

This discussion draft is released by the Finance Committee as a staff document. The document reflects proposals for reforms and best practices in the area of tax-exempt organizations based on staff investigations and research as well as proposals from practitioners, officers and directors of charities, academia and other interested parties. This document is a work-in-progress and is meant to encourage and foster additional comments and suggestions as the Finance Committee continues to consider possible legislation.

A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS.

On every fifth anniversary of the IRS's determination of the tax-exempt status of an organization that is required to apply for such status, the organization would be required to file with the IRS such information as would enable the IRS to determine whether the organization continues to be organized and operated exclusively for an exempt purposes (i.e. whether the original determination letter should remain in effect). Information to be filed would include 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. Such information would be made publicly available. The IRS would not be required to issue a new determination letter (or to review all organizations), but would be permitted to revoke tax-exempt status if a review undertaken by the IRS concluded that the organization no longer was entitled to exemption. Failure to file the five-year review would result in loss of tax-exempt status. A sliding scale processing fee would be charged of all filers by IRS/EO to cover all costs of the reviews performed. (If adequate funding is provided from a 990 filing fee or appropriation of the tax on net investment income of private foundations, a fee for the five-year review may not be required).¹

2. Donor advised fund reforms

In general, donor advised funds (DAF) are public charities that primarily make grants to charitable beneficiaries pursuant to advice provided by the donor. Donor advised funds are not defined under present law and are not subject to any special rules regarding organizational and operational requirements; yet the donor advised fund model is susceptible to abuse. Definitional and other requirements with respect to DAFs would include: 1) Contributions to a DAF other than cash or publicly traded securities would have to be sold within one year of contribution and a plan for sale must exist at the time of gift (alternatively, a DAF may accept only cash or

¹The term "charities" or "charitable organizations" when used in this staff discussion draft refers to any organization described in section 501(c)(3).

publicly traded securities); 2) a DAF would not be permitted to make grants to a non-operating private foundation or to individuals; 3) a DAF would be required to secure from the grantee an acknowledgment that the grant will not convey a private benefit to the advising donor; 4) a DAF would be required to meet an aggregate annual payout consisting solely of grants paid of 5 percent of the DAF's assets – failure to meet the payout would result in a tax similar to that applicable to private nonoperating foundations; 5) individual accounts in a DAF would have to meet a minimum activity threshold; 6) a DAF would be required to disclose its existence on its Form 990 and show satisfaction of the payout and all other requirements; 7) grants by a DAF to nondomestic organizations would be permitted only if the nondomestic organization appears on an IRS published list of approved foreign organizations; 8) DAF grants would be permitted to satisfy a donor's charitable pledge; 9) a DAF's investment managers would be hired according to arm's length principles; 10) a DAF generally would not be permitted to expend amounts for grantee selection, such as site visits, that extend beyond basic due diligence of grant approval; and 11) fees for referrals or transfers of funds to a DAF would be limited.

3. Supporting organizations

Eliminate Type III supporting organizations. This has been an area of significant abuse. Donor Advised Funds can effectively substitute to serve legitimate purposes of such organizations.²

4. Revise exemption standards for credit counseling organizations

A nonprofit credit counseling agency would be eligible for exempt status as an organization described in section 501(c)(3) or (c)(4) only if it: (1) at all times conducts as its primary activity (a) the providing of educational information to the general public on budgeting, buying practices, and the sound use of consumer credit; (b) assisting individuals and families with financial problems by providing them with individual counseling tailored to their specific needs and circumstances, and, if necessary, by establishing budget plans; or (c) any combination of such activities; (2) makes no loans to debtors, negotiates no loans on behalf of debtors, and provides no credit repair services (i.e., services for the purpose of improving any consumer's credit record, credit history, or credit rating) or similar services; (3) may not refuse to provide counseling services to a consumer due to inability to pay or to qualify for debt management plan enrollment, or because of a consumer's unwillingness to enroll in a debt management plan; (4) limits any debt management and similar services to individuals or families for whom a debt management plan is determined to be the most appropriate means to relieve financial distress; (5) at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, consisting of public officials acting in their capacities

²See *Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts*, Lipman and Williams, the Chronicle of Philanthropy, February 5, 2004. *Note: the sources cited in this staff discussion draft are not intended to be exhaustive of the materials relied on in this draft but are provided to be helpful to the reader.*

as such, persons having special knowledge or expertise in credit counseling and education, and community leaders, such as elected or appointed officials, clergy, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community; and (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors fees); and (6) is not related to a person that is in the business of lending money or that provides debt management, credit repair, payment processing, and similar services.

In addition to the above, a credit counseling agency would be exempt as a charitable or educational organization only if it (1) at all times is organized and operated exclusively for charitable or education purposes; (2) charges no fees or nominal fees for services provided to low-income individuals and families and for credit counseling or education services (and waives its fees in those instances where payment would work a financial hardship), receives no compensation for referrals for services provided to the consumer, and does not solicit voluntary contributions from its clients during the initial counseling process or while the client is receiving services from the organization; (3) limits any debt management services to low-income individuals and families; and (4) satisfies all other requirements of section 501(c)(3).

A nonprofit credit counseling agency would be eligible for exempt status as an organization described in section 501(c)(4) only if it: (1) charges no or nominal fees for its credit counseling and education services (and waives its fees in those instances where payment would work a financial hardship), receives no compensation for referrals for services provided to the consumer, and any fees charged for debt management and other services must be reasonable in relation to the services provided by the organization to the client; and (2) satisfies the other requirements of section 501(c)(4).

5. Revoke charitable status for accommodations to tax shelters

Charitable organizations that are determined by the IRS to be accommodating parties to a listed tax shelter transaction or reported transactions (with a significant purpose of tax avoidance) must have received affirmation that the transaction is not a listed or reported transaction. Failure to receive such an affirmation would result in revocation of section 170 status (ability for donors to receive charitable deduction for contribution) for one year with reinstatement only after determination by IRS. There would be a 100 percent tax on all accommodation fees or other direct benefits – net of certain costs to charity.

B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules

Under present law, excise taxes apply if private foundations engage in acts of self-dealing

with disqualified persons. Self-dealing transactions generally include the sale, exchange, or leasing of property; the lending of money or other extension of credit; the furnishing of goods, services, or facilities; payment of unreasonable compensation by a private foundation; transfer to or use by a disqualified person of a private foundation's income or assets; and certain payments to government officials. With the exception of the payment of unreasonable compensation, these rules would be extended to public charities (and social welfare organizations) so that, in general, self-dealing transactions between a public charity (or social welfare organization) and a disqualified person would result in excise taxes. In general, the definition of disqualified person for purposes of the private foundation rules would be adopted for public charities, except that adjustments would be made to include persons with substantial influence over the organization, and the rules would be modified as necessary to take into account relationships with affiliated or supporting entities. With respect to compensation, the regulations that apply to the compensation arrangements of public charities generally would be modified with respect to the rebuttable presumption of reasonableness and reliance on expert opinion as to reasonableness.³

2. Expand definition of disqualified person

For purposes of the self-dealing rules (as modified to apply to public charities and social welfare organizations), the definition of a disqualified person would be modified to include a corporation or partnership with respect to which a disqualified person is a person of substantial influence.

3. Increase taxes for self-dealing, jeopardizing investments, and taxable expenditures

Initial taxes for acts of self-dealing (including as applied to public charities) would be increased from 5 percent to XX percent of amount involved with respect to the self-dealer and from 2.5 percent to XX percent with respect to the foundation manager. The tax on the foundation management for participation in a jeopardizing investment of the foundation would be increased from 5 percent of the amount invested to XX percent. If a foundation manager fails to agree to correction of the jeopardizing investment, the penalty for such failure would be increased from 5 percent of the amount of the investment to XX percent. The tax on foundation managers for agreeing to make a taxable expenditure would be increased from 2.5 percent of the amount expended to XX percent.⁴

³See *Reforming Nonprofit Corporation Law*, Hansmann, 129 U. Pa. L. Rev. 497, 569 - 573 (1981) (proposal of flat prohibition against all self-dealing transactions involving controlled persons in nonprofit organizations).

⁴See *Governing Nonprofit Organizations: Federal and State Law and Regulation*, Fremont-Smith, Belknap Harvard, p. 455 (2004) (advocating removal of punitive taxes imposed on foundations but advocating at the same time adoption of more meaningful sanctions on foundation managers who have caused the foundation to enter into the prohibited transactions; considers whether the standard for sanctions on manager involvement in prohibited transactions

4. Compensation of private foundation trustees

Many private foundations choose not to pay any compensation to trustees. Some private foundations, however, choose to pay trustees significant sums as compensation for work that some would argue should be conducted voluntarily and not to the detriment of charitable beneficiaries.⁵ Under the proposal, compensation to trustees of a nonoperating private foundation would not be permitted; or, in the alternative, would be permitted up to a statutorily prescribed de minimis amount.

5. Compensation of disqualified persons.

Compensation of disqualified persons at nonoperating private foundations (other than persons who are disqualified by reason of employment) must use comparable federal government rates for similar work and similar time to support salary. Compensation (or severance payments) to other individuals above \$200,000 (and above \$75,000 for disqualified persons – not including persons who are disqualified as a manager) trigger filing of additional supporting material with the IRS, which would be publicly available. The IRS would charge a sliding-scale processing fee to review. In addition, all compensation that is subject to special IRS filing requirements must be approved annually and in advance by the Board of Directors (excluding from the approval process those members of the Board who have a conflict with respect to the compensation being considered).

C. Grants and Expense Reforms

1. Treatment of administrative expenses of nonoperating foundations

Private nonoperating foundations that have administrative expenses (which would be defined for this purpose as any expense of a private nonoperating foundation other than a grant to charity) above 10 percent of the foundation's total expenses would be required to file additional supporting material with the IRS, which would be publicly available. Review by the IRS of such supporting material would include a review for purposes of determining whether the administrative expense was "reasonable and necessary" for purposes of counting as a qualifying distribution under the payout rules. The IRS would charge a sliding-scale processing fee to review. Administrative costs above 35 percent of a foundation's total expenses would not count

should be "knew or should have known" instead of the present law standard of knowledge that the act involved was a violation and was not willful and was due to a reasonable cause – "a heavy burden for the IRS to prove.")

⁵See *Foundation Trustee Fees: Use and Abuse*, Ahn, Eisenberg and Khamvongsa, The Center for Public and Nonprofit Leadership, Georgetown Public Policy Institute (September 2003).

as a qualifying distribution for purposes of the payout requirement.

2. Encourage additional grant-making by private foundations

For each year that a private foundation pays out more than 12 percent of the foundation's non-charitable use assets return exclusively for grants, the foundation would not have any liability for the excise tax on net investment income in such year.

3. Prohibit foundation grants to donor advised funds.

In order to prevent circumvention of foundation anti-abuse rules, private foundations would be prohibited from making grants to donor advised funds.

4. Limit amounts paid for travel, meals, and accommodation

For purposes of paying expenses for travel, meals, and accommodation, charities would be subject to the applicable U.S. government rate, or an alternative established/published nonprofit corporate rate (perhaps published by the IRS). A penalty for failure to comply would be 10 percent of the excess payment, payable by the organization and disgorgement of the excess by the individual. Public charities would not be subject to such limitations if, for each expense in excess of the limitation, the Board of Directors of the charity approves the expense and such approval is disclosed on the charity's Form 990.

D. Federal-State Coordination of Actions and Proceedings

1. Establish standards for acquisition/conversion of a non-profit

Concerns have been raised that conversions of tax exempt organizations to for profit organizations have not been conducted in a manner that sufficiently protects charitable interests and assets. The proposal would establish standards for review by State/Federal authorities of conversion transactions to ensure that the acquisition or other conversion occurs only if it is found by the State or Federal reviewer to be necessary to serve the public interest and best serves the interests of the intended beneficiaries of the organization's assets. IRS reporting requirements would be imposed on an exempt organization considering a conversion and would be publicly available (e.g., notification of the IRS within 10 days of establishing intent to pursue a conversion transaction; execution of letter of intent to convert; execution of definitive agreement to convert; adoption of conversion plan; adoption of material changes to the plan or agreement; and consummation of conversion plan). In addition, the organization must provide the IRS a reasonable opportunity to participate in a conversion proceeding conducted or overseen by State authorities, both as a creditor relating to potential unpaid conversion taxes and as a protector of charitable trust assets. Completion of conversion would have to be conditioned upon IRS approval of the conversion (or failure to disapprove within one year of seeking approval) or consummation of conversion would trigger Federal tax liability for the organization at the highest

corporate/trust income tax rate on unrealized built in gains on assets held by the organization at the time of conversion (including any assets disposed of in contemplation of conversion).⁶ This would apply to any substantially similar transaction where major charitable assets are transferred to a for profit entity. IRS would be allowed to impose a filing fee.

The proposal would impose modified self dealing or excess benefit transaction rules with respect to severance arrangements and stock (and stock rights) arrangements with respect to successor entities to address officer and employee compensation arrangements entered into with respect to conversion transactions, and establish reporting requirements for the same.

2. Provide States the authority to pursue federal actions

States would be provided the authority to pursue certain Federal tax law violations by exempt organizations with approval of the IRS. States already are provided such authority with respect to certain Federal law violations that are enforced by the Federal Trade Commission.

E. Improve Quality and Scope of Forms 990 and Financial Statements

The Form 990 (and related Forms 990-PF and 990-EZ) is an annual information return filed each year with the IRS by most exempt organizations. In general, its purpose is to provide detailed financial and programmatic information about the organization. The form is publicly available and serves as the basis for oversight of tax exempt organizations and information to the public. In a report to the Finance Committee, the General Accounting Office found significant problems in the accuracy and completeness of Form 990.⁷ Other studies, including by the General Accounting Office, have highlighted that there are no common standards for filing the Form 990 and thus similarly situated charities can have very different Form 990s.⁸ Because of the significant role played by the Form 990 in public and governmental oversight of tax-exempt organizations, some reforms are necessary to ensure accurate, complete, timely, consistent, and informative reporting by exempt organizations.

⁶See generally, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, Goldschmid, 23 Iowa J. Corp. L. 631, 651 -52 (1998) (suggesting heightened scrutiny and disclosure for conversions).

⁷GAO-02-526 *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities* (April 2002).

⁸See *Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation*, Keating and Frumkin, Hauser Center for Nonprofit Organizations and The Kennedy School of Government, Harvard University (August 2000) and *Can Public Trust in Nonprofits and Governments Be Restored?*, Herzlinger, Harv. Bus Rev., (March-April 1996).

1. Require signature by Chief Executive Officer

Require that the chief executive officer (or equivalent officer) of a tax-exempt organization sign a declaration under penalties of perjury that the chief executive officer has put in place processes and procedures to ensure that the organization's Federal information return and tax return (including Form 990T) complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy and completeness of all material aspects of the return. This declaration would be part of the information or tax return. A similar proposal in the Senate JOBS bill requires that the CEO of a taxable corporation make an attestation regarding the corporation's tax return.

2. Penalties for failure to file complete and accurate 990.

The present law penalty for failure to file or to include required information is \$20/day up to the lesser of \$10,000 or 5 percent of gross receipts per return (increased to \$100/day up to \$50,000 per return for organizations with gross receipts over \$1 million in a year). Under the proposal, the penalty for failure to file would be doubled and for organizations with gross receipts over \$2 million per year, the present law penalty would be tripled. Failure to file a required 990 for two consecutive years (or for three of four years) could result in loss of tax exemption, or other penalties such as loss of status as an organization to which deductible contributions may be made.⁹

In addition, a separate penalty of \$20/day would apply to each failure to include required information on a filed 990 (for example, failure to check a required box), up to a per return maximum of the lesser of \$20,000 or 5 percent of the organization's gross receipts. For organizations with gross receipts over \$1 million the rate would be \$40/day with a per return maximum of \$50,000. For organizations with gross receipts over \$2 million the rate would be \$75/day with a per return maximum of \$100,000. Additional penalties could be brought against a CEO who signs the return as well as against a paid preparer (including employees).¹⁰ All penalties would be retained by Exempt Organizations within the IRS.

3. Penalty for failure to file timely 990

Extended delays in filing the Form 990 affect the ability of donors to evaluate a charitable organization for purposes of making contributions as well as effective oversight. Under the

⁹The CARE Act of 2003 contains a proposal that generally would revoke the exemption of an organization that failed to file a Form 990 for three consecutive years.

¹⁰The CARE Act of 2003 contains a proposal that generally extends the present law penalty on return preparers of a tax return to persons who prepare (for compensation) the information return of an exempt organization.

proposal, extensions of greater than 4 months would be considered a failure to file.

4. Electronic filing

The IRS may require tax exempt organizations to file electronically. The IRS would be required to have electronic filing capability in place by January 1, 2006. The IRS would be required to capture all data required to be reported through electronic filing by January 1, 2007. The IRS also would be required to coordinate electronic filing with State officials to assist State law enforcement, encourage uniform reporting and simplify reporting for tax exempt organizations.

5. Standards for filing

The IRS must promulgate standards for filing a Form 990. Standards would be required by January 1, 2006. As noted above, because there are no standards for filing a Form 990, similarly situated charities can have materially different Form 990s. As a financial statement will be required for most large charities, the standards for the financial statement should conform with the similar data requests from a Form 990.

6. Independent audits or reviews.

Form 990 (and/or annual report) would be subject to a review by an independent auditor for conformity to established Form 990 filing standards. The auditor's report would be attached to the Form 990 and would be a public document. In addition, for an exempt organization with over \$250,000 of gross receipts, an independent audit of the organization's financial statements would be required, including certification regarding the organization's exposure to the unrelated business income tax. A new auditor must be used at least every five years. If the organization's gross receipts exceeds \$100,000 but is not more than \$250,000, its financial statements must be reviewed by a certified public accountant.¹¹

7. Enhanced disclosure of related organizations and insider transactions

Require, as an attachment to Form 990, an affiliations chart showing the organization's relationship with its affiliated exempt and nonexempt organizations. Require enhanced 990 reporting of formation of taxable subsidiaries, and enhanced disclosure of an exempt organization's transactions with such organizations. Require enhanced 990 reporting of insider deals and ancillary joint ventures. Require that an exempt organization attach to Form 990 a schedule listing all partnership interests and the tax exempt organization's role in the partnership. Require that an exempt organization attach to Form 990 all tax opinions received by the

¹¹See generally, BBB Wise Giving Alliance, Standards for Charity Accountability (BBB), Standard 11, and Evangelical Council for Financial Accountability (ECFA) Standard 3.

organization involving agreements with insiders, and all conflicts of interest opinions.

8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements

Charitable organizations with over \$250,000 in gross receipts would be required to include in the Form 990 a detailed description of the organization's annual performance goals and measurements for meeting those goals (to be established by the Board of Directors) for the past year and goals for the coming year. The purpose of this requirement would be to assist donors to better determine an organization's accomplishments and goals in deciding whether to donate, and not as a point of review by the IRS.

Charitable organizations would be required to disclose material changes in activities, operations or structure. Charitable organizations would be required to accurately report the charity's expenses, including any joint cost allocations, in its financial statements and Form 990.¹² Exempt organizations would be required to report how often the Board of Directors met and how often the Board met, without the CEO (or equivalent) present.

9. Disclose investments of public charities

Public charities would be required to make publicly available, upon request, the charities' investments. A somewhat similar, but more extensive requirement, is already placed on private foundations. Smaller public charities would not be required to provide such information.

F. Public Availability of Documents

Public oversight is critical to ensuring that an exempt organization continues to operate in accordance with its tax exempt status. For charitable organizations, public oversight provides donors with vital information for determining which organizations have the programs and practices that will ensure that contributions will be spent as intended. Oversight is facilitated under present law by mandated public disclosure of information returns and applications for tax-exempt status, but more can be done.

1. Disclosure of financial statements

Exempt organizations would be required to disclose to the public the organization's financial statements.

2. Web-site disclosure

¹²See BBB, Standard 13.

Exempt organizations with a web-site would be required to post on such site any return that is required to be made public by present law, the organization's application for tax exemption, the organization's determination letter from the IRS, and the organization's financial statements for the five most recent years.

3. Publication of final determinations

The results of audits of tax-exempt organizations and closing agreements with tax exempt organizations would be disclosed without redaction.¹³ Disclosure may be redact the organizations identity if the audit is initiated pursuant to a voluntary disclosure by the tax-exempt organization to the IRS.

4. Require public disclosure of Form 990-T and affiliated organization returns

The Form 990-T is the tax return filed by exempt organizations with unrelated business taxable income. The form would be made public (with appropriate redactions, e.g., for trade secrets). In addition, the tax returns filed by affiliated organizations would be made public (perhaps as part of a revised Form 990-T).¹⁴

5. Require public corporation filing of charitable giving return.

Publicly-traded corporations would be required to file annually with the IRS a return showing all gifts over \$10,000 (in the aggregate) for which a charitable deduction is claimed by the corporation in the corporation's taxable year. Such return would be made publicly available.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Board Duties

¹³This proposal follows a recommendation of the staff of the Joint Committee on Taxation. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions – Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations* (January 28, 2000), p. 5-7 (noting that such information will be of benefit to the public in determining whether the organization is in compliance with the law and how the organization is using funds).

¹⁴This proposal follows a recommendation of the staff of the Joint Committee on Taxation. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions – Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations* (January 28, 2000), p. 93.

A charitable organization shall be managed by its board of directors or trustees (in the case of a charitable trust).¹⁵ In performing duties, a Board member has to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the mission, goals, and purposes of the corporation. An individual who has special skills or expertise has a duty to use such skills or expertise. Federal liability for breach of these duties would be established.

Any compensation consultant to the charity must be hired by and report to the board, and must be independent. Compensation for all management positions must be approved annually and in advance unless there is no change in compensation other than an inflation adjustment. Compensation arrangements must be explained and justified and publicly disclosed (with such explanation) in a manner that can be understood by an individual with a basic business background.

- The Board must establish basic organizational and management policies and procedures of organization and review any proposed deviations.
- The Board must establish, review, and approve program objectives and performance measures and, review and approve significant transactions.
- The Board must review and approve the auditing and accounting principles and practices used in preparing the organization's financial statements and must retain and replace the organization's independent auditor. An independent auditor must be hired by the Board and each such auditor may be retained only five years.
- The Board must review and approve the organization's budget and financial objectives as well as significant investments, joint ventures, and business transactions.
- The Board must oversee the conduct of the corporation's business and evaluate whether the business is being properly managed.
- The Board must establish a conflicts of interest policy (which would be required to be disclosed with the 990), and require a summary of conflicts determinations made during the 990 reporting year.
- The Board must establish and oversee a compliance program to address regulatory and liability concerns.

¹⁵The duties of a board that are described in this paper would also be the duties of a trustee for a charitable trust.

The Board must establish procedures to address complaints and prevent retaliation against whistleblowers.¹⁶

All of these requirements must be confirmed on the Form 990. Relaxation of certain of these rules might be appropriate for smaller tax exempt organizations.

2. Board Composition

Board shall be comprised of no less than three members and no greater than fifteen. No more than one member may be directly or indirectly compensated by the organization. Compensated members may not serve as the board's chair or treasurer.¹⁷ For public charities, at least one board member or one-fifth of the Board must be independent. A higher number of independent board members might be required in limited cases. An independent member would be defined as free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments.

3. Board/Officer Removal

Prohibition on services. Any individual that is not permitted to serve on the board of a publicly traded company due to Federal, State (or exchange) law may not serve on the board of an exempt organization. Any individual that has been criminally convicted of a Federal or State charge of fraud, or similar offense, may not serve on the board or as an officer of an exempt organization for 5 years after the conviction. Any individual who has been convicted of a crime under the laws enforced by the Federal Trade Commission, U.S. Postal Service or State Attorney General for actions related to service as an officer or director of a tax exempt organization (or the crime arose from an organization that falsely presented itself as a tax exempt organization) may not serve as an officer/director for a tax exempt organization for 5 years. An organization or its officers/members that knowingly retained a person who is not so permitted to serve such organization would be subject to penalty.¹⁸

IRS Authority. The IRS would have the authority to require the removal of any board

¹⁶See *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, BoardSource and Independent Sector (2003)(useful discussion of provisions of whistleblower protections and other provisions of Sarbanes-Oxley and nonprofit organizations).

¹⁷See generally, BBB Standard 4, ECFA Standard 2.

¹⁸See generally *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, Fremont-Smith and Kosaras, 42 Exempt Organization Tax Review 25 (2003) (noting the number of repeat offenders in the survey) and *Where the Law Ends: the Social Control of Corporate Behavior*, C. Stone, 148-189 (1975) (advantages of suspension in corporate world).

member, officer, or employee of an exempt organization who has been found to have violated self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation laws. The IRS may require that such individual may not serve on any other exempt organization for a period of years. An organization that knowingly retained a person who is not so permitted to serve would lose tax exempt status or be subject to a lesser penalty.

4. Government encouragement of best practices.

Grant-Making and Contracts. In determining the recipients of Federal government grants and contracts to tax exempt organizations, the responsible Federal government agency issuing the grant or contract would be required to give favorable consideration to organizations that are accredited by IRS designated entities that establish best practices for tax exempt organizations. The IRS would annually determine those organizations, with a preference for organizations that perform an independent review of accredited organizations and that audit applications for accreditation.¹⁹

Combined Federal Campaign. The IRS, in consultation with OPM, will establish best practices/governance requirements/accreditation for charities participating in the Combined Federal Campaign (CFC). The IRS will ensure that the best practices/governance requirements for the CFC are uniform nationwide in order to encourage charities to participate in the CFC.

5. Accreditation.

There would be an authorization of \$10 million to the IRS to support accreditation of charities nationwide, in States, as well as accreditation of charities of particular classes (e.g. private foundations, land conservation groups, etc.). The IRS can initiate its own accreditation efforts as well as solicit requests. Priority would be given to proposals with matching dollars. The IRS would have the authority to contract with tax exempt organizations that would create and manage an accreditation program to establish best practices and give accreditation to members that meet best practices and review organizations on an ongoing basis for compliance. Such organizations could require dues by members to meet costs; and contract authority to review member information and take corrective action. The IRS would have the authority to base charitable status or authority of a charity to accept charitable donations on whether an organization is accredited.²⁰ The proposal should encourage accreditation that is already taking

¹⁹Compare with the Administration's proposed Millennium Challenge Account (MCA) which uses independent ratings (ex. Freedom House for Civil Liberties) for determining countries that will receive support. Treasury Under Secretary John Taylor Testimony before the Senate Committee on Foreign Relations, March 4, 2003 (www.treas.gov/press/release/js80.htm).

²⁰See *Nonprofit Compensation and the Market*, Frumkin and Andre-Clark, 21 Hawaii L. Rev. 425, 476 (Winter 1999)(general discussion about accreditation).

place at the state level (e.g. Maryland, Ohio, Pennsylvania, Georgia and Louisiana) or in particular classes (nonprofit hospitals, zoos and universities already subject to accreditation).²¹

6. Establish prudent investor rules

A prudent investor rule would apply to the investment activities of charitable organizations. Many States apply a prudent investor standard to non-profit entities incorporated in the State; such State standards would inform the development of a Federal standard.²²

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

In 1969, Congress determined that nonoperating private foundations should pay a tax on net investment income and that the proceeds of such tax should be used to fund the Exempt Organizations function within the IRS. Although the tax has been collected since 1969, the funds raised from the tax were not appropriated to Exempt Organizations and, in 1998, the authorization for making such appropriation was repealed from the Internal Revenue Code. Under the proposal, the authorization for appropriation of up to \$200 million of revenue from the tax on the net investment income of private foundations would be reinstated. Alternatively, a filing fee would be imposed on organizations that file the Form 990 (or 990-EZ, or 990-PF) and retained by Exempt Organizations. The amount of the fee would be determined based on an organization's gross receipts or assets. Proceeds from the fee (or appropriation) would be used for a number of purposes, including:

- State Enforcement-- Funding of \$25 million to States for exempt organization oversight and enforcement pursuant to a formula of \$100,000 for each State with matching federal dollars for each new dollar in State spending.
- Funding of \$25 million for nonprofit exempt organizations that educate other tax exempt organizations on best practices and inform the public of charities that are engaged in best practices; such funds would be provided to State organizations as well as national organizations to ensure an education presence in each state; a priority would be given to organizations that assist small charities in meeting proper standards and accreditation.
- Five year review of the exempt status of charitable organizations (see above), foundation classifications of charitable organizations, and exempt status of all other tax exempt groups.
- Funding of \$10 million for accreditation (see above).

²¹See Standards for Excellence Institute (www.standardsforexcellenceinstitute.org)(discussion of accreditation efforts in states).

²²See Fremont-Smith at 454 (pressing need for adoption of the Modern Prudent Investor rule as the standard for compliance).

- Funding of \$5 million to facilitate public access and review of Form 990s and other information for all tax exempt organizations.
- Establish Exempt Organization Hotline for reporting abuses by charities and complaints by donors and beneficiaries.
- Information sharing with State Attorneys General, the Federal Trade Commission, and the U.S. Postal Service for enforcement purposes, including referrals by the IRS and an annual report to Congress by the General Accounting Office of the results of such referrals (as well as referrals from the FTC, USPS, and State AG's to the IRS).

I. Tax Court Equity Authorities, Private Relator and Valuation

1. Tax Court Equity Authorities

The US Tax Court would be invested with 1) equity powers (including, but not limited to, power to rescind transactions, surcharge trustees and order accountings) to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and 2) equity powers (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers) to ensure that the organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future. In the event that appropriate State authorities institute action against a philanthropic organization or individuals based upon acts which constitute a violation of substantive rules of law applicable to such organization, the US Tax Court before whom the federal civil action is instituted or is pending would be required to defer action on any equitable relief for protection of the organization or preservation of its assets for its philanthropic purposes until conclusion of the State court action. At the conclusion of the State court action, the Tax Court could consider the State action adequate or provide further equitable relief, consistent with the State action, as the case warrants. However, no action by a State court would defer or abate the imposition of the initial Federal excise taxes for the violations.²³

a. The IRS or a director/board member may seek the removal of any director/board member or officer by the Tax Court. The Tax Court may remove the director or officer if the court finds that 1) the director or officer engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation or 2) has failed to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director/officer reasonably believes to

²³See *A Taxing Time for the Bishop Estate: What is the IRS Role in Charity Governance?* Brody, 21 Hawaii L. Rev. 537, 568 (Winter 1999) (discussion of 1977 Treasury Department proposed equity powers).

be in the best interests of the goals and purpose of the corporation. The court must find that removal is in the best interest of meeting the goals and purpose of the corporation. The court may bar the director or officer from serving on the board in any capacity, or any board for a period prescribed by the court.

2. Private Action - Directors.

Any director/trustee (at the time of bringing the proceeding) may bring a proceeding. A complaint in a proceeding brought in the right of a corporation (or trust) must be verified and alleged with particularity the demand made, if any, to obtain action by the directors and state either why the complainants could not obtain the action or why they did not make the demand. If a demand for action was made and the corporation's investigation of the demand is in progress when the proceeding is filed, the court may stay the suit until the investigation is completed.

On the termination of the proceeding the court may require the complainants to pay any defendant's reasonable expenses (including counsel fees) incurred in defending the suit if it finds that the proceeding was commenced frivolously or in bad faith.

If the proceeding on behalf of the corporation results in the corporation taking some action requested by the complainants or otherwise was successful, in whole or in part, or if anything was received by the complainants as the result of a judgment, compromise or settlement of an action or claim, the court may award the complainants reasonable expenses (including counsel fees).²⁴

3. Private Relator Action - Individual.

Any individual may submit a complaint regarding a charity to the IRS for review. The individual will pay a \$250 filing fee and \$10,000 fine for frivolous filing. A complaint in a proceeding brought in the right of a corporation/trust must be verified by the IRS and allege with particularity the demand made, if any, to obtain action by the directors and state either why the complainants could not obtain the action or why they did not make the demand. If a demand for action was made and the corporations' investigation of the demand is in progress when the proceeding is filed, the court or IRS may stay the suit until the investigation is completed. At all times the IRS will retain control of the suit. In addition, the IRS must refer the suit to the relevant state official prior to taking action. The state official has up to thirty days to stay the suit.

On the termination of the proceeding the court may require the complainants to pay any defendant's reasonable expenses (including counsel fees) incurred in defending the suit if it finds

²⁴See generally Cal Corp Code Section 5142 (allowing, inter alia, officers and directors to bring an action against a charitable trust) as well as the Revised Model Nonprofit Corporation Act (1987) Section 6.30 Derivative Suits (allowing directors and members to bring derivative suits).

that the proceeding was commenced frivolously or in bad faith.

If the proceeding on behalf of the corporation results in the corporation taking some action requested by the complainants or otherwise was successful, in whole or in part, or if anything was received by the complainants as the result of a judgment, compromise or settlement of an action or claim, the court may award the complainants reasonable expenses (including counsel fees).²⁵

4. Valuation Resolution.

To assist in resolving Federal tax valuation disputes, a mandatory baseball arbitration procedure is proposed. The arbitration method known as “baseball arbitration” (sometimes referred to as final offer arbitration) involves each party in a proceeding submitting a number to the arbitrator, and providing that number to the other party, on the understanding that following a hearing, the arbitrator will select one of the parties’ numbers to resolve the dispute. In a baseball player contract arbitration proceeding, the arbitrator is limited to selecting only one of the two figures submitted by the player and the owner.

For purposes of determining the value of property contributed to a charity (other than cash or publicly traded securities) to determine any Federal tax liability, the taxpayer and the IRS would be bound by baseball arbitration principles specifically adapted to the tax administration process.

Under the proposal, the taxpayer becomes bound by the taxpayer’s valuation used in the tax return, at the time the taxpayer is notified that the return has been selected by the IRS for examination. Prior to that time, the taxpayer may amend the return to modify the valuation taken in the return. The IRS is required to make a valuation determination at the examination stage, and becomes bound by its valuation position once it issues to the taxpayer the proposed notice of audit adjustment. During the examination stage of the proceeding, the IRS is free to negotiate with the taxpayer to reach a valuation agreement at any time up to the IRS issuing the notice of proposed audit adjustment.

²⁵See generally, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, Gary, 21 Hawaii L. Rev. 593, 624 - 627, 647 (Winter 1999), *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, Atkinson, 23 Iowa J. Corp. L. 655, 684 - 85 and n. 146 (Summer, 1998) (general discussion about benefits – and concerns – of granting standing to members and relators) and Fremont-Smith at 449 (“The best solution is to have an active and interested attorney general who will take action to correct abuses. There is also precedent for allowing him to let individuals bring suit in his name if he believes there is merit to the action but is disinclined to do so himself.”). Also see Fla. Stat. 617.2003 (allowing an individual to have the government initiate suit if the individual provides prima facie evidence to sustain charge and sufficient money to cover court costs and expenses).

During the appeals stage of the proceeding, the IRS and the taxpayer are bound by the parties' respective valuation positions. The IRS Appeals Officer may accept only one of the two valuation positions (IRS' or the taxpayer's) to dispose of the valuation issue. If the taxpayer disagrees with the value selected by the IRS during appeals, the taxpayer must litigate the valuation issue. During litigation, the court is required to select the taxpayer's or the IRS' valuation position. The proposal permits a court to award reasonable appraisal costs to the prevailing party in limited circumstances.