COMMENTS PURSUANT TO INTERNAL REVENUE SERVICE ANNOUNCEMENT 2002-87, 2002-39 I.R.B. 624, ON FORM 990 SERIES DEVELOPMENTS AND REQUEST FOR COMMENTS REGARDING POSSIBLE CHANGES

In Announcement 2002-87, 2002-39 I.R.B. 624 (September 4, 2002), the Internal Revenue Service (the “Service”) solicited comments regarding proposed revisions to the following areas of IRS Form 990, Return of Organization Exempt From Income Tax: fund-raising, political organizations described in Section 527 of the Internal Revenue Code of 1986, as amended (the “Code”), foreign grants, and corporate responsibility.

The following Comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Exempt Organizations of the Section of Taxation. Principal responsibility was exercised by Betsy Buchalter Adler and Victoria B. Bjorklund. Substantive contributions were made by Thomas E. Chomicz, Michael A. Clark, and David A. Shevlin. The comments were reviewed by Robert H. M. Ferguson of the Section’s Committee on Government Submissions and by Carolyn M. Osteen, Council Director for the Committee on Exempt Organizations.

Although many of the members of the Section of Taxation who participated in preparing these comments and recommendations have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

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EXECUTIVE SUMMARY

Except for certain narrow exceptions, every organization exempt from taxation under Code Section 501(a) is required to file an annual Form 990, Return of Organization Exempt From Income Tax. The Service is currently seeking to improve both the content and quality of the information provided on the Form 990, and, in Announcement 2002-87, 2002-39 I.R.B. 624 (September 4, 2002), the Service made several changes to the Form 990 and solicited comments to proposed revisions of the form.

The proposed revisions include additional reporting requirements for organizations that engage in fundraising, adapting the Form 990 to improve annual information reporting by political organizations, additional measures to more effectively identify transactions that present a risk of the diversion of charitable funds outside the United States to organizations or individuals suspected of supporting terrorist activities, and modifying the Form 990 or other requirements to ensure ethical accounting practices and to increase public confidence in the integrity of disclosures by exempt organizations.

We commend the Service’s efforts to improve the content and quality of the information provided on the Form 990 and would welcome the opportunity to work with the Service to explore these matters further.
I. OVERALL COMMENTS

As members of the Committee on Exempt Organizations of the Section of Taxation of the American Bar Association, we welcome the opportunity to respond to the request for comments on IRS Announcement 2002-87, regarding the IRS Form 990 Return of Organization Exempt From Income Tax.

We commend the Service’s EO Technical Division for seeking input on revising specific aspects of the Form 990. Our comments address the fundraising, foreign grants and corporate responsibility areas. We also suggest further measures to accomplish the Service’s oversight responsibilities. We share the goal of improving both the content and quality of the information provided on the Form 990. We would welcome the opportunity to work with representatives of the Service to explore these comments further.

II. RESPONSE TO SPECIFIC AREAS OF IRS INTEREST

A. Fundraising

While we have not provided specific comments on fundraising questions, we do endorse the goal of full and complete reporting of fundraising costs and expenses. Specifically, we encourage clarifying the Instructions for Form 990 and Form 990-EZ to emphasize the expectation that an organization that shows contributions, gifts, grants, and similar amounts received on Part I, Revenue, Expenses, and Changes in Net Assets or Fund Balances, line 1, will have typically incurred costs in raising those amounts. The Technical Division may wish to consider adding the following question, “If Part I, Revenue, Expenses, and Changes in Net Assets or Fund Balances, line 1 shows contributions, gifts, grants, and similar amounts received but Part I, Revenue, Expenses, and Changes in Net Assets or Fund Balances, line 15, Fundraising, shows an amount equal to less than [5%) of the line 1 amount, please explain why the organization had such low Fundraising costs.”

B. Foreign Grants

1. Should a separate schedule of grants to foreign organizations be required?

Yes. We support this proposed change to Form 990. Currently, Form 990 requires filing organizations to report grants to other organizations in Part II, Statement of Functional Expenses, line 22, Grants and allocations, and to attach a schedule showing the name and address of the recipient and the class of activity furthered by the grant. Requiring filing organizations to provide this information on two separate schedules – one for organizations created or organized under United States law, and one for organizations organized under the laws of a jurisdiction other than the United States (a “Foreign Organization”) – is an insignificant additional burden on the filing organization since this information is already required to be provided.
2. Should domestic charities conducting foreign activities be required to provide more specific information about the flow of funds involved in these activities, or about the recipients of these funds?

It depends on the nature of the “more specific information” being requested and the purposes to which the information will be put. With regard to the “flow of funds,” for example, the Voluntary Guidelines issued by the Department of the Treasury in November, 2002, suggest that charities may reduce the likelihood of a blocking order by obtaining and reviewing information about the banking arrangements of potential grantees and avoiding any transactions involving money-laundering jurisdictions or institutions. In our view, it is highly unlikely that even the largest and best-staffed American grant-making organizations would either be able to obtain from their potential grantees the detailed information suggested by the Voluntary Guidelines as “best practices,” or, once in their possession, be able to evaluate such information effectively. Moreover, in many parts of the world where the charitable American dollar contributes significantly to the public good, reliable and non-corrupt banking institutions comparable to American banks simply do not exist. American money can still contribute to the charitable good despite the absence of reliable banking institutions. We therefore question the benefit of seeking “more specific information.” A November 12, 2002 Wall Street Journal article entitled, “Afghan Aid Flows Through Dark Channels: U.S. Is Forced to Move Funds in Money-Transfer Networks Used by Terror Groups,” by Michael M. Phillips, reported that American charities such as CARE and World Vision International depend on the informal “hawala” network in Pakistan and Afghanistan to get badly needed resources to legitimate charitable organizations, since the “hawala” network is the only dependable system available.

While we understand the Service’s reasons for considering this question, we suggest an alternate approach that we believe will better educate public charities as to their responsibilities in sending funds overseas for exempt purposes. First, we strongly suggest that the Service consider issuing new precedential guidance on this issue. The Service’s authority on international grant-making by public charities dates from the 1960s. The most recent authorities, Rev. Rul. 63-252, 1963-2 C.B. 101, Rev. Rul. 66-79, 1966-1 C.B. 48, and G.C.M. 35319 (April 27, 1973), are decades old, and many public charities and practitioners are not familiar with them or consider them of historic interest only. In addition, these authorities approach the operational question from a deductibility perspective (whether the organization is a conduit with the result that the donor is not entitled to claim an income tax charitable deduction), which means that some organizations less concerned with deductibility take the position that these authorities do not apply to their operations. We would be happy to work with Treasury and the Service to draft new precedential guidance on this issue.

Second, we suggest that Form 990 be amended to ask whether the filing organization has obtained from each foreign grantee a signed agreement limiting the use of grant funds to purposes and activities within the scope of Code Section 501(c)(3) and requiring the grantee to refrain from using the grant funds to support or promote violence or terrorist organizations. If the answer to that question is no, Form 990 could contain a follow-up question asking the filing organization to attach an explanation. This reporting requirement could apply to all grants to Foreign Organizations.
3. Should transactions other than grant-making, such as sales or leases where funds flow outside the United States, also be more extensively reported?

We believe that asking questions on Form 990 is not the optimal means to gain useful information on sales or leases where funds flow outside the United States. We do believe, however, that it is appropriate for Form 990 to ask if a filing organization maintains a bank account outside the United States or its possessions and, if so, to identify the countries where it maintains such bank accounts. In addition, we note that an organization with a foreign bank account containing more than $10,000 is also required to file Form TD F90-22.1, Report of Foreign Bank and Financial Accounts.

III. Corporate Responsibility

1. Whether exempt organizations should be required to disclose on Form 990 whether they have adopted conflicts of interest policies or have independent audit committees.

We do not believe that this question will effectively assist the Service in its oversight responsibilities. We believe that adoption of a conflicts of interest policy and the establishment of an audit committee are primarily matters of state corporation or trust law and are secondarily “best practices” in the management of an exempt organization. In addition, we note that adoption of a conflicts of interest policy or establishment of an audit committee does not mean that such policies are followed or that such a committee functions in practice. Such subjective information would have to be gathered on audit. Finally, we note that conflicts of interest policies and establishment of audit committees may be too complex for small filing organizations.

We also note that a significant number of exempt organizations are not required under state law to undergo annual audits. For example, in New York State, audit requirements are only triggered for public charities receiving gross revenue and support in excess of $250,000. In California, state law does not require annual audits for nonprofit corporations of any size.

We respectfully suggest that a better approach might be to formulate and publicize an audit checklist that includes questions about a conflicts of interest policy and an audit committee. For example, the checklist might ask:

-- Does your organization have a conflicts of interest policy?
-- If so, has your organization complied with it?
-- Has your organization established an audit committee?
-- If so, has the audit committee met and performed its duties?

Such a checklist would demonstrate that an organization selected for audit would be expected to provide documentation of its conflicts of interest policy or of state law containing conflicts of interest procedural requirements, as well as a copy of its by-law provision or resolution creating
an audit committee, a description of its audit committee’s duties and responsibilities, if any, or documentation of state law containing audit committee requirements, if any.

2. **Whether non-charitable exempt organizations should be required to disclose information about transactions with its substantial contributors, officers, directors, trustees, and key employees similar to the disclosures required in Schedule A, Part III, Question 2.**

   We believe that it is not unreasonable to require Code Section 501(c)(4) entities to disclose information about transactions with their substantial contributors, officers, directors, trustees, and key employees similar to the disclosures required in Schedule A, Part III, Question 2. Such a requirement is applicable to Code Section 501(c)(4) entities, because they, like Code Section 501(c)(3) entities, are also subject to intermediate sanctions under Code Section 4958.

3. **Whether exempt organizations should be required to disclose on Form 990 any information in addition to that required in Schedule A, Part III, Question 2, about transactions or financial relationships with its substantial contributors, officers, directors, trustees, and key employees.**

   No, such additional disclosure about relationships should not be required. The extensive information requests in Schedule A, Part III, Question 2, about transactions or financial relationships with an exempt organization’s substantial contributors, officers, directors, trustees, and key employees would generally disclose to the Service information sufficient to alert it to the existence of excess benefit transactions or other similar issues warranting its attention. We do recommend, however, that the Service expand the instructions to Schedule A, Part III, Question 2 to add disclosure of the amounts or values involved in the transaction if the Service believes that such information would assist it in its oversight responsibilities.

4. **Whether there are any other changes to the Form 990 or other requirements that would increase public confidence in the integrity of exempt organization disclosures.**

   Yes. Please see detailed comments below.

   a. **Clarification of Reporting Requirements for Public Charity Grants to Individuals**

   Rev. Rul. 56-304, 1956-2 C.B. 306, discusses the documentation that a public charity is required to keep when it makes a grant to an individual. The regulations promulgated under Code Section 4945 outline such requirements for private foundations. We are not aware, however, of the Service having issued any guidance more recent than Rev. Rul. 56-304 on this issue. This ruling is so old as to be almost unknown to many practitioners and public charity officials alike. We strongly recommend that the Service review its 1956 ruling and either reissue that ruling or provide more updated guidance to make public charities aware of what records they are expected to keep and will be asked to produce in the case of an audit.
b. Unusual Grants; Schedule A (Form 990 or 990-EZ), Part IV-A -- Support Schedule, line 28

We believe that a number of preparers misinterpret the meaning of the term “unusual grant,” as used in the Instructions for Schedule A (Form 990 or 990-EZ), Part IV-A -- Support Schedule, line 28, Unusual Grants. We recommend, since this misinterpretation is a common problem, that the Service expand the instructions to the form to provide greater clarification of this term. Specifically, the Instructions for Schedule A (Form 990 or 990-EZ), Part IV-A -- Support Schedule, line 28, Unusual Grants, item 3 define “unusual grants” as follows: “Unusual grants generally are substantial contributions and bequests from disinterested persons and are … [l]arge enough to endanger the organization’s status as normally meeting the support test described in the instructions for lines 10, 11, and 12.” In response to these instructions, preparers often think that they should exclude any and all grants that could jeopardize the organization’s public charity status. The result is that preparers exclude all large grants from their calculation of the support fraction.

To improve preparer understanding, we recommend that the Instructions be clarified to explain to the return preparer that not all large gifts qualify as unusual grants. For example, the Instructions could mention specified criteria, including the criteria outlined in Treasury Regulation § 1.509(a)-3(c)(3) (e.g., the gift is “attracted by reason of the publicly supported nature of the organization”) and the factors outlined in Treasury Regulation § 1.509(a)-3(c)(4).

In addition, because the Instructions ask organizations to prepare a list of unusual grants for their records but do not require the organizations to file the list, the Service might not be aware of the preparers’ misunderstanding outlined above. If the Service is concerned about this misunderstanding, we recommend that the Service instruct the preparer to prepare the schedule and file it as a non-disclosable item on Schedule B (Form 990, 990-EZ, or 990-PF), Schedule of Contributors, the same non-disclosable report on which are filed the names and addresses of contributors to the organization.

c. Additional Guidance for Organizations Conducting Activities Outside the United States or Its Possessions

We note that many filing organizations conduct activities outside the United States or its possessions not by making grants but by operating their own programs. These operating organizations would benefit from plain-English guidance from Treasury on how such organizations can better avoid becoming the victims of fraud, asset diversion, or money laundering. While this would not come within the scope of Form 990, it should be part of any future “plain English” guidance that the Service may issue on international philanthropic activity, in addition to the guidance we recommend above under Section II, question B.2., Foreign Grants.

We would be happy to work with Treasury and representatives of the Service to comment on, or suggest language for, any documents needed to effect the changes we recommend.