Re: Senate Finance Committee Staff Discussion Draft of June 21, 2004

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning the Senate Finance Committee Staff Discussion Draft released June 21, 2004. The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as the position of the American Bar Association.

On June 21, 2004, the Senate Finance Committee released a staff discussion draft of various proposed reforms in the area of tax-exempt organizations (the “Discussion Draft”). The Section of Taxation of the American Bar Association organized a working group of experienced exempt organizations practitioners to review the Discussion Draft and provide comments to the Senate Finance Committee and its staff in connection with the roundtable discussion scheduled for July 22, 2004. Our comments are linked to the specific numbered sections of the Discussion Draft. For the reader’s convenience, we have attached several appendices, which treat particular issues in greater detail.

In general, our comments emphasize the value of added disclosure and the self-policing effect of disclosure requirements for exempt organizations. Particularly for charities, but also for EOs generally, the increased public accountability resulting from the on-line availability of their annual returns on Forms 990 and 990-PF has caused many EOs to improve their governance and their financial management. Because on-line availability is a fairly recent development, we believe that significant further improvement will result over the next few years. We believe that appropriate disclosure is a cost-effective and proactive method of deterring potential abuse as well as providing regulators with increased ability to remedy past or current abuse.

A. Exempt Status Reforms

1. Five-Year Review. The Discussion Draft proposes that each EO would be required to submit information every five years, on the anniversary of the date on which the IRS first determined that the EO was in fact exempt, to enable the IRS to determine whether it continues to be organized and operated exclusively for exempt purposes and, thus, continues to qualify for exempt status. We believe that a periodic review of any organization to determine its continued qualification has certain merit. The question is whether a five-year mandatory review of every EO is either practical or possible, when viewed from the burden it would place on the over 1.6 million domestic EOs and the significant administrative burden on the IRS of collecting and evaluating this information in order to determine an EO’s continuing tax exempt status. In the 1950s and 1960s, when there were far fewer charities in the U.S., the IRS required charities to file information after two years of operation for a final determination. Even with the far smaller number of organizations in play, the two-year review consumed significant resources; it reduced the number of agents available to audit known problem cases and created doubt in the mind of donors as to the deductibility of gifts.
We suggest that if interim review is desired, further study is needed to develop procedures that would avoid these unintended consequences. We also suggest that the IRS’ limited resources could better be directed toward a more effective audit selection program tied to the electronic return filing system. Finally, we suggest that requiring EOs to make certain materials available for public inspection, as part of their annual returns or otherwise, would be a more efficient way of achieving greater transparency.

2. Donor-Advised Funds. The Discussion Draft includes numerous suggested changes to the administration of donor-advised funds (“DAFs”). A DAF is not a separate legal entity; rather, it is a bookkeeping entry on the books of a public charity, identifying assets as to which a donor may make non-binding precatory recommendations to the public charity for charitable distributions and for investment (the “donor advice” of the name). The assets of a DAF belong to the public charity which has control over those assets and discretion as to their investment and use. The charitable purposes of a DAF and the rights and obligations of the public charity and the donor are generally set forth in a written agreement between the donor and the public charity. There is, however, no statutory or regulatory definition of a DAF, and we believe that clarity here would help to prevent both intentional abuse and inadvertent error.

As we discuss in Appendix A, we support several of the Discussion Draft’s proposals, e.g., requiring public charities with DAFs to refrain from making grants from DAFs to private non-operating foundations and requiring public charities with DAFs to obtain confirmation from the grantee that the grant will not convey a private benefit to the advising donor. However, we believe that several of the recommendations require further study in order to prevent abuse without also preventing important charitable activity where abuse is not present, or denying a significant economic benefit to the public charity to which the DAF assets belong. We welcome the proposed clarification that a public charity may pay a donor’s non-binding charitable pledge from a DAF upon reviewing and approving advice from the donor/pledgor.

3. Supporting Organizations. The Discussion Draft recommends abolishing Type III supporting organizations. We agree that this vehicle has been abused in some instances, but we believe that abolishing it is not necessary. Instead, in Appendix B, we suggest reforms that we believe will prevent the abuses that prompted this recommendation while still allowing legitimate Type III supporting organizations to operate.

4. Credit Counseling Organizations. The Section of Taxation agrees that further attention to credit counseling organizations is appropriate. Because of the short time available to respond to the Discussion Draft, however, we offer no comments on the Discussion Draft’s recommendations regarding the prevention of abuses in exempt credit counseling organizations.

5. Tax Shelter and Tax Avoidance Transactions. The Discussion Draft proposes that when the IRS determines that a charity is an accommodating party to a listed tax shelter transaction or a reported transaction with a significant tax avoidance purpose, the charity should be penalized by losing its ability to offer its donors a Section 170 charitable deduction for one year, and the charity should pay a 100% tax on accommodation fees or other direct benefits received. We agree, in concept, to penalizing charities that knowingly use their tax-exempt status to facilitate abusive tax shelters when it has been determined that a tax shelter is abusive, and, in Appendix C, we suggest issues that we believe should be considered in developing this proposal.

B. Insider and Disqualified Person Reforms

1. Self-Dealing and Disqualified Persons. The Discussion Draft proposes applying the private foundation self-dealing rules to public charities, with the exception of the compensation of insiders, which would be addressed by revising the existing Treasury Regulations to Section 4958. It also proposes to apply the definition of a disqualified person under Section 4946 (currently applicable to private foundations via Section 4941) to public charities while retaining Section 4958’s inclusion of persons with substantial influence over the organization. Congress considered and rejected this approach in 1996 when it enacted Section 4958. As practitioners, we have seen positive changes in the behavior of public charities in this area since Section 4958 was enacted, particularly since the Regulations to Section 4958 were promulgated in 2002. Rather than extending the private foundation rules to public charities, in Appendix D we suggest an alternative: a series of targeted reforms that address abusive transactions but leave public charities the flexibility to engage in transactions with insiders where those transactions
are for the public charity’s own benefit and do not confer an improper benefit upon the insider. We also recommend additional disclosure of transactions between public charities and their insiders.

2. **Definition of Disqualified Person.** The Discussion Draft would expand the definition of a disqualified person, as applied to public charities, to include a corporation or partnership with respect to which a disqualified person exercises substantial influence. As noted above, we believe that the existing provisions of Section 4958, including its definition of a disqualified person, should remain in place without modification. To address the concerns of the drafters, we suggest increased Form 990 disclosure of transactions involving public charities and corporations or partnerships in which a Section 4958 disqualified person has a substantial financial interest. Disclosure of all transactions between a charity and members of its board or partnerships or corporations in which a disqualified person has a material financial interest (similar to the proxy disclosure requirement that public companies disclose transactions with their board members) would provide the IRS, the general public and watchdog groups with sufficient information to monitor abusive situations.

3. **Excise Taxes.** The Discussion Draft proposes increasing the excise taxes currently imposed on acts of self-dealing (whether applied to private foundations or, as the drafters propose, to public charities) and on jeopardizing investments and taxable expenditures for private foundations. With regard to self-dealing, we suggest that if penalties are to be increased, abatement procedures should be put in place under Section 4962 for transactions that are due to reasonable cause rather than willful neglect. With regard to jeopardizing investments, we recommend updating and modifying the Section 4944 Regulations rather than increasing penalties for violating the current Regulations, which were drafted over 30 years ago and no longer provide useful guidance. The examples of types or methods of investment described in Treasury Regulation Section 53.4944-1(a)(2)(i), which will be closely scrutinized, do not reflect current investment practices and opportunities and do not recognize the current balanced-portfolio practices of foundations, including so-called alternative investments. Foundations today use sophisticated investment strategies to attempt to manage portfolios in accordance with modern portfolio theory, volatility considerations, and other matters. Rather than increase penalties in an area where a violation of the rules is unclear, the charitable community would be better served by updating and clarifying the rules. Finally, for both taxable expenditures and self-dealing, we believe that increased and rigorous enforcement of existing law by the IRS (funded, we hope, with excise tax revenues as the Discussion Draft recommends) is the most effective deterrent to abuse.

4. **Private Foundation Trustee Compensation.** Under the Discussion Draft, compensation of trustees of private non-operating foundations would either be banned or would be limited to a statutory maximum amount. In Appendix E, we describe several unintended consequences of this proposal which we believe would cause harm to the charitable sector. Instead of a statutory ban or cap, we suggest amplifying the guidance available to private foundations for determining whether trustee compensation is reasonable, possibly by reference to the rebuttable presumption procedures under the Regulations to Section 4958 (with appropriate modifications). Section 4941 already imposes penalties on the payment of unreasonable compensation to private foundation trustees; we question whether additional legislation is required.

5. **Private Foundation Compensation of Non-Trustees.** Under the Discussion Draft, compensation of disqualified persons to non-operating foundations, other than those who are disqualified only by reason of employment, would be determined by reference to comparable federal government rates for similar work and one would not be able to look either to other charities or to the private sector for comparison. Compensation or severance payments to other persons above certain limits would trigger additional public disclosure and IRS review (for which a filing fee would be imposed) and all compensation subject to such filing requirements must be approved annually and in advance by disinterested members of the charity’s governing body. As we suggest in Appendix E, we recommend an alternative: increasing Form 990-PF’s compensation disclosure by increasing the number of employees and independent contractors whose compensation must be disclosed. If Section 4958’s rebuttable presumption is extended to private foundations in some form, as we suggest above, it may be appropriate to require private foundations to affirm on Form 990-PF that they have followed the procedures required to obtain that presumption.

C. **Grants and Expense Reforms**

1. **Private Foundation Administrative Expenses.** The Discussion Draft proposes that private non-operating
foundations with administrative expenses (defined as any expense other than a charitable grant) above 10% of the
foundation’s total expenses would be required to file additional publicly available supporting materials with the IRS.
The IRS would then review this material to determine whether the expense was reasonable and necessary and, thus,
properly treated as a qualifying distribution of a private foundation. Administrative expenses over 35% of a
foundation’s total expenses would not count toward the foundation’s minimum mandatory distribution. In light of
the wide range of non-grant public benefit activities conducted by many private foundations (e.g., research, analysis,
conferences, publications, technical assistance to other EOs for charitable purposes, and other directly operated
programs that do not rise to the levels required for operating foundation status), we suggest instead dealing with
administrative expenses along the lines adopted in H.R. 7 (as passed on September 17, 2003). H.R. 7 redefined what
is allowed as an administrative expense and required the Secretary of the Treasury to write regulations on this
definition. This H.R. 7 definition expressly recognized that administrative expenses directly attributable to direct
charitable activities, grant monitoring and administration activities, compliance with applicable federal, state or
local law or furthering public accountability of the private foundation should continue to be considered qualifying
distributions without regard to amount.

2. Incentives for Increased Grant Funding. The Discussion Draft proposes to waive the Section 4940
excise tax on the net investment income of any private foundation that pays out more than 12% of its non-charitable
assets exclusively for grants. We are concerned that making this benefit available only in connection with increased
grants, rather than including public benefit programs directly conducted by private non-operating foundations,
would have the unintended and unfortunate consequence of curtailing these public benefit activities.

3. Private Foundation Grants to Donor-Advised Funds. The Discussion Draft would bar private
foundations from making grants to donor-advised funds of public charities. We understand that this proposal may
be prompted by concerns that some private foundations are “parking” assets in DAFs without recommending further
distributions, and that some private foundations, in collusive transactions, are making distributions to DAFs and
subsequently advising a grant back to themselves. We agree that such transactions should not be allowed.
However, we believe that there are numerous situations where private foundation grants to donor-advised funds may
enable the more productive use of charitable assets and bring greater, rather than lesser, independent oversight to the
distribution of charitable funds. Therefore, we suggest a more narrowly focused approach to the abuses to which we
believe the Discussion Draft’s proposal is directed. Specifically, we note that distributions from one private
foundation to another under Section 4942(g)(3) may not be counted toward the grantor private foundation’s
minimum distributions unless the grantee private foundation redistributes those funds before the end of the
following tax year (in addition to satisfying its own payout requirement from other funds). A distribution from a
private foundation to a donor-advised fund of a public charity could be treated similarly, though we suggest a
redistribution deadline of up to five years in recognition of the discretion of the public charity that owns and controls
the DAF assets. For this purpose, ‘redistribution’ means either a distribution to another charitable organization other
than a private foundation, or a transfer of assets from a public charity’s DAF to a fund of that public charity that is
not subject to donor advice. If the private foundation is terminating its existence by distributing its assets to a DAF
in a community foundation, however, we do not believe a mandatory redistribution deadline is necessary or
appropriate.

4. Travel, Meals, and Lodging Expenses. Under the Discussion Draft, both private foundations and public
charities would be able to pay travel, meals, and lodging expenses only up to the applicable U.S. government rates.
Public charities (but not private foundations) would be able to exceed this limit only if, for each such expense, the
charity’s governing body approved the expense and the approval was reported on Form 990. While we support
increased disclosure generally, we suggest that a simpler approach might be to follow the approach of H.R.7 here as
well, which excluded private and chartered air travel and any commercial air travel that exceeded coach-class
accommodation from the definition of qualifying distribution. We suggest, however, that an exception should be
created for instances where private or chartered air travel is the only feasible way to reach communities being
served, e.g. in Alaska and other rural areas where few or no alternatives exist.6

D. Federal-State Coordination of Actions and Proceedings

1. Standards for Acquiring or Converting a Nonprofit Organization. The Discussion Draft proposes
establishing standards for review by state and federal authorities of conversion transactions from tax-exempt to for-
profit status, and creating a procedure for notifying the IRS of intent to convert. Current law provides significant safeguards in the event of conversion, including Section 4958’s intermediate sanctions provisions, enacted in 1996, which impose substantial penalty excise taxes on disqualified persons who receive excess benefits from any transfers in which the exempt organization does not receive fair market value, and on organization managers who knowingly approve such transfers. We are concerned that the proposed process would add substantial cost and delay, and would often duplicate state proceedings, without significantly improving the current regulatory scheme. We are also concerned that a procedure which substitutes the IRS’s judgment for that of the exempt organization’s board as to the merits of a proposed transaction may not serve the best interests of the community. We suggest instead that the IRS might discourage abusive transactions, and more reliably identify those that do occur, by requiring prior notice by means of a simple form which (a) defined a conversion transaction; and (b) required the tax-exempt organization to document both the fair-market-value consideration for its assets and compliance with rebuttable presumption procedures under the intermediate sanction rules for any disqualified persons involved.

2. State Authority to Pursue Federal Actions. The Discussion Draft proposes giving states the authority to pursue certain federal tax violations by exempt organizations with the approval of the IRS, and notes that the states already have such authority with respect to certain federal law violations that are enforced by the Federal Trade Commission (“FTC”). With respect to consumer protection investigations and suits, most states have enacted so-called “Baby FTC Acts” that parallel the federal law. The states have the authority to enforce those state laws – not the federal law. The states are authorized to commence civil suits and bring actions under the federal anti-trust laws, either for injuries suffered by the state itself or in a parens patriae role on behalf of their citizens. With respect to the federal law of tax exemption, state laws already encompass concepts of charitable trust and fiduciary duty on which the federal law is based. Many states in addition have standards for state tax exemption that are similar to the federal tax law. We question whether there is any additional enforcement benefit to be gained from providing authority to the states under the federal tax laws.

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

1. Signature on Form 990/990-PF. The Discussion Draft recommends requiring the EO’s chief executive officer to sign the EO’s annual returns. We suggest that since many smaller public charities are run by volunteers, who do not work for the charity on a daily basis, a more effective alternative may be to require the signature of an officer or key employee in a position to certify that the return is complete and accurate. Form 990 might also include a check-box affirmation that copies of Form 990 were provided to each member of the EO’s governing body. In general, however, we agree with this recommendation.

2. Penalties for Failure to File. The Discussion Draft would increase the penalties for failure to file a complete and accurate Form 990. With regard to failure to file, we suggest that a more effective deterrent would be to leave the current penalty structure in place but limit the number of times that penalties could be abated. This would not discourage delinquent filers from “coming in from the cold” but would preclude willful violators from taking improper advantage.

3. Extensions of Time to File Form 990. Under the Discussion Draft, extensions of greater than four months would be considered a failure to file, leading to significant penalties. In our experience, charities do not delay filing their 990’s by choice. Larger charities with investments in partnerships, for example, cannot accurately report the value of their investments until the partnership provides Form K-1 to the charity. Smaller charities often find that they cannot secure the services of a CPA to prepare Form 990 during the January-May “busy season” at an affordable rate. We agree that timely reporting is to be encouraged, and we urge the development of other incentives.

4. Electronic Filing. The Discussion Draft would impose deadlines on the IRS e-filing capability for 990 filers and require the IRS to coordinate e-filing with state officials. We agree that e-filing should be encouraged, and we note that the IRS is actively working toward this goal. We also note, however, that with each addition to Form 990 (such as those recommended in the Discussion Draft and in these comments), implementing the e-filing function becomes a more complex task. Since the IRS is currently devoting significant resources to a complete revision of Form 990 and its variations, we are concerned that the goals of full disclosure of relevant information, coordination and information-sharing with state charity officials, and electronic filing may work inadvertently at cross-purposes. We suggest that the deadline be presented as a goal, rather than a requirement.
5. **Form 990 Standards.** The Discussion Draft would require the IRS to promulgate standards for filing Form 990 by a specified date in order to promote consistency among similarly situated EOs. Standards for financial statements, under the Discussion Draft, would conform to the Form 990 standards. We note that several efforts are already underway in the voluntary sector to promote consistent reporting on Form 990 and its variations. We suggest that the EO Compliance Unit that the IRS established earlier this year and the EO Data Analysis Unit that is expected to be in place later this year should be given the opportunity to determine where additional training and guidance may best be focused.

6. **Audits and Reviews.** The Discussion Draft would require EOs to attach a written review of an independent auditor “for conformity to established Form 990 filing standards.” EOs with more than $250,000 in gross receipts must attach an independent financial statement audit, including certification regarding the EO’s exposure to the unrelated business income tax; EOs with receipts between $150,000 and $250,000 must attach a CPA’s review rather than an audit. A new auditor would be needed every five years. We note that in many areas of the country, there are few auditors with EO expertise and it may be impossible to secure their services at reasonable cost, let alone secure a replacement every five years. We also note that until standards for Form 990 are promulgated as suggested in the preceding paragraph, it may be difficult for an auditor to provide the proposed certification. Various states have adopted different audit thresholds (and many states have none); if audits are to be required, we suggest that the national threshold should focus on EOs with larger asset bases.

7. **Other Disclosure Recommendations.** Under the Discussion Draft, EOs would have to attach an affiliations chart to Form 990 that discloses the EO’s relationships with each affiliated organization, whether or not exempt. Form 990 would require enhanced disclosure regarding taxable subsidiaries and their relationship with the EO, transactions with insiders, ancillary joint ventures, and all partnership interests including the EO’s role in the partnership. The EO would also have to attach copies of all tax opinions that it received involving agreements with insiders and all conflict of interest opinions. We note that large public charities, such as hospitals and universities, are part of affiliated groups in which many participants already file returns independently; this disclosure requirement would thus be a duplication of effort and a burden on government as well as on the EO sector. These considerations also apply to taxable subsidiaries. With regard to partnership interests, in most cases the charity is a passive investor; where the charity plays an active role, however, we agree that disclosure is appropriate. Finally, we are concerned that requiring disclosure of all tax opinions and conflict of interest opinions – entirely aside from questions of privilege – will have the harmful and unintended consequence of discouraging EOs from seeking legal and tax counsel on complex transactions. Without such advice, smaller charities in particular are likely to fall victim more frequently to promoters who do not have the charities’ best interests in mind.

8. **Performance Goals and Governance Disclosures.** The Discussion Draft would require charities with over $250,000 in gross receipts to include in Form 990 a detailed description of their performance goals and how they propose to measure their progress toward those goals, as well as material changes in their activities, operations, or structure. EOs would have to report how often the Board met during the year, and also how often the Board met without the CEO (or equivalent) present. Taking these points in the order presented, we note that many legitimate charities have goals that do not lend themselves to quantification or easy measurement. We also note that Form 990 currently asks for much information on an EO’s activities in Part III, Statement of Program Service Accomplishments. Information on the frequency of Board meetings could be included in the governance disclosures that we suggest in our comments on Part G.

9. **Public Charity Investment Disclosure.** The Discussion Draft proposes to require public charities to make available, on request, information on their investments similar to (though apparently not as detailed as) what is currently required of private foundations. We note that Form 990 already requires investment disclosures, including aggregate capital gain and loss and a schedule of itemized sales of non-publicly traded securities and lump sum sales of publicly traded securities. These disclosures already provide a measure of accountability to the public regarding a public charity’s stewardship of its funds. We suggest that detailed disclosure is appropriate for private foundations because they rely either on gifts from living donors who control their operations or on the income from their endowments; unlike public charities, private foundations typically have no stakeholders to hold them accountable. An alternative approach may be to require public charities to provide additional disclosure for any investment of the charity in which a Section 4958 disqualified person has a material financial interest.
F. Public Availability of Documents

1. Financial Statement Disclosure. The Discussion Draft would require EOs to disclose their financial statements to the public. We suggest considering this proposal in the context of revisions to Form 990 and 990-PF.

2. Web Site Disclosure. Under the Discussion Draft, EOs with web sites would have to post any returns that present law requires to be made public, along with their tax exemption application, their determination letter, and their financial statements for the most recent five years. Aside from questions of whether financial statement disclosure remains important in light of the extensive revisions proposed here to Form 990, and whether financial statements should be public for a longer period than tax returns under Section 6104, we note that there are practical problems for small organizations that would need to hire outside consultants to maintain and post the required documents to their web sites. We note also that posting Form 990 is duplicative, as Forms 990 are already available to the public at www.guidestar.org.

3. Audit and Closing Agreement Disclosure. The Discussion Draft would require the results of EO audits and closing agreements to be disclosed without redaction unless the audit or closing agreement resulted from the EO’s voluntary disclosure. In that case, the EO’s identity may be redacted. We agree that voluntary compliance must be encouraged. We are concerned, however, that this proposal may achieve the opposite effect: it may encourage charities to avoid closing agreements and proceed to litigation. Although litigation documents are often matters of public record, it is much more difficult to gain access to them. The prompt release of redacted EO audits and closing agreements, like the release of redacted private letter rulings and Technical Advice Memoranda, promotes public understanding of IRS interpretations and applications of the tax law and would contribute to compliance in itself.

4. Form 990-T Disclosure. The Discussion Draft also proposes to require Form 990-T, on which an EO reports its unrelated business income, to be made public with appropriate redactions, e.g. for trade secrets. The returns filed by affiliated organizations may also be made public, possibly as part of a revised Form 990-T. It is not clear to us what purpose this disclosure is intended to serve or what abuses it is intended to remedy. We note that the Congressional policy behind the unrelated business income tax was to permit EOs to engage in unrelated businesses but to tax them at rates comparable to taxable enterprises so that they did not have an unfair advantage. Consistent with this notion of parity of treatment between EOs and for-profit businesses, we believe that EOs should not be treated more harshly. Since the tax returns of for-profit businesses are not publicly available, the unrelated business income tax returns (as opposed to the annual returns on Forms 990/990-PF/EZ) should not be publicly available either. To do otherwise would, we believe, undercut the “level playing field” goal of Congress in enacting this tax regime for EOs.

5. Disclosure of Donations by Publicly Traded Corporations. The Discussion Draft recommends requiring publicly-traded corporations to file annually each year, with the IRS, a return showing all gifts over $10,000 (in the aggregate) for which the corporation claims a charitable deduction in that year; this return would be publicly available. We note that Congress considered and rejected this requirement in connection with the Sarbanes-Oxley Act.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Federal Standard of Care and Liability for Breach. The Discussion Draft proposes to create a federal standard of care for members of a charity’s governing body and to establish federal liability for breach of a director or trustee’s duty to the charity. It would also require special attention to, and enhanced disclosure of, management compensation arrangements. Because the laws of the fifty states differ in important respects regarding the governance of charities, any transition to a federal standard should be developed with great care and in close coordination with state attorneys general. We suggest, in the interim, that adding questions to Forms 990/EZ/PF on governance practices would encourage better governance while also providing the IRS and the public with information on actual governance practices of the charitable sector as a whole. We also suggest that some of the proposals could lead to unintended and harmful consequences. In Appendix F, we suggest alternative methods for addressing the concerns that prompted the Discussion Draft’s recommendations.
2. **Board Composition.** The Discussion Draft proposes several rules regarding the composition of a charity’s governing body. In *Appendix F*, we suggest that enhanced disclosure on Form 990 would encourage charities to pay close attention to governance issues without imposing a “one size fits all” structure and would also enhance the ability of government regulators to oversee charitable operations. It would also avoid unintended consequences that would make it more difficult for charities to operate productively.

3. **Eligibility for Board Service.** The Discussion Draft recommends barring any person who has been convicted of certain crimes or who is barred from service on the board of a publicly traded corporation from serving as an officer, director, or trustee of a charity, in some instances for a specified period of time and in other cases permanently. The Discussion Draft also recommends authorizing the IRS to require the removal of any director, officer, or employee of an EO who has been found to violate certain rules and to ban such a person from serving on any other EO’s board for a period of years. We believe existing law contains sufficient penalties and remedies for one-time violations. However, in the rare case where such violations are repeated and willful, we believe it is appropriate to grant the IRS the authority to require the removal of an officer or director, subject to appropriate judicial review.

4. **Preference for Accredited Charities.** The Discussion Draft suggests giving preference in government contracts and grants to organizations that have been accredited, as discussed below, and to conditioning participation in the Combined Federal Campaign on a charity’s adoption of certain specified and nationally consistent best practices, including accreditation. For the reasons stated in the next section and discussed further in *Appendix F*, we believe that this recommendation should be reconsidered.

5. **Charity Accreditation.** The Discussion Draft recommends (and proposes funding for) a nationwide charity accreditation program to be developed by the IRS in conjunction with EOs that would create and manage such programs for states and/or for particular categories of charities. The IRS would have the authority to condition charitable status, and the ability to offer donors a charitable deduction, on whether a charity is accredited. We believe that responsible self-regulation is a trend that government should encourage. However, we are concerned that having the IRS or any other government agency use the standards of best practices set by charitable organizations as standards for granting exempt status or allowing federal income tax deductions for donations could work at cross purposes to development of the highest standard of corporate governance, as self-regulatory groups might be discouraged from setting high standards if government benefits and penalties were tied to those standards. Moreover, governmental reliance on standards set by private organizations may constitute the delegation of governmental rulemaking authority to the private sector, an action that should be undertaken only with the greatest of care.

6. **Prudent Investor Rule.** The Discussion Draft proposes applying a prudent investor rule to the investments of charities. As the Discussion Draft notes, many states have adopted prudent investor standards for nonprofit organizations; indeed, the Draft proposes that any new federal standard would be informed by such state standards. In addition to specific state standards, directors and trustees of charitable organizations are subject to common law fiduciary duties that apply to their oversight of investments. Further, the majority of states have adopted the Uniform Management of Institutional Funds Act (1972) (UMIFA). UMIFA applies an “ordinary business care and prudence” standard to the investment of endowment assets of corporations and unincorporated associations that are organized and operated for charitable purposes. The American Law Institute’s Restatement (Third) of Trusts (1992) and the Uniform Prudent Investor Act adopt a prudent investor standard of care for investments. Given the existence of such common law and state standards, we suggest that it is unclear what goals would be served by the addition of a federal standard in the context of public charities. We suggest that this issue requires further study before legislation is considered.

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

The Section of Taxation and its Exempt Organizations Committee have long advocated for improved funding for federal and state oversight of EOs generally and charities in particular, including educational efforts. We endorse the Discussion Draft’s proposal to reinstate the appropriation of Section 4940 tax revenues to this governmental function. We also endorse the development of information-sharing protocols that would allow charity regulators on the state and federal levels to communicate with each other, with appropriate safeguards in place.
I. Tax Court Equity Authorities, Private Relator and Valuation

1. Tax Court Equity Power. The Discussion Draft proposes investing the U.S. Tax Court with certain equity powers, including the power to rescind transactions, surcharge trustees and order accountings, in order to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and power to substitute trustees, divest assets, enjoin activities and appoint receivers to ensure that an organization’s assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future. Here as in Part G, we are concerned that this proposal creates a federal standard of fiduciary duty that will create more, rather than less, uncertainty and confusion. We are also concerned that Tax Court judges, who are selected for their technical tax expertise and who are generally not called to employ equity principles, would be granted greater equity powers than those afforded to most state court judges in similar instances.

2. Director/Trustee Standing. The Discussion Draft proposes to grant standing to bring a proceeding in the right of a charity to any person who is a director or trustee of that charity. It is not clear from the Discussion Draft whether the proposal contemplates standing in federal court, state court, or both. We suggest that such standing on a state level, which exists under the laws of most states and the Revised Model Nonprofit Corporation Act, is to be encouraged, but for the reasons explained in our comments, we do not support the creation of a federal private right of action to enforce the tax law.

3. Standing for Other Individuals. The Discussion Draft proposes to permit any individual to submit a complaint about a charity to the IRS for review; if both the IRS and the appropriate state authority decline to pursue the matter, the individual would have the right to bring suit against the charity. We suggest that granting open-ended relator status, without requiring any connection between the complainant and the charity, could have serious unintended consequences similar to those that led Congress to reform the federal securities laws in the Private Securities Litigation Reform Act. We recommend against adopting this proposal.

4. Valuation. The Discussion Draft recommends adoption of a procedure known as “baseball arbitration” to resolve differences between donors and the IRS regarding the value of property donated to a charity. We are concerned about the effect on tax law generally of endorsing a specific approach to determining the value of property in a particular area, since the concept of valuation is key to many areas of tax law unrelated to charitable giving. Setting this issue aside for the moment, we suggest considering the variation known as “night baseball arbitration” in order to counteract the possibility of administrative bias in the IRS appeals process. We suggest, however, that at the litigation stage the determination of value is a question of fact that is best left to the judge or jury as the trier of fact, and that a procedure that affects the taxpayer’s right to a jury trial in U.S. district court may raise constitutional issues.

Conclusion

We appreciate the opportunity to provide comments to the Senate Finance Committee and the Committee staff. Should you wish additional information on any of the matters discussed in this paper, please contact Stuart Lewis, the Section’s Vice-Chair for Government Relations, at (202) 452-7933.

Sincerely,

Richard A. Shaw
Chair, Section of Taxation

cc: Gregory Jenner, Acting Assistant Secretary of the Treasury (Tax Policy)
George Yin, Chief of Staff, Joint Committee on Taxation
Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Russ Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee
1 Principal responsibility was exercised by Betsy Buchalter Adler and LaVerne Woods. Substantive contributions were made by Carolyn M. Osteen, Douglas M. Mancino, Eve Borenstein, Paul Feinberg, Lisa Johnsen, James P. Joseph, and Christopher Jedrey with comments from other members of the Section of Taxation’s Exempt Organizations Committee.

2 Some of the proposals apply to all exempt organizations while some apply only to those that are exempt under Internal Revenue Code Section 501(c)(3). In this paper, “EO” refers to all organizations that are exempt under Section 501 and “charity” refers to organizations that are exempt under Section 501(c)(3).

3 Some public charities, such as community foundations, make grants from unrestricted funds as well as from DAFs. Others, such as universities and religious institutions, conduct direct charitable, educational, or religious activities and operate DAFs as a secondary or tertiary activity. For still others, such as the various national-scope grantmakers founded by various financial institutions, DAF grantmaking is their primary activity. Finally, a small but significant group of public charities, in some cases linked with domestic public charities (or foreign public charity equivalents) that operate their own programs abroad, makes DAF grants with international scope.

4 The IRS has looked to Section 1.170A-9(e)(11) of the Treasury Regulations, which sets forth standards for when a component fund of a community foundation may be treated as a part of that community foundation, for guidance in the DAF area. One essential element of those Regulations is the absence of any material condition or restriction on the community foundation’s use of the assets. These Regulations, however, were promulgated before the recent significant growth in assets held by public charities in DAFs and before investment firms created national-scope charities whose primary activity was the management and operation of DAFs.

5 Whether the authors intended this provision to apply to only to trustees of private foundations organized as trusts or also to members of the governing body of private foundations organized as corporations (who may be referred to as trustees, directors, or Board members), the basic principle of reasonable compensation is the same. However, unlike trustee fees, the laws of most states do not address the stipends of board members of nonprofit corporations.

6 A private operating foundation under Section 4942(j)(3) spends at least 85% of its annual net income on the direct and active conduct of its own charitable programs; its donors are treated as having donated to public charities for purposes of Section 170. Other private foundations are sometimes termed “non-operating foundations.”

7 We note that the Department of the Treasury has worked to alert charities and other EOs to the need for enhanced anti-diversion efforts in light of reported abuses resulting in the diversion of charitable assets to the support of violence or terror. These efforts are essential; they are also time-consuming and costly. We believe that it is important to avoid creating counter-incentives to implementing and maintaining these good practices.


9 For a recent example see, e.g., Letter of April 23, 2004, from Richard A. Shaw, Chair, American Bar Association Section of Taxation, to the Senate Appropriations Subcommittee on Transportation/Treasury and General Government, stating that it is essential that the IRS have adequate funding to ensure its ability to carry out its mission in the administration and enforcement of the tax laws of the United States, available at www.abanet.org/tax/pubpolicy/2004/040423sen.pdf.

10 For example, in Minnesota representatives of the Attorney General’s office, the private EO bar, the CPA community, and finance officers of Minnesota charities began working together in 2001 as the Minnesota Nonprofit Accountability Collaborative (NAC) to design workshops and publications on the theme “Making Your Form 990 Work for You.” That effort, which culminated in 2003, yielded eight workshop presentations to date and produced two technical assistance publications for lay readers, including “Tips for Telling the Truth – a Form 990 Tool,” available at www.crcmn.org/npresources/truthtips.pdf. This publication addresses the four areas where the NAC found that 990 preparers needed the most education: explicating program service accomplishments; documenting and disclosing expenses appropriately under the Statement of Functional Expenses; understanding what comprises reportable fundraising expenses; and disclosing insider transactions and compensation.

11 The Discussion Draft speaks in terms of board members but makes clear that these duties, and other recommendations in this section of the Discussion Draft, would also apply to trustees of charitable trusts.

12 Further information on each element of Part I is provided in Appendix G.
APPENDIX A
DONOR-ADVISED FUND REFORMS

At present, neither the Internal Revenue Code nor the Treasury Regulations define a donor-advised fund (“DAF”), although this is one of the fastest-growing forms of charitable giving. For purposes of this discussion and for the convenience of the reader, we offer the following informal working definition of a DAF, as stated in the Section of Taxation’s letter:

A DAF is not a separate legal entity; rather, it is a bookkeeping entry on the books of a public charity, identifying assets as to which a donor may make non-binding precatory recommendations to the public charity for charitable distributions and for investment (the “donor advice” of the name). The assets of a DAF belong to the public charity which has control over those assets and discretion as to their investment and use.

The lack of donor control is a key element of the DAF concept. Whether the public charity that owns the DAF assets is a community foundation, a university, a religious institution, a commercially-sponsored charitable gift fund, or an internationally-focused public charity, the public charity is governed by an independent board of directors that has ultimate authority and responsibility over all distributions, including those from assets subject to donor advice.

The Discussion Draft makes eleven specific proposals regarding the regulation of DAFs (in addition to a proposed ban on the ability of private foundations to make grants to public charities for DAFs, which we address in the Tax Section’s letter). We endorse several of these proposals as being consistent with the practices of many responsible public charities that operate DAF programs. In particular, we support the following proposals:

- A public charity would not be permitted to make grants from DAFs to non-operating private foundations.
- A public charity would be required to secure from the grantee an acknowledgment that a grant from a DAF will not convey a private benefit to the advising donor.
- A public charity that holds assets in DAFs would be required to disclose the existence of the DAFs on its Form 990.
- A public charity would be able to accept donor advice to satisfy a donor’s non-binding charitable pledge.¹
- A public charity would hire investment managers for its DAF assets according to arm’s length principles.
- Fees for referrals or transfers of funds to a DAF would be limited.
- Public charities with DAFs would have to impose a minimum activity threshold on each DAF.²

¹ We believe that the tax consequences of allowing a public charity to implement donor advice to pay a donor’s legally binding charitable pledge require further study. A non-binding pledge, however, does not raise those issues.
² The definition of required minimum activity, including the period of time over which it is measured, poses numerous technical questions. We endorse this proposal in concept, pending the development of answers to those questions.
We turn now to five proposals as to which we have more detailed comments.

Proposal 1 would require public charities to dispose of contributions to a DAF, other than cash or publicly traded securities, within one year of contribution and would require them to have a plan for sale at the time of the gift. Alternatively, a DAF could accept only cash or publicly traded securities. We assume that this proposal was prompted by concerns regarding the valuation of property for which the donor must obtain a qualified appraisal. We further assume that the requirement of sale within one year is intended to allow the IRS to identify any significant differences in the amount of the charitable deduction claimed by the donor and the sales price on disposition by the charity, by means of the charity’s reporting on IRS Form 8282. The issue of proper valuation of “qualified appraisal” property is not limited to gifts to DAFs and should be considered in the larger context of valuation of charitable gifts generally. For example, an unrestricted donation to the local children’s hospital of pre-IPO stock that, under the Securities and Exchange Commission’s rules, may not be sold for a specified period, raises the same valuation issues as a donation of the same stock to a community foundation DAF (or, indeed, to a commercially-sponsored national gift fund DAF). In the interests of consistency in the tax law, we recommend analyzing the valuation of “qualified appraisal” property in the broader context of donations generally, rather than viewing it solely in the context of DAFs. We do not support Proposal 1 in its current form.

Proposal 2 contains two elements: a prohibition on a public charity’s grants from DAFs to private non-operating foundations, which we support, and a prohibition on a public charity’s grants from DAFs to individuals, which we suggest is overly broad. We assume that the former prohibition is designed to prevent donors from claiming the more generous tax benefits available under law for donations to public charities and then recommending a grant to a private foundation controlled by the donor (or by family members or related business entities). We understand that most reputable public charities with DAFs have already adopted policies banning such transactions. With regard to grants from DAFs to individuals, however, we suggest that the public charity’s discretion and control – particularly in the context of community foundation DAFs – provide an important safeguard against abuse. Anecdotal evidence suggests that those community foundations that make grants to individuals from their DAFs typically restrict the practice to scholarships, and while the donor is often involved in the selection process, e.g. by participating on the selection committee, the donor does not control the selection.

We note that the IRS has recently begun a market segment study of community foundations. DAFs will form a significant element of that study because of the significant amount of community foundation assets in the form of DAFs. We suggest that the results of the market segment study will provide a factual baseline that will assist the Senate Finance Committee as well as the IRS to assess whether restrictions are needed on grants from public charity DAFs to individuals. Pending that study, we suggest that additional enforcement of existing prohibitions against private benefit and inurement is the best approach. If the Committee believes that legislation is necessary, however, we suggest that since the issue is improper donor control, the most appropriate remedy is to strengthen the public charity’s control of the DAF assets by requiring any grants from DAFs to individuals to be approved by a

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3 See Treas. Reg. § 1.170A-13(c)(3).
selection committee, appointed by the public charity, on which the donor may serve but which the donor does not control.

Proposal 4 states: “A DAF would be required to meet an aggregate annual payout consisting solely of grants paid of 5% of the DAF’s assets. Failure to meet the payout would result in a tax similar to that applicable to private non-operating foundations.” A DAF, as noted above, is not a separate organization or entity but merely a bookkeeping entry that describes certain assets of a public charity. The reference to an “aggregate annual payout” leads us to believe that the drafters intended to refer to the public charity that owns the DAF assets and not to each individual DAF that a public charity might own. Our comments address that interpretation.

We believe that the payout proposal should be reconsidered. We note that grantmaking public charities, particularly community foundations, often have adopted spending policies under which they aim at distributing a percentage of assets that allows them to build reserves, while still serving the community with grants. These reserves are then available to meet community needs during difficult times, because a board may vary the spending policy in response to such needs. The Uniform Management of Institutional Funds Act, known as UMIFA, and other state laws may impose certain requirements on DAFs that are classified as endowments, such as a prohibition against making expenditures that would cause the DAF value to fall below the historic dollar value of gifts to the DAF. Finally, a number of community foundations may hold the reserve funds of other public charities in the community in a DAF where the local charity itself is the donor-advisor, so that the smaller charity may benefit from the investment expertise available to charities with larger aggregate assets. These reserve funds, sometimes called agency endowments (though not always true endowments from a legal or accounting perspective), may see no activity other than the receipt of investment income until the local charity needs funds. These examples illustrate the complexity of the situation.

If the payout proposal is prompted by concerns that donors are “parking” funds in DAFs with no ultimate benefit to the community, we suggest that a minimum activity requirement, which looks at a period of years rather than focusing on one year at a time, may address perceived issues. We also suggest that the situation of community foundation DAFs is distinctive, since in order to qualify as a community foundation in the first place the charity must have the power (known as the “variance power”) to use its assets for community needs in its complete discretion. In any case, we suggest that the payout proposal would benefit from further study and from discussions with community foundations and other responsible public charities with DAFs.

Turning to international philanthropy, we have serious concerns about the unintended consequences that would flow from Proposal 7, which would bar a public charity from making grants from a DAF to any foreign organization that did not appear on an IRS published list of approved foreign organizations. We emphasize, again, that DAF assets belong

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6 Currently there is no such list. It is not clear to us how the IRS, whose resources are stretched thin with overseeing more than 1.6 million domestic charities and EOs, could develop standards for accrediting charities organized under
to public charities which have discretion and control as to their use. We see no reason to
distinguish between public charity grants from general funds and public charity grants from
funds as to which donors have the right to make non-binding recommendations. Responsible
public charities that make grants to foreign organizations, whether from general fund assets or
from DAFs, commonly exercise a high level of due diligence before the grant is made and
require reports on how the funds were used.\(^7\) Since September 2001, international grantmakers –
whether public charities or private foundations – have invested significant resources in
developing procedures and practices to prevent the diversion of charitable assets to violent or
terrorist ends. Individual donors, private foundations, and public charities without international
expertise have made advised gifts to public charities with international due diligence capability
in order to support good works abroad in a legally compliant manner. We believe that this
practice should be encouraged rather than discouraged. Finally, if Proposal 7 was prompted by
concerns about international grantmaking generally, we suggest that this topic should be
considered separately and not as part of an effort to regulate the donor-advised sector.

Finally, we are not sure what prompted Proposal 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.” A public charity that owns DAF assets generally
conducts such due diligence as may be appropriate in the circumstances. Where the donor
recommends grants for specific projects, the public charity may reasonably conclude that more
due diligence is required and may, thus, expend more resources from the DAF on staff oversight.
If the drafters are concerned that public charities may be reimbursing excessive or improper
expenses of donors who volunteer their time for distant site visits, for example, this may be
corrected with more targeted reforms, such as limits on the reimbursement of donors’ expenses
(and the expenses of their family members or related entities) in connection with selection
activities.

\(^7\) See “Comments in Response to Internal Revenue Service Announcement 2003-29, 2003-20 I.R.B. 928, Regarding
International Grant-Making and International Activities by Domestic Section 501(c)(3) Organizations,” submitted to
the Internal Revenue Service by individual members of the Committee on Exempt Organizations of the Section of
The draft proposal recommends eliminating “Type III” supporting organizations. We share the Senate Finance Committee’s concern about the abusive transactions reported in the *Chronicle of Philanthropy* and elsewhere that involved the misuse of Type III charities. However, we also believe that the Type III supporting organization structure offers institutions and donors valuable flexibility. Most supporting organizations — including Type IIIs — operate in full compliance with federal and state law and provide significant funds to academic institutions, health care organizations, and community foundations for their charitable work.

We believe the abuses identified by the Committee should be addressed through targeted reforms. We do not support elimination of Type III supporting organizations. If Congress does adopt legislation removing this version of public charity status, we believe that existing organizations should be grandfathered, perhaps after demonstrating their continued qualification under Section 501(c)(3).

The basis of all three types of supporting organization structures is the involvement of the supported organization in overseeing or monitoring the operation of the supporting organization. Accordingly, we believe an important means of addressing any systemic tendency toward abuse in this area is to require greater demonstration of involvement by the supported organization. We offer the following non-exclusive list of possible reforms:

- At the application stage, the IRS could require new Type III organizations to attach a statement to Form 1023, signed by an officer of the supported organization(s), that it/they have received copies of the applicant’s governing documents and that they agree to be named as a supported organization. In addition, an officer of the supported charity that will actively participate in overseeing the applicant’s activities should confirm its agreement to do so.

- Existing Type III organizations could be required to attach a similar signed statement, updated annually, to their Form 990.

- For Type III charities organized as corporations, this statement might require a description of the frequency with which the supported organization’s representative participated in board meetings or otherwise exercised a significant voice in how the supported organization operated during the year. Less than a threshold level of actual involvement would be grounds for loss of public charity status.

- All Type III charities, whether organized as trusts or corporations, should be required to report annually to each named supported public charity with a description of their activities. The report should include narrative and financial detail sufficient to allow a supported public charity to determine whether it wishes to separate itself from the Type III organization, to become more actively involved in overseeing it, or to take other appropriate action.
The IRS should consider issuing a Revenue Procedure or information letter that sets forth how a supported organization may properly notify the IRS of its withdrawal of consent to be named as a supported entity. This notice, of course, is important because of its bearing on the public charity status of the Type III organization.
APPENDIX C
TAX SHELTER TRANSACTIONS INVOLVING EXEMPT ORGANIZATIONS

While we agree, in concept, to penalizing exempt organizations\(^1\) that purposefully use their tax-exempt status to facilitate abusive tax shelters, any legislative proposal must be carefully structured to ensure that the obligations of EOs are clearly defined, so that EOs are not penalized too harshly for limited and innocent involvement in a transaction that is subsequently determined to be a part of an abusive tax shelter.

The proposal states that, to avoid sanction, an EO that is determined to be an “accommodating party” in a tax shelter must have received an “affirmation” that the transaction is not a listed or reported transaction. We believe that the proposal would penalize EOs for participating in transactions that have not been determined to be abusive tax shelters, and any penalties should not be imposed until the determination by the Service that a transaction is an abusive tax shelter has been subject to judicial review. If an EO participates in a transaction that the Service has determined – or later determines – is a listed transaction or that is a “reportable transaction,” we suggest that it is not appropriate to impose penalties on the EO without a judicial determination that the transaction is an abusive tax shelter. The listing of a transaction by the Service is merely the Service’s statement that it will challenge a particular transaction. It is not a final determination that the transaction does not “work” from a tax perspective or that it is an abusive tax shelter.

As elsewhere in this submission, we suggest that increased disclosure and transparency on the part of EOs is the answer. In our view, a more appropriate response to Congressional concerns about participation by EOs in potentially abusive tax shelters is to require EOs to disclose any participation in a listed transaction, with the EO being able to rely on an affirmation by a donor or promoter, subject to such safeguards as Congress may select, that a particular transaction is not a listed transaction or substantially similar to a listed transaction. In addition, as a safe harbor, an EO should not be subject to penalties for participating in a transaction which, at the time the transaction was completed, was not a listed transaction or substantially similar to a listed transaction.

We suggest that the following matters, at a minimum, require further study and clarification before legislation is proposed:

- How will “accommodating party” be defined?\(^2\) If an EO receives a donation of a complex financial product or other property, for example, and the EO’s role is that of

\(^1\) As elsewhere in this submission, “charity” refers to organizations described in Section 501(c)(3) and “EO” refers to EOs generally, including non-charitable EOs. All statutory references are to the Internal Revenue Code.

\(^2\) Strictly speaking, a Section 501(c)(3) organization could be characterized as an "accommodating party" in every charitable contribution that it receives for which the donor takes a deduction. For example, charities facilitate avoidance of recognition of capital gain, as well as deductions offsetting gain that was never recognized and taxed, whenever they accept gifts of appreciated securities. Charities are always facilitating tax reduction for donors, because Congress, in Section 170, determined that it is in the public interest to encourage gifts to charity through tax breaks. Charities are not experts in the tax law, however, and the burden should not be on them to distinguish a proper tax avoidance transaction authorized (or permitted) by Congress from an abusive tax shelter, other than by relying on the Service’s list as a safe harbor.
a passive recipient, with no knowledge, beyond the valuation of the property, of the
tax implications to the donor of the contribution, the EO should not be considered an
accommodating party. It may be more appropriate to define an “accommodating
party” for this purpose as an EO that is an active participant in structuring and
implementing the shelter transaction.

- Who must make the affirmation? If it is a donor, what level of due diligence, if any,
  must the EO conduct to confirm the accuracy of the affirmation? What if it is a
  promoter?

- If a donor or promoter provides a false affirmation to an EO, is a penalty imposed on
  the donor or promoter? In such a situation, is the EO at risk of sanction?

- If the EO must obtain the affirmation from a third party, will an opinion of counsel
  suffice? What level of independence must counsel have from the EO, the transaction,
  and other parties in the transaction?

- Some of the terms used in the proposal are open to interpretation (e.g., “significant
  purpose of tax avoidance”). In making an affirmation, what level of certainty must
  the affirming party have? Will a conclusion that the transaction “more likely than
  not” does not have a significant purpose of tax avoidance be sufficient?

- If a transaction, when completed, is not a listed transaction, but is later listed by the
  Service, what must the EO do, if anything, to avoid sanction by the Service? We
  suggest that the EO should have an obligation to disclose to the Service any
  transaction listed before the organization’s Form 990 is filed, along with identifying
  information about the participants known to the EO.

We suggest that any reporting obligation imposed on an EO should be limited to
its participation in “listed transactions.” We consider it appropriate for any tax shelter reporting
rule regarding EOs to rely heavily on the Service’s list of tax shelters. Many EOs do not have
the in-house expertise, or advisors with sufficient expertise, to make independent determinations
about whether a transaction is a reportable transaction. In addition, an EO may not have access
to sufficient information to identify reportable transactions. For example, a tax-exempt
participant in a transaction may not know that another participant is claiming the requisite loss
under Treasury Regulations section 1.6011-4(b)(5) or will show a significant book-tax difference
as a result of the transaction, as required in Treasury Regulations section 1.6011-4(b)(6).
Requiring that all transactions engaged in by EOs be put through the “reportable transaction”
filter of Treasury Regulations section 1.6011-4 may be unworkable and certainly would add an
unnecessary burden on nonprofits. If the Service is going to continue to list tax shelters that it
considers most abusive, we believe that allowing EOs to rely on that list to identify abusive tax
shelters is most appropriate.

The proposed penalties imposed for failure to comply with this rule are loss of
Section 170 status for one year and disgorgement of all fees or other benefits received. In our
view, loss of Section 170 status is unnecessarily harsh, absent intentional violation or a pattern of
Subject to the limitations on imposition of penalties, as discussed above, for individual violations of any rule relating to participation in an abusive tax shelter, a cash penalty should be sufficient, coupled with public disclosure on the organization’s Form 990 as is already required in connection with other penalties, e.g. Sections 4941 and 4958. If an EO engages in a number of abusive tax-shelters, e.g. acting as the tax-indifferent party, we believe that the IRS has the authority to penalize the organization for violating the excess private benefit prohibition or prohibition against having a substantial non-exempt purpose by revoking its tax-exempt status.

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3 Subject to very limited exceptions, non-charitable EOs cannot offer a Section 170 deduction to their supporters.
APPENDIX D
INSIDER TRANSACTIONS OF PUBLIC CHARITIES

The Discussion Draft proposes to apply the private foundation self-dealing rules to public charities – essentially to replace Section 4958 with Section 4941, with the exception of compensation paid to insiders, which would be addressed through revisions to the Treasury Regulations under Section 4958.

We believe that this proposal was prompted by legitimate concerns regarding a narrow set of potentially abusive transactions by a relatively limited number of public charities. We share the concern that abusive transactions be identified and curtailed, and that the legal regime for public charities be designed both to discourage and to disclose such transactions. We also believe that the distinction that Congress drew between public charities and private foundations in 1969 remains valid, however, and that there are sound justifications for applying different regulatory regimes to these two categories of charitable organizations. Public charities achieve that classification by demonstrating that they have characteristics – either by the nature of the services they provide, the public sources of their support and governance or their relationship to another public charity – indicative of a measure of public oversight.1 A public charity may not be fully funded by and controlled by one or handful of private entities or individuals. There is less potential for abuse by public charities than in the private foundation context. Indeed, it is common practice for public charities to recruit board members in part because of the benefits that the board member may be able to offer the charity – such as the provision of below-market goods or services to the charity. It would be unfortunate to foreclose this important source of support for many charities in the name of curbing abuse.

Congress enacted Section 4958 to impose excise tax penalties on disqualified persons who received excess benefits in transactions with public charities, and on any organization managers who knowingly approved such transactions. At that time, Congress considered and rejected the idea of extending the self-dealing rules to public charities, concluding that the self-dealing rules would be not only overbroad and burdensome but also unnecessary. We believe that it is premature to conclude that Section 4958 has not provided sufficient safeguards and deterrence against abuse in public charity transactions with insiders. The statute was enacted in 1996, and final Treasury Regulations were released only in early 2002.2 As practitioners, we have already seen positive changes, particularly as a result of provisions in the Treasury Regulations that allow EOs to establish a rebuttable presumption that a transaction is reasonable when it is approved by the disinterested members of a board or board committee, based on appropriate comparability data and documented in writing.3 These provisions encourage EOs to obtain information regarding comparable compensation packages

1 See IRC Section 509.
2 We note that the enactment of IRC Section 4958 roughly coincided with the IRS reorganization, during which resources that might otherwise have been allocated to enforcement were directed to other needs. This suggests to us that the years since the enactment of IRC Section 4958 may not have been a fair test period for the new rules.
and to have full disclosure and review of compensation matters, in advance, by the independent members of the organization’s board.

As existing compensation arrangements are audited and enforcement actions are brought – and won – by the IRS, there will be additional changes in behavior. The IRS has achieved initial positive results in litigation. As the IRS issues additional guidance and the courts continue to interpret Section 4958, we anticipate that EOs and their disqualified persons will develop a better understanding of the boundaries and the potential for penalty excise taxes, and will modify their behavior accordingly. We also note that some multi-year contracts that were in place in 1995, before the effective date of the intermediate sanctions provisions, may only now be coming up for renewal – in effect, they are being subject to intermediate sanction review for the first time.

Turning to the Discussion Draft proposal, we offer the following examples of common types of transactions with public charities, all of which would be prohibited under the Discussion Draft’s proposal, even where they would clearly benefit the public charity and even where any benefit to the disqualified person is objectively not excessive:

- A board member leases office space to a public charity at below-market rent sufficient to cover only out-of-pocket operating costs of the lessor;
- A company owned 50% by the spouse of an officer at a private school sells curriculum materials to the school at a price that is the best the charity could obtain with reasonable effort;
- A board member loans funds to a public charity museum at below-market rates to allow it to acquire a painting that has unexpectedly come on the market;
- A scientist, serving on the board of a public charity research institute because of her deep background in the institute’s research discipline, licenses intellectual property to the institute for use in its research at a price below fair market value, as established by comparable licenses of the same intellectual property to unrelated parties;
- A University, in order to secure the services of a new department chair or key administrator moving from a lower-cost housing area, provides a below-market mortgage loan secured by the property being financed;
- A job training organization leases equipment for student use from a substantial contributor at significantly below-market rates.

To prevent or eliminate the abuses that have been identified in the public charity arena without prohibiting transactions that are beneficial to public charities, we suggest the adoption of more narrowly focused reforms. For example, with regard to loans involving

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disqualified persons, public charity loans might be restricted to employee or staff relocation loans that are permitted under state law. Public charities could be required to attach a schedule to Form 990 of all loans to disqualified persons, with disclosure including the date of loan, face amount, outstanding balance, interest rate and term.

While Form 990 currently requires disclosure of transactions with officers or directors, we suggest that requiring responses to specific questions would provide more transparency and also provide the IRS with a method of identifying electronically those returns where loans are reported. Perhaps a series of questions similar to those on the Form 990PF would be appropriate. Similarly, the IRS might require more detailed Form 990 disclosure of all sales of assets between disqualified persons and public charities with a purchase price in excess of a threshold amount. We are prepared to provide additional examples of targeted provisions upon request.
APPENDIX E
PRIVATE FOUNDATION COMPENSATION ISSUES

Compensation of Private Foundation Trustees

The Discussion Draft would ban compensation to trustees of non-operating private foundations, or, in the alternative, allow it only up to a statutorily prescribed de minimis amount. We believe that current law provides appropriate restrictions on the level of compensation that may be paid to disqualified persons, including foundation trustees and directors. The challenge is in enforcing those restrictions, which we believe is best accomplished by requiring enhanced disclosure on IRS Form 990-PF and by ensuring that the IRS has sufficient resources to identify and examine potential abuses.

Under current federal tax law there is no explicit prohibition against paying compensation to directors or trustees of private foundations, whether operating or non-operating. The tax law instead sets out standards for the level of compensation that is permissible for interested persons generally and imposes disclosure requirements. In the private foundation context, a disqualified person, including a director or trustee, may receive compensation for the performance of certain personal services that are reasonable and necessary to carrying out the foundation’s charitable purposes, so long as the compensation is not “excessive.” (Under this rule a private foundation may pay compensation that is less than reasonable compensation under a fair market value standard, but not compensation that exceeds reasonable compensation.) The Form 990-PF currently requires disclosure of all compensation paid to directors and trustees.

The tax law also looks to the objectivity of the procedure by which the compensation is determined as a measure of its fairness. In the case of a public charity, the intermediate sanctions rules provide a procedure to invoke a rebuttable presumption of reasonableness in approving compensation arrangements. A key element in that procedure is reliance on appropriate comparability data. A similar approach could be adopted in the foundation context, focusing in particular on obtaining comparability data concerning compensation paid to foundation directors or trustees.

Any analysis of whether and how much director or trustee compensation may be reasonable should take into account a variety of factors, such as whether the fiduciary is a professional manager with a market-based rate for compensation (e.g., a trust company in the business of managing charitable trusts), the director’s or trustee’s job description (e.g., whether the fiduciary is required to devote substantial time to overseeing operations and/or grantmaking), the level of expertise required in fulfilling the fiduciary’s duties, any provisions in the non-profit’s organizing documents that mandate compensation (e.g., provisions created by the donor/founder in a trust document requiring that the trustees be paid reasonable compensation), and the particular skills and experience that a trustee or director may bring to bear in the role. We believe that an approach to director and trustee compensation that encompasses

1 See Treas. Reg. § 53.4941(d)-3(c)(1).
3 We note that such information is readily available on the internet, e.g. at www.guidestar.org and www.fdncenter.org, and in publications from organizations such as the Council on Foundations, www.cof.org.
consideration of the facts and circumstances of each situation and that includes procedural safeguards in establishing compensation is more likely to enable foundations to attract knowledgeable trustees and directors, while at the same time preventing compensation abuses, than a flat prohibition or cap on trustee and director compensation.

We note that the practice of compensating charitable trustees is longstanding and is codified in the laws of many states. In many instances private foundations formed as trusts have an institutional trustee, such as a bank or a trust company, in addition to or instead of any individual trustee(s). State law commonly governs the types of entities that may serve as institutional trustees. Institutional trustees typically perform trust services for a large number of organizations and have standardized fees for various types of services. Any prohibition or cap on trustee fees for institutional trustees would certainly provide a substantial disincentive to offering trustee services, and would likely have a significant adverse impact on the ability of foundations to attract responsible institutional trustees. Moreover, institutional trustees assume risk, as fiduciaries held to high standards under state law, and perform valuable services for the foundations that they oversee. It is not apparent that there is any public policy justification for denying such trustees fair market value compensation for their services.

We note further that it is common practice in many states for individual professionals to serve as trustees and at the same time to provide professional services at established competitive rates. This is common particularly in the case of attorneys and accountants, who are often asked to serve as directors and trustees because of trusted relationships with foundation founders who wish their professional advisors to help oversee their philanthropic pursuits, and because of their specialized expertise in the rules applicable to foundations. A prohibition or de minimis cap on compensation would require either that such persons perform their professional services with little or no compensation, or that the foundation forgo the opportunity to have such persons serve in fiduciary positions for the foundation. Under current law there is already an effective cap on professional fees under the rules prohibiting unreasonable compensation. Comparability of compensation for professional services can generally be readily determined with reference to rates charged by other professional firms.

We share the concerns reflected in the Discussion Draft regarding anecdotal reports of substantial compensation being paid to family members who serve as foundation trustees or directors and whose service to the foundation is limited to attending board meetings. We agree that persons who do not perform substantial services should not be permitted to receive substantial compensation. Current law already prohibits payment of excessive compensation to such persons, however. We submit that any abuses in this area stem from a lack of enforcement of current law, due to the limited enforcement resources that the IRS has at its disposal, rather than any inherent weakness in the existing law. We strongly support allocation of sufficient resources to the IRS to identify and examine potential excessive compensation situations through disclosure on IRS Form 990-PF.

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4 See, e.g., Wash. Rev. Code § 11.36.021 (2004) (trustees must be individuals over the age of 18, trust companies organized under the law of the state, national banks, or nonprofit corporations if their organizing documents so permit).
Compensation of Disqualified Persons.

The Discussion Draft would require non-operating private foundations to use federal government rates to determine compensation paid to disqualified persons for similar work and similar time, other than for persons who are disqualified persons solely by reason of employment. Compensation or severance payments above certain levels would trigger additional disclosure and IRS review, and would require payment of a sliding scale filing fee. Certain compensation would be subject to a requirement of annual approval in advance by the disinterested members of the board of directors.

As with the proposal above concerning compensation to directors and trustees of private foundations, we believe that current law provides appropriate restrictions on compensation levels to disqualified persons, and that the key to addressing the potential for abuse is to enhance enforcement of those restrictions. We are concerned that private foundations should not be denied the opportunity to attract the most qualified staff to assist them in fulfilling their charitable missions – staff to review and develop complex grant proposals, to evaluate varied and myriad grantees administratively and programmatically, and to direct charitable programs. Many private foundations also have substantial assets that must be carefully invested in a manner that complies with state and federal laws and that ensures sufficient liquidity to satisfy annual distribution requirements while also maintaining sufficient assets to support charitable causes well into the future. Foundations need to be able to retain highly-skilled investment managers to manage their resources.

Rather than imposing an additional burden on an already thinly-stretched IRS to review private foundation compensation arrangements on an ad hoc basis and an additional filing obligation on private foundations, we suggest increasing the categories of persons whose compensation must be disclosed on the Form 990-PF and/or lowering the compensation threshold for reporting on Form 990-PF (currently $50,000). At the same time, the procedures for establishing a rebuttable presumption of reasonableness under the Section 4958 intermediate sanctions regulations could be applied to compensation paid to disqualified persons in the private foundation context. It may also be appropriate to require foundations to provide evidence of whether and how they have satisfied the presumption, as an aid to the IRS in identifying potential situations of noncompliance.
APPENDIX F
ENCOURAGE STRONG GOVERNANCE AND BEST PRACTICES FOR EXEMPT ORGANIZATIONS

Overview

The Discussion Draft includes a number of proposals intended to strengthen corporate governance and responsibility within the charitable sector.\(^1\) These proposals are informed by the American Competitiveness and Corporate Accountability Act of 2002 (commonly referred to as the Sarbanes-Oxley Act or, as in this paper, “SOX”), which (among other things) establishes corporate responsibility standards and procedures for boards of directors and officers of public companies.\(^2\) An objective of SOX is to restore integrity and public confidence in corporate governance, financial statements and stock valuations of public companies following Enron and other corporate scandals. Much has been written about the implications of SOX to charitable organizations,\(^3\) and a number of states are considering legislation to apply various concepts from SOX to nonprofit organizations within their jurisdiction.\(^4\)

Strong governance is just as essential in the charitable sector as it is for public companies, and the Discussion Draft builds on efforts by state regulators and indeed within parts of the sector itself to bring these issues to the fore. The challenge is to determine how best to achieve the goals of the Discussion Draft – to encourage strong governance and best practices – within a sector that is considerably more diverse than public companies. While public companies have, by definition, many common operating characteristics and a single overriding mission that is purely economic in nature – to provide a financial return to their owners/shareholders – the charitable sector is far more varied in size, resources, operational characteristics, and mission, making it virtually impossible to have “one size fits all” rules. Although some charities are sophisticated, multi-billion dollar organizations, the overwhelming majority are small, community-based, and in many cases run by volunteers. Churches and religious organizations comprise the largest component of the sector, and the governance models of many of these organizations are inextricably bound with their religious beliefs and traditions.

The diversity of the charitable sector is one of its strengths, allowing as it does not only for the establishment of institutional charities with long-term goals and objectives to serve broad and on-going public needs, but also for the creation of community organizations that are

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1 Charitable organizations may be created in trust rather than corporate form. The Discussion Draft does not consider how corporate governance provisions would be adapted for the trust model.
4 For example, in California the Attorney General has proposed the “Charity Integrity Bill” and the “Nonprofit Integrity Act of 2004, CA Senate Bill 1262” was introduced; the Connecticut Legislature introduced H.B. 5313; in Hawaii, the Attorney General proposes legislation that would give the Attorney General the authority to remove directors; in Massachusetts, the Attorney General is proposing the “Act to Promote the Financial Integrity of Public Charities;” and in New York, the Attorney General has proposed the “Nonprofit Accountability Act” and the legislature has introduced S. 4836 on behalf of the Attorney General.
directed to specific immediate needs and have a limited period of existence. Disaster assistance organizations are just one example of the latter. The diversity of the sector extends not only to type of organization, but also to financial resources, which are limited for many charities. While it is essential that all charitable organizations devote sufficient resources to achieving strong governance – and indeed doing so can be expected to enhance the ability to accomplish charitable purposes – it is nonetheless the case that every dollar spent on governance is a dollar drawn away from mission. This places a premium on developing a cost-effective strategy for encouraging strong governance.

Various current legal standards are directed to achieving good governance within the charitable sector. These include the application of common law fiduciary duties for directors and officers; various state laws directed to corporate governance that are enforceable by state attorney generals; and provisions of the Internal Revenue Code that prohibit private inurement and private benefit and establish excise tax penalties on officers and directors for certain misconduct. Many of the concerns raised in the Discussion Draft might well be addressed through a robust enforcement effort by the IRS and/or state regulators. An often-cited problem is the lack of such enforcement, commonly attributed to an insufficiency of resources at the federal and/or state level. Other provisions of the Discussion Draft seek to address this problem by directing additional funding to the IRS and to state regulators. The ABA Section of Taxation has long supported the provision of sufficient funding for the IRS – including the Exempt Organizations Division – and we hope that provisions in the Discussion Draft directed to this issue will receive immediate attention within the appropriate congressional committees. Indeed, without the provision of adequate funding for enforcement, there is limited value in enacting additional federal legislation in this area.

One means of achieving transparency, accountability and good governance for public companies is through disclosure. Public companies file quarterly and annual reports with the Securities and Exchange Commission; these filings require disclosure of significant financial and narrative information that is intended to promote informed investment decisions. SOX – as well as rules enacted by the stock exchanges following the passage of SOX – provides for enhanced public disclosure to better achieve the intended objectives. Disclosure is also an important means for achieving transparency, accountability and good governance in the charitable sector. Charitable organizations (other than churches and very small publicly supported charities) are required to file annually IRS Form 990 (or 990-PF in the case of private foundations), disclosing a significant amount of information about the organizations, including the names of board members, compensation of officers, directors and the five highest-paid employees, program accomplishments, information about operational matters relating to exempt status requirements and financial data. These Forms are required to be made available to the public upon request and, for the last few years, have been available on-line at www.GuideStar.org. The easy accessibility of Forms 990 and 990-PF has contributed to in-depth media coverage of the charitable sector. As discussed above, other provisions of the Discussion Draft offer thoughtful options for enhancing the Forms 990 and 990-PF so that they

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will serve as better tools for their various constituencies (including the public, the media, the IRS and state regulators).

The strength of governance within the charitable sector ultimately rests on the ability of charitable organizations to attract and retain directors and trustees who are knowledgeable about their responsibilities and willing to devote the necessary time and attention to discharging them, frequently on a volunteer basis. From time to time, concerns have been raised about the difficulties of some charities in finding individuals willing to serve on their boards, at least in part due to the potential liability associated with board service. States have attempted to address this concern by adopting various volunteer immunity provisions which limit the liability of volunteer directors, and in 1997, Congress passed the Federal Volunteer Immunities Act for the same purpose. As the Discussion Draft considers various options for encouraging strong governance in the charitable sector, another challenge will be to do so in a manner that does not discourage individuals from taking on the responsibilities associated with board service in the charitable sector.

Specific Comments

Board duties.

The Discussion Draft provides general statements about the role of the board of directors in managing a charitable corporation, and the fiduciary duties owed by directors. These appear to be consistent with current law. It then introduces a new concept that directors who have “special skills or expertise” would have a duty to use such skills or expertise, and provides for the creation of federal liability for breach of director duties.

With respect to the subject of compensation, the Discussion Draft provides that any compensation consultant hired by a charity should report to the charity’s board and should be independent. It also provides for annual reviews of compensation, and for public disclosure and justification of compensation.

The Discussion Draft lists a number of specific board responsibilities, some of which appear to be encompassed within basic fiduciary duties (e.g., “the Board must establish basic organizational and management policies and procedures of organization and review and proposed deviations,” “the Board must oversee the conduct of the corporation’s business and evaluate whether the business is being properly managed”) and some of which are quite specific and go beyond current requirements and indeed beyond the requirements of SOX (e.g., “an independent auditor must be hired by the Board and each such auditor may be retained only for five years”).

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8 42 U.S.C. § 14503(a).
9 Section 203 of SOX requires rotation of the lead audit partner every five years and not a change in the auditor.
The Discussion Draft indicates that all of these requirements “must be confirmed” on the Form 990, and notes that relaxation of certain of these rules might be appropriate for smaller organizations. It does not specify any penalty that might be imposed for an organization (or its board) for failure to meet the specified board responsibilities. It also does not indicate whether the proposed new federal liability for breach of duties would encompass a failure to comply with the specific listed responsibilities.

The concept in the Discussion Draft that the Form 990 could be used as a vehicle to promote strong governance and best practices is appealing for a number of reasons. First, in terms of reaching the sector, the Form 990 is required for all but churches and the smallest charities, and including a governance section on the Form 990 would be a significant tool in encouraging voluntary compliance with best practices. For example, assume the Form 990 is modified to include a question such as “Does the organization have and follow a conflict of interest policy which prohibits officers and directors from participating in any decision as to which they have a conflict of interest? ______ yes ______ no. If no, please explain.” There is little doubt that this would put considerable pressure on those who don’t have such a policy to adopt one rather than check “no” on the Form. Indeed, SOX uses a similar approach by requiring public companies to disclose whether or not they have adopted a code of conduct for senior financial officers. Moreover, including a governance section on the Form 990 would allow the IRS to educate charities on the importance of this issue through the Form 990 instructions.

Second, such disclosure would provide important information to the public, as individuals decide how to direct charitable contributions, and to the media as they decide which charities may warrant further scrutiny.

Third, such disclosure would help regulators (state attorney generals and the IRS) decide where to target their enforcement efforts. It would also provide a solid base of information as to current governance practices in the charitable sector that could help inform whether there is, in fact, any need for federal or state legislation or regulation in the area.

As discussed above, other provisions of the Discussion Draft are directed to making the Form 990 a more useful tool in promoting accountability and transparency, and expanding the Form to include a well-drafted section asking for information about basic corporate governance standards would be an appropriate part of that effort.

Other concepts in the Discussion Draft, however, warrant reconsideration because of their potential for causing unintended results. For example, the proposal to establish a federal liability for breach of fiduciary duty might well make it significantly more difficult for charities to attract and retain the very type of directors that are necessary to achieve the goal of strong governance. Given the existence of long-established common law fiduciary duty standards, it is unclear what would be gained by adding a provision for federal liability.

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10 Form 990-EZ is a simplified version of Form 990 for smaller charities that are above the nonfiling threshold.
11 Section 406 of SOX.
12 See Appendix G’s discussion of the risks of adopting the private relator approach.
The proposal to require directors who have special skills or expertise to use those skills raises similar – as well as other – concerns. Following the enactment of SOX, the boards of many charitable organizations have established independent audit committees and, if they do not already have directors with SOX-type financial expertise, are seeking to add directors with such expertise to their audit committees. The establishment of what appears to be a higher standard of care for directors with special expertise (such as financial expertise, investment expertise, legal expertise) would likely make it more difficult for them to attract and retain directors with such expertise. Moreover, there is a real danger that such a provision would create an expectation within a board of directors that there should be deference to those who have special skills and expertise, which would deprive the organization of the benefit of input from other directors.

Finally, with respect to the provisions concerning the compensation process, we note that the Form 990 already requires disclosure of the amount of compensation paid to officers, directors and five highest paid employees of charitable organizations. What the Form 990 does not require is disclosure of information about the compensation process itself. The IRS regulations under Section 4958 set forth a three-part process for boards to follow in determining compensation for officers, known as the “rebuttable presumption” procedures13 and if the Form 990 is modified to include a section on corporate governance, it would be helpful to include a question as to whether the board follows the process outlined in those regulations. If the answer is no, the organization should explain why not. That would not only encourage charities to follow the procedures established in the legislative history and regulations under Section 4958, but also would alert the public, the media and regulators as to organizations that are failing to follow such standards. This seems to provide the appropriate level of public disclosure, without requiring disclosure of what would amount to full-blown compensation studies.

Board composition.

The Discussion Draft proposes various requirements relating to board size (no fewer than three, no more than 15), the role of compensated directors (who cannot serve as board chair or treasurer), and the number of independent directors (for public charities, at least one director or one-fifth of the board).

The Discussion Draft’s objectives appear, for the most part, to be clearly related to strong and effective governance. The proposed limits on board size seem designed at the lower end to make sure that control is not vested in just one or two people, and at the upper end to make sure that the board is not so large as to be unwieldy. The requirement to have a certain number or proportion of independent directors in the case of public charities seems designed to make sure that such organizations have the type of “public” control that is intended to distinguish them from private foundations. And while the purpose of the prohibition against having the board chair and treasurer be compensated is less clear, it may relate to the desire to have those positions filled by directors who are not also employees of the charity.

13 The regulations provide a “presumption of reasonableness” for compensation determinations made in accordance with the established process, which requires (1) independence, (2) use of comparable market data, and (3) documentation of the basis for the compensation determination. Treas. Reg. § 53.4958-6.
Given the diversity of the charitable sector, however, it is difficult – if not impossible – to adopt “one size fits all” rules with respect to a matter as fundamental to strong governance as the composition of the board. For example, many large charitable organizations have boards of more than 15 directors and consider that to be essential to good governance. Colleges and universities, for example, often have boards with more than 15 directors, with a board committee structure that allows subsets of the board to exercise oversight over specific aspects of their operations. Service on board committees typically requires a significant commitment of time over and beyond that required for full board meetings, and board members typically serve on no more than two or three committees to allow them to spend the necessary time on committee as well as board service. The objective of the Discussion Draft – to encourage large boards to develop an effective model of governance – might be accomplished by including a question on a new governance section on board committee structure (e.g., “List the names of any board committees”) or requiring the list of directors to include the board committees on which each director serves.

With respect to having a minimum board size, this is, as a threshold matter, a question of state law. Some states require a minimum of three directors for nonprofit corporations, 14 while others require only one. 15 In our experience it is typical for public charities to have more than one director, and we note that the IRS closely scrutinizes Form 1023 applications for exemption from organizations that have fewer than three directors, occasionally requiring expansion of the board as a condition of exemption. There are, however, some cases in which a board of fewer than three directors may be appropriate, including in the context of church-related and religious organizations where the minister may be the sole director. Here, too, including a question in a corporate governance section of the Form 990 asking for an explanation as to why an organization has fewer than three directors might encourage board expansion, as well as provide a useful base of information that would help to inform federal and state regulators as to whether legislation might be useful, as well as what exceptions might be appropriate.

With respect to the subject of independent directors, we note that it might be difficult for some charities to meet the rather expansive definition of independence suggested in the Discussion Draft. For example, private schools whose boards are drawn from parents of the student body might not meet the independence standard contained in the Discussion Draft. We also recognize that the adoption and implementation of conflict of interest policies that prohibit board members from participating in decisions about which they have a financial conflict of interest is a fundamental hallmark of strong governance. By encouraging the adoption of such conflict of interest policies through appropriate Form 990 disclosure (as described above), and possibly by asking an additional question about whether the organization has an independent audit committee and if the answer is no, why not, charities would be encouraged to adopt and follow best practices voluntarily.

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15 See, e.g., Rev. Code Wash. § 24.03.100.
Board/officer removal.

The Discussion Draft proposes that individuals who are not permitted to serve on the boards of public companies, or who have been convicted of certain federal or state offenses, not be permitted to serve as an officer or director of a tax-exempt organization. An organization or its officers/members who knowingly retained such a person would be subject to penalty.

It also proposes that the IRS would have the authority to remove an officer or director who has been found to have violated self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation laws, and that an organization that knowingly retained a person not permitted to serve would lose its tax exemption or be subject to some unspecified lesser penalty.

We note that there is a tradition, within the criminal justice system, of allowing individuals to pay back society for wrongdoing through community service, often with charitable organizations. We recognize, however, that in the typical case this does not include service as an officer or director of a charity. The Discussion Draft raises a legitimate question as to whether individuals not permitted to serve on the boards of public companies – or who have been found guilty of certain other offenses – should be similarly prohibited from serving on the boards of charitable organizations. There are thoughtful arguments to be made on all sides of this issue. The short time available for comment on the Discussion Draft does not allow us to do more than acknowledge the complexity of this issue.

Under current law, the IRS does not have authority to remove individuals as officers or directors. The self-dealing rules under Section 4941 and the intermediate sanctions rules under Section 4958 provide for excise tax penalties that are intended to penalize violations and to ensure that the organizations are made whole. While the intermediate sanctions rules are applicable only to cases where an officer or director has received an excess benefit from the organization, the self-dealing rules may apply to situations where there has been no economic harm to a private foundation, and indeed where the transaction may have provided it with an economic benefit. Typically any violation of the prohibition on private inurement would also be a violation of the self-dealing and/or intermediate sanctions rules. Current law does not penalize “conflict of interest” transactions if there is no violation of the self-dealing or intermediate sanctions rules.

The proposal in the Discussion Draft to allow the IRS to remove an officer or director for any violation of provisions described above appears to be unnecessarily overbroad, since the self-dealing and intermediate sanctions rules provide an appropriate remedy, at least for violations that are not repeated and willful. In the rare case where such violations are found to be repeated and willful, however, granting the IRS authority to require the removal of an officer or director might offer an appropriate alternative to revocation of an organization’s tax

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16 For example, the self-dealing rules of Section 4941 would penalize an officer or director who rented office space to a foundation on a below market basis, even for $1 a year.
exemption. Indeed, there is anecdotal evidence that the IRS has sought to exercise such a remedy on occasion in the context of a closing agreement negotiation.  

**Government encouragement of best practices.**

The Discussion Draft proposes to require federal agencies, in awarding contracts and grants to tax-exempt organizations, to give “favorable consideration” to those accredited by entities designated annually by the IRS as establishing best practices for tax-exempt entities. Along the same lines, the IRS (in consultation with OPM) would establish best practice / governance / accreditation requirements for organizations seeking to participate in the Combined Federal Campaign.

As discussed below, the Discussion Draft places significant reliance on the ability of various nonprofit accrediting organizations to encourage best practices within the charitable sector. We recognize the value of such organizations in encouraging voluntary compliance with best practices. Given the size and diversity of the charitable sector, however, we question whether IRS approval of accreditation organizations is the best use of scarce IRS resources or the best way to establish high standards of corporate governance. Moreover, we are uncertain that an organization’s adherence to standards set by an accrediting organization would necessarily mean it is better able to carry out the purposes of a particular federal contract or grant program.

With respect to the Combined Federal Campaign, this is an important service that the federal government provides to the charitable sector and to federal employees who wish to contribute to that sector. However, as discussed below, we believe that standards of best practices will be most effective if established by appropriate segments of the charitable sector itself and that tying government benefits and penalties to those standards could undermine efforts to encourage excellence in corporate governance. For this reason, we have concerns with making adherence to accreditation standards a prerequisite to participation in the Combined Federal Campaign.

**Accreditation.**

The Discussion Draft would provide $10 million to the IRS to support accreditation of charities nationwide, in states, and of particular classes of charities. The IRS would have a great deal of latitude in designing or approving an accreditation program. It could initiate its own efforts or solicit requests. It would have authority to contract with tax-exempt organizations to develop and manage accreditation programs. Accreditation programs could operate on a membership basis and require dues to defray expenses and could take corrective action. The Discussion Draft indicates that the IRS proposal should encourage initiatives that are taking place at the state level. Finally, the Discussion Draft provides that the IRS would have authority to base charitable status or eligibility for charitable donations on whether an organization is accredited.

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In the wake of recent scandals and media reports, there have been many efforts to articulate standards of best practices for nonprofit governance. In addition, there have been efforts to encourage charities to adopt such standards.

The Discussion Draft refers to one such effort. Specifically, it references the Standards for Excellence Institute, a division of the Maryland Association of Nonprofit Organizations, which has published *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector*. This code was developed by a team of volunteers from the nonprofit sector and covers eight areas of operations with 55 specific performance standards. It has been adopted, with modifications, in six states. Nonprofit organizations can apply for a “Seal of Excellence” which indicates that the charity has met the standards set forth in the code.

Another standard setting effort has been undertaken by the BBB Wise Giving Alliance, an organization whose CEO testified at the Senate Finance Committee hearings on June 22, 2004. This organization, which has published *Standards for Charity Accountability*, monitors tax-exempt organizations and publishes reports on whether or not they meet these standards. Its goal is to provide potential donors with useful information for evaluation of charities. Tax-exempt organizations that meet the BBB Wise Giving Alliance standards may display a seal of approval (subject to signing a licensing agreement and paying a fee).

Defining best practices in corporate governance and encouraging their adoption by charities is a laudable objective. Those organizations that are well governed should be the most successful in achieving their missions — and that is the ultimate goal on which we should all be focused. As with so many of the issues that face the charitable sector, the challenge is to achieve this objective in a cost effective manner that recognizes and preserves the diversity and the plurality of the sector. The Discussion Draft appears to recognize this challenge and to recognize that there are many ways to encourage best practices.

An accreditation program raises a host of issues, many of which are suggested by the Discussion Draft. Who will be the accrediting organization or organizations? Who will monitor the accrediting organizations? Who should set the standards? Should there be one nationwide standard or should standards be set at the state level? Should different subsectors of the charitable sector have different standards? What happens if we end up with conflicting standards? Who decides which standard should prevail? Is it possible to set “bright line” standards that will truly encourage excellence in corporate governance?

We believe that government should encourage charities to answer these questions themselves by establishing their own standards of best practices and their own methods for promoting and encouraging the adoption of such standards. We have not had time to research the extent to which self regulatory bodies exist in the charitable sector today, but our impression is that self regulation with respect to nonprofit corporate governance is relatively new and is not widespread. At the same time, at least some of these efforts appear to be receiving favorable reports.  

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Thus, we believe that IRS or other government grants to support accreditation programs should be made to organizations that will operate as membership organizations and will establish standards of best practices and systems of accreditation and regulation with input and ongoing feedback from their members. This approach would permit organizations that view themselves as having common issues to come together to regulate themselves and would permit periodic re-evaluation of the standards, much as a corporation’s governance committee evaluates a specific corporation’s governance on a regular basis. For the IRS to undertake an effort to establish or review standards for the entire charitable sector would be a huge undertaking that would divert scarce resources from enforcement of current laws and would be unlikely to produce standards of best practices that would be as effective as those that the organizations themselves could establish. Moreover, because of its size and government regulatory procedures, it would be difficult for the IRS to obtain feedback on standards, evaluate standards, and amend standards on a frequent basis. Because development of best practices for nonprofit organizations is in its infancy, a system that facilitates changes and evolution over time is preferable.

We are concerned that having the IRS or any other government agency use the standards of best practices set by charitable organizations as standards for granting exempt status or allowing federal income tax deductions for donations could work at cross purposes to development of the highest standard of corporate governance. As we see it, the purpose of government and the purpose of accreditation organizations are different. Government is concerned with establishing minimum standards that must be met to obtain recognition of exempt status and government benefits or to avoid penalties. Accreditation organizations, at their best, should encourage excellence. Self regulatory groups might be discouraged from setting high standards if government benefits and penalties were tied to those standards. Moreover, reliance by the government on standards set by private organizations would appear to be an inappropriate delegation of governmental rulemaking authority to the private sector.

**Establish prudent investor rules.**

The Discussion Draft proposes to apply a federal prudent investor rule to the investment activities of charitable organizations. It notes that many states apply a prudent investor standard to nonprofit corporations formed in the state and suggests that such state standards would inform the development of a federal standard. The Discussion Draft does not discuss how such a rule would be enforced.

We assume that this proposal is intended to apply only to public charities. Private foundations are subject to a federal jeopardy investment rule, under Section 4944.

Most states, in their nonprofit corporation statutes, have adopted a prudent person standard of care for directors in fulfilling their fiduciary duties generally. With respect to the oversight of investments specifically, the American Law Institute’s Restatement (Third) of Trusts and the Uniform Prudent Investor Act (“UPIA”) provide a prudent investor rule, which is

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19 See, e.g., Rev. Model Nonprofit Corporation Act (1987), which provides at Section 8.30 that a director shall discharge his or her duties “(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.”
a refinement of the prudent person rule.\textsuperscript{20} UPIA, at Section 2, imposes a standard of using “reasonable care, skill and caution.” In addition, the majority of states have adopted the Uniform Management of Institutional Funds Act (UMIFA)\textsuperscript{21} which applies to the endowment assets of “incorporated and unincorporated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes…” UMIFA, at Section 6, imposes an “ordinary business care and prudence” standard on a governing board in its oversight of investments.

Given the existence of these common law and state statutory standards, it is unclear what goals would be served by adding a federal standard in the context of public charities, or what specific issues a federal standard might be intended to address.

**Funding of exempt organizations and for State enforcement and education.**

The Discussion Draft proposes to dedicate some portion of the Section 4940 tax on private foundations to the Exempt Organizations Division of the IRS, restoring a legislative provision that was authorized in 1969 but never effectuated through appropriations. As an alternative, it might impose a filing fee on Form 990 filers, based on a portion of assets or gross receipts. Proceeds of these funds would be used for several purposes, including state enforcement for exempt organizations oversight, nonprofit education by state and/or national organizations, five year review of exempt status of charities, accreditation efforts, facilitation of public access to Forms 990, and establishment of an “exempt organizations hotline” for reporting abuses and complaints involving charities.

The Discussion Draft also proposes to permit information sharing with, and IRS referrals to, state attorneys general, the Federal Trade Commission, and the US Postal Service, with an annual report by the General Accounting Office to Congress on the results of such referrals.

The American Bar Association is a long-standing proponent of the provision of adequate funding for the IRS, including the Exempt Organizations Division.\textsuperscript{22} When the comprehensive private foundation rules were enacted by Congress in 1969, there was a recognition of the importance of robust IRS enforcement of the charitable sector, and the lack of funding has been a continuing source of frustration of the IRS and the charitable sector alike. The solution proposed in the Discussion Draft – allowing at least a part of the private foundation excise tax revenues to be dedicated to that purpose – seems appropriate and allows, in effect, for a self-funding of IRS oversight of the charitable sector.


\textsuperscript{22} For a recent example see, e.g., Letter of April 23, 2004, from Richard A. Shaw, Chair, American Bar Association Section of Taxation, to the Senate Appropriations Subcommittee on Transportation/Treasury and General Government, stating that it is essential that the IRS have adequate funding to ensure its ability to carry out its mission in the administration and enforcement of the tax laws of the United States, available at www.abanet.org/tax/pubpolicy/2004/040423sen.pdf.
The proposal in the Discussion Draft that some of these funds be made available
to state regulators also seems appropriate (assuming it would not detract from the funding needed
by the IRS to regulate the sector), since greater state enforcement would be helpful in policing
the charitable sector and yet is jeopardized by inadequate financial resources at the state level.

The use of a reasonable portion of these funds for educational purposes is also
appropriate. The IRS Exempt Organizations Division has undertaken a number of new
initiatives directed at meeting the educational needs of the sector, and we think it is possible that
the funds proposed for this purpose would be more effectively used by the IRS than by state or
national nonprofit organizations.

With respect to the establishment of an exempt organizations hotline, this seems
to be a useful vehicle for communicating potential abuses involving exempt organizations. We
understand that the IRS Exempt Organizations Division receives a significant number of referrals
of potential abuses even without the existence of a formal hotline. Given the adversarial nature
of many organizations in the charitable sector (pro life vs. pro choice, etc.), however, we recom-
mend that consideration be given to the imposition of penalties in the case of misuse of the
hotline for frivolous or fraudulent referrals.

State attorneys general have repeatedly called for greater sharing of information
with the IRS, and it seems appropriate to authorize such sharing under certain circumstances and
with appropriate safeguards.
APPENDIX G
TAX COURT EQUITY AUTHORITIES, PRIVATE RELATOR AND VALUATION

Tax Court Equity Authorities

The Discussion Draft proposes investing the U.S. Tax Court with certain equity powers, including the power to rescind transactions, surcharge trustees and order accountings, in order to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and the power to substitute trustees, divest assets, enjoin activities and appoint receivers to ensure that an organization’s assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future. The proposal mirrors one made by the Department of the Treasury in 1977,1 which would have invested such powers in the U.S. district courts.

The Tax Court is a court established under Article I of the Constitution.2 As such, it has power to adjudicate only those controversies that have been expressly statutorily conferred on it by Congress. The heart of the Tax Court’s jurisdiction is the power to redetermine a deficiency asserted by the IRS in income, gift or estate taxes.3 In certain limited areas, the Tax Court has authority to issue declaratory judgments.4 Because of the Tax Court’s very targeted substantive focus, its judges are generally selected based on their technical expertise in federal tax law. The authority proposed in the Discussion Draft stretches far beyond the Tax Court’s core function and expertise of redetermining tax deficiencies. Any such extension would also likely require additional budget and staffing to address the broader substantive scope.

A key consideration is whether the proposed equity powers are necessary tools for enforcing the tax laws. The Tax Court currently has the power to affirm the Internal Revenue Service’s denial or revocation of federal tax exemption, to issue declaratory judgments regarding an organization’s qualification under Section 501(c)(3) and regarding the qualification of debt obligations as tax-exempt bonds, to affirm the imposition of excise taxes under the private foundation rules and under the intermediate sanctions rules at Section 4958. Indeed, the intermediate sanctions rules, which penalize persons who have substantial influence over a charity and who engage in an excess benefit transaction with the charity, were a legislative response in 1996 to insider abuses, and final regulations under those rules were issued only in 2002. This powerful new tool to combat misdeeds has not yet been given sufficient time to demonstrate its effectiveness.

The Discussion Draft further proposes that the IRS or a director/board member may seek the removal of any director/board member or officer by the Tax Court. It then sets out the standard that the Tax Court would apply in determining whether to remove, as follows: “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

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2 See Section 7441. Unless otherwise noted, all statutory references in this paper are to the Internal Revenue Code of 1986, as amended.
3 See Section 6213.
4 See Section 6234.
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 be in the best interests of the goals and purpose of the corporation.” The court could then bar the director or officer from serving on the board, or “any board” for a period established by the court.

This proposal appears to be based on two provisions of the Revised Model Nonprofit Corporation Act (1987) (the “Model Act”). First, Section 8.10 of the Model Act provides that the court of a county where the corporation’s principal office is located may, in a suit brought by the corporation, its members, or the attorney general, remove a director if “the director or officer engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation,” and the court in addition finds that “removal is in the best interests of the corporation.” Second, Section 8.30 of the Model Act provides that a director shall discharge his or her duties “(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.” Section 8.42 of the Model Act applies essentially the same standard to officers.

This proposal would provide the Tax Court, a court not generally invested with equity powers, with greater powers to remove officers and directors than those provided to state courts, which commonly exercise equity powers, under the Model Act. A court’s removal power arises under the Model Act when a director has committed grievous acts – fraud or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation. Even in this limited circumstance under the Model Act, the court must take the additional step of concluding that removal would be in the best interests of the corporation. The Discussion Draft does not contain such a requirement, and provides an additional, and far broader basis for removal: whenever the director (or officer) 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 reasonably believes to be in the best interests of the corporation. This would empower the Tax Court to remove a director or officer whenever he or she has failed to satisfy an ordinarily prudent person standard of care.

The judicial experience reflected in the common law suggests that it is desirable to consider a wider array of factors in determining whether to take the significant step of removing a director from office, such as whether the director has substantially complied with principles of conflict of interest, whether the governing board consents to any appropriate modifications in governance practices necessary to ensure future compliance, and whether it is reasonable to expect that the director will perform his or her duties as required in the foreseeable future.5

A key element in any such decision is the appropriate standard of care to be applied in determining whether a director (or indeed a trustee of a charitable trust, which the proposal does not appear to cover) has fulfilled his or her fiduciary obligations. Every fiduciary of an organization that is qualified as a charity for federal tax purposes will be subject to a standard of care under state law in fulfilling his/her duties, which standard can differ quite

significantly depending on the state’s particular formulation of the duty and the type of legal entity involved. States have widely different approaches in their statutory treatment of nonprofit corporations, and may reach different outcomes even under standards of care that are expressed in the same language. The question of the appropriate standard of care for director of a nonprofit corporation has been the subject of a good deal of litigation and scholarly commentary. In states where there is no statutorily mandated standard of care, there is often ambiguity as to whether the trustee standard or the corporate standard should be applied to assess the conduct of directors of nonprofit corporations.

While the Discussion Draft does not specifically address charitable organizations formed as trusts, the trust form is often used, and brings into play a different, and generally higher, standard of care. A common formulation is that a trustee must exercise such care and skill as a person of ordinary prudence would use in dealing with his own property. Some charitable organizations may be formed as unincorporated associations, limited liability companies or even, in limited circumstances, professional corporations, and may be subject to still different state law standards of care.

The Discussion Draft proposal, using as it does one particular state law model formulation of a charitable fiduciary’s standard of care, effectively seeks to overlay a federal standard that may differ substantially from the applicable state law standard, and to require the Tax Court to interpret and apply that federal standard. Such a bifurcated scheme would seem to create a great deal of uncertainty for directors, officers and trustees as to what the applicable duty of care may be, and for what actions. It further seems likely to create undesirable inconsistencies between historic state common law and statutory concepts of fiduciary duty and a new, parallel, federal articulation and interpretation of those duties.

Private Action – Directors

The Discussion Draft proposal appears to be based on the Revised Model Nonprofit Corporation Act (1987), Section 6.30, which provides that a director of a nonprofit corporation may bring a derivative suite against the corporation, similar to the rights of shareholders to bring derivative suits under corporate law.

As illustrated by the Model Act on which the proposal is based, directors often have standing to bring an action under state law. States with nonprofit corporation statutes that are based on the Model Act generally provide for such a right of action. States with substantially different statutes may also convey standing to directors, in some cases adding additional safeguards, such as a requirement that the plaintiff notify the attorney general, and the authority of the attorney general to intervene in any such action. In the case of charitable organizations formed as trusts, a co-trustee generally has standing to bring suit to enforce a charitable trust. State courts would also generally have the equity powers proposed above for the U.S. Tax Court,
so the proposed avenue for addressing misdeeds involving charitable organizations would seem already to be in place under state law.¹⁰ It is accordingly unclear what additional benefit would be gained by providing a parallel federal right of action.

As a practical matter a state right of action would generally encompass not only the state law applicable to nonprofit corporations but also the federal law concerning tax exemption. In the case of charitable organizations that are classified as private foundations under the federal tax law, many states include in their statutes the private foundation restrictions under Chapter 42 of the Internal Revenue Code.¹¹ In the case of charitable organizations that are classified as public charities, action (or inaction) by directors that results in an excess benefit transaction under the intermediate sanctions rules or in revocation of federal tax exemption is arguably a per se violation of state law fiduciary obligations. Accordingly, if the goal is to allow a director to bring a derivative suit, e.g., to seek removal of another director for engaging in or approving acts that resulted in violation of the tax law, such an action is likely already available in many, if not most, cases on the basis of asserted violation of state law fiduciary obligations.

Moreover, a federal private right of action to enforce the tax law would represent a significant departure from the current system of enforcement, not only in the context of tax-exempt organizations but in the federal tax law as a whole. Under the current enforcement scheme, IRC Section 7401 prohibits the commencement of any civil action for the recovery of a tax penalty unless the Secretary of the Treasury authorizes or sanctions the proceedings, or the attorney general or his delegate directs that the action be commenced, and precludes the filing of private lawsuits against third parties based upon alleged violations of the Internal Revenue Code.¹² The Discussion Draft does not seem to contemplate any review of the merits of a private action under the tax law by the executive branch prior to the plaintiff filing an action and bringing into play the resources of the federal courts.

**Private Relator Action – Individual**

The Discussion Draft proposes to permit “any individual” to submit a complaint regarding a charity to the IRS for review. The complaint would be reviewed and evaluated by the IRS. If both the IRS and the appropriate state official decline to pursue the suit, the complainant individual will have the right to bring a suit against the charity. As the Discussion Draft indicates, a few states such as California have given the state attorney general the discretion (but without imposing an obligation) to give relator status to any person to bring an action to enjoin, correct, obtain damages for or otherwise remedy a breach of a charitable trust.¹³ In addition, private individuals have been given relator status under Federal law, such as the relator status a person could obtain under the Federal False Claims Act, which was first passed by Congress in 1863 in an attempt to prevent government contractors from bilking the United States during the war between the states. In a qui tam action brought under the False Claims Act,

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¹⁰ See Revised Model Nonprofit Corporation Act (1987), Section 8.10.
a private person is allowed to bring a suit on behalf of the United States. The purpose of these “qui tam” provisions is to encourage private citizens who may know of fraud against the Federal government to come forward. The qui tam provisions encourage private citizen relators, while also restricting their access to the courts through a series of jurisdictional bars.\(^\text{14}\)

There are several considerations that should be evaluated during the course of considering whether it is appropriate to grant private relator status to individuals as proposed. First, it is unclear whether an individual would be able to obtain relator status simply because the IRS and the relevant state official decline to pursue the lawsuit. In California, the attorney general has the sole discretion to determine whether to grant relator status and anecdotal experience suggests that the attorney general seldom has done so. Similarly, in the False Claims Act, a qui tam relator is required to file the complaint under seal and, while the proposed qui tam relator can pursue the action if the government chooses not to, the predicate for bringing a qui tam action is fraud, a rather high standard.

Second, the recommendation contemplates a demand must be made by the individual complainant to obtain action by the directors or the complainant must state either why the complainant could not obtain the action or why they did not make the demand in the first place. A similar requirement is found in state corporation laws pertaining to shareholder derivative actions. As an example, in Delaware this requirement is set forth in Chancery Court Rule 23.1, as follows:

> In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation . . . the complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.

With respect to a demand on directors, Chancery Court Rule 23.1 is virtually identical to its Federal counterpart, Federal Rule of Civil Procedure 23.1. The United States Supreme Court has held that the demand requirement is substantive rather than procedural.\(^\text{15}\) The purpose of the demand requirement is “first to ensure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.”\(^\text{16}\)

Unlike state and federal shareholder derivative lawsuits, the Discussion Draft proposal contemplates that “any individual” may submit a complaint irrespective of whether that individual is a member of the charity or has any other relationship with the charity. In fact, it appears that the individual need not even be a member of the charitable class directly benefited by the charity. Some level of nexus with either the charity itself or the benefited class should be required as a predicate to a party achieving relator status. An overly-broad grant of relator status could lead to charities incurring substantial costs to defend lawsuits that are ultimately determined to be frivolous, brought by parties with no relationship to the charities and their missions.

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A good example of the potential consequences of granting open-ended relator status is a lawsuit brought by an individual against 13 charitable foundations located in the Buffalo, New York area alleging racial discrimination against himself, his children and his foundation in that the foundations refused to hire him as a director of their foundations, refused to give scholarships to his children and refused to grant money to his foundation, all for reasons of race. The individual also challenged an alleged pattern of discriminatory employment and investment by the foundations. The individual sought injunctive and declaratory relief, damages, the revocation of the foundations’ tax exempt status, and an order directing the foundations to surrender all their assets to the United States Treasury. This action ultimately was dismissed. According to the U.S. district court:

Time and again the plaintiff has failed or refused to follow the directions of the Court. He has failed to file objections to interrogatories, to file answering affidavits in support of his resistance to the summary judgment motions, and has failed to file the explanatory affidavits required by the orders. He tactics have been designed to frustrate a reasonable resolution of the problems facing the Court and, at times, have bordered on the contemptuous. His refusal to follow the directions of the Court has required the expenditure of a great deal of time and money on the part of the litigants and the Court. Although given every opportunity to make a case and to respond to the motions within the rules, the plaintiff has failed or refused to do so.\footnote{Jackson v. Statler Foundation, 75-2 U. S. Tax Case (CCH) ¶ 9721 (W.D. N.Y. 1975).}

It is significant to note that this lawsuit was initially dismissed by the U.S. district court on the pleadings but was reversed in part, affirmed in part and remanded for further proceedings by the Court of Appeals for the Second Circuit.\footnote{Jackson v. Statler Foundation, 496 F.2d 623 (2d Cir. 1974), cert. den. 420 U.S. 927 (1975).} Thus, this represents a good example of a lawsuit found to be completely frivolous yet one that undoubtedly cost the foundations involved tens of thousands if not hundreds of thousands of dollars to defend.

Moreover, because the question of whether a demand has been made is a substantive matter, rather than a procedural matter, it can be expected that this too would be an issue that would be hotly contested by a charity, particularly if the charity believed that the complaint was frivolous or represented a strike suit.

Finally, this type of procedure will require considerable resources to administer at the IRS and the relevant state officials are unlikely to have resources sufficient enough to allow them to stay the suit within the 30 day time period proposed.

**Valuation Resolution**

The Discussion Draft proposes “baseball arbitration to resolve disputes between taxpayers and the IRS concerning the value of property contributed to a charity.” Under baseball arbitration each party to a proceeding submits a number to an independent arbitrator. Following
a hearing the arbitrator must select one of the numbers submitted, precluding the arbitrator from “splitting the baby.”

There is first an issue as to whether it is desirable as a matter of tax policy to identify one particular valuation issue for special treatment. The determination of value is a pervasive issue throughout the law of taxation. In the exempt organizations area alone, far from being limited to issues involving charitable contributions, the question of value is central in a multitude of situations, such as the value of assets involved in transactions between charities and insiders to determine whether there is private inurement, the value of assets contributed to joint ventures between exempt and non-exempt parties to determine whether there is excess private benefit, and the reasonableness of executive compensation, to name a few. It is equally prevalent in other areas of tax law, such as corporate formation, distributions and reorganizations, allocations of purchase price, transfer pricing, the application of estate and gift tax, partnership formation, compensation, etc. It would seem anomalous and inconsistent to impose a rigid procedure for resolving valuation issues only in the context of charitable contributions when the question of value permeates the tax law generally.

With respect to the particular dispute resolution procedure proposed, there is a great deal of academic literature evaluating the effects of baseball arbitration, including the extent to which it affects the likelihood of settlement, and how the results of such arbitration compare with the potential range of negotiated settlements. California’s Commission on Health and Safety and Worker’s Compensation commissioned an in-depth study of the literature in the area in 1999. The authors concluded that the evidence in the literature supports the contention that baseball arbitration increases the probability of settlement between parties. They nevertheless expressed significant concern regarding the practical implementation of the procedure, including the tendency of the parties and the arbitrators to seek to avoid its usage. The authors also noted that baseball arbitration tends to favor the party that is less risk-averse, which in the context of a tax controversy will generally be the government, raising concerns regarding the equity of the procedure. A review and understanding of the California experience could provide valuable empirical data in considering a baseball arbitration approach in the tax arena.

Putting those issues aside, the Discussion Draft proposes utilizing baseball arbitration at two stages of dispute resolution: the IRS administrative appeal, and in litigation. At the appeals stage of a valuation controversy, the IRS and the taxpayer would be bound by the parties’ respective valuation positions. The IRS appeals officer would then be required to accept one of the two valuation positions. While it seems possible that this approach in the administrative appeals context may encourage settlement, a variation on baseball arbitration, known as “night baseball arbitration” may be more appropriate to counteract concerns with potential perceived bias by appeals officers towards the IRS position. In night baseball arbitration, as in baseball arbitration, each side chooses a number. In night baseball arbitration, however, the numbers are not revealed to the arbitrator. The arbitrator makes a decision regarding the value, selecting his/her own number, and the parties must then accept whichever of their figures is closer to the arbitrator’s number.

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While baseball arbitration may be a feasible approach with respect to valuation controversies in the administrative appeals context, in the litigation context it raises both policy and constitutional issues. The determination of value is a question of fact. The trial judge (or the jury, if the action is brought in U.S. district court and a jury is requested) is the trier of fact, and brings to bear all his/her knowledge and expertise on what is frequently the key factual issue in a tax case. The jurisdictional provisions of the Internal Revenue Code explicitly recognize the value of this judicial role: the Tax Court has specific authority to issue declaratory judgments concerning the value of gifts for gift tax purposes. To require baseball arbitration on a valuation question would effectively remove judicial discretion in determining the facts of a case.

The recent case of *Caracci v. Commissioner*, 118 T.C. 379 (2002), the first case under the intermediate sanctions provisions at Section 4958, presents a judge’s view of the importance of judicial discretion in determining value. The central issue in the case was the value of assets transferred by charitable organizations to corporations controlled by a family that controlled the charities and owned the corporations. Judge Laro, in his opinion, described the role of the judge in determining value as follows:

As typically occurs in a case of valuation, each party relies primarily upon an expert’s testimony and report to support the respective positions on valuation. A trial judge bears a special gatekeeping obligation to ensure that any and all expert testimony is relevant and reliable. [Citations omitted.] The Court has broad discretion to evaluate the cogency of an expert’s analysis. [Citations omitted.] Aided by our common sense, we weigh the helpfulness and persuasiveness of an expert’s testimony in light of his or her qualifications and with due regard to all other credible evidence in the record. [Citations omitted.] We may embrace or reject an expert’s opinion in toto, or we may pick and choose the portions of the opinion to adopt. [Citations omitted.] We are not bound by an expert’s opinion and will reject an expert’s opinion to the extent that it is contrary to the judgment we form on the basis of our understanding of the record as a whole. [Citations omitted.]

A taxpayer has three forum options for bringing an action concerning tax liability. The taxpayer may file a petition in the Tax Court for redetermination of a proposed deficiency, or the taxpayer may pay the tax and file an action for refund in either the Court of Federal Claims or the U.S. district court. The baseball arbitration proposal raises special issues in the context of actions brought in the U.S. district courts, which are established under Article III of the Constitution.

There is a question whether a statute could permissibly require a U.S. district court to choose between two predetermined numbers in making the factual determination of value. The Federal Sentencing Guidelines would seem to present a similar situation – although

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20 § 7477.
21 118 T.C. at 393-4.
there is no obvious policy parallel in the charitable contribution valuation context to the public interest in ensuring that persons convicted of the same crime receives similar sentences. (Baseball arbitration does not even seem to ensure similar results for similar taxpayers, because the procedure is designed to enhance motivation to settle, rather than to establish fair market value.) Indeed, even sentencing guidelines may not pass Constitutional muster.\textsuperscript{22}

In addition, both the taxpayer and the government have the right to obtain a jury trial in U.S. district court.\textsuperscript{23} The taxpayer’s rights in this regard are based in the Seventh Amendment to the Constitution, and it would not seem that they could not be overridden by a statute requiring the court to apply baseball arbitration in the determination of a factual issue.

\textsuperscript{22} See \textit{Blakely v. Washington}, No. 02-1632 (U.S. Supreme Court, June 24, 2004), in which the Supreme Court invalidated Washington State’s sentencing guidelines as unconstitutional because they allow defendants’ sentences to be increased by judges instead of juries.