundation's longtime outside counsel, Hitchcock Foundation v. Burke. Allegations include breaches of fiduciary duties, self-dealing and conflicts of interest. Both matters are currently pending in Nebraska state court.

The balance of this letter briefly summarizes one of the transactions that have come to light during the litigation. As you will note, this transaction and other similar events indicate a disturbing pattern of potential self-dealing and governance decisions tainted by conflicts of interest.

**1. Grant to the Stephen Center**

<sup>1</sup>See, e.g., *Battle in an Omaha Charitable Group Reflects Issues Raised in Corporate Scandals*, New York Times (Jan. 9, 2004).

In December 2000, Thomas Burke, longtime outside counsel and Secretary to the Foundation, and thus a disqualified person, proposed that the Foundation make a grant between \$50,000 and \$75,000 to the Stephen Center, which operated a drug treatment center and transitional living facilities. Mr. Burke disclosed that his daughter and her two children resided in one of the transitional homes. At that time, he also served on the Development Committee of the Stephen Center. He did not disclose his position to the Board. At the January 2001 annual meeting of the Board of Trustees, the grant that Mr. Burke solicited was approved in the amount of \$50,000, to be paid in two installments: \$25,000 in 2001 and \$25,000 the following year.

The Foundation's grant funds were used to renovate certain transitional housing units at the Stephen Center, including the one Mr. Burke's family members occupied at the time. The fact that he held fiduciary roles with respect to both organizations raises the possibility that he may have earmarked the grant for his daughter's and grandchildren's benefit. Available documents and correspondence seem to support this conclusion. When he proposed the grant, Mr. Burke wrote a note to Denman and Edward Kountze explaining that "[t]his is the center where my daughter is living and raising her two boys." Following the distributions, Mr. Burke received several thank-you notes from his colleagues at the Stephen Center for his help in steering the grants to the Center. In one example, a representative of the Center wrote: "Just a note to thank you for all of your support and for interceding for us with the Foundation." For your reference, I have enclosed the correspondence mentioned above as well as excerpts from deposition testimony describing the circumstances of these grants.

Outside the scope of the litigation, we have also learned of several instances where current and former employees of the Stephen Center have alleged that the Center's funds were misappropriated.

## **2. Other Examples of Potential Self-Dealing and Conflicts of Interest**

For your information, the Foundation's fiscal year ends on December 31. The 990-PF for 2000, the earliest open tax year, was filed in May 2001. Thus, while the questionable grant to the Stephen Center, discussed above, is still ripe for review, the statute of limitations has expired with respect to certain other potential insider transactions that have come to light during the litigation. Nevertheless, you may wish to consider the facts surrounding of these transactions, as they appear to suggest a pattern of self-dealing and conflicts of interest. They are fully described in Defendants' Trial Brief filed December 17, 2003, which I have enclosed for your reference.

### **a. Grant to the Omaha Children's Museum**

In 1990, Neely Kountze, a Trustee of the Foundation, and a business partner donated property to the Omaha Children's Museum, and the Museum agreed to assume two outstanding mortgages as well as certain other expenses. Three years later, Neely Kountze proposed that the Foundation make a grant to the Museum for \$50,000, coincidentally the same amount as the remaining balance on the mortgage. The Museum made the final payment on the mortgage shortly thereafter. In an expert report prepared for the litigation (enclosed for your reference), Bruce Hopkins concluded that the grant constituted both self dealing and a taxable expenditure,

on the theory that the \$50,000 was expended for a noncharitable purpose: to relieve Mr. Kountze and his business partner of personal liability.

**b. Grants to Brownell-Talbot School**

Over the period 1962-2002, the Foundation provided considerable financial support (\$2.7 million in total) to the Brownell-Talbot School, a local private school. Neely Kountze, a Trustee, annually voted for the Brownell-Talbot School to receive such grants from the Foundation. Notably, Mr. Kountze and his children graduated from the school, and unbeknownst to the other Trustees he served on the Board from 1976-1980 and again from 1986-1999. As a member of the two Boards, his participation in the decisions to make grants to the school during periods when he served on the school's Board suggest a conflict of interest that should have been disclosed. Because of the non-disclosure, the Foundation's Trustees are concerned about the possibility that the grants may have been made to satisfy personal pledges by Mr. Kountze, thus potentially constituting self-dealing for purposes of section 4941. In addition, Neely Kountze sold over \$30,000 in computers to Brownell Talbot school during the period that Brownell-Talbot School received \$25,000 from Hitchcock Foundation for the "Hitchcock Computer Fund", which Neely Kountze kept hidden from the board .

\* \* \* \* \*

Based on the documents available to us and some of the transactions described above, the Trustees are concerned that there has been a pattern where fiduciaries of the Foundation have allowed conflicts of interest to taint the Board's grantmaking decisions. In addition to the steps being taken internally to address governance matters, the Trustees hope to address any Chapter 42 violations as soon as possible, so that justice can be served on any wrongdoers and the Foundation can move forward with its important work in the community.

Please do not hesitate to call me (202/862-5020), or my colleague Diara Holmes (202/862-7829) with any questions or comments. We would also be happy to provide any additional background materials or documentation that you may find useful in your own review. Additionally, Denman Kountze and Edward Kountze are willing to meet with your staff in Dallas to answer any questions that may arise. If such a meeting would be useful from your perspective, please contact me or Ms. Holmes.

Sincerely,

Marcus S. Owens

Enclosures

cc: Denman Kountze, Edward Kountze, Neb.AG, NY AG.(William Josephson,Charities Bureau)

May 4, 2004

**VIA FACSIMILE**

Ms. Rosie Johnson  
Director, EO Examinations  
Exempt Organizations Division  
Internal Revenue Service  
1100 Commerce Street  
Dallas, TX 75242

**RE: Gilbert M. and Martha H. Hitchcock Foundation (EIN: 47-6025723)**

Dear Ms. Johnson:

On behalf of the Gilbert M. and Martha H. Hitchcock Foundation (the "Foundation"), I am writing to follow up on the letters we sent you in February and March regarding instances involving potential self-dealing, taxable expenditures and improper governance decisions that warrant the Service's attention. I thought you should be apprised of recent developments in the litigation that have shed additional light on the questionable practices of the Foundation's former Secretary, Thomas Burke. As I explained in my previous correspondence, Mr. Burke apparently exploited his fiduciary roles with respect to both the Foundation and the Stephen Center to steer grant funds for the benefit of his family members.

I recently received a transcript of the TRO hearing involving Mr. Burke which documents his continued claim to the title and functions of Secretary, notwithstanding his removal from that office at the Foundation's annual meeting in 2002. We understand that Mr. Burke has presented bills totaling over \$90,000 for unauthorized legal and administrative services that he allegedly has performed for the Foundation since his resignation. Moreover, he has refused to turn over the Foundation's books and records to the new Secretary, Edward Kountze, pending payment for these services. My clients inform me that some of these "services" have included clandestine meetings with one group of directors and their friends for the express purpose of revising a certain quorum provision of the Bylaws with a view toward effectively ousting a Kountze family member from the Board. In addition to the potential ethical implications of an attorney working

for a sub-group of the Board of his client organization, these unauthorized expenses clearly would not be justifiable expenditures of the Foundation's charitable funds.

I am enclosing the transcript of the TRO hearing for your review. To date, Mr. Burke has not received payment for the excessive amounts billed. However, depending on which group of directors prevails in the current litigation, my clients are concerned that he may succeed in obtaining payment at the Foundation's expense for these questionable bills.

Please feel free to call me (202/862-5020), or my colleague Diara Holmes (202/862-7829) with any questions or comments.

Sincerely,

Marcus S. Owens

Enclosure

cc: Edward Kountze  
Denman Kountze  
Neb.AG  
NYAG  
IRS COMMISSIONER EVERSON



Member Services Center  
15810 Inderola Drive  
Rockville, Maryland  
20855 USA  
**Phone** +1 (301) 530-6500  
**Fax** +1 (301) 530-1516  
**TDD** +1 (301) 530-9759  
[www.goodwill.org](http://www.goodwill.org)

July 6, 2004

The Honorable Charles Grassley  
Chairman, Senate Finance Committee  
219 Dirksen Senate Office Building  
Washington, D.C. 20510

Attention: Mr. Bob Merulla

Dear Chairman Grassley:

Please find enclosed a copy of testimony prepared for the record from Goodwill Industries International, Inc. on the June 22 hearing entitled "Charity Oversight and Reform: Keeping Bad Things from Happening to Charities."

Thank you for your leadership in this area. I can be reached at (240) 333-5331, if we can be of further assistance.

Sincerely,

A handwritten signature in black ink, appearing to read "Lisa P. Kinard".

Lisa P. Kinard  
Director of Public Policy

**Statement of George Kessinger, President/Chief Executive Officer  
Goodwill Industries International, Inc.  
Rockville, Maryland**

**Testimony Before the Senate Finance Committee**

**Hearing on Charity Oversight and Reform**

**June 22, 2004**

Mr. Chairman and members of the committee, thank you for the opportunity to submit testimony for the record on "*Charity Oversight and Reform: Keeping Bad Things from Happening to Charities.*" Goodwill Industries International, Inc., a network of 207 community-based, autonomous organizations, supports responsible fiscal oversight and proposed reforms to the charitable community that would strengthen nonprofit accountability.

**Overview**

For more than a hundred years, Goodwill Industries has been committed to expanding occupational opportunities for individuals who face a variety of obstacles to becoming productive members of the workforce. Goodwill Industries believes that ethics and fiscal management are critical in ensuring the public's trust. We operate more than 1,950 retail stores and an online site to sell donated clothes and other household items to fund our mission.

As a recipient of charitable contributions, Goodwill Industries recognizes its responsibility to ensure that funds received are used to further its mission and to safeguard the assets of the corporation. In 2002, Congress passed the Sarbanes-Oxley Act in response to accounting scandals involving several major corporations. The statute imposes stringent accounting and reporting requirements on publicly traded companies and served as a wake-up call to both nonprofit and publicly traded corporations.

**Sarbanes-Oxley Act of 2002**

The statute strengthens the independence of corporate audit committees; bars companies from purchasing certain services from their outside auditor; requires a Code of Ethics for senior financial officers; and requires a company's Chief Executive Officer and Chief Financial Officer to report to the shareholders and board of directors on the financial statements and internal controls and to file copies of these signed reports with the Securities and Exchange Commissions.

In addition, the Sarbanes-Oxley Act requires companies to disclose all material transactions not included in the company's balance sheet and prohibits personal loans or

other extensions of credit to company directors or executive officers. Two provisions in the statute apply to both publicly traded companies and nonprofits: whistleblower protection and document destruction policies.

Goodwill Industries formed a task force in November 2003 to review the Sarbanes-Oxley Act of 2002, and this task force developed guidelines in the form of a code of ethics on fiscal accountability and management, as well as a code of conduct. Goodwill Industries recognizes that financial reporting and an integrated system of internal controls are key responsibilities of our Chief Executive Officers and Chief Financial Officers. We believe that periodic review of our financial status by our Board of Directors is an essential and integral part of their duties. We further recognize that an annual independent examination and assessment of our finances under the supervision of an audit committee is a key element in maintaining our credibility and ensuring the safeguarding of our assets.

For example, Goodwill Industries reaffirms its responsibility to report the financial position and results of operations and cash flow of the organization in accordance with generally accepted accounting principles to our Audit Committee and Board of Directors at least quarterly. Goodwill Industries will create an integrated system of internal controls designed to provide reasonable assurances that will attain the effectiveness and efficiency of our operations, including the safeguarding of assets; reliable financial statements; and compliance with applicable laws and regulations.

Goodwill Industries developed a set of recommendations closely aligned with the Sarbanes-Oxley Act of 2002, especially where the standards, for example in accounting, could be applied to the nonprofit sector. Although the guidelines are voluntary for our members to adopt, many have already adopted the guidelines and demonstrated a renewed commitment to increased fiscal responsibility. We agree that nonprofits should have a sound conflict of interest policy and that both the Chief Executive Officer and the Chief Financial Officer should sign the Internal Revenue Service Form 990 to attest to the accuracy and completeness of its contents. We also support electronic filing of the 990 form. Our code of ethics includes policies in these areas.

The duty to ensure the public's trust is incumbent upon all charities and nonprofits. Goodwill Industries served 616,000 individuals last year. Donors play a pivotal role in Goodwill Industries' ability to fulfill its mission. More than 84 percent of Goodwill's total revenues are channeled into education and career services, as well as other critical community programs.

#### **Corporate Compliance**

As part of its accreditation process, Goodwill Industries established a corporate compliance program known as CARF. The intent behind corporate compliance is to protect organizations from potential situations of waste, fraud and abuse, either intentional or unintentional, especially if it involves a federal audit or investigation. Specifically, corporate compliance is the sum of all actions, policies, procedures, reviews,

audits, prevention strategies, corrective actions, modifications, staff training efforts, and reporting systems that are developed and implemented by an organization and its employees to detect illegal or unethical activity and/or fraud, waste and abuse.

For Goodwill Industries, the issues around corporate compliance were introduced in the 2003. The Commission on Accreditation of Rehabilitation Facilities (CARF) released a Standards Manual that has become the basis for the accreditation of many of our local Goodwill agencies. Organizations that receive federal funds (either directly or indirectly) must conform to the corporate compliance standards that have been recently implemented through the CARF accreditation process. Corporate compliance is relatively new to community service providers but was developed in response to the Federal Sentencing Reform Act of 1984, which in itself was created in response to the Medicare reimbursement system that has shown to be filled with potential for waste, fraud and abuse.

At this point in time, examples of corporate compliance plans primarily involve the financial aspects of an organization. However, best practices show that compliance issues cross over various disciplines including health and safety, employment, and eligibility determination with respect to funding for service delivery.

During a CARF survey, at a minimum, an organization should address the leadership standards around corporate compliance and show to have the following in place:

- A formal resolution on corporate compliance adopted by the leadership
- Written designation of an individual who is the primary point of contact for monitoring and reporting on matters related to corporate compliance
- Specific procedures that guide personnel in responding to subpoenas, search warrants, investigations and other legal actions
- Initial and ongoing training on billing and coding procedures for staff with these responsibilities.

Other standards that are in line with corporate compliance include the development of policies on waste, fraud, abuse and other wrongdoing including a no reprisal approach for reporting, and finance standards that involve the regular testing of billing and service delivery records. It is important for organizations to link all elements that relate to corporate compliance when developing a program that works effectively for their organization. Along with the CARF accreditation process, Goodwill Industries has developed policies around the Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 has increased our awareness of the critical role fiscal accountability and oversight plays in the governance of our organization. Goodwill Industries adopted regulations outlined for public companies in the Sarbanes-Oxley Act as part of good corporate governance.

### **Conclusion**

The Sarbanes-Oxley Act is not a mandate for nonprofit organizations, but it sets a benchmark for nonprofit organizations to emulate. Sound fiscal policies and internal

controls can help ensure the proper stewardship of donations to the nonprofit sector. At Goodwill Industries we have committed to following these standards.

LAW OFFICE OF  
GREGORY F.W. TODD  
888 SEVENTH AVENUE, SUITE 4500  
NEW YORK, NEW YORK 10106

TELEPHONE: 212-246-5151

FACSIMILE: 212-246-5454  
EMAIL: gtodd@gfwtesq.com

July 2, 2004

Senate Finance Committee  
Editorial and Document Section  
219 Dirksen Senate Office Building  
Room SD-203  
Washington, D.C. 20510-6200

Re: Charity Oversight and Reform - Recommendations

Dear Senate Finance Committee:

I am writing with respect to the Staff Discussions Draft of the Senate Finance Committee, on the oversight of exempt organizations. My recommendations are the result of my involvement for much of 2003 in a lawsuit brought by a subsidiary of a tax-exempt "church".

This letter is divided into two sections, Recommendations and Background, with a series of Appendices. The Recommendations are very brief. The Background is added to illustrate the concerns that underlie the Recommendations. The Committee will note that this section contains a number of statements based upon information and belief, but which have not been proved and which could only be proved on the basis of an IRS audit.

I would ask, accordingly, that this letter not be made public without first blocking out the name of the church and its affiliated persons; while the matters included in this letter are matters of public record, the history of the church and its founder indicates that a very aggressive reprisal campaign might be undertaken against me if the letter were made public.

I. Recommendations

1. The Draft should make clear that churches, as well as other exempt organizations, are included within the scope of entities required to submit to periodic IRS review. The filing of a statement of purpose, articles of incorporation, etc. will not be sufficient; rather, other financial information, and personal affirmations concerning the nature of political

LAW OFFICE OF  
GREGORY F.W. TODD

Senate Finance Committee

July 2, 2004  
page 2

activities, profit-making activities, the absence of private inurement, etc. (along the lines of Sarbanes-Oxley certifications) should be required. Such a reform is suggested by the Committee for organizations required to file Forms 990; the same should apply to churches.

2. Churches should be required to file annual returns with governmental authorities in all cases, contra to the current rules. The wide ambit permitted to churches to engage in non-church activities, and the scope of tele-evangelism and other new media church outreach today (versus the traditional "church", which is limited to a building) means that old ideas concerning the safe purposes of church activities are no longer suitable.

3. If a designated amount of church fund-raising, loans, expenditures or other activities, is dedicated to either business activities or political activities (or, in the alternative, if the church is anything other than a structure-based religious church), then the church information statements should be made available to the general public, as well as to governmental authorities. Disclosing such information to the public will help parishioners understand the workings of their church, and the American public generally in evaluating the compliance of churches, as actually operated, with their stated goals.

4. Churches should be subject to regular audit and to possible revocation of their tax-exempt status, on a retro-active basis. This will encourage compliance by churches with their stated church purposes, and will discourage deviations into the realms of profit-making activities, private enrichment of the ministers, and corruption of the church/state separation doctrine.

5. The Draft suggests a \$10,000 fine for individuals that file a "frivolous" complaint regarding a charity. While we have every reason to discourage frivolous lawsuits and administrative actions, a \$10,000 fine will deter participation by the public in performing a very important compliance function for the US government and taxpayers generally. The amount of the fine should be lowered so that individuals are not intimidated in their efforts to bring appropriate matters to the attention of the government.

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GREGORY F.W. TODD

Senate Finance Committee

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II. Background: The Foundation of Human Understanding

During 2003, I assisted in defending a harassment suit brought by a church-owned talk-radio station against an individual resident of California. The individual was alleged to have posted comments on a website which were critical of one of the radio station's talk-show hosts, known as "Michael Savage", concerning his bigoted views on immigrants, minorities, women, and other groups. See Appendix A for further background.

The church which owns the radio station is called the Foundation of Human Understanding ("FHU"). FHU is involved in numerous profit-making ventures and political activities in and around its home base, in southern Oregon. See list of entities at Appendix B. While these activities seem questionable in themselves for a "church", my information indicates, more importantly, that FHU fails to meet the basic elements of a "church" under the law. Indeed, FHU may now fail even to meet the lesser standards required of a not-for-profit entity. Instead, FHU appears to be engaged solely in activities that enrich its "ministers" (the family of the founder), and that advance the political objectives of the founder through radio and internet media.

A. The failings of FHU as a "church".

I repeat that I am presenting these statements not to have the tax-exempt status of an institution revoked, but to illustrate what might be possible abuses by a church, and so to encourage the Committee to adopt means to reduce such abuse.

The definition of what constitutes a "church" is not an easy matter, particularly in a country that has prided itself on respecting a separation of church and state. Those factors were discussed at some length by the Tax Court in a case which granted tax-exempt "church" status to FHU. See Appendix D for a copy of this case, and a more general statement of elements that determine church status.

"At a minimum," that case found, "a church includes a body of believers or communicants that assembles regularly in order to worship". Besides an established congregation, a church needs an organized ministry, the provision of religious services, and dissemination of a doctrinal code. See Appendix D.

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GREGORY F.W. TODD

Senate Finance Committee

July 2, 2004

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However, if FHU ever had these elements, it appears to have lost them now -- and therefore no longer meets the requirements that conferred the tax-exempt, and non-reporting status, of a church. There is no body of worshippers, no regular assemblies, no organized ministry, no religious services and no doctrinal code.

1. FHU appears to have no church. It sold the building in Grants Pass, Oregon which it had purchased as its church. It will doubtless claim that its "retreat", the so-called Tall Timber Ranch in Selma, Oregon, is now used as a church, but aside from occasional seminars, there appear to be no services offered there. Instead, it appears the Tall Timber Ranch has been used for business activities -- housing the start-up operations of The World Net Daily, a provocative internet site which mixes news, right-wing political editorials, and advertising for religious materials and for the FHU-owned Talk Radio Network. See Appendix C.

2. FHU appears to have no congregation. FHU has always maintained that its "parishioners" are reached by radio. In fact, the religious component of Talk Radio Network's offerings is minimal; Roy Masters, founder of FHU, broadcasts for several hours per day, but often in the dead of night, and these are mostly reruns of earlier shows, which just fill up time on the radio program (see Appendix A-2). The station is otherwise devoted to political commentary, of which the Michael Savage Show, Laura Ingraham and others are the live-wire programs.

3. FHU appears to have no religious services or doctrinal code, and lacks an independent ministry. FHU is not recognized by other Judeo-Christian churches as a Christian "church", for its failure to recognize the divinity of Christ, but rather as a personality cult built around Roy Masters, and his teachings of relaxation and stress relief. The "ministry" of FHU appears comprised exclusively of the family members of Roy Masters. All of these are primarily business people. One of the "ministers", Roy's son Mark Masters, is the "CEO" of the many "Talk Radio" entities. Another of the "ministers", Roy's son David Masters (also known as David Ruben), is reportedly the producer of The Michael Savage Show, a top money-earner for the Talk Radio Network.

B. FHU appears even to fail the requirements of a 501(c)(3).

LAW OFFICE OF  
GREGORY F.W. TODD

Senate Finance Committee

July 2, 2004  
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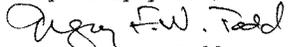
It even appears that FHU today fails to maintain the standards of a tax-exempt organization under section 501(c)(3), let alone a church. A substantial part of its activities (e.g., provision of services to WorldNetDaily, funding of Talk Radio Network), may be attempts to influence political campaigns. Its charitable or church purposes are limited to selling self-help tapes over the website, and running occasional broadcasts by its leader Roy Masters, many of them re-runs, over its controlled radio network(s). See Appendix C-4 for representative pages from WorldNetDaily, which openly attack certain candidates and parties.

A substantial part of its earnings appear to benefit the "ministers" and other individuals, through the extensive operations controlled by FHU or its ministers. See Appendix B-2.

In short, FHU does not appear to be "organized and operated exclusively" for non-profit activities, but rather the contrary.

III. Conclusions.

Churches should be subject to greater scrutiny by the IRS, including increased information filings and regular IRS oversight. Individuals should not be penalized for their efforts to try to bring abuses to the attention of the government.

Very truly yours,  
  
Gregory F.W. Todd

## Appendices

## Appendix A: Talk Radio Network

## Appendix A-1: Talk Radio Network litigation

I spent most of 2003 assisting in the pro bono defense of a California individual who was sued in diversity jurisdiction in Chicago federal court by plaintiff "Talk Radio Network, Inc.," alleged to be an Oregon corporation.

The complaint, filed in May 2003, alleged that defendant had tortiously interfered with plaintiff's advertising for "The Michael Savage Show", on the grounds that a website with which defendant individual was associated made occasional postings to protest the bigoted, racist and sexist statements made by Michael Savage on his show, and encouraging viewers who shared their views to express their opinions to plaintiff's advertisers. That website speech is protected by the First Amendment, and Talk Radio Network's litigation was brought not to win the damages suit, but to attempt to force the individual defendant into settlement. Certain states have enacted statutes to protect against such "strategic litigation against public policy", or SLAAP suits. Illinois had not adopted such a statute, so the litigation could not be easily dismissed in that forum.

In discovery, it transpired that Plaintiff "Talk Radio Network, Inc." (TRN) was an unregistered "doing business" name for "The Original Talk Radio Network, Inc.", an Oregon corporation 100% owned by FHU. We learned also that FHU in turn is owned and controlled by one man, Roy Masters. Members of the family of Mr. Masters are, to my knowledge, the sole "ministers" of this church.

The corporate organization of the "Talk Radio" group of companies turned out to be highly complex, with many such companies sharing similar names, operating from the same address, and under common control of Roy Masters and his son Mark Masters. Such entities were apparently thinly capitalized, operating primarily on the basis of loans from FHU which however appeared to have little prospect of being repaid.

The litigation was concluded in December 2003, when plaintiff filed a motion to withdraw its own complaint. At such time, defendants' motion to dismiss the case was pending in federal district court and defendants' counter-motion to compel jurisdictional discovery on plaintiff in the State of Oregon was pending in that state.

Appendix A-2: Programming schedule, with info on talk show hosts


**Talk Radio Network**
AFFILIATES SCHEDULE  

Friday, Jul 02, 2004



**TRN Updated Schedule as of: Jul 02, 2004**  
**TRN 24 hour Program Schedule Call Toll Free:**  
**888-383-3733**

**LOGI**

Email address: \_\_\_\_\_

Password: \_\_\_\_\_

Forgot your pa  
Trouble Loggin



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**ABC STARGUIDE GE-8 - TRN-1 - Also GE-1**

<b>Mon-Fri</b>						
Laura Ingraham	R	Pacific	5-6am	Eastern	8-9am	
Laura Ingraham	L	Pacific	6-9am	Eastern	9am-Noon	
Roy Masters	L	Pacific	9-11am	Eastern	Noon-2pm	
SAVAGE	R	Pacific	11am-1pm	Eastern	2-4pm	
Rusty Humphries Show	L	Pacific	1-4pm	Eastern	4-7pm	
SAVAGE	L/R	Pacific	4-7pm	Eastern	7-10pm	
Jerry Doyle	L	Pacific	7-10pm	Eastern	10pm-1am	
Jerry Doyle	R	Pacific	10pm-1am	Eastern	1-4am	
Roy Masters (Tue-Sat)	R	Pacific	1-5am	Eastern	4-8am	
<b>Saturdays</b>						
Watchdog on Wall Street	L	Pacific	5-6am	Eastern	8-9am	
The John Bradshaw Layfield Show	L	Pacific	6-8am	Eastern	9-11am	
MotorTrend Magazine	L	Pacific	8-10am	Eastern	11am-1pm	
SAVAGE	R	Pacific	10-1pm	Eastern	1-4pm	
Insights with Barry Farber	L	Pacific	1-2pm	Eastern	4-5pm	
America On Watch	L	Pacific	2-5pm	Eastern	5-8pm	
Saturday Night America	L	Pacific	5-8pm	Eastern	8-11pm	
Jerry Doyle	L	Pacific	8-11pm	Eastern	11pm-2am	
Tammy Bruce	R	Pacific	11pm-2am	Eastern	2am-5am	
<b>Sundays</b>						
Saturday Night America	R	Pacific	2-5am	Eastern	5-8am	
Legends of Success	T	Pacific	5-6am	Eastern	8-9am	
Roy Masters	L	Pacific	6-8am	Eastern	9-11am	
MotorTrend Weekend	L	Pacific	8-10am	Eastern	11am-1pm	
Robert Scott Bell	L	Pacific	10-1pm	Eastern	1-4pm	

**OTHER TRN VOICES**

-  **Barry Farber**
-  **David Horowitz**
-  **Laura Ingraham**
-  **John Resnick**
-  **Roy Masters**

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**“On A listen L**

**NEWSLE**

Get TRN's FRE

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**TRN P**

Has John Kerr defined his po fighting the w

Yes, Clea

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Not At All



Sunday Live w/ Barry Farber	L	1-4pm	4-7pm
Fight Back	L	4-6pm	7-9pm
Tammy Bruce	R	6-9pm	9-Mid
Roy Masters	R	9pm-Mid	Mid-3am
<b>Monday Morning</b>			
Roy Masters	R	Mid-2am	3-5am
Bob Dornan	R	2-5am	5-8am

**WW1 STARGUIDE GE-8 - TRN-2 - Also GE-1**

<b>Mon-Fri</b>		<b>Pacific</b>	<b>Eastern</b>
Laura Ingraham	R	5-6am	8-9am
Laura Ingraham	L	6-9am	9am-Noon
Bob Dornan	L	9-Noon	Noon-1pm
SAVAGE	R	Noon-1pm	3-4pm
Rusty Humphries Show	L	1-4pm	4-7pm
Laura Ingraham	R	4-7pm	7-10pm
Jerry Doyle	L	7-10pm	10am-1am
Roy Masters	R	10pm-2am	1-5am
SAVAGE (Tue-Sat)	R	2-5am	5-8am
<b>Saturdays</b>			
Watchdog on Wall Street	L	5-7am	8-10am
The John Bradshaw Layfield Show	L	6-8am	9-11am
MotorTrend Magazine	L	8-10am	11-1pm
SAVAGE	R	10-1pm	1-4pm
Laura Ingraham	R	1-4pm	4-7pm
Tammy Bruce	L	4-7pm	7-10pm
Saturday Night America	L	7-8pm	10-11pm
Jerry Doyle	L	8-11pm	11pm-2am
Tammy Bruce	R	11pm-2am	2am-5am
<b>Sundays</b>			
Saturday Night America	R	2-5am	5-8am
Legends of Success	T	5-6am	8-9am
Roy Masters	L	6-8am	9-11am
MotorTrend Weekend	L	8-10am	11am-1pm
Robert Scott Bell	L	10-1pm	1-4pm
Sunday Live w/ Barry Farber	L	1-4pm	4-7pm
Laura Ingraham	R	4-7pm	7-10pm
Tammy Bruce	R	7-9pm	10-Mid
Roy Masters	R	9-Mid	Mid-3am

<b>Monday Morning</b>		<b>Pacific</b>	<b>Eastern</b>
Roy Masters	R	Mid-2am	3-5am
SAVAGE	R	2-5am	5-8am

L = Live      R = Refeed      T = Tape (First Airing)

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**Talk Radio Network**
TRN HOSTS  

Friday, Jul 02, 2004

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**Michael Savage**

Author of the best selling book "The Savage Nation" (30 weeks on the New York Times Best Seller List), Michael Savage is the number one drive time talk show host in the San Francisco market and in many other cities across America. He is currently syndicated on over 350 stations.

"I guess people love my show because of my hard edge combined with humor and education," he says. "Those who listen to me say they hear a bit of Plato, Henry Miller, Jack Kerouac, Moses, Jesus, and Frankenstein. I pull many of my life experiences, including that of father, son, husband, brother, ice cream factory worker, busboy, lifeguard, writer, scientist, and my huge library of books," says Savage. Listeners also hear top-flight guests and hear literate callers with intelligence, wit, and energy, a benefit that a program like The Michael Savage Show attracts.

An independent-minded individualist, Michael Savage fits no stereotype. He attacks big government and liberal media bias, but champions the environment and animal rights. Trained as a scientist, he holds Master's degrees in medical botany and medical anthropology and earned his Ph.D. from the University of California at Berkeley in Epidemiology and Nutrition Science. Savage created the phrase "Compassionate Conservative" in 1994. He has used this concept in his radio program and in conducting the first of four hugely successful Compassionate Conservative Conventions bearing that name in 1995. Savage has consistently drawn sold-out audiences to hear him live. For Savage, these words describe a "firewall of balance" that limits how far to the right his opinions go. The word compassion means "with feeling," and that's the magnetic attraction Michael Savage has proven he has by pulling top numbers in one of America's biggest trend-setting markets.

Give your audience a chance to hear why for the past four years Talkers Magazine named Savage as one of America's top talk radio hosts. He knows how to explore issues, entertain, stimulate, and promote in ways that boost the ratings and profits of every station lucky enough to carry him.

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[On Air Listen Live official website](#)

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**Email address**

**Password:**

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Has John Kerr defined his po fighting the w

Yes, Clea

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-  [John "Bradshaw" Layfield](#)
-  [Rusty Humphries](#)
-  [Laura Ingraham](#)
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-  **John "Bradshaw" Layfield**
-  **Dick Marcinko**
-  **Laura Ingraham**
-  **David Horowitz**

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**Roy Masters**

More than a talk host, Roy Masters is also a listen host. He has counseled radio callers since Dr. Laura was in knickers with a unique ability to hear inner problems, heal fears and sexual stresses, and help people take charge of their own lives. From Miami to Los Angeles his show has touched and brought life-changing courage to millions, including such diversely famous fans as the late John Wayne and Internet journalist Matt Drudge.

Roy speaks with the enchanting accent of his British boyhood, and with the crystal clarity and flashing brilliance of the diamonds he polished as a young craftsman. Early on he studied hypnosis, used it to help people overcome their problems, was arrested in Houston for 'diagnosing' without a license, and made headlines when during a few days in jail he led hardened cellmates to change their minds and hearts away from crime.

Roy no longer uses hypnosis because he understands its dark power well. "We need to dehypnotize people under the spell of charlatans, politicians, and authority figures who have programmed them," says Roy. His show helps people understand and reclaim control over their own lives. Millions more have seen or heard Roy Masters on shows such as CNN's "Crossfire," "Sally Jesse Raphael," Fox News Channel's "Drudge Report", Sean Hannity's WABC Show, and CNN's "Larry King Live." Many others have found their lives changed by reading one or more of his 15 best-selling books, which include How Your Mind Can Keep You Well?, Surviving the Comfort Zone, The Hypnosis of Life, The Secret Power of Words, How to Conquer Negative Emotions, and Understanding Sexuality.

America's most beloved radio referee in the battle of the sexes, Roy attracts both men and women with his incisive understanding, clear advice, charming humor, deep passion, bedrock values, and sometimes-shocking honesty and frankness. He has a magnetic gift for attracting and holding listener attention. Give Roy a try and you'll quickly see many new listeners tuning to your spot on the dial.

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**On Air Listen Live**  
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**Laura Ingraham**

Always articulate and entertaining, "The Laura Ingraham Show" has been addicting legions of listeners since her launch into national syndication in 2001. Smart, funny, and ahead of the curve in politics and the culture, Laura's busting down the door of the "boys only" radio club. Her show takes listeners on a wild ride through the colliding worlds of politics, the news media, and Hollywood.

Her legal, political, writing, and television background distinguishes Laura in the field of increasingly homogeneous radio syndication. Whether she's on the watch for evidence of media bias, political hypocrisy or Hollywood inanity, Laura infuses her program with a level of energy and commitment to conservative principles that grabs hold and won't let go.

In addition to hosting her own syndicated radio program, Laura is an author, frequent columnist, and television commentator. Her book *The Hillary Trap*, first released in June 2000, was recently re-released as an updated paperback version. Her latest book, *Shut Up & Sing: How the Elites in Hollywood, Politics...and the UN are Subverting America* (Regnery) is bound to be a bestseller.

Laura worked as a speechwriter in the final two years of the Reagan Administration at the White House, the Department of Transportation and the Department of Education. She went on to graduate from the University of Virginia School of Law, where she was Notes Editor of the Law Review. She served as a law clerk on the U.S. Court of Appeals for the Second Circuit, and then on the Supreme Court of the United States for Justice Clarence Thomas. After clerking, Laura worked as a white-collar criminal defense attorney for Skadden, Arps, Slate, Meagher & Flom. Laura is a graduate of Dartmouth College.

Smart political talk isn't just for the boys anymore. Just say no to stupid radio and get hooked on Laura. It's not just a talk show - It's an addiction.

**OTHER TRN VOICES**

-  **Jerry Doyle**
-  **Michael Savage**
-  **John Resnick**
-  **Rusty Humphries**
-  **Roy Masters**

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- [Robert Scott Bell](#)
- [Tammy Bruce](#)
- [Michael Savage](#)
- [Barry Farber](#)

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**Tammy Bruce**

Best Selling Author, Ms. Bruce is a veteran radio personality, hosting The Tammy Bruce Show in Los Angeles on KFI from 1993-1998. She is also a contributor on the Fox News Channel. Her editorials and commentaries on significant social issues have been published nationally and internationally in a wide variety of magazines, newspapers, and on television and radio. Ms. Bruce's first book, *The New Thought Police*, was published in October 2001. An analysis of freedom of expression and the culture wars, it explores the importance of freedom of expression and personal liberty and how that liberty is under attack by the dangerous rise of Left-wing McCarthyism. Her current book, *The Death of Right and Wrong: Exposing the Left's Assault on Our Culture and Values*, addresses the rise of moral relativism in society and quickly became a New York Times Best Seller. Two years after joining the National Organization for Women, introducing a brand of feminism that places her somewhere between Donna Reed and Thelma and Louise, Ms. Bruce was elected president of the Los Angeles chapter of NOW at the age of 27. The youngest ever to achieve that position, she doubled the chapter's membership from 2,000 to 4,000 within a year with issue campaigns that introduced a fresh view of feminist activism. In her seven years as president (1990-1996, the longest continuous tenure in the chapter's 30 year history) she mobilized activists locally and nationally on a whole range of issues, including women's image in media, child care, health care, violence against women, economics, and domestic violence. Ms. Bruce also served two years as a member of the National NOW board of directors. Tammy Bruce is an openly gay, pro-choice, gun owning, pro-death penalty, voted-for-President Reagan progressive feminist. Ms. Bruce eviscerates the Feminist Elite's hatred of men, marriage and motherhood, the Black Elite's championing of violent rap, the Gay Elite's "grab for children" by insinuating let-it-all-hang-out Sex-Ed programs into schools, the Academic Elite's nihilism and anti-Americanism, and the Entertainment Elite's "moral depravity beyond measure." A native of Los Angeles, Ms. Bruce holds a Bachelor's Degree in Political Science from the University of Southern California. Her most recent public political experience was serving on California Governor Arnold Schwarzenegger's Transition Team. She also notes that her interest in politics and individual liberty was sparked during her childhood in part because of the work of authors Ray Bradbury and George Orwell, both of whom remain her favorite writers.

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**OTHER TRN VOICES**

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-  [Chris Markowski](#)
-  [John Resnick](#)
-  [Barry Farber](#)
-  [Robert Dorman](#)

[More Voices](#)



**Rusty Humphries**

"The Rusty Humphries Show" is a fast-paced, issue-oriented, caller-driven talk show. Rusty's unique talent can make you laugh one minute and cry the next as he challenges his listeners on the hottest topics of the day. His "matter-of-fact" common sense delivery is highly entertaining and informative. Rusty's high-energy and passion transcends the radio and feels as though he is in the same room with you. Talkers magazine has ranked Rusty as the 9th largest show in national syndication. Rusty is now heard from coast to coast on over 200 stations. Rusty has recently been nominated for R&R News/Talk Personality of the Year and for the last five years in a row he has been named to Talkers Magazine's "Heavy 100". Rusty was inducted into the Nevada Broadcasters Hall of Fame as its youngest inductee ever. Rusty combines his unique comic genius with his musical talent to sing and produce some of the best song parodies in the business today. It doesn't matter if it is a Rusty classic or just made up on the spot, the audience loves them. Rusty is not afraid to say what he thinks or how he feels. At an early age, he lost his father in the Vietnam War and has been a passionate supporter of Veterans issues ever since. While Rusty is extremely generous in all his charitable pursuits, he approaches charity as a 'help' for those who truly need it or those that try to help themselves'. He is critical of wasteful government programs and the people that cheat those systems. Listen for Rusty's quick wit and sincere passion as he engages his callers and audience in the hottest conversations of the day.

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Appendix B

Background: Roy Masters, FHU and entities  
controlled by them

Appendix B-1: An email received during the TRN  
litigation, which contains a series of internet-listed items of  
background on Roy Masters and FHU (not independently verified as  
accurate). See also items posted, toward the end, on "New  
Dimensions" magazine.

MSNBC Unwittingly Promoting Dangerous Religious Cult Involved in Exorcisms, Brainwashing, Right-Wing Agenda and Apocalypse.

In their press about their new "Michael Savage" TV show, MSNBC proudly tells you "his radio show airs nationally on the Talk Radio Network."

Yet, MSNBC, an investigative and news gathering organization, WAS NOT SAVVY ENOUGH to research the "Talk Radio Network" and find out that it is owned and operated by a dangerous religious cult in Southern Oregon, which is using Savage as a mouthpiece for their agenda.

Michael Savage's radio show was given a national platform by Talk Radio Network based in Southern Oregon. Talk Radio Network [www.talkradionetwork.com](http://www.talkradionetwork.com) is OWNED and OPERATED by cult leader Roy Masters, his family and their Foundation of Human Understanding [www.fhu.com](http://www.fhu.com)

Roy Master has spent over 40 years daily spewing hate against Women, Gays, the Government and Liberals on radio stations on which he has purchased time (KRLA in Los Angeles for example) and through his Talk Radio Network. He spent the late 70's, complete 80's and most of the 90's talking about the Apocalypse that was forthcoming in America--and that the only safe place to be was with him--in Grants Pass, Oregon.

He spent thousands of hours in 1999 talking about the end of America as we know it because of the "Y2K" plot." This included an appearance on Fox News in which he warned of the upcoming takeover by the government which would use Y2K as an excuse to take away all American's liberties.

For many years, Roy Masters and his family published an extreme right-wing magazine called "New Dimensions" which Masters blames the liberal media for destroying.

Where do you think Michael Savage got his act from? Savage is a dedicated follower of Roy Masters.

In the late 70's, 80's and 90's, Roy Masters told listeners that "the world would be ending soon" and they must "come to Grants Pass, Oregon...the only place safe from nuclear fallout."

<http://www.watchman.org/cults/newdimen.htm>

<http://www.watchman.org/cults/roymstrs.htm>

Thousands followed Roy Masters and his family to Grants Pass, Oregon which also operated a religious retreat where cult members could work free for the organization.

-----

In 1991, after two men kidnapped their own children to get them away from their "evil Mothers" (based on Masters' diatribes)...CBS News "48 Hours" did a one-hour story of the mothers' search for their children and the influence of Roy Masters on the fathers.

-----

In 1999, TV's news magazine "Extra" did this report:

Former relative denounces Grants Pass evangelist

Spiritual leader Roy Masters' ex-daughter-in-law will accuse him on national TV of violence against her and her daughters

Sunday February 28, 1999

>From The Associated Press

MEDFORD -- The former daughter-in-law of conservative Grants Pass spiritual leader Roy Masters is about to accuse him on national television of violence against her and her daughters.

A Los Angeles producer says Lisa Masters of Grants Pass is scheduled to appear Thursday on "Extra," a nationally syndicated news show.

"I just want people to know he's dangerous," Lisa Masters said in her home last week. "I just thought, 'I know a lot about this man; I'll just turn around and let him have it.' "

Lisa Masters told "Extra" producer Frank Snepp that the controversial radio personality punched her once while she was married to his son, David Masters, and that Roy Masters slapped her daughters in 1997 while they visited his home.

She said she considered the incidents consistent with what she says is a long history of Masters' denigration of women. "He's said on the radio there's a time women have to be restrained and even slapped," she said.

Snepp said that he talked to both Roy and David Masters on the phone during two visits to Grants Pass but that neither would let him put them on camera. Roy Masters declined to be interviewed by the Medford Mail-Tribune. David Masters was out of town.

Roy Masters' spokeswoman, his daughter, Dianne Masters, 42, said the radio personality denies Lisa Masters' charges.

"She's a disgruntled wife," Dianne Masters said Thursday. "She's using every possible way of getting back at her husband and my dad."

Snepp said Roy and David Masters backed out of an

interview with "Extra."

Roy Masters is a radio preacher and former professional hypnotist who moved to the United States from England in 1949. His real name was Reuben Obermeister.

He moved to Josephine County from Southern California 20 years ago. Estimates of the number of supporters of his Foundation for Human Understanding in Josephine County range from 1,500 to several thousand. Many moved there after Masters told listeners to move to Southern Oregon to escape what he said was the inevitable collapse of a sick society.

-----  
 THIS IS A DANGEROUS CULT. There was a 5-part series on the cult in the Grants Pass (Oregon) Daily Courier from 1991, a story in the Los Angeles Times where Masters calls himself "the closest thing on earth to Jesus," and it goes on and on.

These are the people that decided to give Michael Savage a national radio platform--so they could get their views out through him.

-----  
 Cult Periodical: New Dimensions - A Masters' Magazine

NOTE: Roy Masters' magazine, New Dimension, stopped publishing in 1994. To this day, he speaks glowingly about his magazine and says that the mass media "conspired to put it out of business." This is an older article from the web during its existence.

A funny side note: When "60 Minutes" commentator Andy Rooney found out that his written column had been syndicated to the magazine (without his knowledge), he was outraged and renounced any association with the magazine and the organization behind it.

The Washington Times, Insight (Unification Church), World Monitor (Christian Science), are not the only quality conservative publications owned by the cults.

New Dimensions is a slick and staunchly conservative magazine which sports frequent syndicated articles by Cal Thomas, Phyllis Schlafly, Pat Buchanan, Jeane Kilpatrick, William Safire and William F. Buckley, Jr. It has also received the endorsement of Concerned Women of America.

There is another name whose articles also appear in every issue. That name is Roy Masters. Masters is the controversial leader of the new age meditation and mind control cult, the Foundation of Human Understanding (FHU). The by-line of each of Master's articles states that he is "an internationally recognized expert on stress management."

Masters operates his church of several thousand, many of whom moved with Masters, along with the magazine to Grants Pass, Oregon. He also maintains a syndicated radio program, How Your Mind Can Keep You Well which airs on a number of stations around the country.

Like the Baghwan Rajneesh, Masters has been the center of controversy with the law and with his neighbors. Salvation and successful living in the FHU is obtained through new age meditation, tuning in to the direction from your own "intuition" which he calls "Reality" consciousness, the "Light," and "Truth within" (Introduction to Meditation, FHU, 1981, p. 3).

Masters typical approach at his gatherings is to engage in hypnosis/meditation exercises with his followers who he jokingly calls "Roybots." He then performs "exorcisms" by touching people on the forehead with a wooden cross.

He normally castigates, insults, and ridicules his listeners in a domineering controlling manner. Masters says "I could get people to die for me any day. I've got more power over people than Adolph Hitler and Jim Jones combined, because I'm smarter. I know how to push people's buttons" (Los Angeles Times, 12/3/78).

Master's meditation exercises, reproduced on three cassette tapes and a book, are classic progressive relaxation techniques which are standard hypnosis/meditation induction methods. This state leaves a person highly suggestible, with difficulty in distinguishing between reality and fantasy.

In a 1984 interview with US magazine, Masters said, "I am a man without sin... I bring out the evil alien force that controls people."

The public relations department of New Dimension claims that Masters sued US magazine and won but Watchman Fellowship has discovered that US was sold to Rolling Stone magazine and the lawsuit was negated (data sheet from the Cult Awareness Network).

The US article goes on to quote Masters, "I'd like to earn a reputation so I'm remembered in the same breath as Moses, Jesus the Apostles, Buddha, Gandhi, Martin Luther King, and John F. Kennedy" (US, 4/23/84, p. 41).

Besides having a different God, different Jesus, different gospel, and having a controlling, authoritative leader, the FHU also displays other cultic characteristics. A cult often uses deception and duplicity, with hidden agendas.

The public relations office of New Dimensions is communicating that the magazine has no connection with FHU, that the editor, Mark Masters, does not agree with his father, it is owned by Publishers Press, and that the only connection Roy Masters has is that he

donated the seed money which is being paid back (telephone conversation with WLBF).

When checking on the validity of this information, it was discovered that Publishers Press had no phone number. Its average monthly 110,000 copies are actually published in a two-story house next to FHU's church building (Washington Post, 11/29/90, p. 9).

In addition, New Dimensions assumed its new name in 1986 from what was formerly the Iconoclast, the official publication of FHU.

New Dimensions itself was listed as "a monthly publication of the Foundation of Human Understanding" as late as the June 1988 issue.

Mark and David Masters have certainly been active members of FHU as they have been part of numerous lawsuits with the "church." The December 1990 issue has its mandatory legal notice buried in the back in fine print which lists FHU as the only major stockholder of New Dimensions.

The question remains for Christians whether or not they want to participate with cult enterprises.

To paraphrase what Jesus prayed to the Father, we are not to be taken out of the world but are to be protected while in the world. We must be salt and light while involved in the arenas of life.

But as John Lofton of the Conservative Digest stated, "Masters is a false prophet and theological fraud" and was critical of Christians who embraced the magazine (Ibid).

Christians must decide if the end of getting out our conservative message justifies the means, furthering the influence and platform of a destructive cult.

---

Roy Masters-linked "New Dimensions" Magazine Draws Fire

A conservative news magazine is under fire across the U.S. due to its links with controversial religious leader Roy Masters.

The monthly magazine, New Dimensions, is also increasingly finding its way into the hands of politically conservative evangelical Christians, as its publishers have been giving away free ads to conservative groups, according to the January 1991 Cult Awareness Network News. In an apparent push to thrust the magazine into the mainstream, thousands of free copies are being regularly passed out, with many evangelical pastors receiving them.

What many don't yet know is that the magazine is

loaded with advertisements and propaganda for Master's Foundation of Human Understanding, which has long been considered a pseudo-Christian sect by experts, including the Christian Research Institute (CRI). Walter Martin's *The New Cults*, published in 1980 in collaboration with the CRI research staff, concludes: "The basic doctrines and many of the practices of Roy Masters and the Foundation of Human Understanding are decidedly not Christian. They are certainly not in harmony with what God has revealed to us in the Bible" (p. 317).

A recent issue of the magazine had three full-page ads either promoting Masters's nationwide radio program, "How Your Mind Can Keep You Well," or booklets his organization sells.

Spokesmen for New Dimensions have claimed no official connection with Masters or the Foundation. However, Masters is listed in the magazine's "staffbox" as a "contributing writer" along with conservatives Cal Thomas and Patrick Buchanan. Editor-in-chief is Mark Masters and the art director is David Masters, both sons of Roy Masters.

Despite the denials, the Watchman Fellowship's (a Christian countercult group) Craig Branch has pointed out that prior to 1986 the magazine, under the name the *Iconoclast*, was the official publication of the Foundation. And as late as the June 1988 issue it was listed as "a monthly publication" of the organization. Moreover, in the mandatory legal notice buried in the back of the December 1990 issue, Masters's Foundation is listed as the "only major stockholder of New Dimensions" (*Watchman Expositor* 8:6 [1991], pp. 8, 10).

New Dimensions has a listed address in Grants Pass, Oregon (the same community Masters moved to from the Los Angeles area with many members), and according to the November 29, 1990 *Washington Post*, the magazine is published in a house next to the Foundation's church building.

The magazine regularly features leading conservatives as contributing writers. But now with publicized allegations that New Dimensions is merely a front for Masters's organization, or at best a public relations tool in the same vein as the Unification Church-owned *Washington Times*, some leading voices have been trying to distance themselves from the magazine.

According to the January 1991 *Cult Awareness Network News*, after CBS commentator Andy Rooney learned that his column was running in the magazine, he insisted it be withdrawn.

Others have been critical of Christians associating themselves with the magazine due to Masters's heretical view of Christ, and his open antagonism toward Christians. In the previously mentioned issue of the *Washington Post*, John Lofton of the *Conservative Digest* criticized Christians promoting New Dimensions because, as he put it, Masters is "a false prophet and theological fraud."

However, in a telephone interview with the *CHRISTIAN RESEARCH JOURNAL*, Christian columnist/commentator Cal Thomas said it was not that simple -- he didn't know

he was listed as a "contributing writer" for the magazine.

"I have no special relationship with them and no agreement with them," Thomas said. "In fact, I've never even corresponded with those people."

Thomas said his syndicated column is managed by the Los Angeles Times Syndicate. Only recently did he find out that New Dimensions is one of many publications that purchases his column. "I saw the name New Dimensions on my royalty statement," he said, adding that he didn't at first know what it was. Thomas added that his listing as a "contributing writer" might be misleading since most "contributing writers" are in steady communication with their publications.

At the core of Masters's sect, which was founded in 1960, is a reliance on meditation, yoga, and hypnotism mixed with many Eastern concepts. Although he claims to be a mystical Christian he rejects the central doctrine of Christianity -- Christ's death on the cross as atonement for sin.

For a short time there was a dialogue between Walter Martin and Masters. CRI continues to offer a two-cassette tape of Martin debating Masters live on the "Bible Answer Man" program.

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QUOTES FROM ROY MASTERS:

"WOMEN ARE THE CAUSE OF ALL THE MISERY AND SUFFERING ON EARTH"

"THE DOWNFALL OF AMERICA BEGAN WHEN WOMEN GOT THE VOTE"

"PRINCESS DIANA IS A WHORE"

"THE MORE EDUCATED YOU ARE, THE MORE PERVERSE YOU BECOME"

"ALL DEMOCRATS ARE COMMUNISTS"

"I HAVE NEVER BEEN WRONG IN 40 YEARS"

"THIS NATION IS DEGENERATING INTO A BUNCH OF PIGS. AMERICANS ARE SELF-SATISFIED IN THEIR OWN SWILL,"

"I AM ASHAMED TO BE AN AMERICAN"

Who does this sound like to you???

---

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Appendix B-2:

List of entities from Oregon Secretary of State  
owned or controlled by FHU or Masters family

[partial listing; excludes entities nominally controlled by other  
Masters family members with different last names, and certain  
other Talk Radio Network or Masters-related individuals]

Business Name	First Name	Last Name	Address	City	State
BROADCAST COMMUNICATIONS INCORPORATED	ANN	MASTERS	7911 UPPER DEER CRK	SELMA	OR
COBBLESTONE MOBIL HOME PARK	ANN	MASTERS	307 NELSON WAY	GRANTS PASS	OR
CORNERSTONE BOOKS, INC.	ANN	MASTERS	7911 DEER CREEK RD	SELMA	OR
FOUNDATION PUBLISHING COMPANY	ANN	MASTERS	307 NELSON WAY	GRANTS PASS	OR
FRIENDS OF LIFE, INC.	ANN	MASTERS	2900 DEER CREEK RD.	SELMA	OR
PACIFIC NORTHWEST FACTORY MALLS MANAGEMENT CORP.	ANN	MASTERS	307 NELSON WAY	GRANTS PASS	OR
SHINON ENTERPRISES, INC.	ANN	MASTERS	307 NELSON WAY	GRANTS PASS	OR
THE FOUNDATION OF HUMAN UNDERSTANDING	ANN	MASTERS	307 NELSON WAY	GRANTS PASS	OR
FIRST AMENDMENT FOUNDATION, INC.	ANN	MASTERS	744 PINE ST	CENTRAL POINT	OR
LIGHT HOUSE COMMUNICATIONS	DAVID	MASTERS	2021 DEER CREEK RD	SELMA	OR
LIGHT HOUSE COMMUNICATIONS	DAVID	MASTERS	2021 DEER CREEK RD	SELMA	OR
LIGHTHOUSE COMMUNICATIONS	DAVID	MASTERS	2021 DEER DREEK RD	SELMA	OR
LIGHTHOUSE COMMUNICATIONS	DAVID	MASTERS	2214 JUDY LN	GRANTS PASS	OR
THE HUNGRY MIND, INC.	DAVID	MASTERS	2023 DEER CREEK RD	SELMA	OR
WILDERNESS ENTERTAINMENT CO	DAVID	MASTERS	2021 DEER CREEK RD	SELMA	OR
WILDERNESS ENTERTAINMENT CO	DAVID	MASTERS	2021 DEER CREEK RD	SELMA	OR
DIAMANT & MASTERS, INC.	MARK	MASTERS	2900 DEER CREEK RD	SELMA	OR
DIGITAL MEDIA INTERNATIONAL, INC.	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
DIGITAL MEDIA INTERNATIONAL, INC.	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
ERA PRESTIGE HOMES II, INC.	MARK	MASTERS	2220 JUDY LANE	GRANTS PASS	OR
FOUNTAINHEAD RADIO PROGRAMS, LLC	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
JENTESH, INC.	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
NEW DIMENSIONS PUBLISHING CO., INC.	MARK	MASTERS	874 NE 7TH ST	GRANTS PASS	OR
NEW DIMENSIONS PUBLISHING CO., INC.	MARK	MASTERS	874 NE 7TH ST	GRANTS PASS	OR
PACIFIC NORTHWEST FACTORY MALLS MANAGEMENT CORP.	MARK	MASTERS	250 ERIC WAY	GRANTS PASS	OR
PACIFIC RIM TECHNOLOGIES, INC.	MARK	MASTERS	PO BOX 1130	GRANTS PASS	OR
PRESTIGE HOMES II, INC.	MARK	MASTERS	761 NW BELLEVUE	GRANTS PASS	OR
REAL MONEY, COINS AND BULLION, INCORPORATED	MARK	MASTERS	2900 VEER CREEK RD.	SELMA	OR
RIVER CITY RESOURCES, LLC	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
TALK RADIO GROUP, LLC	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
TALK RADIO NETWORK, LLC	MARK	MASTERS	225 NE HILLCREST DRIVE	GRANTS PASS	OR
TALK RADIO SYNDICATION SERVICES, LLC	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
THE ORIGINAL TALK RADIO NETWORK, INC.	MARK	MASTERS	225 NE HILLCREST DR	GRANTS PASS	OR
BROOKHURST P.U.D., LLC	MARK	MASTERS	PO BOX 3755	CENTRAL POINT	OR
DIAMANT & MASTERS, INC.	MICHAEL	MASTERS	206 NE 7TH ST	GRANTS PASS	OR
ERA PRESTIGE HOMES	MICHAEL	MASTERS	2900 DEER CREEK RD	SELMA	OR
ERA PRESTIGE HOMES	MICHAEL	MASTERS	PO BOX 1130	GRANTS PASS	OR
ERA PRESTIGE HOMES II, INC.	MICHAEL	MASTERS	201 WEST 6TH ST	MEDFORD	OR
ERA PRESTIGE HOMES II, INC.	MICHAEL	MASTERS	205 CLASSICK DR	ROGUE RIVER	OR

ERA PRESTIGE HOMES II, INC.	MICHAEL	MASTERS	197 SARADAN LANE	GRANTS PASS	OR
ERA PRESTIGE HOMES REAL ESTATE COMPANY	MICHAEL	MASTERS	PO BOX 1030	GRANTS PASS	OR
ERA PRESTIGE PROPERTIES, INC.	MICHAEL	MASTERS	201 W 6TH ST	MEDFORD	OR
ERA PRESTIGE PROPERTIES, INC.	MICHAEL	MASTERS	201 W 6TH ST	MEDFORD	OR
FOREST HILLS LLC	MICHAEL	MASTERS	206 NE 7TH ST	GRANTS PASS	OR
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NEW DIMENSIONS PUBLISHING CO., INC.	MICHAEL	MASTERS	874 NE 7TH ST	GRANTS PASS	OR
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PRESTIGE HOMES REAL ESTATE CO.	MICHAEL	MASTERS	164 TEEL LN	GRANTS PASS	OR
PRESTIGE HOMES REAL ESTATE CO.	MICHAEL	MASTERS	164 TEEL LN	GRANTS PASS	OR
PRESTIGE HOMES REALTY & CONSTRUCTION	MICHAEL	MASTERS	PO BOX 1130	GRANTS PASS	OR
PRESTIGE HOMES REALTY & CONSTRUCTION	MICHAEL	MASTERS	206 NE 7TH	GRANTS PASS	OR
PRESTIGIOUS HOMES BUILDING & DEVELOPMENT CO.	MICHAEL	MASTERS	P O BOX 1030	GRANTS PASS	OR
PRESTIGIOUS HOMES BUILDING & DEVELOPMENT CO.	MICHAEL	MASTERS	206 NE 7TH	GRANTS PASS	OR
SPIRIT WOLF RANCH	MICHAEL	MASTERS	272 RIDGE RD	NORTH BEND	OR
THE VIDEO STATION	MICHAEL	MASTERS	164 TEEL LN	GRANTS PASS	OR
THE VIDEO STATION	MICHAEL	MASTERS	164 TEEL LN	GRANTS PASS	OR
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THREE RIVERS MORTGAGE, INC.	MICHAEL	MASTERS	130 NE F STREET	GRANTS PASS	OR
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CORNERSTONE BOOKS, INC.	ROY	MASTERS	7911 DEER CREEK ROAD	SELMA	OR
CORNERSTONE BOOKS, INC.	ROY	MASTERS	7911 DEER CREEK RD	SELMA	OR
COUNTRY VIEW MOBILE PARK	ROY	MASTERS	PO BOX 1000	GRANTS PASS	OR
FOUNDATION PUBLISHING COMPANY	ROY	MASTERS	307 NELSON WAY	GRANTS PASS	OR
FOUNDATION PUBLISHING COMPANY	ROY	MASTERS	307 NELSON WAY	GRANTS PASS	OR
FRIENDS OF LIFE, INC.	ROY	MASTERS	2900 DEER CREEK RD	SELMA	OR
FRIENDS OF LIFE, INC.	ROY	MASTERS	2900 DEER CREEK RD.	SELMA	OR
QUEST PRODUCTIONS, INC.	ROY	MASTERS	923 ROSE VALLEY DR	CENTRAL POINT	OR
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SHINON ENTERPRISES, INC.	ROY	MASTERS	307 NELSON WAY	GRANTS PASS	OR
THE COBBELSTONE MOBIL HOME PARK	ROY	MASTERS	607 NELSON WAY	GRANTS PASS	OR
THE FINISH LINE CAR WASH & EXPRESS DETAILING	ROY	MASTERS	1134 COURT	MEDFORD	OR
THE FOUNDATION OF HUMAN UNDERSTANDING	ROY	MASTERS	307 NELSON WAY	GRANTS PASS	OR

## Appendix C: World Net Daily

## Appendix C-1: Background on World Net Daily

WorldNetDaily (www.worldnetdaily.com), headed by Joe Farah, gives its address as PO Box 1087, Grants Pass, Oregon. Grants Pass is the headquarters for the many Talk Radio Network entities, and nearby Selma, Oregon is Tall Timber Ranch, the seminar "retreat" of FHU.

In the course of discovery, I found an internet posting in which an individual recounted his interview for a position as a website programmer for WorldNetDaily, on the grounds of Tall Timber Ranch. See Appendix C-2. This is corroborated by a 1999 posting from the WorldNetDaily itself which states that its "new headquarters is in Selma, Oregon". Appendix C-3.

If WorldNetDaily has operated from the Tall Timber Ranch, this shows that FHU has made its assets available to further the overtly political agenda of WorldNetDaily. See e.g. the printout of July 2, 2004 for WorldNetDaily, attached as Appendix C-4. A related question is to what extent church monies have been made available for this purpose.

FHU's interest in WorldNetDaily is consistent with its sponsorship of the political agenda magazine "New Dimensions" during the 1990's. See discussion in emails attached as Appendix B-1.

Appendix C-2: Internet posting re: WorldNetDaily  
activities conducted at Tall Timber Ranch

Can the New World Order be far away? - www.czboard.com wysiwyg://216/http://216.239.41.10...+Masters&hl=en&lr=lang\_en&ie=UTF-8

Posts: 67

(6/22/02 11:19:58 AM)

[Reply](#)

Yea they do good work!

The far-right rag World Net Daily exposes its anti-Semitic leanings with an ignorant 'how the Jews were responsible for the 9/11 attacks... of course they're 'just reportin' "right"...

'Why can't Americans talk about these suspicions? Game'a explains: "When I asked they had the courage to talk about it openly, they said, "We can't." I asked why, and know very well that the Zionists control everything and that they also control politic decision-making, the big media organizations and the financial and economic institut daring to say a word is considered an anti-Semite."

World Net Daily is a web based newspaper, at <http://www.wnd.com>. Officially it is h Cave Junction, but in reality it's offices and webmasters work from buildings and tra Tall Timber Ranch, located outside Selma. Recently the web-paper advertise webmaster/editors and this writer applied for the job. I was interviewed fir director Mark Vanderbilt and a few other webmasters under his supervision. interviewed by Peter Dingledey who is ceo of the virtual paper.

During the course of the interview I was lied to twice by Dingledey. The firs stated that WND does not endorse any political party. But out in the parking the company van, with a huge Bush-Cheney sign on the side. Well, endorsin not endorsing a party, so maybe that wasn't a lie. His second whopper was that WND endorses no religion. In fact, two books have been offered on thei is a book about how evolutionary scientists have lied to us for years. The ot how our founding fathers were Christians. In fact fundamentalist. Interesti are outright attacks on other religions by their columnist

As it turns out Tall Timber Ranch is owned by the Foundation of Human Und which is the disinformation arm of RoyMasters ministry. Apparently WorldN the propaganda arm of the cult. Did I say cult? Roy is well known in the Gra as being a master of hynosis and mind control. His minions, known as "Roy bit as brainwashed as any Moony is said to be.

The "paper" is subtle. It's fanatical far-right message is hidden enough so t reader may not pick up on it right away, but all of it's articles and news stor in a particular way, a way designed to promote the facist agenda of Roy Mas cult.

Edited by: Prisoner at: 6/22/02 11:21:46am

[<< Prev Topic](#)

Oregon Appendix C-3: Web posting re: headquarters in Selma,

WorldNetDaily

FRIDAY  
OCTOBER 1  
1999



**SHE MARRIED HIM??!!  
AND THEYVE GOT 7 KIDS??**  
clasmates.com



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A CHILD TODAY!  
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### World's 'No. 1 website' goes for-profit Starting today, WND is 'out of begging business'

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- ShopNetDaily
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- BizNetDaily
- LocalNetDaily
- Commentary
- Classified Ads
- Letters
- People Search
- Health
- Weather
- TV Guide
- MusicNetDaily
- Movies
- Stocks

Beginning today, WorldNetDaily.com, voted the most popular website on the Internet the last 23 weeks, is officially a for-profit corporation, completing its transition from being an operation of the non-profit Western Journalism Center, announced Chief Executive Officer and Editor Joseph Farah.

The new company, WorldNetDaily.com, Inc., a subsidiary of Western Journalism Center, launches the independent operation today with an editorial staff of 12, and plans for major expansion as a news agency and information provider.

While Western Journalism Center remains headquartered in Fair Oaks, Calif., WorldNetDaily.com's new headquarters is in Selma, Oregon, with plans for future offices in the Silicon Valley, Washington, D.C., and elsewhere.

"We believe WorldNetDaily.com could only truly reach its potential as one of the leading news providers on the Internet and in other media through this process," explained Farah, the founder of both Western Journalism Center and WorldNetDaily.com. "That could not happen while WND was operating as part of a non-profit entity and in the tax-exempt, charitable realm."

Farah previously served as editor-in-chief of the Sacramento Union, the oldest daily in the West, as executive editor of daily and weekly newspapers in Southern California and as executive news editor of the Los Angeles Herald Examiner. He is an author, daily columnist and the recipient of awards for reporting, journalistic integrity, headline writing and newspaper design.

Also leading the new corporation is Chief Operating Officer Pete Dingledey, a Harvard MBA with over 30 years of management and administrative experience. He is a retired Naval Reserve Supply Corps captain and has consulted to numerous commercial and government agencies.

Chief Technology Officer Bob Evans was the founder of Autotalk Inc., International Teletext Communications Inc., MediaCity World Inc. and has been responsible for wiring entire countries to the Internet. He remains chief technology officer for the ISP Channel in

#### WND Today's highlights

#### NEWS:

Pastors seek sermon insurance for hate-crime law

Ashcroft: Tougher Patriot Act needed

Grateful Iraqis thank America for sacrifice

Yossef Bodansky on Farah show

Islamists kidnap Christian girl to force conversion

Mideast 'indifferent' to Sudan massacre

56% in Lebanon want Syrians out

Federal court backs public nativity scene

Mosquito plague spreads to 4 more states

Hillary: We'll take your money for 'common good'

Porn wins in free-speech Internet battle

#### COMMENTARY:

When the drug war ends  
By Joseph Farah

HA  
Selma,  
Oregon

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Keep abreast of Christian persecution

the Silicon Valley.

The most immediate and visible change on the website resulting from this corporate reorganization is a new WorldNetDaily.com storefront. You can still make tax-deductible contributions to the Western Journalism Center at the old storefront.

"There will be many other exciting innovations coming to readers of WorldNetDaily.com in the weeks and months ahead," said Farah. "We'll have some important announcements and new features very soon."

WorldNetDaily.com has been voted the "most popular website on the Internet" for the last 23 straight weeks on [WorldCharts.com](#), an independent, weekly Internet survey.

**2 lazy 2 teach**  
By Michelle Malkin

**Michael Moore: The Dems' David Duke**  
By Hugh Hewitt

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**WorldNetDaily**

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Daily Appendix C-4: Representative web pages from World Net



### Moore claims victory over 'Passion of Christ' BREAKING!

--WND Exclusive--



A Free Press  
For A Free People  
Founded 1997

FRIDAY, JULY 2, 2004

# WorldNetDaily

Morning Edition

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The  
definitive  
expose  
of a  
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contender

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- MusicNetDaily
- Movies
- Stocks

whietlahinuuor

WorldNetDaily

## Marlon Brando dead at age 80 BREAKING!

Considered greatest living actor  
by many of his Hollywood peers

--WND



**THE NEW WORLD DISORDER**

WorldNetDaily

### UN observers requested for U.S. election BREAKING!

Congress members send letter to Secretary General Annan  
--WND

**HOMELAND INSECURITY**

WorldNetDaily Exclusive

### Pakistan to protest new security rules BREAKING!

Top diplomat: Terror camps don't exist, Islamabad doing more than U.S. Army  
--WND

**GEOSTRATEGY-DIRECT INTELLIGENCE BRIEF**

WorldNetDaily

### Bin Laden focusing on U.S. elections BREAKING!

Close aides say next campaign to 'malign' Tony Blair



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Other News Services  
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Media  
Entertainment

**WND FORUMS:**

WND Daily Poll  
Mr. President!  
Operation Spike!

Today's American Minute

**The Clinton conspiracy to muzzle internet journalists**

--WND

**FBI urges increased vigilance for July 4 BREAKING!**

Intelligence indicates al-Qaida wants to strike this summer or fall  
--Associated Press

**Could terror attack cancel Election Day?**

Federal voting official seeks process for stopping, rescheduling balloting  
--Detroit Free Press

**WND BOOKS**

*WorldNetDaily Exclusive*

**The real Kerry: Flip-flops, payoffs, tax hikes, lies**

Former congressional investigator's blockbuster uncovers shocking facts  
--WND

**SPECIAL OFFER**

*WorldNetDaily*

**Divine intervention sought in presidential race**

Get FREE copy of 'We Will Pray for Election Day' blockbuster  
--WND

**OPERATION: IRAQI FREEDOM**

*WorldNetDaily*

**Saddam's chemical weapons found by Polish troops**

Rumsfeld informed at NATO summit of discovery of undeclared WMD  
--WND

**Official: Terrorists nearly got WMD BREAKING!**

Polish troops reportedly recovered chemical weapons  
--Associated Press

**WND POLL**

**Eureka ... maybe**

What constitutes 'finding weapons of mass destruction in Iraq'?  
--WND

**Rockets fired at Baghdad hotels BREAKING!**

Minor damage, attacks come as Jordan says it will send troops  
--Associated Press

**Defiant Saddam admits nothing in court**

Insists he still be referred to as 'president of the Republic of Iraq'  
--Associated Press

**WHISTLEBLOWER MAGAZINE**

*WorldNetDaily Exclusive*

**The role of Iraq, Israel, USA in Bible prophecy**

Limited time, get Michael Evans' stunning bestseller 'Beyond Iraq' FREE!

**How Clinton's national security policy set the stage for 9/11**



**Contact WND**

**Who's Who at WND**

**See Columnists**

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--WND

**GLOBAL INSECURITY**  
*WorldNetDaily Exclusive*

**Police searching for 'next Mohammed Atta'**

Central America on alert for FBI 'top 5' terror suspect  
--WND

**NEWS ANALYSIS**

*WorldNetDaily Exclusive*

**Central American terrorists – what's going on? **BREAKING!****

Questions remain over Honduras sightings of 'next Mohammed Atta'  
--WND

**SPECIAL OFFER**

**Clinton's devastating 'Intelligence Failure'**

How he undermined America's defense and paved the way for 9-11  
--ShopNetDaily

**TROUBLE IN THE HOLY LAND**

*WorldNetDaily Exclusive*

**Israel debating response to terror-rocket threat **BREAKING!****

Security walls keeping out suicide bombers, but new jihad tactic emerging  
--WND

**SPECIAL OFFERS**

**'From Time Immemorial'**

Most powerful, acclaimed book on 'Arab-Jewish conflict over Palestine'  
--ShopNetDaily

**'Chilling' DVD documents jihad as never before**

Now available! 'Relentless: The Struggle For Peace in the Middle East'  
--ShopNetDaily

**TECHNETDAILY**

*WorldNetDaily Exclusive*

**Israeli invention sees through walls **BREAKING!****

Important uses for military, rescue operations  
--WND

**WorldNetDaily Commentary**

**Important message to readers on WND's future**

Exclusive: David Kupelian reveals how top newsite plans to stay free  
--WND

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to the  
Oklahoma  
City  
bombing**

**Get Fit Fast  
Master  
Your Own  
Bodyweight**

**Filth, fraud, fascism: Exposing 'The Party of Treason'**

How Democrats corrupt morals, steal elections, aid enemies  
--WND

**MINORITY REPORT**

**Cosby: Stop blaming 'the white man'** **BREAKING!**  
Delivers harsh words to blacks at Jesse Jackson event  
--CNSNews.com

**SPECIAL OFFERS**

**'Revolve: The Complete New Testament' for teen girls**  
Formatted like a modern magazine, this popular Bible is bursting with life  
--ShopNetDaily

**'Refuel: The Complete New Testament' for teen guys**  
A 'totally cool' new way for adolescent males to read the Word of God  
--ShopNetDaily

**ATTENTION WorldNetDaily READERS...  
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**Colin Powell performs Y-M-C-A** **BREAKING!**  
Entertains delegates at Asia security meeting  
--Associated Press

**PHOTONETDAILY**

**See Powell's Village People rendition** **BREAKING!**  
Performs at Asia meeting's traditional skit, song night  
--Associated Press

**MEDIA MATTERS  
WorldNetDaily Exclusive**

**Moore's film gets rave -- from Communists** **BREAKING!**  
Stalinist Reds love 'Fahrenheit 9/11'; Maoists love it, too  
--WND

**Glickman named to head Hollywood lobby**  
Former agriculture secretary under Clinton replaces Jack Valenti  
--Associated Press

**SPECIAL OFFER**

**Unite with the right!**  
Click to learn how you can take 3 conservative books for \$1 each  
--Conservative Book Club

**ELECTION 2004**



Who's this Pop Diva?

- ◊ Jennifer Lopez
- ◊ Britney Spears
- ◊ Christina Aguilera

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**Kerry cited in Catholic heresy case** BREAKING!

Accused of 'scandal' for taking Communion as pro-choice Catholic  
--Washington Times

**WorldNetDaily**

**Fed supports money laundering?** BREAKING!

Bulk supplies of cash abroad go mostly to criminals  
--WND/Insight

**SPECIAL OFFER**

**Buy 'Enemy Within,' get 'Savage Nation' FREE!**

For limited time, get No. 1 New York Times best seller as WND's gift!  
--WND

**LIFE WITH BIG BROTHER**

**Hand scanners to keep tabs on students**

Teacher: 'My kids ... think it's so high-tech, so FBI, so cool'  
--South Florida Sun-Sentinel

**Car computer to stop you speeding**

Global-positioning satellite identifies local limit, warns driver  
--London Times

**SPECIAL OFFER**

**Keep your PC in tune**

Eliminate harmful files that slow performance with the PC PowerScan!  
--Intrigue Learning

**THEIR GOVERNMENT AT WORK**

**WorldNetDaily**

**Town to hire 'condom coordinator'** BREAKING!

Duty is to provide local teens with contraceptives  
--WND

**WorldNetDaily Exclusive**

**John Stossel: 'Scourge of the liberal media'**

Get freedom-loving reporter's 'Give me a Break' autographed!  
--WND

**WND AT THE WHITE HOUSE**

**WorldNetDaily Exclusive**

**Kerry campaign staff 'small-minded'?**

Spokesman asked about recent comments by East Coast mayors  
--WND

**SPECIAL OFFER**

**John Kerry's health-care proposals flatline**

Read how medical model hurts business, get free preview  
--Business Reform Magazine

**WHEN THE EARTH MOVES****Earthquake kills 18, injures 27 in Turkey** BREAKING!

Heavy damage reported in village near Iranian border  
--Associated Press

**WND ON THE AIR****WorldNetDaily****'Ron Brown's Body' No. 5 on black best-seller list**

Jack Cashill to discuss on C-Span book shunned by major media  
--WND

**SPECIAL OFFER****What, or who, really killed Ron Brown?**

Sensational new WND book shows 'how one man's death saved the Clinton presidency'  
--ShopNetDaily

**BIZNETDAILY****Unemployment rate holds steady in June** BREAKING!

Payroll increase was 10th straight month of gains  
--Associated Press

**SPECIAL OFFERS****Golden security**

Experts pick gold in an era of war, terror and global competition  
--Lear Financial

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--Investing Systems Inc.

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**PAGE 2 NEWS HIGHLIGHTS**

- Fed-up Nevada county reconsiders its brothels
- New rule lets juries ask own questions

Click here for these stories, much more  
--WND

**BIZNETDAILY HIGHLIGHTS**

- Day-of-rest statute worries employers

• [Time Warner gathers forces for MGM bid](#)

Click for stories from the financial sector  
--WND

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**WND.COMMENTARY HIGHLIGHTS**

- ['Michael Moore's daring film' By Bill Press](#)
- ['The Bushophobes need therapy' By David Limbaugh](#)

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--WND

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Savage Appendix C-5: Cross-links between WND, TRN and Michael

WorldNetDaily

TUESDAY  
MAY 4  
2004

What's your real IQ? Take a free IQ test and find out now!  
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WORLDNETDAILY

Joseph Farah's  
**G2 Bulletin**  
Know the news before it's news. SUBSCRIBE TODAY

**MEDIA MATTERS**  
**Savage show upgrades timeslot**  
Talker's popular program moves 1 hour earlier

Posted: May 4, 2004  
1:00 a.m. Eastern

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The company that syndicates nationwide talk-radio host Michael Savage's daily program has upgraded the show's timeslot, moving it one hour earlier.

According to a statement from **Talk Radio Network**, stations many major radio markets, including New York and San Francisco, requested "The Savage Nation" be broadcast earlier in the day.

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[www.lowrateadvisors.com](http://www.lowrateadvisors.com)

Those stations wishing to keep Savage's show at the original time can still do so.

"I am extremely excited about upgrading Michael's timeslot and being able to continue to provide a separate feed for those stations that prefer the existing slot," said **Mark Masters, CEO of Talk Radio**

**WND Today's highlights**  
**NEWS:**

- Kerry aide: Cheney coaching president**
- Baptist call to action: Pull kids out of school**
- Use of 'uppers' gains among preschoolers**
- Prince blames Saudi attack on 'Zionism'**
- Leapin' lizards! Live frog served in airline salad**
- POW/MIA expert on Farah show**
- Savage show upgrades timeslot**
- Protesters answer anti-American sign**
- Repentant 'Passion' viewer still pleads not**

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Network.

**PC PowerScan**

The show began its new schedule yesterday. It now is aired live Monday through Friday from 3 p.m. to 6 p.m. Pacific, 6 p.m. to 9 p.m. Eastern. The existing 4 p.m. to 7 p.m. Pacific feed will remain available for affiliates who cannot or choose not to move the show. The first two hours of the original feed will be live with the third hour consisting of a tape delay from the first hour's program. "The Savage Nation" is currently being heard on over 350 stations nationwide. He draws between 8-10 million listeners per week.

"This move comes after four years of showing consistent, high octane rating performance from coast to coast. Michael is just now hitting his stride," said Masters. "An earlier timeslot, especially on the East Coast, will expose a whole new potential audience to Michael's dynamic intellectual range that consistently keeps listeners coming back for more."

guilty

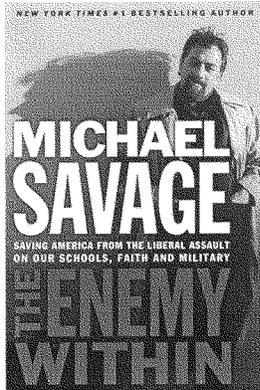
**Look who's teaching Johnny about Islam**

**COMMENTARY:**

**Drafting women**  
By Joseph Farah

**Coaching for life**  
By Rebecca Hagelin

**Liberalism, Kerry's wartime handicap**  
By David Limbaugh



Savage's latest book, "The Enemy Within," published by WND Books, has showed consistent staying power since being released, making the New York Times

best-sellers list for 12 weeks.

"The Enemy Within," subtitled "Saving America from the Liberal Assault on Our Schools, Faith and Military," is available autographed exclusively at WorldNetDaily's online store, and unsigned copies are available there below Amazon's discounted price.

In his follow-up to "[The Savage Nation](#)," the talk-radio sensation again goes for the jugular in a brash, incendiary attack on the corrosive effects of liberalism on American culture. Where "[The Savage Nation](#)" dealt with many topics, "[The Enemy Within](#)" focuses squarely on the dangers assailing the cornerstones of American life, pointing out how liberal propaganda and agendas are seeping into America's churches, schools, even its families.

Purchase "[The Enemy Within](#)" - signed by the author or unsigned - and, for a limited time, get a FREE copy of Savage's previous book, "[The Savage Nation](#)."

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## Appendix D: What is a church?

## Appendix D-1: Defining "Church" - The concept of a Congregation

**A. DEFINING "CHURCH" - THE CONCEPT OF A CONGREGATION**

by

Robert Louthian and Thomas Miller

"The term "church" is intended to be synonymous with the terms "denomination" or "sect" rather than to be used in the universal sense."

"... [T]he word "church" implies that an otherwise qualified organization *bring people together as the principle (sic) means* of accomplishing its exempt purpose. The objects of such gatherings need not be conversion to a particular faith or segment of a faith nor the propagation of the views of a particular denomination or sect." (Emphasis supplied.)

"To be a "church" a religious organization must engage in the administration of sacerdotal functions and the conduct of religious worship in accordance with the tenets and practices of a particular religious body."

**1. Introduction**

The interesting thing about these three definitions is not that they differ, but that they are from the same court case. In Chapman v. Commissioner, 48 T.C. 358 (1967), three Tax Court judges agreed that an organization was not a church within the meaning of IRC 170(b)(1)(A)(i), but could not agree why. The majority opinion, which contained the first quote, and two separate concurring opinions, each emphasized a different characteristic of the word "church."

The judges in Chapman were not unique, for the meaning and scope of the term "church" have puzzled the Service, courts, and scholars since Congress excepted churches from the newly imposed unrelated business income tax in the Revenue Act of 1950. The task was not made easier as subsequent acts added provisions that distinguish churches from other religious organizations, but do not define "church." See various articles in the Exempt Organizations CPE texts from the 1978 EO ATRI at 1, to the 1992 CPE at 1. In addition, for an in-depth discussion of the history of the term "church" in the Code, see Whalen, "Church" in the Internal Revenue Code: The Definitional Problems, 45 Fordham L. Rev. 885 (1977).

This article will discuss the method used to define "church," focusing on one aspect: the concept of a congregation. Because of the nature of the term, however, it is impossible to discuss a component factor in a vacuum.

## 2. The Fourteen (or Fifteen) Points

In making the required distinctions between churches and religious organizations that are not churches, the Service has followed the basic principles set out in De La Salle Institute v. United States, 195 F. Supp. 891 (N.D. Cal. 1961). In that case the court, in deciding that a religious order operating schools and a novitiate was not exempt from unrelated business income tax on its winery, stated, at 903, that in the absence of a statutory definition of "church," we should apply "the common meaning and usage of the word."

To apply the "common meaning and usage" of the word "church," the Service attempted to identify historically or judicially recognized objective characteristics of churches. The result was the so-called "fourteen points test," which was later expanded to include a fifteenth criterion - any other facts and circumstances. The word "test" is misleading, as there is no minimum number of criteria an organization must meet to be classified as a church. Rather, the criteria serve as a guide to assist case-by-case analysis.

In applying the analysis to determine whether a religious organization may properly be characterized as a church, the Service considers whether the organization has the following characteristics: (a) a distinct legal existence, (b) a recognized creed and form of worship, (c) a definite and distinct ecclesiastical government, (d) a formal code of doctrine and discipline, (e) a distinct religious history, (f) a membership not associated with any other church or denomination, (g) an organization of ordained ministers, (h) ordained ministers selected after completing prescribed studies, (i) a literature of its own, (j) established places of worship, (k) regular congregations, (l) regular religious services, (m) Sunday schools for religious instruction of the young, (n) schools for the preparation of its ministers, and (o) any other facts and circumstances that may bear upon the organization's claim for church status. See IRM 7(10)69, Exempt Organizations Examination Guidelines Handbook, text 321.3(3).

The fifteen criteria are not an attempt to quantify the factual circumstances required for recognition as a church. Determinations are not made solely on the number of characteristics an organization possesses. Given the variety of religious

practice, the determination of what constitutes a church is inherently unquantifiable. Attempts to use a dogmatic numerical approach might unconstitutionally favor established churches at the expense of newer, less traditional institutions.

### 3. The Concept of a Congregation as an Important Criterion

Although no court has specifically adopted the fourteen points test, many have used the criteria in rulings. One criterion that consistently appears is the presence (or absence) of a regular congregation. The most frequently cited case is American Guidance Foundation, Inc. v. United States, 490 F.Supp. 304 (1980). In that case, the court, after acknowledging the fourteen points test as a useful guide, stated that "[a]t a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship." Id. at 306.

In Spiritual Outreach Society v. Commissioner, 927 F.2d 335 (8th Cir. 1991), the court concluded that the organization was admittedly engaged in religious activity and possessed some of the fourteen criteria discussed in American Guidance Foundation v. United States, supra. The court noted that of central importance is, inter alia, the existence of an established congregation served by an organized ministry. The facts failed to show that the participants in the organization's activities considered it their church. Thus, the participants did not form a congregation.

In Church of Eternal Life and Liberty, Inc. v. Commissioner, 86 T.C. 916, 924 (1986), the Tax Court defined a church, for IRC 170(b)(1)(A)(i) purposes, as "a coherent group of individuals and families that join together to accomplish the religious purposes of mutually held beliefs." In other words, according to the Tax Court, a church's principal means of accomplishing its religious purposes must be to assemble regularly a group of individuals related by common worship and faith.

Although the exact origin of this "associational" or "societal" component is unknown, courts have given it great weight in determining if an organization should be classified as a church. Judge Tannenwald, in a concurring opinion in Chapman v. Commissioner, supra, viewed it as an essential criterion. He stated that religious purposes

"... may be accomplished individually and privately in the sense that oral manifestation is not necessary, but it may not be accomplished in physical solitude. A man may, of course, pray alone,

but, in such case, though his house may be a castle, it is not a church. Similarly, an organization engaged in an evangelical activity exclusively through the mails would not be a church." Chapman v. Commissioner, supra at 367.

#### 4. What is a Congregation?

##### A. Historical View

Given the importance of a congregation, the next issue is what constitutes a congregation. The concept of "congregation" implies that there are persons that associate for some kind of religious services. This requires consideration of both the number of persons involved and the form in which they associate.

Case law is lacking on the issue of the number of people needed to constitute a congregation, but available precedent suggests size is less important than activity. In cases involving organizations with few members, courts have avoided the issue of congregation size by basing their decision on private benefit or inurement. For example, in Unitary Mission Church of Long Island v. Commissioner, 74 T.C. 507 (1980), aff'd, 670 F.2d 104 (9th Cir. 1981), the Tax Court, confronted with a "family" church that had been denied exemption, held that the denial was proper because of the private benefit and inurement to the organization's controlling members. In note 5 of the opinion, the court stated that because the case was decided on other grounds, the court did not have to address whether the organization was entitled to recognition as a church.

Likewise, the courts in The Basic Unit Ministry of Alma Karl Schurig v. Commissioner, 511 F.Supp. 166 (D.D.C. 1981), aff'd per curiam, 670 F.2d 1210 (CA DC 1982) and Bubbling Well Church of Universal Love, Inc. v. Commissioner, 670 F.2d 104 (D.D.C. 1981), both based their decisions on the private benefit/inurement issue and, therefore, avoided having to determine whether the organizations were churches. In Church By Mail v. United States, 88-2 USTC 9625 (D.D.C. 1988), the district court stated that the organization had no congregation in the sense of a regular gathering of worshipers, but avoided the church classification issue by ruling that the organization's net earnings inured to private shareholders and was, therefore, not exempt.

In The Church of Eternal Life and Liberty, Inc. v. Commissioner, supra, the Tax Court found that a two-person congregation did not satisfy the "threshold test" for church status, the associational role. The determining factor was not that its

congregation had only two members, but that it had not increased in size since its inception and, in fact, made no attempts to attract new members. The court stated

"[w]hile incipient churches may have only two or three gathered together, a church membership will grow well beyond those small numbers given the vitality of its associational role. Petitioner, by contrast, seems to have intentionally pursued a policy that discouraged membership for reasons, we believe, that served the private purposes of its founder." *Id.* at 924-25.

Thus, the fact a church may be small does not preclude it from receiving church recognition. The inquiry must continue to determine whether the organization is attempting to attract new members or, in some cases, whether the organization prevents new memberships. If the organization limits its size, a determination whether private purposes are being served must be made. If no private purposes are being served, the organization may qualify as a church based on the facts and circumstances.

Determining whether a congregation exists also requires considering the form in which members associate. The concept of a congregation does not require that members meet regularly for prescribed religious services. For example, churches in some religions do not hold group services, but serve as quiet refuges where members come for individual reflection and prayer. Their membership can constitute a congregation for purposes of the Internal Revenue Code just as surely as a membership that assembles at least weekly for group services led by a minister. However, the concept implies that the membership, whatever the size, have some religious bond and some element of continuity. Usually in addition to individual practices, members participate in mutual ceremonies, observances, and celebrations important to their religion. In *Spiritual Outreach Society v. Commissioner*, *supra*, this element was found lacking where there was no evidence that participants considered themselves part of a congregation.

The issue of whether an organization has a congregation has been raised with respect to evangelistic organizations, and most recently by evangelistic organizations that carry on radio or television ministries. The Service traditionally classified evangelistic organizations as publicly supported organizations under IRC 170(b)(1)(A)(vi) rather than churches under IRC 170(b)(1)(A)(i) because the organizations engaged in short-term revivals or crusades intended to supplement and reinforce, not replace, the activities of local churches. An evangelistic organization usually did not maintain a regular and continuing program in the

localities it visited.

Recent years have seen a change in the classification of many evangelistic organizations. This change has been caused not by a change in Service position, but by evolving changes in the structure and activities of evangelistic organizations. Once purely "itinerant" organizations have built permanent churches from which they now broadcast their services. Many of these organizations are devoting more time to local church activities and, in many cases, have developed an established congregation that attends regular religious services.

Merely carrying on incidental "church activities" should not justify classifying a religious organization that is otherwise engaged in "non-church" activities as a "church" under IRC 170(b)(1)(A)(i). This was considered in De La Salle Institute v. United States, *supra*, in which the court proffered one of the most often quoted phrases in this area. When confronted with an organization that conducted church activities as an incidental part of its overall activities, the court, in holding that the organization was not a church, stated that "the tail cannot be permitted to wag the dog." Whether an activity is a "tail," a "dog," or something in between is a question of fact.

#### B. Media Ministries

One kind of religious organization that is difficult to analyze under the facts and circumstances test is the television (or radio) ministry. Where media evangelism was once merely an extension of a church or of a non-church religious organization, and did not serve to change the character of the organization, recent years have seen the growth of organizations whose primary purpose is broadcasting religious programming. These raise the issue whether a congregation must be physically present.

When confronted with this factual scenario, keep the basic principles in mind. Not only must an organization seeking church status have religious purposes, but the Tax Court has held that the principal means of accomplishing its religious purposes must be to assemble regularly a group of individuals related by common worship and faith. Church of Eternal Life and Liberty, Inc. v. Commissioner, *supra*, at 924. In order to receive recognition as a church, the facts and circumstances must show that the primary focus of or purpose towards which the organization's activities are directed is the promulgation of its religious beliefs and doctrines through a congregation. *See* G.C.M. 38982 (May 3, 1983). The fact that a small part of an organization's activities may constitute a church will not

allow the organization as a whole to be recognized as a church if its principle means of accomplishing its religious purposes is the dissemination of its message on the airwaves or through the publication of literature.

In Foundation of Human Understanding v. Commissioner, 88 T.C. 1341 (1987), the Tax Court was faced with an organization that was once purely evangelistic, but, over time, had built a church building and now served a regular congregation of between 50-350 persons. The broadcasting activities of the organization continued to reach approximately 2 million persons, of which 30,000 were regular listeners. In addition to the broadcasting activities, the organization produced a publication with 5,200 subscribers and an estimated readership of 15,000. Broadcasting activities represented approximately 50 percent of the organization's total expenses. The amount of income attributable to the broadcasting activities was not available because the organization combined the contributions from the radio listeners with that of the congregation. The court was troubled with the amount of broadcasting activities conducted by the organization, but ruled that a congregation of between 50-350 persons could not be considered incidental. Therefore, despite the substantial broadcasting activities, the court held that the organization was a church. [In a dissenting opinion, one judge, citing Church of Eternal Life and Liberty, Inc., *supra*, at 4, wrote that because the principal means of spreading the organization's beliefs was through broadcasting activities, it was not entitled to church status.] Although the Service agreed with the court's understanding of the law in Foundation of Human Understanding, *supra*, it disagreed with the application of the facts and, therefore, acquiesced "in result only" with respect to the church issue in A.O.D., Foundation of Human Understanding, 1987-2 C.B. 1.

Realizing the importance of having a congregation, organizations tend to include every person who has a potential tie to the organization as being a member of the congregation. For example, organizations that broadcast their religious services often include their employees in calculating the number of members in the congregation. Radio ministers and televangelists often include their radio and television audiences in the calculation of how many members are in their congregation. The inclusion of such persons in an organization's estimation of the size of its congregations should not be interpreted as an attempt at deceiving the agent or determination specialist. Many radio ministers and televangelists truly consider these persons as part of their congregation. However, for purposes of determining whether an organization is a church for federal income tax purposes, these people are not to be considered as part of the congregation. For although they may be listening to the message via electronic media or present in the room

because of their employment, they do not represent a coherent group of individuals and families that join together to accomplish the religious purposes of mutually held beliefs. Church of Eternal Life and Liberty, Inc. v. Commissioner, supra. It is this community of people that embodies the concept of a congregation.

##### 5. Summary

The presence or absence of a congregation is a key factor in analyzing whether an organization should be classified as a church. In looking for a congregation, the central focus is whether the organization's membership is a coherent group of individuals or families that join together to accomplish religious purposes or shared beliefs. The size of the congregation is less important than its dynamic. An organization with few current members that is actively seeking to convert new members should not be denied church classification solely on the grounds that its membership does not constitute a congregation. However, a very small membership that is not seeking to grow may not only be cause to question whether the organization should be classified as a church, it may also indicate the presence of inurement that would disqualify the organization from exemption. Another consideration is the manner in which the claimed congregation participates. Although it is not essential that a regular congregation come together for services, purely passive participation, for example through television or mail, is not the manner of participation commonly characteristic of a congregation.

Appendix D-2: Foundation of Human Understanding v.  
Commissioner, 88 T.C. 1341 (1987)

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Citation: 88 t.c. 1341

88 T.C. 1341, \*; 1987 U.S. Tax Ct. LEXIS 75, \*\*;  
88 T.C. No. 75

Foundation of Human Understanding, Petitioner v. Commissioner of Internal Revenue,  
Respondent

Docket No. 10431-83X

UNITED STATES TAX COURT

88 T.C. 1341; 1987 U.S. Tax Ct. LEXIS 75; 88 T.C. No. 75

May 19, 1987.  
May 19, 1987, Filed

**DISPOSITION: [\*\*1]**

*Decision will be entered for the petitioner.*

**CASE SUMMARY**

**PROCEDURAL POSTURE:** Petitioner religious organization challenged the determination of respondent Commissioner of Internal Revenue that petitioner was not a "church" within the meaning of I.R.C. § 170(b)(1)(A)(i).

**OVERVIEW:** Responder Commissioner of Internal Revenue determined that petitioner religious organization was not a church and petitioner challenged that determination. The court found petitioner was a church. The court found that there was an actual controversy involving a determination made by the Commissioner under I.R.C. § 7428 (a), and the court therefore had jurisdiction to review the determination. The court found that the term "church" was not defined in the Internal Revenue Code. The court held that for a religious organization to be classified as a church under the Code, the court had to look to its religious purposes and, particularly, the means by which its religious purposes were accomplished. The court did not adopt the test used by the IRS for organizations to qualify as a church but the court found the test helpful. The court held petitioner satisfied most of the criteria which were considered to be of central importance and that based on all the facts and circumstances, petitioner was a church within the meaning of I.R.C. § 170(b)(1)(A)(i).

**OUTCOME:** The court decided for petitioner religious organization and held that petitioner qualified as a church under the Internal Revenue Code.

**CORE TERMS:** church, religious, classification, nonprivate, organization described, actual controversy, declaratory judgment, exempt, qualification, exemption, religious organization, followers, educational, publicly, regular, plurality, qualify, classified, adverse determination, declaratory, favorable, meditation, worship, radio, tax-exempt, congregation, public support, associational, declaration, Tax Reform Act

**LexisNexis(TM) HEADNOTES - Core Concepts - ♦ Hide Concepts**

 Tax Law > Federal Tax Administration & Procedure > Tax Court (IRC secs. 7441-7491)  
**HN1** ♦ The I.R.C. § 7428 authorizes review by the court and other courts in an actual controversy involving a determination (or the failure to make a determination) by

the Commissioner of Internal Revenue with respect to the initial classification or continuing classification of an organization as (1) an organization described in I.R.C. § 501(c)(3) or I.R.C. § 170(c)(2), (2) a private foundation as defined in I.R.C. § 509(a), or a private operating foundation as defined in I.R.C. § 4942(j)(3) and I.R.C. § 7428(a).

 Tax Law > Federal Tax Administration & Procedure > Tax Court (IRC secs. 7441-7491)  
**HN2**  The focus of the court's inquiry in declaratory judgment actions under I.R.C. § 7428 is whether the administrative determination of the Commissioner is correct. For this purpose, the court assumes that all facts contained in the administrative record are true. The role of the court in declaratory judgment actions is to resolve disputes as to the legal issues raised by the Commissioner's denial of an exemption ruling on the basis of uninvestigated statements of facts submitted by the taxpayer in its ruling request and related papers. The burden of proof is on petitioner.

 Tax Law > Federal Taxpayer Groups > Exempt Organizations > Conditions & Restrictions (IRC 501-505, 521, 526-530)  
**HN3**  The term "church" is not defined in the Internal Revenue Code.

 Tax Law > Federal Taxpayer Groups > Exempt Organizations > Conditions & Restrictions (IRC 501-505, 521, 526-530)  
**HN4**  Although every church may be a religious organization, not every religious organization is a church. To classify a religious organization as a church under the Internal Revenue Code, the court should look to its religious purposes and, particularly, the means by which its religious purposes are accomplished.

 Tax Law > Federal Taxpayer Groups > Exempt Organizations > Conditions & Restrictions (IRC 501-505, 521, 526-530)  
**HN5**  Although the criteria developed by the Internal Revenue Service are helpful in deciding what is essentially a fact question, whether petitioner is a church, the court does not adopt them as a test.

◆ Show Headnotes

**COUNSEL:** *Joel R. Bryan*, for the petitioner. [**\*\*2**]

*Joan R. Domike*, for the respondent.

**JUDGES:** *Goffe, Judge. Sterrett, Simpson, Nims, Shields, Clapp, and Parr, JJ.*, agree with the majority opinion on the jurisdictional issue. *Nims, Parker, Whitaker, Korner, Shields, Hamblen, Cohen, Clapp, Swift, Jacobs, Wright, and Parr, JJ.*, agree with the majority opinion on the substantive issue. *Wells, J.*, concurs in the result only on the substantive issue. *Gerber, J.*, did not participate in the consideration of this opinion. *Whitaker, J.*, concurring. *Korner and Cohen, JJ.*, agree with this concurring opinion. *Simpson, J.*, dissenting in part. *Sterrett, Chief Judge*, agrees with this dissent. *Chabot, J.*, dissenting. *Parker, J.*, agrees with this dissent. *Williams, J.*, dissenting. *Hamblen, Swift, Jacobs, Wright, and Wells, JJ.*, agree with this dissent.

**OPINIONBY:** GOFFE

**OPINION:** [**\*1341**] OPINION

In 1965, the Internal Revenue Service issued a ruling letter which recognized that petitioner is exempt from Federal income tax as an organization described [**\*1342**] in section 501(c)(3).

n1 The Commissioner subsequently recognized petitioner as a nonprivate foundation because petitioner satisfied the requirements **【\*\*3】** of a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi). Petitioner later requested a ruling to modify its exemption so that it would be recognized as a nonprivate foundation under section 509(a)(1) because it is a "church" within the meaning of section 170(b)(1)(A)(i). The Commissioner determined that petitioner is not a church, but this determination did not affect petitioner's exemption as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi). Petitioner has challenged the determination of the Commissioner by invoking the jurisdiction of this Court for declaratory judgment pursuant to section 7428. The issue for decision is whether petitioner is a "church" within the meaning of section 170(b)(1)(A)(i).

-----Footnotes-----

n1 All section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

-----End Footnotes-----

This proceeding was submitted fully stipulated under Rule **【\*\*4】** 122. Pursuant to Rule 217, the parties filed the administrative record along with a joint original and a supplemental stipulation as to its contents. n2

-----Footnotes-----

n2 Pursuant to Rule 217, we also granted petitioner's motion to admit certain documentary evidence not found in the administrative record.

-----End Footnotes-----

The Foundation of Human Understanding (petitioner) was established in 1961 by Roy Masters as the organizational vehicle whereby his doctrine concerning meditation, salvation, emotional self-control, and man's relation to God could be spread to the world. Roy Masters has summarized his beliefs, which are based upon Judeo-Christian principles, as follows: "man is a fallen being, and hence is subject to his emotions. Through meditation and faith in Christ, it is possible for man to gain control of his emotions, to become self-disciplined, and hence a disciple of Christ." In this regard, Roy Masters has developed a particular form of meditation that is used by his followers.

On January 15, 1963, Roy Masters, Ann Masters, his wife, **【\*\*5】** and Patrick C. Shields executed articles of association whereby petitioner became a nonprofit, unincorporated association organized for religious purposes under the laws of California. On May 27, 1963, petitioner was incorporated **【\*1343】** under the nonprofit corporation law of California. The original directors were Roy Masters, Ann Masters, and John Brill. The articles of incorporation stated that the purposes for which petitioner was formed were "the promulgation of the religious, charitable, scientific, literary and educational aspects of mind over matter and spiritual health known as psychocatalysis."

On March 31, 1964, petitioner filed Form 1023, Exemption Application, requesting recognition of exemption from Federal income tax under section 501(c)(3). On December 20, 1965, the Commissioner recognized petitioner's exemption in a determination letter that characterized petitioner's purposes as religious and educational.

On August 17, 1970, petitioner filed with the IRS Form 4653, Notification Concerning Foundation Status, on which petitioner gave notice that it was not a private foundation. An organization filing Form 4653 is required to indicate the basis for its nonprivate **【\*\*6】**

foundation status. Petitioner indicated that it was a nonprivate foundation because it was a church under sections 509(a)(1) and 170(b)(1)(A)(i), and "An organization that normally receives no more than 1/3 of its support from gross investment income and more than 1/3 of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions \* \* \*. Section 509(a)(2)." Despite the fact that petitioner indicated that it was a nonprivate foundation as a church under sections 509(a)(1) and 170(b)(1)(A)(i) and as an organization described in section 509(a)(2), IRS personnel noted on Form 4653 that petitioner was "An organization that normally receives a substantial part of its support from a Governmental unit or from the general public. Section 170(b)(1)(A)(vi)." Subsequently, by a letter dated October 20, 1970, the IRS informed petitioner that "Based on the information you recently submitted, we have classified you as an organization that is not a private foundation as defined in section 509(a) of the Internal Revenue Code." The letter did not inform petitioner that its nonprivate foundation status was based upon a determination that petitioner **\*\*\*7** was a publicly supported organization under sections 509(a)(1) and 170(b)(1)(A)(vi), instead of a church under sections 509(a)(1) and 170(b)(1)(A)(i).

**\*\*\*1344** On May 15, 1972, the purpose clause of the articles of incorporation of petitioner was amended to indicate that petitioner was a church. Counsel for petitioner mailed the amendment to the articles of incorporation to the District Director of Internal Revenue. Thereupon, counsel for petitioner notified petitioner that "The Foundation is now a church."

As a result of the advice of counsel, petitioner believed that all steps necessary to change the nature of its exemption to that of a church had been completed. Accordingly, petitioner did not file information returns for the years 1973 through 1978. Ultimately, representatives of the IRS informed petitioner that it was not recognized as a church and that a formal application for such recognition would be necessary. Consequently, in 1979 petitioner prepared and filed Forms 990, Return of Organization Exempt from Income Tax, for the years 1973 through 1978 and requested a ruling that it was a church.

Although no formal application for a ruling that it qualified as a church **\*\*\*8** for Federal tax purposes appears in the record, the record clearly demonstrates that petitioner's request for church status was placed under consideration by the District Director. On August 14, 1979, petitioner complied with the request of the District Director for additional information upon which to base a determination of exempt status.

On September 12, 1979, petitioner again amended its articles of incorporation to include a charitable dedication provision and to amend its purposes and powers to read as follows:

(a) Purposes of the corporation:

The sole purpose for which this church is formed is the promulgation of the religious, charitable, scientific, and literary and educational aspects of the theological concepts upon which this church was founded and is organized and operated exclusively for religious purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1954.

(b) Powers of the corporation:

The general power of this church is to engage in any activity which is in furtherance of the above-stated specific purpose.

Petitioner's application was subsequently referred to the Exempt Organizations Division of the IRS National Office. **\*\*\*1345** On January **\*\*\*9** 14, 1980, Roy Masters participated in a meeting in Washington, D.C., with IRS representatives regarding petitioner's exemption application. On March 13, 1980, the Commissioner issued an adverse determination letter denying petitioner's application to have its exemption classification modified to that of a church under sections 509(a)(1) and 170(b)(1)(A)(i).

On February 10, 1981, petitioner commenced an action in U.S. District Court for the Central District of California seeking declaratory relief from the adverse determination of the Commissioner. By agreement with the Assistant U.S. Attorney, the Department of Justice, and the Office of the Chief Counsel of the IRS, petitioner agreed to dismiss the District Court suit without prejudice and requested a rehearing on its church status with the Exempt Organizations Division of the IRS National Office. On November 12, 1982, the Commissioner issued an adverse determination letter pursuant to the rehearing in which the Commissioner again refused to modify the nonprivate foundation status from that of a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi) to that of a church described in sections 509(a)(1) [\*\*10] and 170(b)(1)(A)(i). Following a protest filed by petitioner, the Commissioner issued a final adverse determination letter on February 23, 1983.

At about the time petitioner was formed, Roy Masters, using his own resources, began purchasing radio air time to present a program entitled "A Moment of Truth" during which he preached concerning his doctrine. Masters also began conducting discussion and teaching groups to educate people about his doctrine and meditation technique. After petitioner was incorporated, it continued to purchase radio air time to broadcast the pre-recorded "A Moment of Truth" on various radio stations. Petitioner also began purchasing radio air time for a live show in Los Angeles hosted by Roy Masters using a call-in format whereby listeners telephone Masters with their questions, concerns, and problems, and he responds with counseling in keeping with his doctrine and teachings. At one point these radio shows, including taped replays of the live call-in show, were broadcast 5 or 6 days a week over more than a dozen stations from New England to Hawaii. The programs are [\*\*1346] also broadcast every night on Satellite Radio Network by local cable television [\*\*11] in many communities throughout the country. The estimated listening audience for these programs is approximately 2 million with a regular following of 30,000.

Petitioner has published several books and pamphlets written by Roy Masters. The following is a list of the books written by Roy Masters and published by petitioner, with the respective year of publication:

Year	Title
1964	Secret of Life and Death
1970	Sex, Sin and Salvation (Solution)
1975	How to Control Your Emotions
1977	No One Has to Die
1978	How Your Mind Can Keep You Well
1979	Life Itself is Hypnosis! THE SATAN PRINCIPLE -- Self Defense Lessons to Help You Cope with Everyday Pressure

Petitioner published the following pamphlets:

- What You Should Know About Being Upset
- A Guide to True Peace: The Meditations of Three Ancient Mystics, or The Excellency of Inward and Spiritual Prayer -- Part 1
- A Guide to True Peace: The Meditations of Three Ancient Mystics, or The Excellency of Inward and Spiritual Prayer -- Part 2
- How to Meditate Correctly
- Stress and Suffering

## Understanding Meditation

Petitioner also distributed the following tapes:

The Power of Words  
Man & Woman Relationship Part II  
Man & **[\*\*12]** Woman Relationship Part III  
Pride the Cause of Death  
Man - Woman Relations  
"1683"

These tapes are, for the most part, recordings of petitioner's call-in radio show.

Petitioner publishes a magazine, "The Iconoclast," with 5,200 subscribers and an estimated readership of 15,000. Each issue features writings described as follows:

**[\*1347]** [Iconoclast writings] focus on the role that illusions, false religious images, misplaced beliefs and disintegrating institutions play in our personal and inter-personal problems. \* \* \* Once our illusions have been destroyed, the path to true religion is revealed.

More particularly, each issue contains an article by Masters, plus features that keep readers informed of petitioner's activities, as well as materials and services offered by petitioner.

Petitioner owns and operates a building in Los Angeles, which at one time housed its headquarters. The building displays the name "Foundation of Human Understanding" along with the following quote: "Where there is no insight, the people perish." The building contains facilities to record Roy Masters' radio programs and to duplicate tapes. The building also contains a meeting hall for followers **[\*\*13]** of petitioner to congregate, as well as office space.

Petitioner conducts "services" at its Los Angeles building 3 or 4 times a week. These services, which are open to the public, are conducted by one of the ministers of petitioner. The conducting minister is permitted to structure the service as he chooses, ranging from highly Scriptural exhortations to practical suggestions on overcoming sin, weakness, and depression. Afterwards, followers in the congregation are allowed to and regularly do share their recent experiences concerning the Scriptures, meditation, and God. Although ministers may discuss the meditation technique prescribed by Roy Masters, meditation is performed by petitioner's followers in solitude. Ministers have performed weddings; however, the beliefs of petitioner eschew other rites such as baptism and holy communion. Although petitioner does not require its followers to disavow membership in other churches or religious organizations, many of its followers look upon petitioner as their only church.

In October 1977, petitioner opened a school for children. Although general education is provided, classwork includes religious instruction based upon the beliefs **[\*\*14]** of petitioner. Petitioner also operates one or more thrift stores where donated articles are sold.

In 1979, petitioner applied for authority to transact business in the State of Oregon. In the same year, **[\*1348]** petitioner purchased 373 acres of land near Selma, Oregon, and constructed basic living quarters and facilities for milling wood, ranching, farming, teaching, and conducting seminars and meetings. This property, called the Tall Timber Ranch, is operated by petitioner as a retreat and meeting facility. Although the number of people who have lived or worked at the Tall Timber Ranch has varied, approximately 50 persons were

present in August 1981.

In 1982, petitioner purchased a church building, which formerly belonged to a Seventh Day Adventist congregation, in Grants Pass, Oregon. Petitioner relocated its headquarters to Grants Pass while retaining its building in Los Angeles. Petitioner encouraged its followers to relocate to Oregon and some did so. In Oregon, followers of petitioner attend services in the Grants Pass church, take part in activities at the Tall Timber Ranch, and are able to associate with other followers on a daily basis. Attendance at services **【\*\*15】** at both Grants Pass and Los Angeles ranges from 50 to 350 people.

In 1981, petitioner had nine ordained ministers who were employed full time. The ministers included Roy Masters, his wife, Ann Masters, and his children, David Masters, Dianne Masters, and Michael Masters. In addition, there were five ministers in training. The ministerial training process is a 3-year apprenticeship under the personal tutelage of Roy Masters.

Petitioner paid the following compensation to its officers, directors, and trustees during the years 1975 through 1980:

Year	Roy Masters		Robert McQuain		Arlyn Haun		Ann Masters
	Salary	Parsonage	Salary	Parsonage	Salary	Parsonage	Salary
1975	\$ 24,103	\$ 9,900	\$ 11,482	\$ 6,600	\$ 8,635	\$ 3,950	\$ 326
1976	30,350	10,650			12,036	4,650	4,680
1977	34,450	11,650			15,450	5,650	3,000
1978	39,000	13,000			19,500	6,500	13,000
1979	36,000	12,000			7,500	2,500	13,800
1980	36,000	12,000			13,800		

Petitioner also paid the following compensation, presumably including salaries to ministers, along with parsonage allowances in the following amounts for the years 1975 through 1980: **【\*1349】**

Year	Amount
1975	\$ 26,100
1976	33,459
1977	62,562
1978	89,099
1979	104,145
1980	150,815

**【\*\*16】**

The following table shows the total receipts reported by petitioner for the years 1971 through 1980, the amounts of contributions received, proceeds from the sale of its religious publications, and school tuition:

Year	Total receipts	Contributions	Sales of religious publications	School tuition
1971	\$ 160,169	\$ 119,410	\$ 38,842	
1972	217,979	147,600	63,500	
1973	284,123	182,607	95,009	
1974	352,546	244,727	104,739	

1975	506,698	315,735	171,281	
1976	678,564	366,125	290,423	
1977	739,167	482,722	221,458	
1978	896,376	638,838	218,355	\$ 11,611
1979	1,064,014	668,600	297,962	41,424
1980	1,217,101	856,672	285,079	126,205

The figures given for receipts from sales of religious publications for the years 1979 and 1980 include receipts from the thrift stores operated by petitioner. For the years 1975 through 1978, thrift store receipts averaged more than \$ 16,000.

During the years 1971 through 1980, contributions constituted 65.8 percent of petitioner's total receipts with the remainder derived from the sales of religious publications, school tuition, thrift store sales, interest, capital gains, and royalties. The record does not reveal what **\*\*\*17** percentage of the total contributions was made by followers who attended services of petitioner in Los Angeles and Grants Pass. The record also does not reveal whether tuition income for the years 1979 and 1980 in the amounts of \$ 41,424 and \$ 126,205, respectively, was derived solely from operating the school for children or whether those figures also include receipts from seminars and weekend retreats conducted by petitioner.

**[\*1350]** The percentage that petitioner's broadcasting expenditures bore to total expenditures for exempt purposes for the years 1975 through 1980 was as follows:

Year	Percent
1975	46
1976	45
1977	48
1978	45
1979	48
1980	49

In the adverse determination letter issued on November 12, 1982, the Commissioner denied the request of petitioner to be classified as a church as follows:

In determining whether a particular organization can be considered to be a "church" within the meaning of section 170(b)(1)(A)(i) \* \* \* the following criteria are taken into consideration: (1) a distinct legal existence; (2) a recognized creed and form of worship; (3) a definite and distinct ecclesiastical government; (4) a formal code of doctrine or discipline; (5) **\*\*\*18** a distinct religious history; (6) a membership not associated with any church or denomination; (7) a complete organization of ordained ministers ministering to their congregations; (8) ordained ministers selected after completing prescribed courses of study; (9) a literature of its own; (10) established places of worship; (11) regular congregations; (12) regular religious services; (13) Sunday schools for the religious instruction of the young; and (14) schools for the preparation of its ministers. These criteria are not exclusive and are not mechanically applied, but, rather, serve as a list of some of the characteristics that may be used in determining whether an organization is a church \* \* \* any other facts and circumstances which may bear upon an organization's claim that it is entitled to church status must also be taken into consideration.

The final adverse determination letter dated February 23, 1983, holds:

The primary purpose and function of your organization are to evangelize and promulgate your teachings and doctrines through a religious broadcasting service and a religious publications operation. While you are a religious and educational organization, you are not described **[\*\*19]** in section 170(b)(1)(A)(i) because you are not a church as that term is commonly understood.

Petitioner has invoked our declaratory judgment jurisdiction under section 7428 to review the determination of the Commissioner that, for purposes of determining whether it is a private foundation under section 509(a)(1), petitioner does not qualify as a church within the meaning of section **[\*1351]** 170(b)(1)(A)(i). Careful consideration of whether this Court has jurisdiction in this case is merited.

In 1965, petitioner received an exemption from Federal income taxes as an organization described in section 501(c)(3). Following the enactment of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 536, which required exempt organizations to give notice if they considered themselves to be other than a private foundation, petitioner filed Form 4653 to notify the Commissioner that it was a nonprivate foundation. The reasons claimed for nonprivate foundation status were that petitioner was a church under sections 509(a)(1) and 170(b)(1)(A)(i) and that petitioner was an organization described in section 509(a)(2). Shortly thereafter, the Commissioner notified petitioner that it was considered **[\*\*20]** to be a nonprivate foundation, but he did not indicate the basis upon which nonprivate foundation status had been granted. Subsequently, petitioner twice amended its articles of incorporation to clarify its contention that it was a church, and it filed these amendments with the Commissioner.

Petitioner, believing itself to be recognized as a church, ceased filing annual information returns. See sec. 6033(a)(2)(A)(i). Petitioner did not learn that it was not recognized by the IRS as a church until after 1978. Beginning in 1979 petitioner sought a ruling that its nonprivate foundation status was based upon a determination that it was a church within the meaning of section 170(b)(1)(A)(i). Ultimately, the Commissioner, on February 23, 1983, issued a final adverse determination letter denying petitioner's request for church status under sections 509(a)(1) and 170(b)(1)(A)(i).

*Issue 1. Jurisdiction*

**HN1** Section 7428 authorizes review by this Court and other courts in an actual controversy involving a determination (or the failure to make a determination) by the Commissioner with respect to the initial classification or continuing classification of an organization as (1) an organization **[\*\*21]** described in section 501(c)(3) or 170(c)(2), (2) a private foundation as defined in section 509(a), or a private operating foundation as defined in section 4942(j)(3). Sec. 7428(a). **[\*1352]** Therefore, we need to decide whether there exists an "actual controversy" with respect to the ruling by the Commissioner that petitioner does not qualify as a nonprivate foundation classified as a church under sections 509(a)(1) and 170(b)(1)(A)(i).  
n3

-----Footnotes-----

n3 The petition herein was timely filed and the parties agree that petitioner has exhausted its administrative remedies as a prerequisite to this cause of action. Secs. 7428(b)(2), 7428(b)(3).

-----End Footnotes-----

In this case, petitioner received nonprivate foundation status, but upon a less advantageous basis than desired. Looking solely to the statute, it is unclear whether there exists an actual controversy when an organization receives nonprivate foundation status under a classification

different from the classification requested. It may be argued that when the Commissioner recognizes an **【\*\*22】** organization as a nonprivate foundation under section 509(a), there is no actual controversy under section 7428, and this Court has no jurisdiction to review the classification which the Commissioner used to grant nonprivate foundation status. The legislative history of section 7428 fails to disclose whether our jurisdiction is limited to deciding simply whether the Commissioner correctly granted or rejected an organization's request for nonprivate foundation status, or whether we may properly hear a case challenging a ruling that grants nonprivate foundation status, albeit on a less desirable classification. See H. Rept. 94-658 (1975), 1976-3 C.B. (Vol. 2) 701, 976; S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 624. Nevertheless, the cases decided under section 7428 indicate that our jurisdiction is broad enough in some instances to examine and decide the classification upon which status as a nonprivate foundation is granted. *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C. 1114 (1986); *Friends of the Society of Servants of God v. Commissioner*, 75 T.C. 209 (1980); **【\*\*23】** see *CREATE (Christian, Research, Education, Action, Technical Enterprise), Inc. v. Commissioner*, 634 F.2d 803 (5th Cir. 1981), affg. an unreported order of this Court (hereinafter referred to as *CREATE*).

In *Friends of the Society of Servants of God v. Commissioner, supra* (hereinafter referred to as *Friends*), we were confronted with the question of whether this Court has jurisdiction to review a ruling that an organization failed to **【\*1353】** qualify as a nonprivate foundation under section 509(a)(1) as a section 170(b)(1)(A)(i) church, even though the Commissioner ruled that it could still expect to qualify as a nonprivate foundation under section 509(a)(1) by being classified as a publicly supported organization under section 170(b)(1)(A)(vi). Although we disagreed with the argument of the organization that section 7428 "grants jurisdiction in all cases where the parties disagree about some aspect of a private ruling on an organization's private foundation or tax-exempt status," we concluded there was an "actual controversy" to support jurisdiction under section 7428 because the Commissioner's ruling was adverse **【\*\*24】** in important respects. 75 T.C. at 215-216.

The Commissioner's ruling in *Friends* was found to be adverse because he determined that the organization was entitled only to an advance ruling even though a definite ruling had been requested. 75 T.C. at 216-217, 219. We also found the private foundation ruling to be adverse because, by basing nonprivate foundation status on a determination that the organization was a publicly supported organization defined in section 170(b)(1)(A)(vi), it imposed terms and conditions on the organization that would not be imposed upon a church. 75 T.C. at 217, 219. For example, a publicly supported organization under section 170(b)(1)(A)(vi) must meet certain public support standards that churches need not meet. Sec. 1.170(a)-9(e), Income Tax Regs. n4 Finally, we found that the record did not support the determination of the Commissioner that the organization was a publicly supported organization under section 170(b)(1)(A)(vi). 75 T.C. at 217-219.

-----Footnotes-----

n4 Church status is also desirable because churches are exempted from filing annual information returns. Sec. 6033(a)(2)(A)(i). IRS examinations of churches are also severely restricted. Secs. 7605(c), 7611.

-----End Footnotes----- **【\*\*25】**

In *CREATE*, the Court of Appeals affirmed the decision of this Court dismissing the petition for lack of jurisdiction. *CREATE, Inc.*, a non-profit corporation, applied for recognition as a tax-exempt organization described in section 501(c)(3) and for a ruling that it was not a private foundation. The Commissioner issued a ruling which recognized that *CREATE* was exempt from Federal income tax as a 501(c)(3) organization. The Commissioner also made an **【\*1354】** advance ruling that *CREATE, Inc.*, could reasonably expect to be classified as a nonprivate foundation under section 509(a)(1) as a publicly supported organization described in section

170(b)(1)(A)(vi). At the end of the advance ruling period, the Commissioner again ruled that CREATE, Inc., was not a private foundation. However, nonprivate foundation status was granted to CREATE, Inc., as a public charity under section 509(a)(3), rather than under sections 509(a)(1) and 170(b)(1)(A)(vi). The change in the classification for nonprivate foundation status was caused by the determination of the Commissioner that contributions received from a trade association were subject to the rule providing that to the extent the contributions **[\*\*26]** exceeded 2 percent of the total support received by CREATE, Inc., they could not be counted toward the 33 1/3-percent public support requirement imposed by sections 509(a)(1) and 170(b)(1)(A)(vi). Sec. 1.170A-9(e)(6), Income Tax Regs. Despite the disadvantageous treatment of the contributions from one of its major contributors, CREATE, Inc., was able to demonstrate that it still satisfied the public support requirement, at that time, through the contributions of others. Later, the Commissioner conceded that CREATE, Inc., qualified as a nonprivate foundation under sections 509(a)(1) and 170(b)(1)(A)(vi), as well as section 509(a)(3). Although CREATE, Inc., obtained nonprivate foundation status upon the classifications it had requested, it was concerned that future support from the sources considered to be public might fall below the 33 1/3 percent level unless contributions from the trade association were counted in full. As a result, CREATE, Inc., filed a petition in this Court for declaratory judgment under section 7428 that contributions from the trade association were not subject to the 2-percent rule of section 1.170A-9(e)(6), Income Tax Regs. We dismissed the petition for **[\*\*27]** lack of jurisdiction.

On appeal, the Court of Appeals considered whether there existed a justiciable "actual controversy" because of the ruling by the Commissioner as to the treatment of the contributions from the trade association. The Court of Appeals held that because the treatment of the contributions from the trade association had no present effect on the nonprivate foundation status of CREATE, Inc., and **[\*1355]** because CREATE, Inc., had received nonprivate foundation status on the classifications requested (sections 509(a)(1) through 170(b)(1)(a)(vi) and 509(a)(3)), this court properly dismissed for lack of jurisdiction under section 7428. 634 F.2d at 812. See also *Urantia Foundation v. Commissioner*, 684 F.2d 521, 525 (7th Cir. 1982), affg. 77 T.C. 507 (1981). Although the Court of Appeals in *CREATE* generally agreed that receipt of a presently favorable ruling as to foundation status precludes review of the basis for the ruling, the court, citing *Friends*, acknowledged a crucial exception:

The Tax Court opinion in *Friends of the Society of Servants of God* specifically states **[\*\*28]** that § 7428(a), which speaks in terms of an "actual controversy," cannot apply unless the taxpayer has received an adverse ruling. But it makes clear that the receipt of a favorable ruling on a nonprivate status that is a different and less advantageous status that [sic] the one which is the subject of the ruling request will not defeat § 7428 jurisdiction. [ 634 F.2d at 813.]

We believe our opinion in *Friends*, cited with approval in *CREATE*, is controlling as to our jurisdiction in the instant case. In the instant case, as in *Friends*, granting nonprivate foundation status as a publicly supported organization under sections 509(a)(1) and 170(b)(1)(A)(vi) imposes requirements upon petitioner that it would not be required to meet if it were classified as a church. Accordingly, the final adverse determination as to church status was sufficiently adverse to create an "actual controversy" for purposes of our declaratory judgment jurisdiction under section 7428. *Friends of the Society of Servants of God v. Commissioner*, *supra*; see *CREATE, Inc. v. Commissioner*, *supra* at 812-813.

#### Issue **[\*\*29]** 2. Status as Church

**HN2** The focus of our inquiry in declaratory judgment actions under section 7428 is whether the administrative determination of the Commissioner is correct. For this purpose, we assume that all facts contained in the administrative record are true. Rule 217. The role of this Court in declaratory judgment actions is "to resolve disputes as to the legal issues raised by the [Commissioner's] denial of an exemption ruling on the basis of uninvestigated statements of

facts **[\*1356]** submitted by the taxpayer in its ruling request and related papers." *Houston Lawyer Referral Service v. Commissioner*, 69 T.C. 570, 573 (1978). The burden of proof is on petitioner. *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488, 492 (1977).

**HN3** The term "church" is not defined in the Internal Revenue Code. Nor are the regulations promulgated under section 170 helpful in deciding what is a church. They simply restate the statutory language of section 170(b)(1)(A)(i). n5 Sec. 1.170A-9(a), Income Tax Regs. It seems clear, however, that Congress intended that the word "church" have a more restrictive definition **[\*\*30]** than the term "religious organization." *American Guidance Foundation v. United States*, 490 F. Supp. 304, 306 (D. C. 1980), *affd.* without opinion (D.C. Cir., July 10, 1981); *Church of the Visible Intelligence that Governs the Universe v. United States*, 4 Cl. Ct. 55 (1983).

-----Footnotes-----

n5 At one time the regulations under sec. 170 contained a cross-reference to the regulations under sec. 511, which define a church as follows:

(ii) The term "church" includes a religious order or a religious organization if such order or organization (a) is an integral part of a church, and (b) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministrations of sacerdotal functions and the conduct of religious worship. \* \* \* [ Sec. 1.511-2(a)(3)(ii), Income Tax Regs.]

The Tax Reform Act of 1969 made several changes in the tax treatment of exempt organizations including repeal of the exemption given to churches from the tax on unrelated business income under sec. 511. Pub. L. 91-172, 83 Stat. 536. Following enactment of the Tax Reform Act of 1969, the Treasury proposed regulations defining "church" for purposes of sec. 170 that closely resembled the definition found in sec. 1.511-2(a)(3)(ii), Income Tax Regs. Sec. 1.170A-9(a), Proposed Income Tax Regs., 36 Fed. Reg. 9298 (May 22, 1971). Because of objections from the public, the proposed regulation defining "church" under sec. 170 was never promulgated as final. Instead the current regulation merely provides that "An organization is described in sec. 170(b)(1)(A)(i) if it is a church or a convention or association of churches." Sec. 1.170A-9(a), Income Tax Regs. See Whelan, "Church' in the Internal Revenue Code: The Definitional Problems," 45 *Fordham L. Rev.* 885, 916-917 (1977).

-----End Footnotes----- **[\*\*31]**

In the absence of guidance by Congress and a meaningful regulatory definition, it has been suggested that the term "church" is to be interpreted in light of the generally accepted meaning and usage of the word. *De La Salle Institute v. United States*, 195 F. Supp. 891, 903 (N.D. Cal. 1961). However, given the plurality of religious beliefs in this country, the validity of this approach is not without doubt. See *American Guidance Foundation, Inc. v. United States*, *supra* at 306. We can only approach this question with care for all of us are burdened with the baggage of our **[\*1357]** own unique beliefs and perspectives. We must recognize that one person's prophet is another's pariah. Consequently, we must also assiduously avoid expanding our inquiry into the merits of petitioner's beliefs or risk running afoul of First Amendment religious protections. *Parker v. Commissioner*, 365 F.2d 792, 795 (8th Cir. 1966), *affg.* in part, *revg.* in part, and remanding a Memorandum Opinion of this Court, *cert. denied* 385 U.S. 1026 (1967); *Unitary Mission Church of Long Island v. Commissioner*, 74 T.C. 507, 514 (1980), **[\*\*32]** *affd.* without published opinion 647 F.2d 163 (2d Cir. 1981).

**HN4** Although every church may be a religious organization, not every religious organization is

a church. *Chapman v. Commissioner*, 48 T.C. 358, 363 (1967). To classify a religious organization as a church under the Internal Revenue Code, we should look to its religious purposes and, particularly, the means by which its religious purposes are accomplished. See *Chapman v. Commissioner*, *supra* at 367 (Tannenwald, J., concurring). "The means by which an avowedly religious purpose is accomplished separates a 'church' from other forms of religious enterprise. \* \* \* At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship." *American Guidance Foundation, Inc v. United States*, *supra* at 306 (citation omitted); see *Church of Eternal Life and Liberty, Inc. v. Commissioner*, 86 T.C. 916, 924 (1986); *Chapman v. Commissioner*, *supra* at 367 (Tannenwald, J., concurring). When bringing people together for worship **\*\*\*33** is only an incidental part of the activities of a religious organization, those limited activities are insufficient to label the entire organization a church. *De La Salle Institute v. United States*, *supra* at 901; see *Chapman v. Commissioner*, *supra* at 364.

In its efforts to identify organizations that qualify for church status the IRS has developed 14 criteria. These criteria, which were first announced in a speech by a former Commissioner, n6 were applied by the Commissioner in the instant case. The criteria are as follows:

- [\*1358]** (1) a distinct legal existence;
- (2) a recognized creed and form of worship;
- (3) a definite and distinct ecclesiastical government;
- (4) a formal code of doctrine and discipline;
- (5) a distinct religious history;
- (6) a membership not associated with any other church or denomination;
- (7) an organization of ordained ministers;
- (8) ordained ministers selected after completing prescribed studies;
- (9) a literature of its own;
- (10) established places of worship;
- (11) regular congregations;
- (12) regular religious services;
- (13) Sunday schools for religious instruction of the young; and
- (14) schools **\*\*\*34** for the preparation of its ministers.

[See Internal Revenue Manual 7(10)69, Exempt Organizations Examination Guidelines Handbook 321.3(3) (Apr. 5, 1982).]

In addition to the 14 criteria enumerated above, the IRS will consider "Any other facts and circumstances which may bear upon the organization's claim for church status." Internal Revenue Manual 7(10)69, Exempt Organizations Examination Guidelines Handbook 321.3(3) (Apr. 5, 1982).

-----Footnotes-----

n6 See Remarks of IRS Commissioner Jerome Kurtz, PLI Seventh Biennial Conference on Tax Planning (Jan. 9, 1978), reprinted in Fed. Taxes (P-H) par. 54,820 (1978).

-----End Footnotes-----

Although this Court has not adopted these 14 criteria in deciding whether an organization is a church, other courts have expressly adopted them or at least given them the appearance of judicial imprimatur. See *Lutheran Social Service of Minn. v. United States*, 758 F.2d 1283, 1286-1287 (8th Cir. 1985), revg. and remanding 583 F. Supp. 1298 (D. Minn. 1984); *Williams Home, Inc. v. United States*, 540 F. Supp. 310, 317 (W.D. Va. 1982); **[\*\*35]** *American Guidance Foundation v. United States*, supra; *Church of the Visible Intelligence that Governs the Universe v. United States*, supra. It is recognized that few traditional churches could meet all of the criteria. None of the criteria are considered controlling, but one court has said --

While some of these are relatively minor, others, e.g., the existence of an established congregation served by an organized ministry, the provision of regular religious services and religious education for the young, and the dissemination of a doctrinal code, are of central importance. \* \* \* [ *American Guidance Foundation, Inc. v. United States*, supra at 306.]

**HNS** Although the criteria developed by the IRS are helpful in deciding what is essentially a fact question, whether petitioner is a church, we do not adopt them as a test.

**[\*1359]** Petitioner, a nonprofit corporation incorporated under the laws of California, certainly has a distinct legal existence. Although based on Judeo-Christian principles, the emphasis on emotional self-control through a specific type of meditation as the key to salvation sets **[\*\*36]** petitioner apart from other recognized religions. Petitioner provides regular religious services for established congregations that are served by an organized ministry. Worship takes the form of regular meetings of regular congregations at established places of worship, petitioner's Los Angeles headquarters and the Grant Pass, Oregon, church building. These services are open to the public. Cf. *American Guidance Foundation, Inc. v. United States*, supra at 307 (husband, wife, and minor child do not constitute a church). These services were regularly conducted by the ministry for congregations consisting of 50 to 350 persons. Such activity is far from incidental. Cf. *De La Salle Institute v. United States*, supra. Although petitioner does not require its followers to reject membership in other churches, many followers consider petitioner to be their only church. Although the regular services have no set structure or liturgy, they are conducted by petitioner's ordained ministers. Ministers ordained by petitioner must serve a 3-year apprenticeship under the personal tutelage of Roy Masters. Petitioner does not maintain **[\*\*37]** separate physical facilities for the preparation of its ministers. Although petitioner does not separately provide for the religious instruction of the young, such as through Sunday School classes, its school includes religious instruction as part of the general education curriculum.

Petitioner clearly has a distinct, if relatively short, religious history. Petitioner first existed as an unincorporated association formed in 1961 as the vehicle to spread the beliefs of Roy Masters, its founder. The record is unclear as to when and how Roy Masters formulated his beliefs or had them revealed to him. Nonetheless, petitioner had existed, at the time the Commissioner made his final adverse determination, for more than 20 years as an association and a corporation.

Petitioner lacks a definite ecclesiastical government. The record does not reveal how religious or doctrinal decisions are made. However as founder, Roy Masters is clearly the **[\*1360]** leader of petitioner. He is also president of petitioner under civil corporate law. Furthermore, his ample writings illustrate fully the beliefs and doctrine of petitioner. Nonetheless, petitioner lacks a formal code of doctrine and discipline. **[\*\*38]**

Petitioner does not possess all of the criteria. It does, however, possess most of the criteria to

some degree. Moreover, most of the factors considered to be of central importance are satisfied. It possesses associational aspects that are much more than incidental. Despite the involvement of several members of Roy Master's family, petitioner is more than a one family church. Cf. *American Guidance Foundation, Inc. v. United States*, *supra* at 307. Furthermore, petitioner is not a sham organization created solely for tax purposes. See, e.g., *Davis v. Commissioner*, 81 T.C. 806 (1983), *affd.* without published opinion 767 F.2d 931 (9th Cir. 1985) (Universal Life Church case). Based upon all the facts and circumstances, we conclude that petitioner is a church within the meaning of section 170(b)(1)(A)(i).

We acknowledge that petitioner reaches far more people with its message of emotional self control through its radio broadcasts, books, pamphlets, and magazine. Petitioner's radio broadcasts have the potential to reach 2 million people with a regular listening audience of 30,000. Petitioner's **[\*\*39]** magazine, the *Iconoclast*, has a subscription circulation of 5,200. In contrast, approximately 2,000 followers relocated to Oregon at petitioner's behest, leaving approximately that many in Los Angeles. Attendance at services at the Los Angeles and Grants Pass, Oregon, locations, ranged from 50 to 350. In financial terms, petitioner's radio broadcast and publishing efforts constitute a large percentage of petitioner's total receipts and expenditures. Nevertheless, petitioner's substantial broadcasting and publishing activities do not overshadow the other indications that petitioner is a church. The call to evangelize or otherwise spread one's religious beliefs is, undeniably, an integral part of many faiths. The fact that in this case, the religious outreach was substantial both before and after petitioner began to possess many church-like characteristics does not change our conclusion. More importantly, despite the breadth of petitioner's broadcasting and publishing efforts, its associational **[\*1361]** aspects are much more than incidental. Cf. *De La Salle Institute v. United States*, *supra*. We hold that petitioner has sufficient associational **[\*\*40]** aspects to be considered a church. *American Guidance Foundation, Inc. v. United States*, *supra*; see *Church of Eternal Life and Liberty v. Commissioner*, *supra*; *Chapman v. Commissioner*, *supra*.

We readily acknowledge that this case presents a close question. Our conclusion is based upon the particular facts of this case. At its inception petitioner was not a church, nor did it perceive itself as such. It was granted tax-exempt status as a religious and educational organization described in section 501(c)(3). But as more people heard and began to follow the teachings of Roy Masters, petitioner began to adopt church-like characteristics. The means by which petitioner accomplished its admittedly religious purposes have developed such that we conclude that petitioner is now a church. We hasten to emphasize that by its use of the term "church," Congress must have intended a more narrow classification than that embodied by a term such as "religious organization." Despite the lack of guidance from Congress, and in the absence of a more explicit regulatory definition of the term "church," we will continue **[\*\*41]** our efforts to give a distinct meaning to this statutory classification.

Based upon the foregoing,

*Decision will be entered for the petitioner.*

**CONCURBY:** WHITAKER

**CONCUR:** **[\*1362]** Whitaker, J., concurring: For the reasons set forth herein, I believe the majority in this case have reached the right result on jurisdiction but on an incorrect rationale.

There are two aspects to our jurisdiction in cases under section 7428. As we recognized in *Friends of the Society of Servants of God v. Commissioner*, 75 T.C. 209, 215 (1980), there must be an "actual controversy." An actual controversy exists when an exempt organization receives a favorable ruling, but upon a basis which is different from and less advantageous to the organization than that which the organization requested. *CREATE, Inc. v. Commissioner*, 634 F.2d 803 (5th Cir. 1981); *Friends of the Society of Servants of God v. Commissioner*,

*supra*. I agree with the majority that an actual controversy exists in this case.

The second aspect of our jurisdiction is based solely upon the provisions of section 7428(a). That Code section grants jurisdiction **【\*\*42】** to this Court under section 7428(a)(1)(A) as to the initial or continuing qualification of an organization described in section 501(c)(3) or in section 170(c)(2), and under section 7428(a)(1)(B) and (C) with respect to the initial or continuing classification of an organization as a private foundation or as a private operating foundation.

The real issue with which we are wrestling is whether under section 7428(a)(1)(A) we are limited to determining only whether the organization is or is not exempt or whether we can go beyond that basic qualification question and determine the nature of the organization and its basis for exemption, i.e., its status under section 501(c)(3). The majority have struggled to find jurisdiction under section 7428(a)(1)(B), based upon the reference therein to section 509(a) and the reference in section 509(a) to section 170(b)(1)(A). I disagree with this approach. I conclude that the jurisdiction granted to us in section 7428(a)(1)(B) and (C) is very narrow - to determine only private foundation or private operating foundation status. It is section 501(c)(3) which contains the broad based grant of jurisdiction. n1

-----Footnotes-----

n1 For present purposes I ignore the reference to sec. 170(c)(2), simply noting that a foreign organization can be exempt from tax under sec. 501(c)(3) although by reason of sec. 170(c)(2) contributions thereto would not be deductible.

-----End Footnotes----- **【\*\*43】**

Section 501(c)(3) exempts organizations which are organized and operated "exclusively for religious, charitable, **【\*1363】** scientific, testing for public safety, literary, or educational purposes, or to foster" amateur sports competitions or for the prevention of cruelty to children or animals. A number of these categories of exempt organizations have special tax attributes or burdens or both under various other provisions of the Internal Revenue Code, regulations, and rulings. For example, hospitals and educational institutions both differ from each other and from other charitable organizations in important respects. Also, there are various categories of religious organizations all of which are a special category of tax-exempt organizations. But of all exempt organizations under section 501(c)(3) a church has by far the greatest number of significant preferences. There is, thus, a singular advantage in exempt status predicated upon being a church.

There is nothing in section 7428(a) or in its legislative history which explicitly or implicitly limits our authority to determine simply that the organization is exempt or nonexempt. H. Rept. 94-658 (1975), 1976-3 C.B. (Vol. 2) 284, **【\*\*44】** states that: "Accordingly, your committee has agreed to provide in this bill for a declaratory judgment procedure under which an organization can obtain a judicial determination of its own *status* as a charitable, etc., organization." (Emphasis added; fn. ref. omitted.) The Senate report uses almost identical language. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 587. Both reports also state in their respective explanations of the proposed legislation that the new jurisdiction arises in the case of an actual controversy involving a determination "with respect to the initial or continuing qualification or classification of an organization" as exempt under section 501(c)(3). Both reports also state flatly that the designated courts "are to have jurisdiction to make a declaration with respect to the status of the organization." A declaration that a specific organization is exempt or nonexempt is a declaration with respect to "status" but so is a declaration that an organization is exempt *as a church*.

True, there is nothing explicit in the statute or legislative history which grants us jurisdiction to go beyond the bare determination of exempt **【\*\*45】** status to the determination of the

basis for the exemption. While we are a court of limited jurisdiction, there is no policy reason why, within a specific **[\*1364]** grant of jurisdiction by the Congress, we should not construe the grant broadly instead of narrowly, especially where, as in this case, this declaratory judgment legislation was intended to be remedial, responding to the problems described by the Supreme Court in the *Americans United* and *Bob Jones* cases. n2

-----Footnotes-----

n2 *Alexander v. "Americans United," Inc.*, 416 U.S. 752 (1974); *Bob Jones University v. Simon*, 416 U.S. 725 (1974).

-----End Footnotes-----

The majority falls into error in predicating our jurisdiction in this case on section 7428(a)(1)(B), that is on sections 509(a)(1)(A) and 170(b)(1)(A)(i), instead of upon section 7428(a)(1)(A) or upon the section 501(c)(3) determination. n3 The fact that the ruling was apparently requested under section 509(a) does not limit this Court in its jurisdiction. n4

-----Footnotes-----

n3 Parenthetically, the reference to sec. 170(b)(1)(A)(i) nowhere appears in sec. 7428. Sec. 509(a) uses the sec. 170(b)(1)(A) cross-reference simply as a shorthand way to refer to various types of organizations. It has no bearing upon our jurisdiction. **\*\*\*46**

n4 Conceivably, we might have dismissed the petition here because the petitioner sought classification as a church under sec. 509(a) instead of under sec. 501(c)(3), but that would not be a jurisdictional matter.

-----End Footnotes-----

It does not appear that any court has heretofore focused upon this analysis of our jurisdiction under section 7428(a)(1)(A). In *Friends*, the application requested a ruling under section 509(a)(1) on the basis that the organization was a church described in section 170(b)(1)(A)(i). We held that "petitioner may not ask for a declaratory judgment that it is a church under section 170(b)(1)(A)(i) unless qualification as a church has a direct bearing on petitioner's foundation status under section 509(a)." *Friends of Society of Servants of God v. Commissioner*, *supra* at 215-216. Finding that status as a church "directly affects" qualification as a nonprivate foundation, we concluded that we had jurisdiction under section 7428(a)(1)(B). *Friends of the Society of Servants of God v. Commissioner*, *supra* at 220. The question **\*\*\*47** as to the scope of section 7428(a)(1)(A) was not raised in *Friends*. The decision in *CREATE* is not to the contrary. There the petitioner had received a favorable ruling under section 509(a); hence, there was no controversy as to nonprivate foundation status.

In many of the decided cases, the issue has been as to the existence of an actual controversy. For example, in *Urantia Foundation v. Commissioner*, 77 T.C. 507 (1981), *affd.* 684 F.2d 521 (7th Cir. 1982), we reviewed the distinctions we **[\*1365]** had made in *Gladstone* n5 and *New Community* n6 and again held that we have no jurisdiction unless there is a controversy with respect to a determination dealing directly with the exemption or classification of the organization. *Urantia Foundation v. Commissioner*, 77 T.C. 507 (1981), *affd.* 684 F.2d 521 (7th Cir. 1982). The Court of Appeals summarized our jurisdiction in this language:

In summary, § 7428(a)(1) authorizes judicial review of IRS determinations that directly affect the tax status of a charitable organization, *New Community*. The determination **\*\*\*48** must directly put in issue the organization's classification or qualification under the sections listed in § 7428(a)(1)(A)-(C), and must cause sufficient adverse consequences to that organization to create an actual controversy, *CREATE*, *Friends of Society of Servants of God v. Commissioner*,

75 T.C. 209 (1980). [ *Urantia Foundation v. Commissioner*, 684 F.2d 521, 525 (7th Cir. 1982).] n7

-----Footnotes-----

n5 *J. David Gladstone Foundation v. Commissioner*, 77 T.C. 221 (1981).

n6 *New Community Sr. Citizens Housing Corp. v. Commissioner*, 72 T.C. 372 (1979).

n7 An argument can be made on the basis of this language as well as similar language in the legislative history that we can under sec. 7428(a)(1)(A) determine both "qualification" and "classification," i.e., classify various types of exempt organizations. However, I prefer my broad analysis of sec. 501(c)(3). It is also worth noting that respondent's determinations of exempt status normally include a classification determination.

-----End Footnotes----- **[\*\*49]**

*Eiry Trust v. Commissioner*, 77 T.C. 1263 (1981), holds that we lack jurisdiction to determine whether the organization's income is exempt under section 115, although we concluded that we could determine whether it was a trust under section 4947(a)(1) since that issue was "inextricably related to the issues of whether the organization is qualified under section 501(c)(3) or classified as a private foundation under section 509(a)." *Eiry Trust v. Commissioner*, *supra* at 1267.

Some support for this broad interpretation of section 7428(a)(1)(A) is found in *Church of the New Testament, Its Members and Friends v. United States*, 783 F.2d 771 (9th Cir. 1986), in that the Court of Appeals stated that declaratory judgments may be brought under section 7428 concerning the status of an organization under section 501(c)(3) and that the appellant church was a potential petitioner in a section 7428 action because its qualification or classification was at issue. More direct authority for a broad interpretation of our jurisdiction is found in our Court-reviewed opinion in *Associated Hospital Services, Inc. v. Commissioner*, 74 T.C. 213 (1980). **[\*\*50]** The petition sought a **[\*1366]** declaration of exemption under section 501(c)(3). We discussed the scope of section 501(c) and extensively analyzed section 502, concluding that the petitioner was a feeder organization under section 502 and, therefore, not exempt under section 501(c)(3). Thus, in the course of determining nonexempt status, we clearly classified the organization under the Internal Revenue Code.

Arguably, as Judge Williams points out in his dissent, *Ohio County & Independent Agriculture Societies v. Commissioner*, 610 F.2d 448 (6th Cir. 1979), disapproves the majority's analysis, since the Sixth Circuit affirmed our conclusion (in an unreported order) that we would not determine whether the organization was described in section 170(b)(1)(A)(6), i.e., a governmental unit. Respondent had long recognized the organization to be exempt under section 501(c)(3) as an educational organization. I would reach the same conclusion as we and the Court of Appeals, since governmental organizations are not described in section 501(c)(3). See sec. 170(c)(1) and (2). But that decision did not undertake to interpret the scope of our section 501(c)(3) **[\*\*51]** jurisdiction.

Where, as in this case, a determination of exempt status under section 501(c)(3) is only a part of the story, and the nature or type of organization which has requested the ruling is significant, I conclude that we have the jurisdiction under section 7428(a)(1)(A) to make a complete determination. That this approach may require us to distinguish between a church and a church auxiliary or between a church and a hospital is simply responding to the underlying purpose of the Congress in its grant of declaratory judgment jurisdiction to this Court. This is the clear, direct, and understandable solution to the case at bar.

**DISSENTBY:** SIMPSON (In Part); CHABOT; WILLIAMS

**DISSENT:** Simpson, J., dissenting in part: I agree with the majority's conclusion that we have jurisdiction in this case, but I must, with due respect, disagree with the conclusion **[\*1367]** that the petitioner is a church. This Court recently embraced the "spiritual togetherness" definition of a church suggested by Judge Tannenwald in *Chapman v. Commissioner*, 48 T.C. 358, 367 (1967); in *Church of Eternal Life v. Commissioner*, 86 T.C. 916, 924 (1986), we defined **[\*\*52]** a church as:

a coherent group of individuals and families that join together to accomplish the religious purposes of mutually held beliefs. In other words, a church's principal means of accomplishing its religious purposes must be to assemble regularly a group of individuals related by common worship and faith. \* \* \*

In my opinion, that definition should be applied in this case, and this petitioner does not satisfy that definition.

Fortunately, we are not required to decide what constitutes a religion or a religious organization. The Commissioner concedes that this petitioner is a religious organization. We must decide merely whether this organization is a church, and to decide that issue, we must decide what characteristics distinguish a church from other types of religious organizations.

Churches receive more favorable tax treatment than any other exempt organizations. Under section 170(b)(1)(A), contributions to them are subject to the maximum deduction limitation; to qualify for the maximum deductions, other religious organizations are required to demonstrate that they receive substantial support from the general public. Sec. 170(b)(1)(A)(vi).

Religious organizations **[\*\*53]** that are described in section 501(c)(3) are exempt from the income tax, but they are treated as private foundations unless they come within the exceptions described in section 509(a)(1), (2), (3), or (4). Private foundations are subject to certain excise taxes and stringent reporting and record-keeping requirements. However, a religious organization that is a church is exempted from such taxes and such requirements. In fact, although other religious organizations are required to give the Commissioner notice of their establishment, the Commissioner is prohibited by statute from requiring churches to give notice. Sec. 508(c)(1). In other words, the Commissioner has no authority to require any notices or reports from **[\*1368]** churches. No other religious organization is granted such freedom from reporting and supervision.

There is no recorded legislative history explaining the reasons for the preferred treatment of churches. It has been suggested that churches are exempted from the reporting requirements in order to avoid the touchy subject of what constitutes a religion. *Church of the Visible Intelligence v. United States*, 4 Cl. Ct. 55, 64 (1983). **[\*\*54]** However, the exemption from the reporting requirements applies only to churches, not to all religious organizations; therefore, an organization which seeks exemption from tax as a religious organization described in section 501(c)(3) may be required to demonstrate that its activities constitute a religion. Thus, the Commissioner and the courts may be required to pass judgment on whether the activities are religious.

The true explanation for the congressional deference to churches is more likely to be due, at least in part, to a belief that traditional churches do not require supervision by the Commissioner. A traditional church involves regular and frequent meetings of members of the community, and although a minister or other employees may be engaged to carry on the day-to-day administrative activities of the church, members of the community are generally active participants in the management and carrying on of the activities. The community is fully aware of all the activities of the church and can assure that those activities are carried on for public purposes. Consequently, in the case of a traditional church, there is no need for the

Commissioner to require reports and to **[\*\*55]** oversee the activities of the church.

It has been recognized that a church involves an associational activity. In *American Guidance Foundation v. United States*, 490 F. Supp. 304, 306 (D. D.C. 1980), affd. without opinion (D.C. Cir., July 10, 1982), the court said:

At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship. Unless the organization is reasonably available to the public in its conduct of worship, its educational instruction, and its promulgation of doctrine, it cannot fulfill this associational role.

The same test was adopted by the Claims Court in *Church of the Visible Intelligence v. United States*, 4 Cl. Ct. at 65. **[\*1369]** This petitioner clearly carries on some associational activity, but is that activity sufficient to justify calling it a church.

In his concurrence in *Chapman*, Judge Tannenwald suggested that for an organization to be treated as a church, the associational activity had to be "the principal means" of carrying out its purposes, and in *Church of Eternal Life*, we declared that the associational activity had to be "the principal **[\*\*56]** means" of accomplishing its religious purposes. If a religious organization engages extensively in activities not involving meetings of the community, there is no assurance that the community will participate in those other activities and no assurance that the community will be aware of those activities. Hence, unless the activities not involving the community are only incidental, the reasons for granting the organization full exemption from any reporting requirements do not exist. In my opinion, Congress meant to grant exemption from the reporting requirements only for those organizations that constitute traditional churches serving the community and controlled by the community.

The facts of this case show that this petitioner was not a traditional church. Although it conducted regular meetings for significant numbers of participants, it also sought to spread its beliefs through extensive radio and television activities. Those broadcasts were the principal means of spreading its beliefs; they were not merely broadcasts of services conducted for its members. Under these circumstances, I would hold that this petitioner is not a church for tax purposes.

Chabot, J., dissenting: **[\*\*57]** Both parties agree that petitioner is not "a private foundation (as defined in section 509(a))" (sec. 7428(a)(1)(B)). Both parties agree that this is so because petitioner is "an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii))" (sec. 509(a)(1)). Respondent contends that this is so because petitioner is a publicly supported organization described in **[\*1370]** section 170(b)(1)(A)(vi); petitioner contends this is so because it is a church described in section 170(b)(1)(A)(i). No deficiency has been determined that would be affected by the resolution of this limited dispute; n1 the dispute is before us solely by way of our declaratory judgment jurisdiction.

-----Footnotes-----

n1 Because of somewhat different rules under sec. 514(b)(3)(E), it is possible that this difference in status could affect a liability for unrelated business income tax. Another difference, in sec. 512(b)(14), applies only to years beginning before Jan. 1, 1976.

-----End Footnotes-----

The majority hold that we have declaratory judgment jurisdiction **[\*\*58]** to resolve this dispute. I would hold that we do not. I dissent.

#### I. Background

Before 1974, the effect of the Anti-Injunction Act (sec. 7421(a) and its predecessors, dating back to 1867) and the Federal tax exception to the Declaratory Judgment Act (in 28 U.S.C. sec. 2201, the exception having been enacted in 1935, one year after the enactment of the Declaratory Judgment Act) was to preclude declaratory judgment proceedings in Federal tax cases. *Bob Jones University v. Simon*, 416 U.S. 725 (1974).

In the Employee Retirement Income Security Act of 1974 (sec. 1041(a) of Pub. L. 93-406, 88 Stat. 829, 949), the Congress enacted section 7476 to authorize the issuance of declaratory judgments to resolve certain types of retirement plan disputes. In the Tax Reform Act of 1976 (secs. 1306(a) and 1042(d)(1) of Pub. L. 94-455, 90 Stat. 1520, 1717, 1637), the Congress enacted sections 7428 and 7477 to authorize the issuance of declaratory judgments to resolve certain types of charitable organization disputes and section 367 disputes. In the Revenue Act of 1978 (sec. 336(a) of Pub. L. 95-600, 92 Stat. 2763, 2841), the **1371** Congress enacted section 7478 to authorize the issuance of declaratory judgments to resolve certain types of municipal bond disputes.

In sections 7476, 7477, and 7478, the Congress gave declaratory judgment jurisdiction only to the Tax Court; in section 7428, the Congress gave this jurisdiction to the Tax Court, the Court of Claims (now, the Claims Court), and the District Court for the District of Columbia. In sections 7428, 7476, and 7477, trial court determinations are reviewable in the same Courts of Appeals to which other cases **1371** would go; in section 7478, trial court determinations are reviewable only by the Court of Appeals for the District of Columbia (sec. 7482(b)(3)). Each of these four declaratory judgment sections requires that there be "a case of actual controversy"; each then specifies what kind of controversy is a permissible declaratory judgment subject. Each of these four declaratory judgment sections specifies who may be a petitioner; in sections 7428 and 7478, there can be only one petitioner, while in sections 7476 and 7477 there are several potential petitioners as to any dispute. In sections 7476 and 7477, a petitioner is deemed to have not exhausted **60** its administrative remedies before the expiration of 270 days after its request for determination; in section 7428, a petitioner is deemed to have exhausted its administrative remedies upon the expiration of 270 days; in section 7478, a petitioner is deemed to have exhausted its administrative remedies upon the expiration of 180 days.

Each of the following statutes dealt with at least one of the declaratory judgment sections: the Tax Reform Act of 1976 (amended sec. 7476; enacted secs. 7428 and 7477), the Revenue Act of 1978 (amended secs. 7476, 7428, and 7477; enacted sec. 7478), the Federal Courts Improvement Act of 1982 (amended sec. 7428), the Deficit Reduction Act of 1984 (amended secs. 7476 and 7428; repealed sec. 7477), and the Tax Reform Act of 1986 (corrected a typographical error in sec. 7476). From the foregoing, I conclude that --

- (1) the Congress has not swept away the general prohibitions on declaratory judgments in Federal tax cases;
- (2) the Congress has provided for declaratory judgments only to resolve the categories of disputes specifically set forth in the provisions enacted into law; and
- (3) the Congress has fashioned each of these provisions with a view towards **61** the specific problem or problems it was then addressing; although the Congress used one general format for all four sections, the content of each portion was tailored to the problems to be addressed by that particular section; when the Congress modified its views it modified accordingly the section involved, to the point of repealing one of the declaratory judgment sections 8 years after enacting it.

**1372** Since the general prohibition on declaratory judgments in Federal tax matters remains in the statute, it is particularly important that we adhere closely to the Congress' grant of jurisdiction in section 7428 as the Congress wrote section 7428.

II. Section 7428

Section 7428(a) n2 authorizes this Court, the Claims Court, and the District Court for the District of Columbia to issue declaratory judgments under certain circumstances.

-----Footnotes-----

n2 SEC. 7428. DECLARATORY JUDGMENTS RELATING TO STATUS AND CLASSIFICATION OF ORGANIZATIONS UNDER SECTION 501(c)(3), ETC.

(a) Creation of Remedy. -- In a case of actual controversy involving --

(1) a determination by the Secretary --

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or as an organization described in section 170(c)(2),

(B) with respect to the initial classification or continuing classification of an organization as a private foundation (as defined in section 509(a)), or

(C) with respect to the initial classification or continuing classification of an organization as a private operating foundation (as defined in section 4942(j)(3)), or

(2) a failure by the Secretary to make a determination with respect to an issue referred to in paragraph (1),

upon the filing of an appropriate pleading, the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia may make a declaration with respect to such initial qualification or continuing qualification or with respect to such initial classification or continuing classification. Any such declaration shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. For purposes of this section, a determination with respect to a continuing qualification or continuing classification includes any revocation of or other change in a qualification or classification.

-----End Footnotes----- **[\*\*62]**

The statute requires that there be "a case of actual controversy involving -- (1) a determination by the Secretary \* \* \* or (2) a failure by the Secretary to make a determination." Each of the Internal Revenue Code declaratory judgment sections includes these specific requirements. Each of these sections then (i.e., after the words "a determination by the Secretary") lists what controversies are cognizable under the particular section. None of the controversies listed in section 7428 is present in the instant case. In particular --

(1) the parties agree that petitioner qualifies "as an organization described in section 501(c)(3) which is exempt from tax under section 501(a)" (sec. 7428(a)(1)(A));

(2) the parties agree that petitioner qualifies "as an organization described in section 170(c)(2)" (sec. 7428(a)(1)(A));

**[\*1373]** (3) the parties agree that petitioner is not "a private foundation (as defined in section 509(a))" (sec. 7428(a)(1)(B)); and

(4) it does not appear that either side contends that petitioner is "a private operating foundation (as defined in section 4942(j)(3))".

Thus, although there clearly is a controversy between the parties in the instant case, that controversy **[\*\*63]** (whether petitioner is a church, within the meaning of section 170(b)(1)(A)(i)) is not one of the list of controversies that the Congress gave us jurisdiction to resolve under section 7428.

Ordinarily, that would be the end of the matter and we would dismiss the case for lack of jurisdiction.

### III. *Friends of the Society of God v. Commissioner*

Our precedents make it clear that, at times, the problem is more subtle. I agree with the majority that we can find useful guidance in our opinion in *Friends of the Society of God v. Commissioner*, 75 T.C. 209 (1980) (hereinafter sometimes referred to as *Friends*).

In *Friends*, the organization requested a ruling that it was tax-exempt as an organization described in section 501(c)(3), and also that it was not a private foundation because it was a church described in section 170(b)(1)(A)(i). The organization received a ruling that it was tax-exempt as an organization described in section 501(c)(3). The ruling also stated as follows (75 T.C. at 211):

Because you are a newly created organization, we are not now making a final determination of your foundation status under section **[\*\*64]** 509(a) of the Code. However, we have determined that you can reasonably be expected to be a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi).

Accordingly, you will be treated as a publicly supported organization, and not as a private foundation, during an advance ruling period.

\* \* \* \*

If you do not meet the public support requirements during the advance ruling period, you will be classified as a private foundation for future periods. Also, if you are classified as a private foundation, you will be treated as a private foundation from the date of your inception for purposes of sections 507(d) and 4940.

**[\*1374]** We held that in *Friends* that we had jurisdiction to determine whether the organization was a church described in section 170(b)(1)(A)(i).

The majority herein conclude that "our opinion in *Friends* \* \* \* is controlling as to our jurisdiction in the instant case." (See p. 1355) The majority conclude that our opinion in *Friends* leads to a conclusion that we have jurisdiction in the instant case. I agree that *Friends* gives us the answer to the jurisdictional question in the instant case. However, I respectfully suggest **[\*\*65]** that the majority have missed the point of our opinion in *Friends* and, as a result, their conclusion is directly opposite to the one that *Friends* requires.

In *Friends*, we analyzed the basic dispute as follows (75 T.C. at 215):

The parties in this case differ in their interpretation of the scope of the review available. Petitioner points out that the statute by its terms confers jurisdiction in cases "involving (1) a

determination by the Secretary \* \* \* (B) *with respect to* the initial classification or continuing classification of an organization as a private foundation (as defined in section 509(a))." Petitioner contends that respondent's determination that it was not a church was made "with respect to" its initial classification as a private foundation. Stated generally, petitioner argues that the statute grants jurisdiction in all cases where the parties disagree about some aspect of a private ruling on an organization's private foundation or tax-exempt status. [Emphasis in original.]

From the foregoing, we derived the following rule (75 T.C. at 215-216) to apply to the facts in determining whether we have **[\*\*66]** declaratory judgment jurisdiction:

We disagree for two reasons. First, section 7428(a) applies only "In a case of actual controversy." Therefore, the statute cannot apply unless the taxpayer has received an adverse ruling. Second, the statute confers jurisdiction only with respect to four subsections of the Code -- subsections 170(c)(2), 501(c)(3), 509(a), and 4942(j)(3). Since these four sections are specifically enumerated, and declaratory judgments or injunctions are otherwise prohibited by section 7421(a) (*Bob Jones University v. Simon, supra*), it follows that the jurisdictional prerequisite for an action under section 7428(a) is an adverse determination under one of the four above-listed Code sections. See *Ohio County & Independent Agricultural Societies, Delaware County Fair v. Commissioner*, 610 F.2d 448 (6th Cir. 1979), *affg.* an order of this Court dated July 14, 1977 (docket No. 4811-77X), cert. denied 446 U.S. 965 (1980). Section 170(b)(1)(A) is not among the listed subsections. Thus, in the circumstances of this case, **[\*1375]** petitioner may not ask for a declaratory judgment **[\*\*67]** that it is a church under section 170(b)(1)(A)(i) *unless* qualification as a church has a direct bearing on petitioner's foundation status under section 509(a). [Emphasis in original.]

Applying this rule to the facts in *Friends*, we point out that, although the ruling appeared to be favorable in form, in substance it was an unfavorable ruling as to the organization's *nonprivate foundation status*. We noted that the ruling merely gave the organization a trial period to demonstrate public support under section 170(b)(1)(A)(vi) (75 T.C. at 216) and that the record in *Friends* suggested that the organization was not very likely to meet the public support requirements (75 T.C. at 217-219). Thus, the ruling that was issued was, as a practical matter, a ruling that the organization was (or shortly would be) a private foundation. We also noted that, if the organization were a church (sec. 170(b)(1)(A)(i)) then it would not have to meet the public support test, and would not be a private foundation. (75 T.C. at 219-220.) Thus, we concluded as follows (75 T.C. at 220):

**[\*\*68]**

In other words, petitioner's status as a church *directly affects* its qualification as a nonprivate foundation. In this context, petitioner's church status is a justiciable issue under section 7428 (a)(1)(B), which authorizes a declaratory judgment determining whether or not petitioner is a private foundation. [Emphasis in original.]

Now, let us apply in the instant case the learning of *Friends*. In the instant case, respondent issued a definitive ruling, not merely an advance ruling. Also, our findings in the instant case do not suggest that petitioner has any difficulty in meeting the public support requirements. Accordingly (in contrast to the situation in *Friends*), the ruling petitioner received is favorable both in substance and form on the question of whether petitioner is a private foundation.

In *Friends*, we noted the fact that "the ruling letter imposes terms on [the organization's] foundation status which would not have been imposed upon a church." (75 T.C. at 217.) The majority point out (see p. 1355) that the same is true in the instant case. The majority in the instant case pass over the fact that, in *Friends*, the next **[\*\*69]** 2 1/2 pages of the opinion (75 T.C. at 217-220) explain why those **[\*1376]** particular "terms" made a practical difference in that organization's ability to avoid private foundation status. In the instant case, the majority do not suggest that those "terms" make any difference at all in petitioner's ability to avoid private foundation status.

In *Friends*, we noted as follows (75 T.C. at 213):

If petitioner is a church, it \* \* \* would also be entitled other benefits unrelated to section 501(c)(3) or 509(a), primarily the relief from having to file annual information returns granted under section 6033(a)(2)(A)(i). n7

n7 See also secs. 410(c)(1)(B) and (d), 411(e)(1)(B), 412(h)(4), and 414(e); 508(c)(1)(A); 512(b)(14) and 514(b)(3)(E), 3309(b)(1); 5122(c); 6043(b)(1); and 7605(c).

In the instant case, the majority also note some collateral effects of church status (see p. 1353). Although those (or other) collateral effects may be the real reason why there is an "actual controversy", the mere existence of an actual controversy is not enough to give us jurisdiction. In *Friends* we held that the controversy must be **["\*70"]** one that "has a direct bearing" on the organization's qualification or classification under one or more of the four sections listed in section 7428(a)(1). (75 T.C. at 215-216.)

The approach of the majority in the instant case appears to be that we can resolve -- in a declaratory judgment proceeding -- any actual controversy about whether an organization is described in one rather than another of the first six clauses of section 170(b)(1)(A), even if that controversy is bottomed on collateral consequences instead of consequences affecting qualification or classification under one or more of the four sections listed in section 7428(a)(1). This approach would place before us many disputes that have nothing to do with the four sections listed in section 7428(a)(1). For example:

(1) The telephone excise tax provisions (secs. 4251 et seq.) include exemptions for hospitals "referred to in section 170(b)(1)(A)(iii)" (sec. 4253(b)) and educational organizations "described in section 170(b)(1)(A)(ii)" (sec. 4253(j)), but not for churches described in section 170(b)(1)(A)(i). If an organization receives a ruling that it is a church but not a hospital (or not an **["\*71"]** educational organization), then are we to take declaratory judgment jurisdiction because of the actual **["\*1377"]** controversy that is based primarily on liability for the telephone tax? n3

-----Footnotes-----

n3 Published rulings attempting to define when an organization qualifies under sec. 170(b)(1)(A)(iii) (or under sec. 503(b)(5), as in effect before the Tax Reform Act of 1969), include the following: Rev. Rul. 76-9, 1976-1 C.B. 348; Rev. Rul. 75-295, 1975-2 C.B. 437; Rev. Rul. 73-131, 1973-1 C.B. 446.

-----End Footnotes-----

(2) Section 403(b) provides for "tax-sheltered annuities" for employees of "an educational organization described in section 170(b)(1)(A)(ii)" (sec. 403(b)(1)(A)(ii)) if the annuities are bought by governmental employers. These annuities are not available for employees of other governmental institutions. All of these governmental institutions are described in section 170(b)(1)(A)(v), and so are section 509(a)(1) **["\*72"]** organizations, and so are not private foundations. If a governmental museum or a governmental hospital receives a ruling that it is a governmental unit, but it is not an educational organization, then are we to take declaratory judgment jurisdiction because of the actual controversy that is based primarily on availability of tax-sheltered annuities to employees? n4

-----Footnotes-----

n4 A published ruling dealing with the circumstances under which some activities of a private museum may be treated as an educational institution, although in a different context, appears

as Rev. Rul. 76-167, 1976-1 C.B. 329.

-----End Footnotes-----

(3) Under prior law, gross income did not include any amount received "(A) as a scholarship at an educational organization described in section 170(b)(1)(A)(ii), or (B) as a fellowship grant" (sec. 117(a)(1)). The exclusion was available, respondent ruled (Rev. Rul 60-130, 1960-1 C.B. 46; Rev. Rul. 58-76, 1958-1 C.B. 56), **【\*\*73】** for fellowship grants by the American Cancer Society and the American Heart Association, for nondegree research work. The Congress has modified section 117 so as to allow the exclusion only for "a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii) (sec. 117(a)). If a public charity grant-making organization n5 refuses to make grants for studies at organizations that are not described in section 170(b)(1)(A)(ii), then will we take jurisdiction over controversies as to whether the organization qualifies under that provision even though respondent agrees that it also qualifies under clause (i), (iii), (iv), (v), or (vi) of section 170(b)(1)(A)? If we go that far, will we then also be willing **【\*1378】** to rule whether that organization issues "degrees" within the meaning of section 117?

-----Footnotes-----

n5 Private foundations are likely to have the same concerns. See secs. 4941(d)(2)(G)(ii) (relating to self-dealing by Government officials) and 4945(g)(1) (relating to individual grants as taxable expenditures).

-----End Footnotes----- **【\*\*74】**

The majority rely also on two sentences in *CREATE, Inc. v. Commissioner*, 634 F.2d 803 (5th Cir. 1981), affg. an unreported order of this Court. Respondent had ruled that CREATE was not a private foundation because it was a section 509(a)(3) organization and also because it was a section 509(a)(1) organization. Respondent ruled adversely to CREATE as to the treatment of certain contributions to it, but that adverse portion of the ruling did not affect CREATE's status as not being a private foundation. After affirming our order that we did not have declaratory judgment jurisdiction to consider the dispute as to the treatment of the contributions that were the subject of the adverse portion of the ruling, the Court of Appeals noted a "caveat", based on our opinion in *Friends* (634 F.2d at 812-813). If the Court of Appeals means that we can rule on other disputes where such rulings are necessary in order to decide one of the issues set forth in the statute, then I agree with the Court of Appeals' dictum. However, if the Court of Appeals contends that the statute gives us declaratory judgment jurisdiction to decide collateral **【\*\*75】** questions merely because there are actual controversies as to those questions, then I respectfully suggest that the Court of Appeals' caveat is contrary to the statute. n6 We follow a Court of Appeals where that Court of Appeals has ruled in a manner that is clearly dispositive of the issue we face in the instant case, and the instant case is appealable to that Court of Appeals. *Golsen v. Commissioner*, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971). See, e.g., *David Metzger Trust v. Commissioner*, 76 T.C. 42, 72-74 **【\*1379】** (1981), affd. 693 F.2d 459 (5th Cir. 1982). The issue in the instant case has not been clearly disposed of by the Court of Appeals for the Fifth Circuit, and this case is not appealable to that Court of Appeals.

-----Footnotes-----

n6 It is in this regard that I must respectfully disagree with Judge Williams' dissenting opinion because of his reliance on *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C. 1114 (1986). In *Junaluska*, the Court gave the above noted "caveat" in *CREATE, Inc. v. Commissioner*, 634 F.2d 803, 813 (5th Cir. 1981), a construction that is outside the statute. That is, the Court decided the question whether the organization in *Junaluska* was a church within the meaning of sec. 170(b)(1)(A)(i) for purposes of deciding whether that organization

escaped private foundation status because of sec. 509(a)(1) rather than section 509(a)(3). In that sense, *Junaluska* is similar to the instant case in that we should have declined to take jurisdiction over that additional question since both sides agreed that the organization was not a private foundation pursuant to sec. 509(a).

Notwithstanding my disagreement with Judge Williams on this point, it is clear that under both approaches taken in these dissenting opinions, the majority's analysis in the instant case is incorrect. Thus, proper decision of the instant case does not turn on a reexamination of *Junaluska*.

-----End Footnotes----- **[\*\*76]**

#### IV. Conclusion

In sum, the opinion of this Court in *Friends* presented a careful analysis of the statute that the Congress chose to enact and explained why, in the setting of *Friends*, it became necessary for us to decide whether the organization was a church *but only* because that issue had to be resolved before we could decide the actual controversy as to whether the organization was a private foundation. In the instant case, there is no actual controversy as to whether petitioner is a private foundation. There is an actual controversy, but it is not as to any of the specific matters that the Congress addressed when it carved out exceptions to the prohibitions in the Declaratory Judgment Act (and, by implication, to the Anti-Injunction Act). Finally, decision of that issue would have no effect on any of the specific matters set forth in section 7428.

When we decide, in the instant case, whether petitioner is a church, we go beyond the jurisdiction that the Congress saw fit to grant us. I would not decide that question.

Respectfully, I dissent.

Williams, J., dissenting: A plurality of this Court hold that section 7428(a)(1)(B) n1 grants jurisdiction to declare **[\*\*77]** whether an organization is described in section 170(b)(1)(A). **[\*1380]** Judge Whitaker believes that section 7428(a)(1)(A) n2 grants jurisdiction to declare whether an organization described in section 501(c)(3) is a church. While Judge Whitaker's approach is direct and less susceptible of producing unforeseeable collateral harm, like the plurality opinion it reverses this Court's and others' consistent interpretations of section 7428.

-----Footnotes-----

n1 SEC. 7428. DECLARATORY JUDGMENTS RELATING TO STATUS AND CLASSIFICATION OF ORGANIZATIONS UNDER SECTION 501(c)(3), ETC.

(a) Creation of Remedy. -- In a case of actual controversy involving --

(1) a determination by the Secretary --

\* \* \* \*

(B) with respect to the initial classification or continuing classification of an organization as a private foundation (as defined in section 509(a)), or

n2 SEC. 7428(a). Creation of Remedy. -- In case of actual controversy involving --

(1) a determination by the Secretary --

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or as an organization described in section 170(c)(2),

-----End Footnotes----- **【\*\*78】**

The rule applicable here is a general bar against declaratory judgments in Federal tax matters. Sec. 7421(a); *Bob Jones University v. Simon*, 416 U.S. 725, 732 n. 7 (1974). It was in response to the Supreme Court's observation in *Bob Jones* that Congress had "imposed an especially harsh regime on section 501(c)(3) organizations threatened with loss of tax-exempt status" in forbidding injunctive or declaratory relief that Congress enacted section 7428. S. Rept. 94-938, at 586, 1976-3 C.B. (Vol. 3) 624. The Senate Finance Committee report states,

This provision is intended to facilitate relatively prompt judicial review of the specified types of exempt organization issues; it is not intended to supplant the normal avenues of judicial review (redetermination of a deficiency or suit for refund of taxes) where those normal procedures could be expected to provide opportunities for prompt determinations. \* \* \* [S. Rept. 94-938, at 588, 1976-3 C.B. (Vol. 3) 626.]

Section 7428 was designed, not to supplant the normal deficiency/refund litigation routes, but to make relief available in three courts where **【\*\*79】** the Government challenged the tax-exempt status of the organization. Specifically, this Court, the Claims Court, and the District Court for the District of Columbia were given jurisdiction to declare the proper status of an organization as (1) tax exempt (section 501(c)(3)), (2) a qualified recipient of deductible charitable contributions (section 170(c)(2)), (3) an organization that is not a private foundation (section 509(a)), or (4) an operating foundation (section 4942(j)(3)). These four categories are the "specified types of exempt organization issues" over which we have jurisdiction. None of them is at issue in this case.

**【\*1381】** The plurality premise our jurisdiction on *Friends of the Society of Servants of God v. Commissioner*, 75 T.C. 209 (1980). I believe the plurality's reliance on that case is not only misplaced but without foundation. Indeed, the plurality would overrule *Friends*. Specifically, the plurality's opinion directly contradicts two principles of jurisdiction under section 7428, enunciated in *Friends*:

First, section 7428(a) applies only "In a case of actual controversy." Therefore, the statute cannot apply **【\*\*80】** unless the taxpayer has received an adverse ruling. Second, the statute confers jurisdiction only with respect to four subsections of the Code -- subsections 170(c)(2), 501(c)(3), 509(a), and 4942(j)(3). Since these four sections are specifically enumerated, and declaratory judgments or injunctions are otherwise prohibited by section 7421(a) (*Bob Jones University v. Simon*, *supra*), it follows that the jurisdictional prerequisite for an action under section 7428(a) is an adverse determination under one of the four above-listed Code sections. See *Ohio County & Independent Agricultural Societies, Delaware County Fair v. Commissioner*, 610 F.2d 448 (6th Cir. 1979), affg. an order of this Court dated July 14, 1977 (docket No. 4811-77X), cert. denied 446 U.S. 965 (1980). Section 170(b)(1)(A) is not among the listed subsections. Thus, in the circumstances of this case, petitioner may not ask for a declaratory judgment that it is a church under section 170(b)(1)(A)(i) unless qualification as a church has a direct bearing on petitioner's foundation status under section 509(a). [ 75 T.C. at 215-216.] **【\*\*81】**

First, there is no adverse ruling in this case. Second, section 7428 does not grant this Court,

or any other, the authority to declare the status of an organization under section 170(b)(1)(A) where classification under section 509(a) is not at issue. An organization's private foundation status is directly affected by whether it is classified under section 509(a)(1), section 509(a)(2), section 509(a)(3), or section 509(a)(4), and we have jurisdiction to give declaratory relief where the organization's classification under one or more of the four paragraphs of section 509(a) is at issue. *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C. 1114 (1986). Petitioner's classification is, however, not at issue. There is no actual controversy between the parties in this case with respect to petitioner's proper classification under section 509(a), and the Fifth Circuit has stated the rule applicable to this case, which I believe to be correct: this Court does not have jurisdiction to give declaratory relief that has no present effect on a taxpayer's classification under section 509(a). *CREATE, Inc. v. Commissioner*, 634 F.2d 803 [\*1382] (5th Cir. 1981). [\*\*82] As in *CREATE, Inc.*, the parties both agree that petitioner is properly classified as an organization other than a private foundation pursuant to section 509(a)(1). Regardless of whether a determination is made with respect to petitioner's status as an organization described in section 170(b)(1)(A)(i) or section 170(b)(1)(A)(vi), petitioner's classification as an organization described in section 509(a)(1) will not change. Therefore, pursuant to section 7428, this Court does not have jurisdiction to hear this case.

In *CREATE, Inc.*, the Fifth Circuit did *not* state the exception crafted by the plurality, viz, where a petitioner receives "nonprivate foundation status, but upon a less advantageous basis" than the one requested, the Tax Court may entertain a suit (see p. 1352, emphasis added). In fact, the Fifth Circuit rejected the plurality's standard as a standard for exercising jurisdiction. What the Fifth Circuit stated was --

If taxpayers could seek review of a negative holding by the Service on an alternative basis for classification as a nonprivate foundation, even though the negative holding had no effect on the actual classification, it could give rise [\*\*83] to a significant volume of sec. 7428 litigation, some of which would be needless. In this case, for example, such litigation would necessarily involve a future course of events which may never come to pass. We do not think that sec. 7428(a)(1) demands such an outcome. [ 634 F.2d at 812; emphasis added.]

The Fifth Circuit then enunciated what we later specifically held in *Junaluska*: "that the receipt of a favorable ruling on a nonprivate foundation status that is a different and less advantageous status \* \* \* will not defeat jurisdiction." *CREATE, Inc. v. Commissioner*, 634 F.2d at 813 (emphasis added). *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C. at 1127.

Private foundation status is an issue determinable solely within the confines of section 509(a). The parties agree that petitioner's status is that it is not a private foundation pursuant to section 509(a)(1). That status is unaffected by any determination regarding the basis for its qualification as a section 170(b)(1)(A)(i) organization.

No authority supports the plurality's reach through section 509(a) to the [\*\*84] underlying section 170(b)(1)(A) basis for [\*1383] such status. In an analogous case under section 7428, the Sixth Circuit, affirming an unreported order of this Court, held that no case or controversy existed though an organization declared to be exempt under section 501(c)(3) also wanted to be declared a section 170(b)(1)(A)(v) organization so as not to be subject to the tax on unrelated business income. *Ohio County & Independent Agriculture Societies v. Commissioner*, 610 F.2d 448 (6th Cir. 1979). The Sixth Circuit refused to reach classification under section 170(b)(1)(A). The more favorable tax status sought, though the subject of a real dispute, was not within the purview of section 7428. Although the parties disputed the proper classification, it had no present effect on the organization's status under section 501(c)(3). See also *Eiry Trust v. Commissioner*, 77 T.C. 1263 (1981).

Judge Whitaker in effect looks behind respondent's section 501(c)(3) determination to declare not only that the organization is tax exempt as a religious organization but also that the

organization is a church. n3 The plurality's opinion **[\*\*85]** reaches the same result, but, instead of directly holding that we can declare an organization's church status under section 501(c)(3), the plurality strain section 509(a) to find our jurisdiction. The plurality have in effect incorporated sections 170(b)(1)(A)(i), (ii), (iii), (iv), (v), and (vi) into section 509(a)(1) notwithstanding that (a) some of these organizations are not section 501(c)(3) organizations (see, e.g., sec. 170(b)(1)(A)(v)), and therefore could not possibly be described in section 509, and (b) section 170(b)(1)(A) does not relate to the "specific types of exempt organization issues" addressed by Congress in the enactment of section 7428 but simply provides a 50-percent of adjusted gross income limitation on individuals' charitable contributions.

-----Footnotes-----

n3 I would point out, however, that just as there is no controversy between the parties as to the organization's sec. 509(a)(1) status, there is no controversy between them as to the organization's sec. 501(c)(3) status.

-----End Footnotes-----

*Friends of the Society of Servants of God v. Commissioner, supra*, **[\*\*86]** should be distinguished. In that case, petitioner requested a definitive ruling under section 509(a)(1) as a church within the meaning of section 170(b)(1)(A)(i). Respondent issued an advance ruling that petitioner was an organization that was not a private foundation under **[\*1384]** section 509(a)(1) because he determined it to be an organization described in section 170(b)(1)(A)(vi). We held that the case presented an actual controversy because (a) respondent's ruling was not a definitive ruling, (b) his determination that petitioner was an organization described in section 170(b)(1)(A)(vi) was not supported by the record, and (c) the advance ruling imposed additional requirements on petitioner which it was not likely to satisfy.

In this case, none of the *Friends* factors are present. Petitioner has received a final favorable ruling from respondent that petitioner is an organization other than a private foundation under section 509(a)(1) as an organization described in section 170(b)(1)(A)(vi). Petitioner has operated as such for many years. There is no indication that respondent's determination that petitioner is not an organization described in section 170(b)(1)(A)(i) **[\*\*87]** will result in petitioner's failure to continue to qualify under section 509(a)(1). Petitioner has failed to make the minimal showing that respondent's determination will have some present effect on its private foundation status.

The majority have extended our holding in *Friends of the Society of Servants of God* beyond the boundaries of the statute, in contravention of the well-settled principle that jurisdictional statutes are to be narrowly construed. See 13 Wright, Miller & Cooper, Federal Practice and Procedure: Jurisdiction 2d, sec. 3522 (1984). The majority have opined on a matter not involving a "case of actual controversy."

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**Written Testimony of  
Robert G. Ottenhoff  
President and CEO  
GuideStar  
Williamsburg, VA and Washington, DC**

**United States Senate  
Committee on Finance  
June 22, 2004, Hearing  
“Charity Oversight and Reform:  
Keeping Bad Things from Happening to Good Charities”**

427 Scotland Street  
Williamsburg, VA 23185  
(757) 229-4631

1156 15<sup>th</sup> Street NW  
Suite 805  
Washington, DC 20005  
703.625.4901  
[bottenhoff@guidestar.org](mailto:bottenhoff@guidestar.org)  
[www.guidestar.org](http://www.guidestar.org)

**Written Testimony of Robert G. Ottenhoff  
President and CEO, Philanthropic Research, Inc. a.k.a. GuideStar  
For the Senate Finance Committee  
July 2, 2004**

Mr. Chairman, Senator Baucus, and distinguished Members of the Committee, thank you for providing GuideStar with the opportunity to share with you our recommendations. We believe that the federal government can strengthen the transparency and accountability of nonprofit organizations by making strategic investments in current infrastructure to maximize the impact of enforcement actions at the federal and state levels.

We want to recognize the Committee staff for its good work in preparing the "white paper" and convening the witnesses for the hearing on June 22, 2004. We have met with staff from both the Chairman's and Senator Baucus's offices. They have been of great assistance to GuideStar in providing answers to our questions and in listening to our suggestions on what steps could be taken to strengthen the current enforcement regime at both the federal and state levels.

The staff's white paper raises significant issues concerning possible new legislation. Although we do not address the individual proposals in this testimony, we urge you to find solutions that balance the need to target abuses that harm the public's trust in the nonprofit sector with the reforms and efficiencies that can support the vital public service performed by the overwhelming majority of nonprofits.

We look forward to working with you, the Congress, your staffs, and other nonprofit leaders to ensure an outcome that serves both the American people, whose generosity fuels the good deeds of the nonprofit sector, and the beneficiaries of the good works of the sector.

Our statement has three major points:

1. GuideStar's experience demonstrates that both the public and the nonprofit community welcome efforts to increase transparency and accountability of charitable organizations.
2. Electronic filing is important but faces difficult and complex hurdles.
3. There are several steps the federal government can take immediately to improve transparency and accountability in the nonprofit sector.

### **I. GuideStar—Leading a Revolution in Philanthropy and Nonprofit Practice**

GuideStar is a public charity with offices in Williamsburg, Virginia, and Washington, D.C. We are the nation's database on nonprofits, the most comprehensive source of information about America's public charities and private foundations.

GuideStar was founded a decade ago on the belief that charitable organizations have an obligation to share not only the specifics of their good works with the public but also details of their operations and finances. Furthermore, GuideStar believes that this information should be collected and made readily available from one central place so that the public can access the data it needs to make good decisions. Today the GuideStar database houses data on more than 1 million nonprofit organizations; you can find this information on the Internet at [www.guidestar.org](http://www.guidestar.org).

Nearly 20,000 users visit GuideStar every day, and we are on pace to have more than 4 million user sessions accessing information about America's charities by the end of 2004. More than 250,000 users have registered with GuideStar in order to access more in-depth data on individual nonprofits. GuideStar provides this service at no charge to the public.

Who are our users? Nonprofit leaders, academics, foundation staff, service providers to the nonprofit sector, the media, government, job seekers, and donors.

What are they looking for? Many of our users come to GuideStar to view the 1.8 million Forms 990 posted on the site and the contextual information about missions, programs and accomplishments that is voluntarily provided by nonprofits. Again, access to these forms is provided at no cost to the users. Many users are also subscribing to GuideStar's next generation of analytic tools to use the Form 990 and 990-PF data for benchmarking nonprofit compensation, searching for grant opportunities, and for comparing nonprofit performance.

#### **Bringing IRS Form 990 to the Internet—Background**

According to Steve Miller, now a commissioner at the Internal Revenue Service, the appearance of Form 990 on the Internet "changed the face of philanthropy."

But it was a long and difficult journey for GuideStar and our colleagues at the National Center for Charitable Statistics (NCCS) at the Urban Institute, to bring the Forms 990 to the Internet for the first time in October 1999. And it could not

have happened without the help of leading foundations, which provided the financial resources to fund this revolution.

Beginning in 1995, GuideStar and NCCS approached the IRS with a then “crazy” idea to scan images of the Forms 990 that 501(c)(3) organizations file with the IRS and to transcribe the data from the forms. Convincing the IRS to change its processes back then was no easy task—dedicated civil servants embraced the concept, but they had no resources with which to change their processes.

As often happens in America, organized philanthropy stepped in when government could not act alone. With foundation backing, NCCS provided the IRS with nearly \$1 million to purchase the needed scanning equipment. GuideStar received the images and began digitizing the Form 990 data.

#### **Without Philanthropy None of This Could Ever Have Happened**

It is critical for members of the Committee to understand and appreciate the vital role philanthropy has played in supporting GuideStar’s mission. There would be no GuideStar without our philanthropic partners.

GuideStar’s funders include: Andrew W. Mellon Foundation; Ford Foundation; W.K. Kellogg Foundation; Surdna Foundation, Inc.; Carnegie Corporation of New York; The Atlantic Philanthropies (USA) Inc.; C. S. Mott Foundation; Rockefeller Brothers Fund; Lilly Endowment, Inc.; The David and Lucille Packard Foundation; The William and Flora Hewlett Foundation; Skoll Foundation and many other generous foundations and corporations over the last ten years.

#### **Leading Nonprofits Embrace Transparency and Accountability**

The staff’s white paper and a number of the witnesses at the hearing have pointed to Form 990’s limitations. GuideStar agrees that it is an imperfect document. Our experience, however, shows that nonprofits do not need new disclosure requirements to achieve greater transparency and accountability.

Since 1996, fully three years before posting the Forms 990, GuideStar has provided an on-line tool for nonprofits to share additional and contextual data about their programs, missions, accomplishments, and leaders. Today, more than 85,000 organizations have voluntarily provided GuideStar with this additional information.

These organizations recognize that the public’s trust is our most vital asset. Nonprofits are not waiting for the IRS to fix the Form 990. The American people

are demanding more transparency, and the nonprofits already are responding: they are embracing transparency and accountability.

Over the years, we have suggested many changes to the Form 990. Many have been adopted. We are still working on a number of revisions we think would make the form more useful. We look forward to bringing our expertise to the table to discuss reforms of the Form 990 and 990-PF.

**GuideStar – A Trusted Government Partner.**

In addition to serving the public, GuideStar plays an essential role in government's oversight of the nonprofit sector. Government users are an important part of the community that depends on GuideStar as a reliable source of nonprofit information. Almost 600 separate federal, state, and local government agencies are represented among GuideStar's more than 2,000 individual government users.

The IRS is the largest government user of the GuideStar Web site, and IRS employees are among the top 10 of our most frequent users. They find our data valuable and essential to their oversight work.

In 2003, GuideStar contracted with the IRS to provide the Service with digitized Form 990 data for law enforcement purposes. The contract specifically provides the IRS with the ability to use GuideStar data to respond to queries from other federal agencies and to Congress about the activities of nonprofits as reported on Form 990.

In 2003, the Federal Trade Commission invited GuideStar to participate with the FTC and 34 states in Operation Phoney Philanthropy, a law enforcement and public education campaign targeting fraudulent fund-raising. The FTC held up GuideStar as an important place for the donating public to find information about charities soliciting contributions.

In 2003, the U.S. Department of Commerce awarded GuideStar a grant under the Technology Opportunities Program to work with the National Association of State Charity Officials (NASCO) to build NASCONet, a centralized national charity information system. The goals of this \$1.3 million project are to interconnect state charity offices, allow charity regulators to share information, expand the public's access to data on charitable organizations, and help state charity officials complement federal efforts to create a single-point electronic filing system.

GuideStar is also involved with individual states to assist them in their oversight and enforcement activities. Let me point out a few highlights:

- Partnering with the California Department of Justice to operate its public Web site to display Forms 990 (2004);
- Acting as the nonprofit compensation expert for the Hawaii Attorney General's Office and preparing a detailed compensation study for a legal challenge in a case regarding the Trustees of the Bishop Estate Trust (2003);
- Partnering with the New Mexico Attorney General's Office to operate its public Web site to display Forms 990 (2001-present; see <http://www.guidestar.org/partners/newmexico/>).

## II. Electronic Filing Is Not a Silver Bullet

A number of witnesses testifying at the June 22 hearing spoke favorably about the promise of electronic filing of Forms 990. GuideStar agrees. But, as a leader deeply involved in this effort, we need to temper some of the enthusiasm with news from the front lines.

Although great progress has been achieved in the area of electronic filing to date, there is a long way to go. The IRS may reach 1 percent of Forms 990 filed electronically in 2003. Similar efforts to promote electronic filing in Pennsylvania and in Colorado have also received very low rates of adoption.

The lack of commercial software to file Form 990 electronically is a key obstacle that must be overcome. Studies on Form 990 filing shows that about 80 percent of all returns are prepared professionally, primarily by CPAs. A robust commercial marketplace of accounting software with Form 990 e-filing capabilities must be developed. We note that there is legislation in Congress that, if enacted, would give the IRS the authority to require paid preparers to file Form 990 electronically. This authority has the ability to accelerate e-filing without burdening smaller nonprofits.

The inability to consolidate federal and state reporting by nonprofits is another barrier to electronic filing. The IRS has announced plans to build a federal/state retrieval system to provide single-point filing for the nonprofits. Currently, the IRS has indicated that this project will come on-line in 2006.

For nonprofits that solicit contributions nationally, the patchwork of laws in the various states is a costly and time-consuming gauntlet to run. Experts have projected total compliance costs for a single public charity registering nationally

to be at least \$25,000. The transformation of the regulatory system from a paper-driven process to an electronic one provides an important opportunity to simplify the way nonprofits comply with the law. The federal/state retrieval system is an important step that should be taken to reduce compliance costs for nonprofits.

There are, however, a number of technical, political, and budgetary issues that must be resolved in order to keep the federal/state retrieval project on track. The states have their own challenges in creating back offices to accept electronic data. A number of states are currently acting as laboratories of innovation, forging ahead with state-specific electronic filing initiatives. Others are holding back because of budget constraints or to ensure that their technology investments will be compatible with the IRS federal/state retrieval system.

Alongside the federal/state retrieval system, the IRS has an aggressive calendar to publish the XML Schemas for the IRS Form 990-PF and the IRS Form 990-T. The schemas are the essential building blocks for commercial software applications. Once the schemas are published, the commercial software can be developed, a process that can take nine months or more. The IRS is projecting the capability to accept e-filing of Forms 990-PF and 990-T in 2005.

Great technical challenges and tight budgets are a few things that GuideStar knows all too well. In this environment, the only wiggle room becomes the date of the project launch. The calendar projected by IRS is aggressive and may slip under the technical and political challenges these projects pose.

Congress can make building the infrastructure for electronic filing a priority and can provide the necessary funding to ensure that the IRS has the proper resources to succeed in this area. Electronic filing will transform the regulatory systems, but this change will not come overnight. Realistically, we are looking at three to five years of hard work to begin to realize the promises of e-filing.

### **III. Increasing Federal Support for Taking Immediate Steps to Improve Transparency and Accountability**

#### **Remove Barriers to Shared Federal/State Enforcement Efforts**

One of the challenges federal and state charity regulators face in coordinating efforts to investigate and prosecute charitable abuses is the confidentiality rules established in Section 6103 of the Internal Revenue Code. GuideStar supports current legislation—such as the Care Act and the Tax Administration Good Government Act—that would allow the IRS to disclose to appropriate state officers certain information about investigations into the affairs of nonprofits.

GuideStar notes that IRS and state tax authorities have been sharing information for years. The need for efficient tax administration requires such collaboration. The argument for efficient administration of the oversight of nonprofits is even more compelling. Nonprofits exist solely to serve public interests. Information sharing between federal and state charity regulators makes good sense. GuideStar appreciates that the Chairman, Senator Baucus, and members of the Finance Committee have been supportive of these reforms.

#### **Strategic Investments Can Improve Enforcement Capabilities Now**

Trust in nonprofits is at an all-time low. Can we afford to wait for electronic filing to address the public's growing concerns about the nonprofit sector?

Although nonprofit leaders will debate with each other and with Congress over which new laws are needed, consensus already exists about the need for more enforcement of current laws.

We would like to offer a four-point, commonsense enforcement agenda for the IRS and state charity officials:

##### **A. Capture all Forms 990 filed by all tax-exempt organizations**

The posting of Forms 990 for 501(c)(3) organizations changed the face of philanthropy. Creating transparency across the entire universe of 501(c)s will have the same effect. GuideStar has long sought the Forms 990 from other subsections of the tax code. The federal government should provide the IRS with the budget resources to make the Forms 990 of all 501(c) organization available to the public in as timely a manner as practical and to **make all scanned 990 images available to the public via the Internet.**

GuideStar has five years of expertise in taking raw 990 images and converting them into a form that appears on the Internet. This technology will become obsolete in an electronic-filing world, but that era is still many years away. In the meantime, GuideStar wants to partner with the IRS and the government to scan all Forms 990 and post them to our Internet site.

##### **B. Provide more resources to states to post information about nonprofits**

Economies of scale can be achieved by taking GuideStar's national database and customizing it for each state as we are currently doing for the states of California and New Mexico. Currently, many states can provide only summary information about the charities registered with them. Critics contend that the

summary information lacks context and distorts the charities' overall accomplishments by zeroing in on certain financial ratios. Providing access to the actual filed forms is fair to the charities and makes more information available to the public. With federal support, the GuideStar database can be customized to meet the public information needs of the individual states.

**C. Digitize all data fields of all Forms 990 filed by all tax-exempt organizations**

GuideStar is the nation's leader in taking Form 990 data and digitizing it so that it can be used for research and analytical purposes. As electronic filing takes hold, this costly and complicated process will be transformed. But until that day occurs, digitization is the most effective way to take the valuable information from the Forms 990 and use it for analysis, including regulatory oversight and law enforcement. GuideStar's efforts at digitization should be supported by the federal government so that more government agencies can have access to this information.

**D. Provide resources to NASCO to develop NASCONet into a secure platform connecting federal, state, and local law enforcement agencies**

Under a U.S. Department of Commerce grant, GuideStar will build NASCONet for our partner, the National Association of State Charity Officials (NASCO). But the grant provides funds only for development, not for operations.

Mark Pacella, deputy attorney general for the Commonwealth of Pennsylvania and president of NASCO, was a witness at the June 22 hearing. In his testimony, Mr. Pacella highlighted the importance of NASCONet as a law enforcement platform connecting all states. He also highlighted the need for a sustainability model for this project and asked Congress to support it financially.

Funded with federal dollars, NASCONet could be expanded to serve the law enforcement needs at the federal, state, and local government levels. Loaded with Form 990 images and data and powered with analytic tools to search and sort through this information, NASCONet would be a cost-effective means of targeting enforcement dollars to serve a broad law enforcement community.

**Conclusion**

Although private foundations and public charities are currently paying for federal and state enforcement programs, these activities remain under-funded because of other pressing social needs. Whether we are looking at the excise tax on private foundations' investment income or at registration fees paid by

charities soliciting contributions in almost any state, foundations and charities are paying more to government than the appropriating bodies are returning to the regulators for enforcement programs and activities.

One obvious solution would be to redirect the federal excise tax on private foundation investment income – now estimated at about \$500 million annually – to the IRS and state charity regulators for oversight and enforcement. Those dollars have been funneled into general revenues appropriated for purposes unrelated to oversight of the nonprofit sector. In the current daunting fiscal environment, it may be more realistic to require new initiatives to pay for themselves. Given the history of the excise tax, the idea of new fees levied on nonprofits is likely to be opposed by many. If, however, new fees are considered, there may be ways to make their imposition more acceptable to nonprofits.

There should be a mechanism to put fees paid upon filing Form 1023, Form 1024, Form 990, Form 990-EZ, and Form 990-PF into a “lock box” solely for the purposes of law enforcement and tax administration. Nonprofits work with the concept of restricted funds every day. It makes sense that fees collected from nonprofits be restricted solely to oversight of the nonprofit sector.

Fees collected should take into account the impact on the organizations paying them. Indexing the filing fees based on a nonprofit’s total income and net assets will even out the burden by basing these costs on an organization’s ability to pay. Requiring the entire Section 501(c) filing universe to pay also balances the burden on the many small 501(c)(3) organizations that are created to serve local needs in communities.

If fees paid at the federal level are shared with the states, consideration of federal preemption of state and local filing fees that nonprofits currently pay should be addressed. Nonprofits will embrace the ability to pay one fee and file their forms in one place (the federal/state retrieval system), leading to the simplification of the compliance process that I addressed earlier.

The staff white paper raised the possibility of new federal dollars for the nonprofit sector to engage in education, technical assistance, accreditation, and other related infrastructure-building activities. GuideStar agrees that these activities are valuable and needed.

In addition to new federal spending for these priorities, Congress should consider requiring all private foundations to pay a portion of their 5 percent minimum pay-out requirement to support infrastructure-building activities. Far easier than finding new money, redirecting a certain percentage of foundation

giving to these vital efforts will more efficiently serve the nonprofit sector by building its internal capacity to do a better job for the American people and for the beneficiaries of nonprofits' good works.

Mr. Chairman, Mr. Baucus, and distinguished Members of the Committee, I have shared some recommendations concerning actions the federal government can take immediately to strengthen the transparency and accountability of nonprofit organizations by making strategic investments in current infrastructure to maximize the impact of enforcement actions at federal and at the state level.

Enforcement of the current rules is most important. More resources are needed now for that task. The need for "brighter lines" makes good sense where appropriate. Finding the appropriate balance will take time and dialogue with all stakeholders.

I have tried to emphasize in my testimony that nonprofits and philanthropy have played a vital role in American society. As we move forward to address the abuses that have occurred, we need to protect the genius and vitality of the nonprofit sector.

GuideStar will continue to be government's trusted partner in providing a platform for transparency and accountability. We welcome the opportunity to participate in the dialogue that you have begun.

Thank you for this opportunity to convey some of our recommendations on this important matter.

June 28, 2004

**Statement of Allison Fine, President of Innovation Network, with regard to the June 22, 2004 hearing “Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities.”**

Senate Finance Committee:

Mr. Chairman and Members of the Committee, I thank you for the opportunity to accept statements regarding your recent June 22, 2004 hearing “*Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities.*”

As President of a nonprofit organization whose primary purpose is to promote, provide tools and assist nonprofits with greater self-regulation and increased accountability, I am very cognizant of the critical role nonprofits play in communities across our nation and the abuses that have eroded public confidence in this well respected American tradition.

Over the past several years, there has been a significant and frightening decrease in the amount of public confidence in the nonprofit sector causing a quiet crisis with enormous ramifications. As the last refuge for hope and humanity from the greed of the corporate world and the indifference of the government, the nonprofit sector is on the verge of a major meltdown – and we have no one to blame but ourselves.

In December 2003, Paul Light a researcher at the Brookings Institute published findings from an ongoing survey that found that the percentage of Americans who said they had “a lot” of confidence in charitable organizations fell from 25 to 18 percent, while the percentage who said they had “none” rose from 8 to 17 percent from July 2001 to May 2002. Perhaps more devastating for nonprofits in the long run, 60 percent of respondents said that charitable organizations wasted a “fair amount” to a “great deal” of money.

Declining public confidence is just one indication of the degree of the crisis. The increase in government and media scrutiny of nonprofits and the struggling economy that has led to a decline in government support for social services, the arts and other mainstays of the nonprofit sector, are all straining the sector.

Combine these factors and here, in a microcosm, is what happens: Recently, I was sitting with a program director of a small nonprofit after school-program. The organization’s chief fundraiser burst triumphantly into the room and shouted, “We did it, we got a \$50,000 grant from the community foundation for mentoring!” After the development director left, the program director burst into tears. “What’s wrong?” I asked. “We don’t do mentoring,” she whispered.

Statement of Allison Fine, President, Innovation Network  
 June 22 Hearing: "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities."

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Questionable fundraising practices are only part of the story. Mainstream media coverage of nonprofits in the past several years has focused on exorbitant pay for chief executives, self-dealing on the part of foundation trustees, interest free loans for senior staff and other unscrupulous behavior.

However, the real scandal isn't that malfeasance can be found in a handful of scrutinized nonprofits; bad apples are everywhere. The real problem is that in the face of criticism and declining public opinion, the possibility and potential for the nonprofit community to press for real long-term solutions to social problems has become unattainable.

We have the potential to demonstrate our accountability and articulate the positive impact of the sector, yet in the face of criticism and declining public opinion, we choose to remain mute. As the best -- and often only -- voice for the disaffected and underserved members of our society, we have been silent. For instance, when HUD recently announced that it would not reimburse communities in full for Section 8 housing subsidies that provides basic shelter for 2 million people, the nonprofit community did not respond. Without a significant change in the way we work, the nonprofit sector will become an afterthought in the creation of public policy, negatively impacting how most Americans will live in the next decade.

In many respects, it is not surprising that the sector finds itself under the spotlight and tongue-tied. For most of its history the nonprofit arena was the provincial backwater of "good works"; neither important nor large enough to be the cause of attention or concern. Explosive growth over the past twenty years has completely changed the nonprofit landscape and created a true third leg to the economy alongside government and corporate sectors. As reported in the *Philanthropy Journal*, Ken Lewis, CEO of Bank of America, estimated that if charitable giving were a business sector, it would be the 10th largest in the U.S., ranking roughly between real estate and mining. The sector represents 9.5% of the nation's workers, and 6.1% of the national income and it has tremendous reach. Over a third of the population -- approximately 100 million people -- touch the nonprofit sector as staff, clients, donors and volunteers<sup>1</sup>.

While the size of the sector is enormous; the pace of growth is even more startling. The number of nonprofits organizations grew by 31 percent between 1987 and 1997, surpassing the growth rate of both business and government. According to the Center for Charitable Statistics, there are approximately 1.5 million IRS registered nonprofit organizations.

This vast growth has led to an all-consuming competition for funds among nonprofits while having a devastating effect on the ethos and values of the sector. Fundraising is to nonprofits what political action committees (PACs) are to the political system -- a seducing strangler. The common thread running throughout the myriad scandals reported in national and local news media the past several years has been financial malfeasance, the misuse of funds and fundraising scams.

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<sup>1</sup> This calculation is based on the following assumptions: 1.5 million nonprofits each averaging 3 staff people, 5 board members, 50 clients equals 10 donors. Given the likelihood that there is some overlap between board members, donors and staff, I chose to randomly reduce this number by 25% to approximately 100 million.

Statement of Allison Fine, President, Innovation Network  
 June 22 Hearing: *"Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities."*

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The growth in the sector is due in part to increased community needs. A surge in government deficits at federal and state levels has left millions of people at risk without a government supported social safety net. Nonprofit social service providers are often the last and only resource for housing, food, legal protection, health services and employment support. The result for nonprofits is a whirlpool whereby the demand for services feeds growth in the number of nonprofits, which drives the need for more funds, and around goes the circle.

Of course, all nonprofit organizations have to raise money. And they should be as creative and diversified in their funding strategies as possible. However, what donors are experiencing is an explosion of fundraising techniques and strategies that is numbing in its ubiquity. The onslaught of fundraising campaigns and activities has the unintended consequence of making it very difficult for donors to distinguish between charities while also alienating those that currently give. Epsilon, a fundraising consulting company, conducted a survey a year ago that found that 14 percent of the people surveyed had stopped giving to a charity that they had previously supported because of concerns about how the money was being spent.

What is the nonprofit sector's response to all of this? Well... very, nearly nothing.

And this is the crux of the matter -- not that the sector has grown in size and relevance, not that the fundraising machinery is operating in overdrive or that Legislators are taking pot shots at an easy target. The critical point is that the nonprofit sector is not responding to the criticism and questionable practices--and by not responding, we are fundamentally disserving the people and communities we serve. Nonprofits represent the on-the-ground service providers, and as such, can offer the best solutions to intractable social problems. With the right tools and attitude we can move from crisis interventionists to advocates for systemic, positive social change.

The loss of public trust, which is the backbone of the nonprofit sector, must be remedied quickly. Solutions are available. The question is whether the sector has the will to implement them. By championing transparency, open and honest communication with constituents, and a balanced approach to measuring success, we can mobilize to counter criticism and become effective advocates for social change.

**The first area of needed reform is for greater transparency.** Transparency is a two-way street, much to the chagrin of many organizations. To be transparent, organizations must share information about finances and operations, welcome information and feedback from constituents and use that information to improve the organization. And that's where most nonprofit organizations fail miserably. As a result, we support the Committee's suggestion to disclose performance goals, activities and expenses in Form 990 financial statements. In this way, nonprofits can use the opportunity to focus on self-regulation of objectives and activities while promoting transparency to potential donors and the public-at-large.

Rather than treating donors like ATM machines, nonprofits should be talking to their supporters and inviting them into their organization as key constituents to help shape the direction and activities of the organization. This alternative to traditional hierarchical structure creates a web of supporters who are also shapers, activists and ambassadors for the cause. Too often, when

Statement of Allison Fine, President, Innovation Network  
 June 22 Hearing: *"Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities."*

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grassroots groups mature they put a distance between the organization—made up of its professional cadre of fundraisers and policy makers—and donors. The corporate sector is full of examples where lack of attention to key constituents led to trouble. Consider the trials of GM and McDonalds. When we can do a better job of engaging in sincere dialogue with constituents, we will make significant strides to restore public confidence in the sector.

**The second thing that we have to do is to get real.** One of the habits of fundraising-driven organizations is that they begin to believe their own "proposal" language—the sweeping overstatements that they use to describe their accomplishments in order to hook donors. The overblown hyperbole of proposals creates an enormous chasm within organizations wherein the staff responsible for providing services is left trying to solve homelessness with a \$5,000 grant – or worse left with the private fear that they will be found out for not doing so.

**Third, we need a more balanced approach to measuring nonprofit success.** The focus of charity watchdogs like Guidestar and Charity Navigator and government legislators has primarily been with regard to financial reporting. However, this is insufficient to improving the transparency, accountability and more importantly the effectiveness of the nonprofit sector. Nonprofits have two bottom lines—financial and programmatic. There has to be a greater balance between financial activities (including fundraising) and the successful fulfillment of an organization's mission. In other words, just balancing the books doesn't make a nonprofit successful, we also have to serve people and make a positive difference in the world. Shelters have to house people and move them into more permanent housing; after school programs have to protect and educate children; employment programs have to train and place people in them in jobs.

There has been a sea change of interest on the part of nonprofit organizations in planning and measuring the results of their programs. Part of the surge of interest is pressure from donors and government agencies, but that's just a part. We're also seeing a new crop of nonprofit managers who inherently understand the need for more rationale decision-making and want to use online tools to gather and use data to make decisions. But simply responding to external pressures or relying on the efforts of a select few are not enough.

We need board members to better understand that nonprofit success is more than financial health; that nonprofit success must be measured by how well clients are served and what difference nonprofit services are making in the lives of people and communities. Donors need to stop accepting proposal language and help grantees to make better choices of how to use precious resources in the most effective ways. Most of all, we need to develop the gumption to tell it like it is. Social change is the hardest work there is. It takes time and money and perseverance and courage. Choosing not to collect and use data that demonstrates the results of our "good work" is self-defeating.

For far too long nonprofits have hidden behind a curtain of denial and fear when it comes to measuring their own performance and only acceding to it when funders push hard for measurable results. The objection that changes in attitudes and behaviors aren't measurable is a chorus that I've heard too many times to count. If we can define something, we can measure it.

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By engaging in sincere dialogue, acknowledging what works and learning from mistakes, we have the potential to solve the problems we all work so hard to fix. By measuring success, we can build a strong collective voice to advocate for social change. When we use language based on facts and data, we will not sit silently as our motives and the value of our work are questioned. By articulating the outcomes of our programs, we will have a convincing platform for activism and public policy. The indisputable language of real results moves beyond "tugs at the heartstrings" and provides concrete examples of how well nonprofit organizations are doing, what areas we need to improve and what real resources are needed to accomplish charitable work successfully. For too long, nonprofits have hidden behind a curtain of moral certainty and measurement uncertainty while resisting, if not outright refusing, to measure the effectiveness and impact of their work. Given the environment of scandal and criticism, it is critically important that nonprofit organizations take the lead in measuring their own effectiveness.

Without greater self-regulation and increased transparency, and accountability owned and enforced by the nonprofit community, abuses will continue to erode public confidence, trust in and donations to nonprofits that serve as the social service backbone in most communities.

Theodore Roosevelt Conservation Partnership  
International Association of Fish and Wildlife Agencies  
Ducks Unlimited – National Wild Turkey Federation – Pheasants Forever  
The Wildlife Society - American Fisheries Society - Wildlife Management Institute  
American Sportfishing Association - Federation of Fly Fishers – Pure Fishing  
Izaak Walton League of America - Trust for Public Land - Environmental Defense  
Boone and Crockett Club – Safari Club International – Quail Unlimited  
North American Grouse Partnership – Bear Trust – Mule Deer Foundation  
Land Trust Alliance – Civil War Preservation Trust – Mississippi Land Trust  
Mississippi River Trust – Texas Wildlife Association  
Conservation Force – Campfire Club of America

TESTIMONY TO SENATE FINANCE COMMITTEE

Hearing of June 22, 2004

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

Dear Chairman Grassley and Ranking Member Baucus:

Conservation easements are among the most powerful and effective tools available for the voluntary protection of fish and wildlife habitat, agricultural lands, forests and historic resources.

A conservation easement allows a landowner to retire development rights to his or her property to protect resources important to the public. The landowner can continue to own, manage, live and work on their property, and can leave it to their heirs. Forty-eight states have passed statutes specifically providing for the use of permanent conservation easements by private landowners.

This tool is essential to conservation progress, as nearly seventy percent of the lower forty-eight states is privately owned. Eighty percent of all hunters hunt on private land, and private lands are just as important in providing habitat for fish and access for anglers. Many of our nation's most important historic sites are on private lands, and most endangered species depend on privately owned habitats.

Conservation easements are also an important tool for preventing key agricultural lands from being lost to development. The cattlemen's associations in Colorado, California, Wyoming, Oregon and Kansas have formed land trusts to hold conservation easements donated or sold by their members. National nonprofits such as Ducks Unlimited and the Rocky Mountain Elk Foundation, local and regional land trusts, local governments, and state wildlife and

agriculture agencies all are working with landowners across the country to create and take care of conservation easements.

Private landowners have donated conservation easements on more than 4 million acres of land. These conservation donations are among the nation's most cost-effective long-term conservation programs.

Many farmers or ranchers own land that would be worth \$1 million or more if it were removed from agriculture or forestry and subdivided for development. Yet, because many of these landowners have modest incomes, donating a conservation easement yields these landowners minimal tax benefits under current law. We support the conservation incentives passed by the Senate Finance Committee and the full Senate last year as part of the CARE Act. These new incentives are needed if we expect private landowners to continue making extraordinary gifts to society for conservation.

At the same time, we support reasonable measures to ensure that these provisions of law are not abused. Requiring the use of state-licensed appraisers, requiring that appraisals comply with the Uniform Standards of Professional Appraisal Practice, and increasing penalties for over-valuation of donations are changes that we would support.

In examining proposals for new requirements for donors, we urge the committee to be particularly sensitive to the most generous of donors – land-rich, cash-poor farmers and ranchers for whom substantial additional costs would present a serious disincentive.

Reforms increasing the tax benefits available to modest-income donors, together with reforms that helped prevent abuse of these tax benefits without discouraging valuable conservation, would be a boon to conservation across the country. We urge the Finance Committee to move such a package forward as soon as possible.

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For additional information, please contact:

Gary Taylor  
International Association of Fish and Wildlife Agencies  
444 North Capitol Street, NW  
Suite 544  
Washington, DC 20001



Statement of  
Rand Wentworth, President  
LAND TRUST ALLIANCE  
1331 H Street, NW Suite 400  
Washington, DC 20005

Submitted to the Senate Finance Committee  
for the record of the hearing of June 22, 2004

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

Dear Senators Grassley and Baucus:

The Land Trust Alliance (LTA) represents the community of more than 1,300 land trusts across the country. These are charities that work directly with landowners on land conservation.

We want to start our testimony by thanking both of you for your leadership on conservation issues, and particularly for your work together to advance new federal tax incentives for private landowners who voluntarily conserve land. Sections 106 and 107 of S. 476 would provide a major step forward in the conservation of private lands across the country.

More than 1,000 land trusts are dues-paying members of LTA, and they are a diverse group. Some work solely to keep land in agriculture, including working ranches. Others protect natural areas. Some, like Rocky Mountain Elk Foundation, are working for the benefit of a particular species of wildlife. The Civil War Preservation Trust protects historically important battlefields. We have member organizations dedicated to protecting recreation trails, river corridors, urban parks, community gardens, and working forests.

Some of these organizations operate nationally. Some, like the Iowa Natural Heritage Foundation and the Montana Land Reliance, work statewide. Others may be working in

a specific community, often no larger than a township or county. Many of these locally focused land trusts are all-volunteer organizations, with no paid staff.

Together, these organizations have helped protect resources important to the public on millions of acres. Many have become important institutions in their communities. They do tremendous work, and LTA is proud to be able to help them, by working on policy issues that affect them, by providing training and information, and by developing and promoting standards for these organizations and their work.

#### Land Trust Standards and Practices

In 1989 LTA issued a “Statement of Land Trust Standards and Practices”, the ethical and technical guidelines for operating a sound land trust. In 1993 we published “The Standards and Practices Guidebook”, a 533-page detailed operating manual for land trusts. The standards, and the guidebook, were collaborative productions of the entire land trust community.

LTA is now in the midst of a new, year-long effort to work with land trusts to revise Land Trust Standards and Practices to incorporate a decade’s worth of lessons learned by land trusts, and to respond to changes in our field and in society. This work is led by a committee of land trust leaders that began work last summer and issued a public comment draft of the revised standards in January. We held over 50 meetings with land trusts and received more than one thousand comments on the draft revisions, and have made substantial changes in response. A new draft will be circulated late this month, and we hope that we will have a final version ready for approval by our board of directors this fall.

The land trust community created Land Trust Standards and Practices to show a clear and well-marked path toward operating a land trust legally, ethically, efficiently, effectively and sustainably. All of our sponsor members are required to have their board formally adopt a goal of coming into substantial conformance with the Land Trust Standards and Practices.

Land Trust Standards and Practices focus on governance of a land trust, the role and responsibility of its board of directors, and insuring that there is focus on the organization’s mission and on its responsibilities to the public. Because land transactions are central to land trusts’ work, Land Trust Standards and Practices pay particular attention to responsibly managing those transactions, on the use of conservation easements, and on the stewardship of lands and easements for the future.

#### Appraisals of Land and Conservation Easements

We have had discussions with land trusts and other conservation organizations for five months, trying to develop a consensus on what new rules Congress or the Internal Revenue Service (IRS) could impose to help ensure sound appraisals and ensure that transactions have a clear charitable purpose.

Those discussions have not led to a consensus, although we can say there is broad agreement that the Congress could:

- Direct the IRS to adopt the Uniform Standards of Professional Appraisal Practice, so that it is using the same measures of good appraisal practice as virtually all other state and federal agencies;
- Require that appraisers be state-licensed, as is required for federally-related mortgage transactions; and,
- Increase penalties for substantial misstatements of the value of donations, and expand those penalties to include disbarment of appraisers involved in substantial misstatements from having their work accepted by the IRS in the future.

To the degree that new rules can help ensure better appraisals, or can help identify or prevent appraisals that are abusive, we would welcome them. We have discussed various ideas with the committee staff over the past six months, and look forward to a continued dialogue. Our goal is simple – to find ways to prevent or identify abusive appraisals, without creating barriers to good donations.

#### Avoiding Barriers To Conservation

New requirements that would add substantial costs to land transactions could pose a significant barrier to the success of volunteer land trusts and to the willingness of landowners to make donations of conservation easements. This barriers question is an important one for us, because conservation easements are very high-value donations that can come from donors of very modest incomes. Few cabdrivers donate Rembrandts to a museum – but a good many farmers and ranchers, who may have net cash incomes no greater than a cabdriver, donate development rights to their land that may be worth millions of dollars. For these donors, additional costs could be a substantial barrier to extraordinary conservation gifts to the public.

While changes in the law can help avoid abusive appraisals, the private sector also has an important role to play to improve appraisal practices. We understand that the Appraisal Institute is in the process of creating a credential for appraisers with demonstrated expertise in appraisals of conservation easements, and a training program to support it. We applaud that effort. As publisher of “Appraising Easements,” the only text on this subject, LTA looks forward to working with the Appraisal Institute on this initiative.

### Standards and Practices, and Beyond

Adopting Land Trust Standards and Practices provides land trusts with a way to demonstrate their commitment to the public, and to donors<sup>1</sup>. Over 1,000 land trusts have adopted the Land Trust Standards and Practices. We are glad that a number of foundations require land trusts to adopt Land Trust Standards and Practices to be eligible for funding, as have some government agencies.

Adoption is an important statement, but does not yield an objective measure of how well an organization has done in implementing the standards. We are now beginning a process of examining how we can best provide recognition to those land trusts that have met milestones in implementation. The development of these programs, like the revision of Land Trust Standards and Practices, will be done with the advice and guidance of the land trust community. We expect to engage the land trust community in a dialogue about next steps starting this fall.

We can do a great deal to prevent or expose problems through private sector standards and credentialing. Each of our sponsor organizations, while they receive very valuable donations of land and conservation easements, must also raise cash from donors to support the work they do. The marketplace of charitable giving examines each and every one of these organizations, and adoption and measurement of standards can have a major impact on that market.

Enforcement of federal law, however, remains an essential element. We can inform the marketplace. But without enforcement, we will not be able to stop those who deliberately intend to abuse the rules. We believe that such instances are rare in our sector – but they do exist, and they are a threat to our work.

We recognize that the IRS has a huge and unenviable task in overseeing tens of millions of tax returns and related filings (including Form 990s), and we do not think that any process that simply singles out conservation donations for examination would be either warranted or effective. We estimate that there are 3,000 such donations a year, a number that would likely overwhelm any bureaucratic review. Nor have random audits been very successful in preventing abuses – the odds of such an audit are simply too low.

We believe that a more effective strategy would be to target review to those transactions most vulnerable to abuse. We are willing to work with the IRS and with this committee to identify additional information that could be collected from donors and from donees to identify those transactions. By being strategic and concentrating on these transactions, and by developing and using expertise specific to this field, we believe the IRS could vastly improve the usefulness of its audit work.

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<sup>1</sup> As referenced above, adoption of the Land Trust Standards and Practices consists of a written resolution by a land trust's board of directors that they agree with the Land Trust Standards and Practices, and are either in substantial conformance with them, or will adopt a plan to come into conformance by a date certain. Land Trust Standards and Practices were designed as goals for excellence, not minimum requirements.

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In conclusion, we wish to thank the committee for the opportunity to testify, and offer our continued help in finding solutions that move conservation forward by increasing public confidence that the tax tools provided by the Congress to land trusts and other charities are being used well, and wisely.

# # #



June 28, 2004

Senate Committee on Finance  
Attn. Editorial and Document Section  
Rm. SD-203  
Dirksen Senate Office Bldg.  
Washington, DC 20510-6200

Hearing: **Charity Oversight and Reform: Keeping Bad Things From  
Happening to Good Charities**

Hearing Date: **6/22/2004**

Dear Chairman and Committee Members:

One of the persons who testified before the Committee at the above hearing, Ms. J.J. MacNab, disparaged our organization in her testimony. With regret, I acknowledge that some of what she noted is true. However, I have 3 items of favorable report.

First, the critical deficiencies of our organization have been rectified. Perhaps the most significant deficiency related to the fact that control of the organization was vested in a single person. Tennessee law (and perhaps the law of other states) inadvertently permits nonprofit organizations to be controlled by a single member. By limiting access to membership of the nonprofit (such as by requiring exorbitant membership fees or requiring approval of new members by the existing membership), a person can perpetuate sole control. The control can be exercised through the appointment of directors who can be immediately replaced to the extent that they decline to follow the directives of the member—effectively vesting in the single member complete, unbridled control over the activities of the organization. Of course, such control is a breeding ground for abuse and/or poor decisions, and our organization suffered the ills of such control. This deficiency was corrected when, days prior to the death of the single member, control of the organization was placed into the hands of four additional members. The four members are men of integrity, who have appointed directors that have elected a new president, who has implemented a number of operational changes that have substantially improved the quality and character of the organization. In addition, as a result of the activities of the organization under the direction of the former single member and prior management, the organization experienced rigorous scrutiny on a number of levels, including inquiries and reviews by state departments of insurance, state departments of securities, state attorneys general, state taxing authorities, the SEC, an IRS audit that resulted in a closing agreement, and lawsuits (including a class action suit). Such

scrutiny has prompted the new members and management to shepherd the organization towards best practices in the charitable industry.

Second, from my perspective as a business attorney, having served nearly six years at a charitable organization, it is my opinion that the regulatory framework regarding the operation of charitable organizations, in its present form, is very effective. Thus, additional regulation is not required. Abuse will continue to occur, because we will always suffer the ills of evil people, and evil people operate despite regulation. However, education of the public regarding sound charitable management practices (can be done on the IRS website) and enhanced disclosure requirements imposed on charities (more details in the 990 and then making those details accessible) are two significant keys to reducing exposure to further ills. The giving public is astute; you need only help it know what to look for and then give it the place to find the answers.

Third, Ms. MacNab's concerns regarding compensation being paid by charities to financial professionals who assist charities in their development efforts are overstated. I am providing herewith a copy of a memorandum that addresses her concerns. I trust that you will find the information informative and that you will agree that charities should not be restrained in their development efforts by outdated notions.

Sincerely,



Mark A. Absher  
Corporate Counsel

**Should Charities Be Precluded from Using the Same Compensation Methodologies Used by Nearly Every Other Industry in America?**

By Mark A. Absher<sup>1</sup>

A burdensome and backwards ideology is being indifferently tossed on charities today. A cluster of traditionalists has been advocating that charities should not be allowed to provide transaction-based compensation to financial professionals who assist the charity in closing charitable gift annuity transactions. The traditionalists advocate that a commission form of compensation is simply contrary to the way it always has been, and something is, therefore, amiss when people get paid to benefit a charity. Their arguments, amazingly, have found a home in a few, isolated regulatory frameworks. However, the result is always ill-conceived legislation that stifles the efficiency of charities. Rather than tie charities to tradition, it is time to weigh the anchor and give charities the freedom to embrace the compensation methodologies used by nearly every other industry in America.

**A. *Transaction-Based Compensation is Fair and Reasonable.*** It should be unnecessary to discuss the propriety of commission compensation. American industries have almost universally applied a transaction-based compensation methodology as the most effective means to promote their goods and services. There is something completely understandable and fair about the concept of paying the representative who succeeds in completing a sale and not paying the representative who fails to generate revenue for the organization. The success-related compensation methodology is the very life blood of capitalism; without reward for performance, there simply is no incentive to perform. Even in generic charitable fund-raising activities, there seems to be widespread acceptance of the idea that fund-raisers can be paid compensation based on the success of their development efforts. In addition, in the financial services industry, it is commonplace for financial professionals to be paid commissions for insurance and securities products sold. A charitable gift annuity transaction is little more than a combination of these concepts: the sale of an annuity with a corresponding benefit to charity. Therefore, even a traditionalist should consider it completely appropriate for an individual to receive transaction-based compensation for facilitating a charitable gift annuity transaction.

**B. *Concerns Regarding Fraudulent or Abusive Sales Practices Are Exaggerated.*** The traditionalists advocate that allowing the payment of commissions in connection with charitable gift annuity sales will result in fraudulent or abusive sales practices. However, a number of considerations demonstrate that such arguments are overstated. First, state and federal unfair and deceptive trade practice laws already provide adequate protection to remedy fraud and abuse in connection with the sale of charitable gift annuities.<sup>2</sup> Generally, any person participating in a fraudulent activity in connection with a charitable gift annuity transaction may, depending on applicable law, face claims for compensatory damages, civil

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<sup>1</sup> Mr. Absher serves as Corporate Counsel to National Community Foundation. He received a B.S. degree from Bob Jones University in 1984 and a J.D. degree from The John Marshall Law School in 1988. He has served as a judicial clerk, a litigator, and as counsel to privately held, publicly held, and charitable organizations.

<sup>2</sup> See the Federal Trade Commission Act, 15 U.S.C. § 41 *et. seq.* In addition, states have the ability to regulate and do regulate commercial speech to the extent necessary to avoid "aggressive sales practices that have the potential to exert 'undue influence' over consumers." *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 495 (1996).

penalties, treble damages and the payment of the injured party's attorney's fees. Second, it is important to recognize that fraudulent sales schemes would exist, with or without the payment of commission-based compensation inasmuch as the primary objective of such schemes is the unlawful receipt and appropriation of investor funds. Noteworthy is the Mid-America case, wherein it appears that donors were provided false information regarding the financial integrity of the charity. Commission or no commission, the fraud would have been the same. Third, as noted above, nearly all sales activities, including the sales of securities and insurance products, involve some form of transaction-based compensation, so it cannot be said that the mere use of a commission form of compensation will cause fraud to occur; otherwise, regulation should be directed at proscribing such compensation strategies for all industries. Finally, the suggestion that abuse ("overselling" or the sale of one product over another simply to get a higher commission) would occur in connection with charitable gift annuities ignores the fact that a charitable gift annuity involves a charitable contribution—the value of which is inversely proportional to the value of the payments the annuitants will receive. If the donor truly wanted the highest performing investment for the money, he or she would not likely acquiesce to purchasing a charitable gift annuity regardless of the "pressure" to complete the transaction. Thus, the traditionalists' suggestion that paying commissions in charitable gift annuity transactions will prompt fraudulent or abusive sales practices is simply exaggerated.

*C. Forcing Charities to Use Traditional Methodologies Creates Inefficiencies.* The payment by a charitable organization of transaction-based compensation to a financial professional who assists in closing a charitable gift annuity transaction is likely the most efficient means for the organization to effect such transactions. Again, the fact that nearly every industry in the American marketplace, arguably the most efficient marketplace in the world, uses commission compensation methodologies should, in and of itself, be enough to substantiate the efficiency of the practice. However, it is worthwhile to note the inefficiencies associated with the charity's alternative—which is to hire persons to perform the function of finding prospective donors, educating those donors regarding the benefits of the charitable gift annuity transaction, and assisting the donors in completing the documentation associated with the transaction.

First, the employees so hired may lack the financial training or licensure sufficient to explain adequately the charitable gift annuity transaction to prospective donors—leading to transactions with persons for whom the charitable gift annuity is unsuitable and thereby exposing the charity to liability.<sup>3</sup>

Second, in cases where a particular employee is consistently unsuccessful in closing annuity transactions with prospective donors, the charity would have, in employing such a person, effectively incurred wasted overhead expense in relation to the employee's salary, benefits, etc.—in addition to the opportunity cost of having employed a more successful person in the unsuccessful person's place. Such inefficiencies of operation cost the charitable

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<sup>3</sup> It is interesting to note in this regard that NASD Conduct Rule 2310 requires securities brokers to have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

organization, and society in general, dollars that could have been applied to advance charitable programs.

Third, assuming an employee were adequately trained and licensed to explain the financial, legal, and tax considerations attendant to a charitable gift annuity transaction and had the ability to market the gift annuity to prospective donors and close the transaction, such professional is, nevertheless, as an employee of the charitable organization, unable to offer any other programs or products that may be more suitable to the prospect. Although not without limit, the employee's loyalty runs with the charity—not with the prospect, as is consistently the case with independent financial professionals. Thus, the absence of knowledge of or ability to offer alternative products would likely result in the completion of transactions that are less suitable—an inefficiency that could be particularly material to the consumer.

These operational inefficiencies, however, are virtually eliminated by a transaction-based compensation program using non-employee financial professionals. In compensating transaction facilitators on a commission basis, the charitable organization limits its costs to those relating to the point of sale—well recognized by American industries and capitalism generally as the most efficient means to effect revenue growth. In addition, by using licensed or registered financial, insurance and/or legal professionals to facilitate the annuity transactions, the charitable organization gains reasonable assurance that the transaction will be suitable to the participating donor, because regulatory and professional requirements mandate that other alternatives be explored and reviewed with the participating donor, and such professionals are regularly educated regarding the nature and benefits of available alternatives.

Another consideration is that if the charitable organization does not provide a compensation opportunity to the financial professional in connection with a charitable gift annuity transaction, then that professional is forced to accept an opportunity cost in recommending the charitable gift annuity over another financial product for which commission compensation would be paid to such professional. Because of the prospect for loss of compatible income in a charitable gift annuity transaction, the financial professional may be reluctant to recommend the charitable gift annuity—even if it achieved all of the client's objectives. Of course, the financial professional should not suffer a loss by offering a charitable gift annuity over, for example, a commission-based commercial annuity; on the contrary, the professional's compensation should be the same regardless of the product offered. Therefore, denying a financial professional commission-based compensation for facilitating a charitable gift annuity transaction tends to perpetuate operational inefficiencies for charitable organizations.

### **Conclusion**

In sum, strong policy reasons support the use of a transaction-based compensation strategy in connection with the issuance of charitable gift annuities. Transaction-based compensation is fair and reasonable. Concerns regarding fraud or abuse arising in connection with the use of a commission compensation methodology are overstated, and charities can operate more efficiently using such strategies. Therefore, the arguments of opponents to such compensation strategies should be rejected, and charities should be afforded the ability to apply the same economic strategies used by nearly every other industry in America.



*National Voice • State Focus • Local Impact*

July 6, 2004

Senate Committee on Finance  
Attn. Editorial and Documents Section  
Rm. SD-203  
Dirksen Senate Office Building  
Washington, DC 20510-6200

Statement Submitted to Senate Finance Committee Hearings on "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities" ((6/22/04) by Audrey R. Alvarado, Executive Director, National Council of Nonprofit Associations, 1030 15<sup>th</sup> Street NW Suite 870, Washington, DC 20005; 202-962-0322; [aalvarado@ncna.org](mailto:aalvarado@ncna.org)

Dear Committee Members:

I am submitting this statement on behalf of the National Council of Nonprofit Associations (NCNA) and our membership. NCNA is a membership-based organization organized as a nonprofit corporation under state law and exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). We represent a network of 38 state and regional associations of nonprofits with a membership base of over 22,000 nonprofit charities nationwide. The majority of our members and their members are organized as nonprofit corporations under state law and exempt from federal income taxation under Code section 501(c)(3). Our membership reflects the majority of the charitable sector, that is, organizations that have annual revenue budgets of less than \$500,000. These organizations represent 70% of the total number of nonprofit charities that file IRS Form 990. In addition, many of the members of state associations have revenues below the required filing level of \$25,000. We must state emphatically that the majority of charities are operating legally and ethically and are adhering to their stated mission as outlined in the IRS Form 1023 that they filed to receive 501(c)(3) status. It is disheartening that the actions of a few bad actors, who are in no way representative of what the charitable sector offers our society, has led to a Senate Finance Committee examination of the actions of the sector. We hope that the results of this examination lead to a removal of these bad actors so that the sector can return to serving communities in need and strengthening the public's trust in this valuable resource.

NCNA's state association members provide infrastructure support to their local nonprofit members through workshops, discount programs, communications, technical assistance, and referral services, and serve as call centers that answer questions about regulatory and legal requirements. Through their efforts, we ensure that nonprofits are complying with the legal and ethical requirements that guide the work of the nonprofit charitable sector. As mentioned above, most of the organizations our members serve are small and mid-sized nonprofit charities. Therefore, our comments and recommendations are tailored to reflect the impact of the Committee's actions on these organizations. We cannot stress enough the importance of seeking and including input from these organizations as you move forward and consider proposed changes that impact the work of these community-based organizations.

No entity has greater interest in keeping bad things from happening to good charities than charities themselves. We support efforts that ensure that nonprofit charities operate not only legally, but in ways that do not tarnish the image of the good and vital work done by the majority of nonprofits. Recent media reports of misdeeds and abuses have uncovered practices that, although not always illegal, raise questions about the nature of the practice and who benefits from it. To make sure the charitable sector operates effectively, efficiently, and true to its mission is the concern of all, and we applaud the efforts of this Committee to address this issue. We appreciate this opportunity to share our suggestions so that we do in fact keep bad things from happening to good charities.

#### **Overview Comments**

It is the case with all sectors – public, for-profit, and not-for-profit – that there are a few egregious examples of abuse that can taint an entire industry. We saw this most recently in the for-profit sector with the Enron, WorldComm, and other public company scandals. These abuses led to significant changes by Congressional action through the Sarbanes-Oxley legislation. There are currently fifteen states considering similar legislation for the nonprofit sector. Although some aspects of Sarbanes-Oxley can apply to nonprofits (and NCNA has endorsed those that can be directly and voluntarily adopted by nonprofits) there are valuable lessons that can be gleaned from the implementation of Sarbanes-Oxley that the Committee should review as it continues this process. For one, consider the cost of implementing any new legislation. Recent reports reveal that the cost of implementing new rules of Sarbanes-Oxley incurred by the business sector will be \$5.5 billion this year, according to a recent survey of CEOs. Additional reviews of the business sector reveal that problems still remain in financial auditing practices even after Sarbanes-Oxley has been implemented.

We accept the general premise that the nonprofit sector should be held to higher standards, as we are defined by our work done not for our own personal or

organizational gain, but to serve others. We currently operate under very restrictive conditions to obtain and keep our tax exempt status. The monitoring of our actions, and whether they are in fact principled and ethical, has been left in large part to each organization or to associations that we might be affiliated with. The rash of media coverage in the last couple of years has raised serious concerns about the wisdom of self-enforcement and whether it is time to create a more structured and punitive system of regulatory enforcement.

To fully address this issue we must recognize that we currently have laws on the books that address the current examples of abuse. Rather, it is the enforcement aspect that has been largely at fault. The IRS currently has the legal authority to correct any of the concerns addressed by the committee; however, as the hearings have revealed, the IRS does not have the resources (personnel or financial) to enforce the laws. NCNA has long advocated that sufficient support and funding of IRS oversight and enforcement efforts must happen before we consider additional efforts. It is wise to fix what is broken before moving on to costly and burdensome new reporting systems. New regulations will overload an already overburdened system – both for the enforcement entity and the nonprofits themselves. Only if the existing rules and regulations are found to be insufficient when fully and properly enforced should we move on to changing existing laws and rules.

In recent years the nonprofit sector itself has developed systems to provide guidance in a self-enforcement manner. Some of these efforts have proven to be quite effective and informative for hundreds of nonprofits. Other approaches, due to lack of resources and outreach, have had minimal impact. Congress can work with these groups, as noted in the *Staff Discussion Draft*, to encourage the support of such efforts to “clean up our house.”

#### **Senate Finance Committee Staff Discussion Draft**

NCNA’s response focuses on those items in the *Staff Discussion Draft* that are most applicable and of greatest concern to the segments of the nonprofit charitable sector that we and our state association members represent.

We used two key principles to review the recommendations in the draft document:

1. **Proactivity:** While we recognize the need for regulation, these policies should be proactive to help nonprofits avoid getting into trouble, versus solely reactive.
2. **Reasonableness:** The recommendation should be reasonable and focused on the problems (abuses) that we are trying to solve.

#### A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS. We agree with the general recommendations for the five-year review. We suggest that the requirement for copies of information such as articles of incorporation, by-laws, and conflict of interest policies, be required *only if* significant changes have been made to the documents already on file with IRS. The IRS should maintain a master database that has this information readily available for all organizations that they have reviewed. The review should be a simplified form that is certified by the CEO/Executive Director and Board Chair that the organization is still operating under the same definitions as stipulated in the determination letter. The sliding fee scale should include no fees for organizations under a certain baseline budget. We suggest this amount to be \$100,000 or less.
3. Supporting organizations. Total elimination of Type III supporting organizations without recognition of certain exemptions would cause unnecessary harm to those charitable organizations that are caught in the middle. That is, social action groups, unions, agriculture groups, and trade and professional associations that conduct activities through such support groups but do not qualify under Code 501(c)(3).

#### B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules and 2. Expand the definition of disqualified person. The application of self-dealing transactions to public charities, particularly small and mid-sized organizations, will cause undue hardship. Many of these organizations have active “working” board members that provide valuable services to smaller organizations such as legal, accounting and program services. The involvement of these individuals can save the organization thousands of dollars in fees for services that they cannot afford but are critical to the operations of the organization.
4. Compensation of private foundation trustees. The general practice of private foundations is not to pay compensation to their trustees. Those who do pay compensation have no guidelines on what is reasonable compensation and whether these amounts are eligible to be included in the “payout percentage.” Therefore, general guidelines should be established to ensure that a foundation is in line with general agreed to principles that include benchmarks from comparable institutions. The development of such guidelines should include representatives of the foundation and charitable sector, including those that monitor the activities of foundations.

**C. Grants and Expense Reforms**

1. Treatment of administrative expenses of nonoperating foundations. Nonprofit charities have long had an interest in the payout provisions of foundations and the expenses associated with the payout provision. We recognize that there are administrative costs that are associated with providing grants. These costs should be reasonable and necessary, based on the activities provided to grantees and a scale created by the IRS. Costs beyond this should not be allowed as part of the qualifying distribution unless the foundation can provide supporting documents.
2. Encourage additional grant-making by private foundations. To encourage foundations to pay out more than the current 5% rate is an excellent example of using incentives to support nonprofits.
4. Limit amounts paid for travel, meals, and accommodation. Utilizing current policy and practices of the federal government might seem like a reasonable approach to apply to foundation and charity travel. However, unlike the government, foundations and charities do not have the purchasing power to negotiate low rates for travel and accommodations. Thus, it is likely that foundations and charities will find they cannot reasonably operate under the limits imposed by this recommendation – unless the government extends the use of government rates to nonprofits and foundations.

**D. Federal-State Coordination of Actions and Proceedings**

1. Establish standards for acquisition/conversion of a non-profit. This recommendation is very much needed. One suggestion is to ensure that both federal and state requirements are consistent. There should also be extensive opportunities afforded to impacted constituents (patients and nonprofits) to present their concerns about the planned conversion. Much like an environmental impact study is required before land development is pursued; the same should be done to determine the impact of such a conversion on those individuals who have relied on the service and what will become of their ability to be served.
2. Provide States the authority to pursue federal actions. This should be done with financial support from the federal government. Currently, states do not have the capacity to enforce state and federal law violations.

**E. Improve Quality and Scope of Forms 990 and Financial Statements**

The general problem with filing Form 990 is not due to lack of effort or malfeasance on the part of charities, but rather to lack of information and standards on how to file the forms. Two of the proposed reforms that are included in the *Staff Discussion Draft, Standards for Filing and Electronic Filing*, are the only two that will significantly address the concern for "accurate, complete, timely, consistent and informative reporting."

1. Require signature by Chief Executive Officer. This practice is usually in place given that the Form 990 requires an "officer" signature. The problem has been that the Forms are usually filed by the auditor, CPA, or accountant of an organization. Although the CEO/Executive Director might have the "processes and procedures" in place, there may be differing opinions as to what is to be included in the various attachments and expense line items. This is in part due to lack of uniformity and clarity. Uniformity of definitions should be established and training and/or technical assistance offered to the CEO/Executive Director and Board Chair on the requirements of filing the Form 990.
2. Penalties for failure to file complete and accurate 990. Again, without sufficient definitions and standards and the training that explains the new processes it would not be fair to penalize individuals who have taken all measures to file the form appropriately.
3. Penalty for failure to file timely 990. Many nonprofits who utilize audit firms are serviced after higher paying clients, and therefore find themselves at the mercy of the firms to file the Form 990 when they get to them. This often results in the need for nonprofits to file for extensions. Often when the audit firm is not familiar with the various intricacies of Form 990 laws the draft form has to be corrected, and this takes additional time. The addition of an Audit Committee to review an organization's Form 990 also lengthens filing time. If the desired outcome is correct Form 990s, sufficient time must be allowed given the realities that nonprofit audits are the last to be completed by the audit firms. To apply the failure to file penalty after extensions greater than four months is unreasonable and unrealistic.
4. Electronic filing. NCNA has been working with other national organizations to support federal and state level electronic filing. We support these efforts if they do not cause an undue hardship on smaller nonprofits and support is provided to them to comply with electronic filing requirements.

5. Standards for filing. This effort is welcomed and encouraged. Standards should also be consistent with efforts for uniform charts of accounts (UCOA) that go hand in hand with financial reporting requirements.
6. Independent audits or reviews. Given that Form 990 is filed with the IRS, auditors should have the responsibility to ensure that the form was filed properly, much as they are responsible for reviewing corporate and individual tax returns. To establish an arbitrary amount of \$250,000 as the baseline for requiring an official and costly audit may have some severe financial implications for smaller organizations that have limitations on their expenses. For example, if an organization's primary source of revenue is program-restricted with little or no administrative costs, it would not have the resources needed to pay for an audit. This requirement begs the question: Who will pay for the required audits?
7. Enhanced disclosure of related organizations and insider transactions. No concerns with this suggestion; it appears on surface to be a good idea.
8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements. The specifics on how these disclosures will be reported should be considered in the context of a fuller discussion on reforms of Form 990.
9. Disclose investments of public charities. What is the definition of "smaller public charities?" If the information is included on the publicly available Form 990, there is no need to make it available on another form. This would be redundant and a waste of an organization's resources.

#### **F. Public Availability of Documents**

1. Disclosure of financial statements. The disclosure of financial statements should be required at the end of the organization's fiscal year and not month by month. The report can be filed through the organization's annual report, posting on its website, and the Form 990 (if filed).
2. Web-site disclosure. If an organization does not have the capacity to file such documents on their website they can link to other sources of information, such as Guidestar or the IRS's own database of charities.
3. Publication of final determinations. Allow for the organization to provide its response to the reasons for the audit in order ensure that it has been granted the right to make its case to the public.

4. Require public disclosure of Form 990-T and affiliated organization returns. Allow for additional information provided by the organization about its rationale for engaging in activities considered under Unrelated Business Income Tax. There are often misleading interpretations as to why organizations engage in such efforts and this provides one opportunity for the public to become better informed as to the organization's intentions.
5. Require public corporation filing of charitable giving return. The publicly-traded corporation's filing should match the nonprofit's filing as well.

#### G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Board Duties. The requirement that an "individual who has special skills or expertise has a duty to use such skills or expertise" may cause a problem in our litigious society. For example, lawyers on boards are reluctant to provide legal advice to an organization because of potential liabilities. Many of the duties outlined in the *Staff Discussion Draft* are consistent with the general practices of boards. The requirement of changing auditors every five years, for those organizations conducting audits, might on surface be a good idea but could lead to more mistakes in filings (of both audits and Form 990s). In addition, exceptions may have to be made in communities where there is not an abundance of auditors available for nonprofits. Once again, seeking direct input from those organizations that will be impacted by significant changes in current practices is advised.
2. Board Composition. To establish an arbitrary range of three to fifteen board members does not take into account the extensive board development of long established organizations that have board involvement in program and administrative committees or the implications of the size of an organization. The recent suggestion that boards incorporate an Audit Committee as part of their standing committees, for example, required NCNA to overextend our board members with two to three committee assignments. Other organizations, such as those that are membership based, have elaborate formulas to ensure that their boards are reflective of their constituency, and this might require more than twenty members.
3. Board/Officer Removal. On the surface this seems reasonable and wise.
4. Government encouragement of best practices. If preferential treatment is afforded to those and only those organizations that are accredited by IRS designated entities, the IRS and those entities must be open and transparent in their process and make information easily available on how to gain and seek

accreditation. It is desirable to make existing practices more efficient and uniform.

5. Accreditation. This is an example of a good idea that would be difficult, if not impossible, to implement fairly, cost efficiently, and reasonably. To place the additional financial hardship on organizations to pay fees to retain their accreditation status will jeopardize those organizations that are not in the position to pay for the status. This raises questions as to the legitimacy of such efforts if one is paying for the "stamp of approval". The *Staff Discussion Draft* notes the efforts of our own members: Maryland Nonprofits, Ohio Association of Nonprofit Organizations, Pennsylvania Association of Nonprofit Organizations, Georgia Center for Nonprofits, and Louisiana Association of Nonprofit Organizations, in addition to the Minnesota Council on Nonprofits, Utah Nonprofits Association, and North Carolina Center for Nonprofits. These and other management support organizations have been challenged by the nonprofit sector's own calling for greater guidance on how to operate, stimulated in part by external calls for greater accountability and by their own desires to operate under the strictest adherence to rules and regulations. Investments in efforts such as those of our member state associations is a step in the right direction as long as there is ample time, energy, and outreach to the thousands of nonprofits that do not have ready access to such programs. If the \$10 million were applied to the 1.5 million nonprofits across the country, this would equate to approximately \$6.67 per organization, for the *first year*. Maryland Nonprofits has found the accreditation process to be far more extensive and time consuming than originally determined; if we move towards the accreditation process and use the determination as a status for preferential treatment for government and other revenue sources, we ought to be cognizant of the "real costs" of such an endeavor. The success of an accreditation process requires extensive follow up and monitoring to ensure that organizations are complying with the standards of practice. This again is time- and staff-consuming and requires sufficient support to make it more than a perfunctory function.
6. Establish prudent investor rules. On the surface this sounds like a reasonable recommendation.

#### **H. Funding of Exempt Organizations and for State Enforcement Education**

NCNA has long advocated that the foundation excise tax (2%) be applied to its intended purposes. One of the major reasons we find ourselves in the predicament we are in today is that IRS EO Enforcement entity has not had sufficient resources to catch the "bad apples". Applying the tax revenue for its intended purposes would go a long way to resolving many of the abuse cases.

Attaching additional fees to already strapped nonprofit organizations, plus adding other fees (accreditation, penalties), will punish those that try their best to comply with the existing rules and regulations. It is not just the burden placed by extra financial costs, but the extra time necessary to learn about the new requirements and incorporate new procedures – which for the most part are not funded activities. The result takes precious time away from mission driven activities. This is especially troubling in a time when nonprofits are being admonished for being less efficient and spending too much on overhead and administrative costs versus mission costs.

Government's desire to work in partnership with existing groups to educate other nonprofits, so called infrastructure organizations, is another effort we heartily support. It has long been the dream of NCNA and its members to have government support for "one stop centers" that provide all the necessary information for starting up, shoring up, scaling up and shutting down nonprofits. Education is the key to preventing bad things from happening to good charities. The experience of many of our members reveals that nonprofit staff, board and volunteers are trying to do the best they can with limited resources and information. The challenge is getting the right information to them in a timely and efficient way, as this is the only way to build their capacity and strengthen their organizations.

Currently nonprofit organizations must comply with local, state and federal (IRS primarily) sets of rules – many of which come with their own reporting requirements and filing fees. Efforts that support uniformity of financial and program reporting across the three levels of the public sector would streamline efforts and would be supported by NCNA and its members. Attempts to improve state level enforcement, in consultation with the nonprofits in those states, is far more advisable than leaving enforcement in the hands of the federal government.

### Closing

NCNA looks forward to working with the staff and members of the Senate Finance Committee as it moves forward in its efforts in the area of nonprofit regulation and enforcement. Our linkage to local community based organizations through state associations can provide valuable feedback to the committee as you finalize or reinforce existing legislation. You can become more informed about our organizations and our state association members by logging on to our website [www.ncna.org](http://www.ncna.org).

## THE NIA GROUP *(Nonprofits Insurance Alliance Group)*

P.O. Box 8507, Santa Cruz, CA 95061-8507 [www.insurancefor nonprofits.org](http://www.insurancefor nonprofits.org) (831) 459-0980 (800) 359-6422 Fax (831) 459-0853

July 14, 2004

Senate Committee on Finance  
Attn. Editorial and Documents Section  
Rm SD - 203  
Dirksen Senate Office Building  
Washington, DC 20510-6200

Statement Submitted to Senate Finance Committee Hearing on "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities" (6/22/04) by Pamela E. Davis, CEO, Nonprofits' Insurance Alliance of California (NIAC) and Alliance of Nonprofits for Insurance, Risk Retention Group (ANI-RRG), P.O. Box 8507, Santa Cruz, CA 95061, (831) 621-6018, [pdavis@insurancefor nonprofits.org](mailto:pdavis@insurancefor nonprofits.org)

The Nonprofits' Insurance Alliance of California (NIAC) and Alliance of Nonprofits for Insurance, Risk Retention Group (ANI-RRG) are two members of the NIA Group, a group of charitable risk pools authorized under 501(n) and tax-exempt under 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code.") Both of these organizations are governed by boards of directors elected by their nonprofit member-insureds and exist exclusively to provide their member nonprofits with a stable source of affordable liability insurance and to help them develop tools to reduce accident and injuries.

Together, these two organizations provide various types of liability insurance for more than 5,500 other nonprofit organizations in 19 states and D.C. All member-insureds of these organizations are also tax-exempt under 501(c)(3) of the Code. These organizations are primarily small to mid-sized nonprofits providing social services to their local communities. The vast majority of these have annual budgets under \$1 million.

In our 15 years of pooling the risks of these organizations, our greatest surprise has been how well these organizations are managed and how relatively few bad actors there are within these organizations. We provide coverage for virtually all types of liability exposures, including claims against boards of directors. To date we have handled in excess of 10,000 claims against nonprofits. I am the founder of all of these organizations and I can count on one hand those claims that resulted from truly abusive practices within the nonprofit organization.

Our members show strong interest in learning about and adopting best practices. The biggest impediment to their adopting even better management practices results from the way nonprofits are funded. Precious few funds are available to them to provide training for their volunteers, staff and their boards of directors.

We urge the Committee to focus its energies where they may make a difference in the operations of the nonprofit sector. If there are problems within the nonprofit sector, it is certainly not with the small ones serving their communities. More regulation will do nothing to improve their services or their integrity. Instead, the Committee should urge Congress to provide funding for educational and training opportunities for nonprofit volunteers, staff and their boards of directors.

We are available to the Committee to provide whatever additional information may be of help.

The NIA Group is comprised of the following nonprofit 501(c)(3) tax-exempt organizations:





**NONPROFIT**  
*Coordinating Committee of New York*

June 23, 2004

Senate Committee on Finance  
Attn. Editorial and Document Section  
Rm. SD-203  
Dirksen Senate Office Bldg.  
Washington, DC 20510-6200

Statement Submitted to Senate Finance Committee Hearings on  
"Charity Oversight and Reform: Keeping Bad Things from Happening  
to Good Charities" (6/22/04) by Jonathan A. Small, Executive Director,  
Nonprofit Coordinating Committee of New York, Inc.

Dear Committee Members:

I am submitting this statement on behalf of the over 1,300 nonprofit organizations in the New York metropolitan area that are our members to urge the Committee to consider with great care the administrative burdens that would be imposed on nonprofits, most of them quite small organizations, by reform proposals you may decide to promote, and to weigh those burdens and costs against the benefits to be achieved.

The Nonprofit Coordinating Committee of New York, Inc. is an "umbrella" organization created to help nonprofit organizations of all kinds in the New York metropolitan area to perform their missions better. We provide infrastructure support through workshops, discount programs, our newsletter, our website, telephone and e-mail responses to questions, and, most importantly for your purposes, by seeking to support a legal and regulatory regime for nonprofits that is constructive in terms of protecting the public, and those served by nonprofits, by insuring transparency and accountability. We also seek to insure that those laws and regulations are not overly burdensome relative to the benefits they achieve, thus helping to avoid unnecessarily diverting funds from service to the mission to administrative costs.

The testimony you have heard in your first day of hearings focused, as it should, on trying to identify the problems—and there are problems. An equally important task for you is arriving at solutions that will be constructive. I believe that no one on the speaker list for the first day of hearings represented an organization that is devoted, as ours is, to helping nonprofits face the administrative tasks that legislation and regulations impose. My hope is that your Committee will keep that issue firmly in mind as it develops legislative proposals. "Getting the bad guys" and stopping the bad behavior is certainly important, but, if it is not done with great care and thought, the cost to those

served by the nonprofit sector in terms of money diverted from serving the mission—such as feeding the homeless, providing after-school programs, offering cultural events—can easily exceed by a dramatic multiple the funds saved, directly and indirectly, by preventing bad behavior.

I believe that the first question for you should be: Are the current rules and regulations adequate to deal with the bad behavior you identify? If so, I strongly believe that increased enforcement, and publicity about that enforcement, is the cheapest and most constructive way to proceed. Please do not forget that hundreds of thousands of nonprofits are performing functions that government could or would be performing if the nonprofits were not there. Thus, the costs that would be imposed by these rules should not be ignored simply because they are not costs directly imposed on government.

To the extent you decide that existing rules and regulations and their enforcement with extensive publicity would not be adequate to address the problems you identify, you will be considering new rules and regulations to deal with those problems. As you do this, I urge you, as forcefully as politeness permits, to seek out the views of direct service providers that will be seeking to implement your proposals. For many years I was a lawyer giving nonprofits advice as to what they needed to do to comply with existing rules and regulations; having become the executive director of a small nonprofit, I am now keenly aware, as I never was before, of what it means in terms of time and cost to meet the obligations imposed by those laws and regulations. Currently, for example, a nonprofit engaged in lobbying the New York City Council is required to keep track of and report its expenses under four different sets of rules and regulations—New York City's rules, New York State's rules, the Federal rules imposed by the Internal Revenue Code, and the rules imposed by financial statement requirements. Are the benefits achieved by having four different sets of rules worth the cost of compliance? I sincerely doubt that the answer is "yes."

Thus, my plea to you is to seek out input on the operational aspects of proposals you are considering and to get input from those directly affected, particularly the small nonprofits "on the ground", to help you craft proposals that will be a net benefit in terms of their overall impact.

Thank you for your consideration of these views.

Sincerely yours,

  
Jonathan A. Small, Executive Director  
Nonprofit Coordinating Committee of  
New York, Inc.

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**Statement for Hearing Record by  
Adam Meyerson  
President  
THE PHILANTHROPY ROUNDTABLE  
Washington, DC**

**United State Senate  
Committee on Finance  
June 22, 2004, Hearing  
“Charity Oversight and Reform:  
Keeping Bad Things from Happening to Good Charities”**

The Philanthropy Roundtable  
1150 17<sup>th</sup> St., NW, #503  
Washington, DC 20036  
202 822-8333  
202 822-8325 fax  
[ameyerson@PhilanthropyRoundtable.org](mailto:ameyerson@PhilanthropyRoundtable.org)  
[www.PhilanthropyRoundtable.org](http://www.PhilanthropyRoundtable.org)

**Statement for Hearing Record by Adam Meyerson****President, The Philanthropy Roundtable**

*(The Philanthropy Roundtable is a national association of 500 foundations, philanthropic families, and corporate giving programs. Its mission is to foster excellence in philanthropy, to help donors achieve their philanthropic intent, and to help donors advance freedom, opportunity, and personal responsibility in America and abroad.)*

The Philanthropy Roundtable believes that a number of proposals in the discussion draft would seriously harm philanthropy, civil society, and the vision of “a nation of citizens, not spectators,” articulated by President George W. Bush in his inaugural address. We have six significant concerns about the Finance Committee’s proposals.

First, we are deeply troubled by a proposal giving the Internal Revenue Service the power to review and revoke the tax-exempt status of every charity and foundation every five years. This automatic power, unless it is very carefully circumscribed, would be an open invitation for presidential administrations to use the IRS as a weapon against charities and foundations they disagree with philosophically. Even if tax-exempt status were not revoked, a serious IRS challenge to the exemption would tie up in administrative knots a politically disfavored charity or foundation, making it much more difficult to carry out its mission. The danger of abuse is potentially even graver when the new IRS power is combined with another proposal in the discussion draft, which would make continued tax exemption contingent on approval by a private accrediting agency for charities or foundations. Unless there is a wide variety of philosophically diverse accrediting agencies, or unless there are very minimal standards for accreditation, an accreditation requirement could pose a serious threat to independent thought in charitable and philanthropic organizations.

The second danger of the Finance Committee discussion draft is its proposed micromanagement by the federal government of internal decisions that have historically been the responsibility of foundation donors and boards. This interference in private decisions includes restricting travel expenses, sharply restricting staff compensation, and even more sharply restricting (and perhaps eliminating altogether) trustee compensation. This is a departure from a long tradition in federal and state law of respecting the diversity of the philanthropic sector in terms of mission, philosophy, size, operating style, and division of staff and trustee responsibilities. The tax exemption has been framed broadly to encourage this diversity and flexibility, and regulations such as those guarding against self-dealing and investment abuse have been minimally intrusive. By contrast, the Finance Committee discussion draft suggests that government knows better than foundation leaders how their organizations should be run in order to achieve their mission. Such micromanagement has no place in a free society.

The third and fourth dangers were well articulated at the June 22 hearings by Derek Bok, formerly president of Harvard University and now faculty chair of its Hauser Center for Nonprofit Organizations. Bok reminded the Senators that “the nonprofit sector is extremely heterogeneous, including everything from billion-dollar hospitals and universities to tiny neighborhood organizations and local choral societies.” He then said at least two risks arise in any attempt to craft general regulatory measures for the sector. “First, there is a danger that in enacting rules in response to a few particularly flagrant, widely publicized abuses, regulators will impose burdens of paperwork, record-keeping, and other costs on all non-profits that will more than equal any benefits achieved by government intervention. Second, in such a heterogeneous sector, it is quite possible that rules enacted with particular organizations in mind will prove inappropriate for other kinds of organizations and thereby lead to unanticipated, undesirable consequences.”

A fifth danger comes from proposals in the discussion draft to regulate donor-advised funds—and particularly to require the public disclosure of their contributions. Private foundations have prospered under their public disclosure requirements of the past 35 years, and they would not suffer under proposals in the discussion draft to ensure more accurate and timely filing of IRS Form 990-PFs. However, individual donors have always enjoyed the right to keep their charitable contributions confidential if they wish. One of the many advantages of this right to privacy is that it enables donors to give generously without being besieged by legions of grant-seekers. Disclosure requirements for donor-advised funds would most likely reduce charitable giving by taking away a highly efficient vehicle for living donors who cherish their privacy.

A sixth danger comes from a proposal for government to subsidize efforts within the philanthropic sector to encourage best practices and set accrediting standards. The money would come from the tax on net investment income on foundations. The Philanthropy Roundtable believes that it would be totally inappropriate for the philanthropic sector to turn to government to raise resources for its own self-improvement. Philanthropists and the organizations that serve them have the resources to raise this money themselves. Turning to government for financial help would also be deeply corrupting to the spirit of independence and voluntary initiative that animates philanthropy at its best.

The Finance Committee has presented no evidence that sweeping changes of the magnitude it is proposing in the legal and regulatory framework governing philanthropy and nonprofits are necessary. Most abuses in the philanthropic sector could be corrected by devoting more resources to the enforcement of existing laws. Some narrowly tailored adjustments in current policy may also be needed to address specific problems. The Finance Committee discussion draft runs the risk of causing enormous collateral damage to the sector it purports to reform. What we really need are precision-guided weapons.

## POLICY DEVELOPMENT

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### BEYOND VIGILANCE: STRENGTHENING CHARITY OVERSIGHT AND REFORM

June 22, 2004

*The following testimony was presented by Policy Development Executive Director Aron Goldman, by mail, for the United States Senate Committee on Finance hearing, "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities" on June 22, 2004.*

Senator Grassley, Senator Baucus, distinguished Members of the United States Senate Committee on Finance, thank you for giving representatives of non-profit organizations and concerned citizens across the country an opportunity to share our perspectives on charity oversight and reform.

Much of the testimony presented today is concerned with closing the loopholes in the current system. All of us in the non-profit sector have a new sense of urgency to make changes in light of recent examples of fraud, embezzlement, and gross mismanagement in both the for- and non-profit sectors.

While the economic and social impact of the Enron and Tyco scandals was huge, their correlates in the non-profit sector stand out because these organizations enjoy special tax status and many are entrusted with donations earmarked for critical humanitarian purposes. The misuse of funds at a non-profit organization is therefore equivalent to a diversion of tax dollars from their intended purpose, and a threat to social welfare. The closing of regulatory loopholes is clearly essential.

But that's not new. There will always be attempts to subvert the spirit or letter of the law, and thus an ongoing need for vigilant oversight. While most funders are quite good at parsing out the legitimate and most effective non-profit organizations, and new ways to monitor and evaluate funders are emerging, government oversight will always be important.

The new challenge for all of us concerned about the fate of the social sector, and the impact of the work we do, is to reform the system in such a way that, while abuses are reduced, the highest quality organizations are able to thrive. Federal and state regulatory regimes should not only prevent abuses, but they should also foster an environment where great ideas can come to fruition.

Unfortunately, this is not our reality today. While interesting and effective cross-disciplinary and cross-sectoral initiatives are proving themselves in the domestic and international arenas, the federal tax code is a burden rather than a catalyst. The most glaring example is the vast amount of untapped private sector capital that could be used--in the form of grants and investments--for social purposes. But the natural affinities among for-profit and non-profit entities go unrealized for fear that novel collaborations will be viewed as conflicts of interest, self-dealing, or abrogations of their commitment to social purposes. Again, conflicts of interest and self-dealing are real problems in the industry, but a more sophisticated understanding of the state of the industry could lead to win-win reforms: fewer loopholes and fewer burdens for innovators.

I urge the Committee to continue to look for ways to thwart abuses, while understanding that this task is an ongoing one (and that media coverage of individual instances of abuses should be put in perspective). Simply being more vigilant is not the answer. Instead, regulators must revisit their long-held notions of what constitutes a social purpose organization and develop new rules which reflect the sophistication of the non-profit sector in its current, evolved state.

**Statements for the Record:** Any individual or organization wanting to present their views for inclusion in the hearing record should submit a typewritten, single-spaced statement, not exceeding 10 pages in length. Title and date of the hearing, and the full name and address of the individual or organization must appear on the first page of the statement. Statements must be received no later than two weeks following the conclusion of the hearing.

Statements should be mailed to:

Senate Committee on Finance  
Attn. Editorial and Document Section  
Rm. SD-203  
Dirksen Senate Office Bldg.  
Washington, DC 20510-6200

Regarding:

**6-22-04 Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities**

Tax Exempt Governance Proposals: Staff Discussion Draft

**This is a statement for the record from:**

Stephen Y Ruden  
3655 Albion Place North #3  
Seattle, WA. 98103

Senate Committee on Finance  
Charity Oversight and Reform  
Honorable Committee Members:

I was employed for 21 years as a Property Manager by Historic Seattle Preservation and Development Authority, a quasi-governmental organization that has both 501(c)(3) and 509(a)(?) tax exempt status. This organization has received entitlements of properties, financing, and grants from the Federal Government, the National Trust for Historic Preservation, the State of Washington, King County, the City of Seattle, Corporate donors, and private individuals. The organization is ostensibly in the business of "historic preservation" that includes the protection and renovation of old buildings on behalf of the citizen's of Seattle. It has done some worthy projects in its some 30 years of operations.

I resigned my position as Property Manager in 1999 for "personal reasons". At that time, I was required to sign a full non-disclosure agreement about all aspects of the organization and its operations. In return for signing the agreement, I was given a small cash payment (around \$10,000) and a mutually agreed to letter of recommendation that I could use for possible future employment purposes. Even the fact that I had signed a "non-disclosure agreement", was to be kept secret! It seemed bizarre at the time that a so-called not-for-profit organization, supposedly working in the "public interest" could be allowed (by law) to use such an agreement.

If the practice of using non-disclosure agreements is a common practice for departing employees from “public agencies”, or from “not-for-profits”, then it is little wonder that we (the public) know so little about the actual operations of these organizations. After 5 years of contemplating and evaluating this practice, I can see no value in non-disclosure agreements, other than to quash any possible feedback or dissent that might “at worst” lead to some sort of “self-cleansing” for these notoriously “incestuous organizations”.

**I recommend that the “rules” for “not-for-profits” be amended to disallow any sort of generalized “non-disclosure” agreements. In some way this should become a requirement for organizations to achieve and maintain and IRS Tax Exempt Status.**

In 2000, I discussed this situation with the City of Seattle’s Ethic’s Commissioner (a political appointee). She agreed with my position on the ethics of the practice but was not willing to carry the issue forward in a way that would provide me with any sort of immunity for my testimony, or protect me from disclosing that I had a “secret” non-disclosure agreement.

**I recommend that the “Senate Charity and Oversight Committee” provide past, present, and future employees of not-for-profits with some sort of immunity from prosecution for testimony based on secret non-disclosure agreements. This way some of the experiences of the actual workers in these organizations can be examined in “full day-light”. We (the public) might at least have a chance to hear, “the rest of the story”.**

In the case of Historic Seattle Preservation and Development Authority the public issues related to secrecy may only be ethical in nature and perhaps no out-right crimes have been perpetrated. The Board of Directors (The Council) of this group is allowed to meet in Executive Session (essentially in secret) to discuss matters of real estate and personnel. The City of Seattle’s PDA Oversight Officer or other members of the public are not allowed to observe these sessions. Highly edited minutes of the executive sessions are available but they contain no substantive (detailed) information about what was actually discussed during the meetings.

With very low Council membership turn-over (some-members have served in excess of ten years) this organization essentially conducts business as a ‘private club’. This club is maintained by income from “public projects” for the primary benefit of the Executive Director’s salary, and for the Council Members whimsical projects. While the individual Council Members do not derive any direct benefits from the organization a seat “at the table” does provide a great information resource from which one’s friend’s who sit on other such boards at other such “agencies” are fed a stream of “insider” information about real estate and construction projects “around” town. These “agencies” develop and maintain, “short-lists” for architects, consultants, contractors, engineers, lawyers, etc. There are no written rules but every one in Seattle “knows” that if you are not on one of these “short-lists” you will probably never get a “publicly funded” job in Seattle (even if you are the low-bidder, there are “other” criteria, and “other” values to be met)

I have shared a little insight into what is (lovingly) locally called “the Seattle process”. This process assures the profits of a few at great cost to the many. This process assures that the most expensive way will be found to do anything of importance by the slowest means possible. In Seattle we “socialize costs and privatize profits”.

My view is not unique, I am not an important official, it is a view based on 35 years of observing ‘the process’. I have seen good not-for profit organizations invaded by self-servers using many forms of aggressive and passive-aggressive (hostile to public mission) takeovers. Historic Seattle is only one such organization. I do not believe these organizations can “self-cleanse” and I do not believe that they can be “fixed” by local governments that often have such a huge investment in “business as usual” appearance of public process themselves.

I considered it a great privilege to receive public support to ‘build the community’ for one of Seattle’s first and possibly most unique community centers. I probably could not have done this without the help (and the opposition) of Historic Seattle. It is a great shame to see this wonderful community project reduced to a cash cow (an office rental asset) that is milked across town to maintain the activities of a private club. People in Seattle often ask what happened to “civil society”? Perhaps, I have provided some small part of the answer.

I think Transparency International ranks the US at 17 or 18 on the “Corruption Perception Index”. Some think of the index as a measure of a cost to do business in a given country. Let’s say that one must factor in 17 to 18% as the “corruption cost” for doing business in the US. Perhaps its up to 90% in the Ukraine... that might mean that you could expect that 90% of every dollar put into a program in the Ukraine will be stolen or lost due to corruption. Following this analogy one could expect 17 to 18% to be stolen or lost due to corruption in the US.

When 90% of a charitable donation is taken up by “fund-raising” costs and 10% or less actually gets to the “mission” of the charity we could agree that the “loss factor” is on the level of that lost by corruption in the Ukraine. If these organizations are “allowed” to steal at these levels “civil society” will be entirely looted and “we” will end up like the Ukraine.

Let’s make some more protections for disclosure and find some positive ways to require transparency. Let’s provide some tools for individuals to reach beyond the corruption of their organizations, and their local political situations as a gift to the “civil society” that we are in such great danger of losing.

The Charities and not-for-profits have been one of the few places where one can work and make a difference. Let’s find better ways to protect them.

Thank you for your consideration of the issues that I have raised.



# The Standards for excellence

*An Ethics & Accountability Program for the Nonprofit Sector*

June 22, 2004

Senate Committee on Finance  
Attn: Editorial and Document Section  
Room SD-203  
Dirksen Senate Office Building  
Washington, DC 20510-6200

Re: Hearing on "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities", June 22, 2004

The Standards for Excellence Institute is a new national initiative to promote the highest standards of ethics and accountability in nonprofit governance, management and accountability, built on programs originated in Maryland and replicated in Georgia, Louisiana, North Carolina, Ohio and Pennsylvania. The Institute serves as the catalyst and organizer for the Standards for Excellence program, an ethics and accountability initiative based on the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector (Standards)*. The centerpiece of the program, the *Standards* include eight guiding principles and 55 performance indicators, and provide a model for how the most well managed and responsibly governed organizations operate. The *Standards* show how nonprofits act to be ethical and accountable in their program operations, governance, human resources, financial management, and fundraising.

The Standards for Excellence Institute works with associations, organizations, federations and coalitions of nonprofits to promote adherence to the practices and principles outlined in the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector*. At present six state associations of nonprofits offer Standards for Excellence programs to the nonprofit organizations in their jurisdictions in Georgia, Louisiana, Maryland, North Carolina, Pennsylvania, and Ohio. Thirty other state and regional organizations have expressed interest in utilizing the Standards for Excellence program for nonprofits in their regions.

In addition to disseminating the *Standards*, training opportunities and hands-on assistance is available to help those organizations interested in adopting the *Standards*. A series of written educational materials is available. Introductory and advanced training courses are also offered to assist nonprofit organizations implement the standards in their management and

Standards for Excellence Institute

190 W. Ostend Street, Suite 201 Baltimore, MD 21230 410.727.1726 FAX: 410.727.1914  
[www.standardsforexcellenceinstitute.org](http://www.standardsforexcellenceinstitute.org)

governance activities. A leadership-based, voluntary certification program is also offered in Louisiana, Maryland, Pennsylvania and Ohio.

The *Standards for Excellence*, and other extensive efforts underway throughout the nonprofit sector, recognize the importance of identifying and trying to achieve standards of true 'best practice' in the management and operation of nonprofit organizations. These standards must always assume full compliance with an appropriate structure of government regulation, and also exceed legal requirements in many of the management practices and values they embody. Any full panoply of 'standards for best practice' may never be fully achievable for most organizations, and therefore by its nature would not be appropriate to be construed as a legal requirement. We believe such standards are best developed and promulgated by the nonprofit sector itself. Given the limited resources of, and seemingly unlimited demands placed upon most nonprofit managers and boards, in our experience the greatest value of high standards for excellence or 'best practice', is their use as tools for self-evaluation, and as guides for training and self-improvement within individual organizations.

We have also found that providing technical assistance, training, and additional informational materials, to explain, clarify, and provide sample policies, is essential to assist organizations in understanding and moving toward adherence to our own *Standards*. Without such assistance, nonprofit organizations may find themselves frustrated and unable to develop the internal capacity to implement the best practices on their own.

Apart from the importance and value of a 'best practice' standard, we also recognize that a reasonable and adequate government regulatory structure for tax exempt organizations, and its effective enforcement, is essential to protect both the public interest and the integrity and credibility of the nonprofit sector. The public is generally unaware of the legal standards and requirements already in place, or the extent to which nonprofits may be sanctioned for non-compliance. But they are well aware of publicized cases of questionable practices and unethical behavior by a small number of organizations.

We would strongly endorse both the clarification of existing legal and reporting requirements, including for example the delineation between program and fund-raising activities and expenses on the Form 990, as well as more thorough enforcement of these standards by the Exempt Organizations Division. While it would be unreasonable for government to mandate legal compliance with true, ever-evolving standards of best practice, it would be equally unfortunate if the legal and regulatory structure governing nonprofits lacks the clarity, thoroughness or enforcement to protect the public's interest and inspire confidence in the performance of the sector.

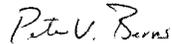
Finally, we hope your examination of these issues will recognize that the management and performance of many of the nation's nonprofit organizations could be enhanced by greater investment in technical assistance and training for nonprofit staff, managers and boards. While organizations such as our own association exist and are accessible in many parts of the nation, the resources available through fees, dues and charitable support limit both the reach

and effectiveness of these services. This creates challenges both for the promotion and achievement of excellence, as well as for the understanding of and compliance with basic legal requirements.

Further, the extensive role of nonprofit organizations as providers of public services creates a relationship with government that now transcends regulation. The management capacity and proficiency of the nonprofit sector is now a significant factor in the efficiency and effectiveness of government programs and services. Models exist for government investment in the development and capacity of business organizations, and the nonprofit sector has been developing networks for training and technical assistance, which could be enhanced and nurtured with government assistance. Compliance with legal requirements, the pursuit of excellence in management, ethics and accountability, and effective delivery of public services would all be enhanced with new support for the sector's management capacity.

Thank you for the opportunity to comment on these interests of the Committee. I would be happy to answer any questions you may have about these comments and can be reached at 410-727-1726.

Sincerely,



Peter V. Berns  
Chief Executive Officer  
Standards for Excellence Institute