Free Speech Coalition, Inc.

8180 Greensboro Drive, Suite 1070
McLean, VA 22102-3860
Phone: (703) 356-6912
Fax: (703) 356-5085

July 6, 2004

Free Speech Coalition, Inc.
Post-Hearing Comments relating to
U.S. Senate Committee on Finance Staff Report and June 22, 2004 Hearings on
"Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities"

The Free Speech Coalition, Inc. ("FSC") is a broad nonprofit alliance of nonprofit organizations and for-profit companies which help nonprofits raise funds and carry out their programs. FSC is particularly concerned with the preservation of the rights of nonprofit advocacy organizations. This diverse group was established in 1993 to defend the interests of Americans who want to participate fully in the formation of public policy in this country without undue governmental interference and restriction.

The Senate Finance Committee, which oversees the Internal Revenue Service's regulation of tax-exempt organizations, released a staff draft report in connection with the above-captioned hearing. That report suggests many dramatic changes in laws governing charities and other exempt organizations, including virtually all members of FSC, which are directly engaged in educating the general public on matters of direct importance to the communities they serve. Some of these groups are 501(c)(3) public charities, while others are 501(c)(4) social action groups. Both of these types of organization are now heavily regulated at the Federal, State, and, in some cases, local levels. Compliance costs for these groups have steadily risen over the past 35 years. Indeed, it is ironic that the very government entities that impose and enforce these rules object to the increasing percentage of total revenues nonprofits must spend on non-program activities, including registration, recurrent filings, and responding to government and watchdog inquiries. Every dollar spent on salaries, accounting fees, legal fees, and registration fees to comply with these laws is a dollar less for the core missions of tax-exempt organizations.

Yet, despite the constantly increasing regulatory burden of mandatory filings, disclosures, and compliance with new rules and regulations at all levels, there is no indication that governmental involvement has had any significant beneficial result. Indeed, rather than the imposition of additional requirements, burdens, regulations, and penalties, this Committee's attention should be focused on lessening currently existing burdens on nonprofits. If Congress believes that something must be done, Congress should focus on enforcing laws currently on the books, as recommended in the June 9, 2004 Report of the Advisory Committee on Tax Exempt and Government Entities (ACT) at page 9, not passing new laws.

In these comments, FSC points out the shortcomings of many of the proposed solutions contained in the discussion draft, numbered to correspond to the sections of that document.

A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS. The draft proposes a five-year review of tax-exempt status. Such a proposal is ill-conceived and would produce absurd results. First of all, there is no demonstrated need for such a pervasive, burdensome requirement, whose benefits to the public are not even apparent. In addition to the costly, unnecessary burdens it would impose on tax-exempt organizations, it would overtax the regulators themselves. The Service is already unable to respond in a timely fashion to applications for recognition of exemption (Forms 1023 and 1024). Field offices send many of these applications to the National Office without even opening a case file in order to reduce their swollen caseload, and in return the National Office is reportedly returning these applications because it does not have the resources to review them. This proposal would increase the number of such renewal applications to be considered each year by hundreds of thousands! Without significant added resources, it is highly unlikely these applications actually will be reviewed by the Service. Requirement that these also be made available to the public, as Forms 1023 and 1024 now must be, would kill plenty of additional trees, consume lots more time of an organization's staff, and help to make accountants and lawyers rich, but would not result in any perceptible benefit to the public.

2. Donor advised fund reforms. Eleven new rules are suggested for DAFs, primarily focused on for-profit investment houses that create the charities housing them, and then manage their funds. Again, it is not clear why such intricate and comprehensive changes should be necessary in view of the statutes and regulations currently in force. Perhaps one constructive suggestion would be for the IRS to publish a list of approved foreign charities to which grants could be made, not only by DAFs, but also private foundations and other public charities without having to exercise the equivalent of expenditure responsibility over them. This proposal could actually *cut* overhead for many charities and get *more* money out for mission. Private foundations should also be allowed to discharge the charitable pledges of their creators, as they are no less worthy than DAFs and their creators in this respect.

3. Supporting organizations. Eliminating Type III (Code Section 509(a)(3)) support organizations is an extremely bad idea. If specific problems concerning manipulation of Section 509(a)(3) organizations have been discovered, that specific conduct should be addressed. This proposal would make it very difficult for many charities, social action groups, unions, agricultural and horticultural organizations, and trade and professional associations to conduct their legitimate, educational, and other ancillary activities through subsidiaries that would qualify for tax exemption. For example, a trade association that wishes to conduct educational programs may want to do so through a public charity. If, however, those educational activities cannot pass the public support tests of Code Section 509(a)(1) and (2) — for example, where more than one-third of the subsidiary's support comes from passive income and the rest of its revenue comes from conference registrations — the entity would be treated as a private

foundation. This was just the sort of foolish result that Code Section 509(a)(3) was enacted to prevent. The Committee should reject "throwing out the baby with the bath water," which is what repeal of Code Section 509(a)(3) would be.

4. Revise exemption standards for credit counseling organizations. These proposals apparently were made in response to particular abuses that have been discovered among some organizations in the debt counseling field. The Service is now engaged in auditing over half of this industry, and there is no reason to believe that the Service lacks the tools to deal with each of the abuses reported to date. If more definite rules are required, these can be issued by the Treasury Department in regulations and rulings, and enforced by the courts. Statutes that attempt to micro-manage complex business and financial relationships almost always end up creating unintended consequences that can only be remedied by more legislation. The results of the credit counseling audits in progress by the IRS will demonstrate whether proceeding by regulation is inadequate, but there appears to be no indication of this at the present time.

5. Revoke charitable status for accommodations to tax shelters. Active participation by a charity in tax evasion is certainly illegal, and in the appropriate case could justify revocation of the organization's exemption. Imposing the tax in appropriate cases would also make sense, as it presumably will steer charities away from such schemes. A requirement for advance approval, however, would require organizations to come to the Service with every new idea proposed in connection with planned giving, partnerships with for-profit companies, and the like — or risk the possibility that the proposed activity is substantially similar to a listed transaction. Further, the IRS likely will be unable to respond to these requests in a timely manner. If more regulation is needed here, it should follow the path of other tax regulation, and include appropriate standards by which the conduct in question could be evaluated.

B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules. There should be a compelling evidentiary record to justify extending the self-dealing regulations, as proposed, to public charities. This would amount to extremely expansive regulatory change which has not been considered necessary in the past. Furthermore, this proposal points out an existing unfairness in the law that Staff proposes to extend further. Social action organizations, contributions to which are *not* tax deductible, were subjected to intermediate sanctions in 1996. There was no apparent justification for imposing those rules upon 501(c)(4) organizations, beyond the fact that such groups inform constituents about the actions of legislators and rally them to contact their representatives — obviously an uncomfortable prospect for those in positions of legislative power. Prior to that time, the basic difference between charities and these groups had been recognized by Congress, the Service, and even by the Supreme Court as a healthy safety valve, permitting lobbying and even political activity to be conducted by organizations related to charities that did not receive tax-deductible contributions. Regan v. Taxation with

Representation of Wash., 461 U.S. 540, 544 and fn. 6 (1983). Staff now proposes to treat these organizations as private foundations.

This proposal is truly odd, since trade and professional associations which *do* receive tax-deductible contributions from their members are omitted, as are fraternal and beneficiary organizations, veterans groups, and social clubs. Organizations that have more in common with charities than do social action groups are given a free ride, while social action groups, which deal directly with the public and serve a recognized, constitutionally-protected function, are discouraged by ever more burdensome regulation. It is doubtful that Congress could field a reasonable basis for this discrimination between social action groups and these others classes of entities. The proposal to apply private foundation rules to social welfare organizations should be rejected, even if it is ultimately decided to extend the private foundation self-dealing rules to public charities.

2. Expand definition of disqualified person. See comments to section B.1.

3. Increase taxes for self-dealing, jeopardizing investments, and taxable expenditures. See comments to section B.1.

4. Compensation of private foundation trustees. This Staff proposal appears to ignore the realities of the non-governmental world. First, not paying directors would not necessarily result in better directors. If directors would not serve on the boards of publicly-held corporations without compensation, why disadvantage nonprofits in seeking qualified directors using compensation? Further, private foundations that do not pay trustees may attract trustees who seek to obtain compensation indirectly, such as through dealings with grantees or in other relationships to the organization.

There must be some understanding of real-world concerns of those who would otherwise like to serve on nonprofit boards. Intelligent people rarely choose to expose themselves to personal liability, public criticism, and governmental attack, for the time-consuming and costly work associated with meeting the existing standards of trustee responsibility, let alone the more stringent proposed rules. Such a proposal would result in only the wealthy (such as creators of the private foundations who have sufficient assets of their own to deflect these concerns), or those with nothing to lose, to serve as directors of private foundations. This could result in the pool of potential directors becoming shallow indeed, leading to more, not fewer, abuses.

5. Compensation of disqualified persons. Limiting the compensation of disqualified persons to government levels artificially limits the ability of nonprofits to recruit talented personnel. Such a proposal is unrealistic, and actually would be self-defeating. Over the past 25 years, some government salaries have failed to keep pace with those available out of government, and some public servants have left public service to put their children through college and otherwise pursue the American dream. To restrict the ability of nonprofits to recruit qualified leadership will deprive the nonprofit sector of those individuals it needs. Moreover, requiring for-profit companies to make executive compensation data publicly available did

nothing to stem the excesses evident in the Enron and Tyco cases, let alone to eliminate the disparity between workers' wages and executive salaries in certain for-profit companies. There is no reason to believe it will do better in the nonprofit sector. It makes no sense to harm the capabilities of the nonprofit sector to do its job so that its reputation in the eyes of some in government is preserved.

C. Grants and Expense Reforms

1. Treatment of administrative expenses of nonoperating foundations. As noted above, more filings and reviews will require added government staff, not to mention added non-grant expense for the foundations, which would itself trigger these requirements more often. Failure to either review the filings or follow them up with audits would cause this to be an empty exercise. This proposal actually reinforces arguments already made above that requiring additional filings is not the answer for anyone.

2. Encourage additional grant-making by private foundations. It is not clear that this incentive would be enough to accomplish its goal; dropping the payout figure needed to obtain exemption from the 2 percent tax to 7 or 8 percent might be successful to some degree. In times of low investment return, however, such an approach would encourage speculative investment, which could not be thoroughly controlled by stiffening the Jeopardy Investment provisions of Code Section 4944.

3. Prohibit foundation grants to donor advised funds. The Service has already informally proposed this rule, which most DAF sponsors are already following.

4. Limit amounts paid for travel, meals, and accommodation. Abusive perks are always an easy target, and setting a bright line test such as government per diem rates has a certain superficial appeal. However, nonprofits are not able to take advantage of deeply discounted government airline and hotel rates. Furthermore, travel, meals, and accommodation coverage is no less an element of director, officer, and staff recruiting than other forms of compensation. To arbitrarily limit these small cost items clearly would result in limiting the pool of those willing to serve charity. Current rules, properly enforced, would in fact achieve the desired goal; more enforcement, not more arbitrary rules, is needed.

D. Federal-State Coordination of Actions and Proceedings

1. Establish standards for acquisition/conversion of a non-profit. This is a subject that has received much attention in connection with the purchase of nonprofit health facilities by for-profit organizations. The proposal raises important, difficult questions of federalism. Any legislation should clearly establish the lines of Federal versus State authority, and specify the extent of preemption intended by Congress. Failure to do so will likely result in conflicting rules at each level, turf wars over enforcement and uncertainty for charities that seek to "do right" by the public interest.

2. Provide States the authority to pursue federal actions. This proposal highlights the risks associated with unlimited cooperation and information sharing between Federal and State authorities. It would almost certainly require the sharing of audit materials between the Federal and State enforcement arms, which is something that has traditionally raised issues of personal privacy, freedom of association, and abuse of power. If State and Federal enforcement authority is to be integrated in this way, information that is provided for one purpose could well be used for another, even though to do so would violate constitutional protections. The Federal government should gather only that information which it needs, and use it only for its own purposes. The same is true for States. If wrongdoing is found, the agency uncovering it should deal with it, rather than some type of Federal-State consortium threatening to exponentially increase the consequences of a misstep. Federalism issues must be carefully considered before any regulatory measure of this type is established.

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

The comments noted above concerning the cost of compliance are particularly important here. Thirty-five years of ever-increasing reporting on Form 990 have few demonstrated benefits, but clearly have increased administrative costs. There is no reason to believe that asking more questions will produce anything more than higher administrative costs with less money going to charity and more complaints about dropping percentages of funding going to mission.

1. Require signature by Chief Executive Officer. This proposal is unnecessary at best. Such a change would make it impossible for a CEO to delegate this responsibility to a CFO, who presumably has superior personal knowledge.

2. Penalties for failure to file complete and accurate 990. Government at all levels usually assumes malice and fraud by citizens. Honest mistakes are sometimes made by nonprofit officials and accountants, just as they are made by Congressmen and Congressional staffers. Intentional misrepresentation should be required before substantial penalties are threatened or imposed.

One hallmark of the Exempt Organizations function at the Service since its inception has been its commitment to ensuring organizations acted properly, regardless of whether it produced tax revenue. To incentivize the Exempt Organizations function by giving it the ability to benefit from tax collections would fundamentally change this from a function that does the right thing, to one that "follows the buck." This would be a dangerous development. In times of rising deficits, this would likely trigger the institutional self-preservation response to assert claims even where not justified, especially in view of the adverse publicity that such claims would bring.

3. Penalty for failure to file timely 990. Many times, apparent inconsistencies on Forms 990 are due to differing interpretations of the instructions or simple human error. Putting such heavy burdens on the organization for inadvertent error is unrealistic, and undoubtedly unfair. There are frequently genuine reasons that Forms 990 are filed late, most often to allow

correct information to be gathered. Accounting firms or other return preparers, many of whom answer the call when asked to perform these audits at reduced rates or entirely for free, require the allowable period of time for filing, with occasional extensions, in an attempt to do their job properly. Creating such a deadline would merely encourage rapid filing of incorrect information, with nonprofits playing the audit lottery.

4. Electronic filing. This more efficient way of providing ready information to the Service is a good idea. Making all filed information available to the States is a bad one. In NAACP v. Alabama, 357 U.S. 449 (1958), the Supreme Court recognized that donor and membership lists could be used by government or those gaining unauthorized access to government data bases to harass persons affiliated with unpopular groups. Sharing donor contribution information with State authorities, as well as with elements of the federal government outside the Service, would be a dangerous step.

5. Standards for filing. If the Committee and Treasury can develop reasonable rules relating to the accurate reporting of nonprofit finances, this would be a heroic feat, and could bring order out of chaos. When undertaking this step, the Committee should be aware that the costs associated with capturing information, reporting in greater detail and otherwise complying with the added rules called for in the discussion draft are often used by large charities to keep out new and smaller charities that cannot afford the administrative costs. Care should be taken to require expensive compliance actions only from groups whose gross receipts are large enough to absorb them without having to give up a substantial portion of their revenue. In other words, perhaps there should be a policy that limits the costs that government, at all levels, can impose upon nonprofits (say the same 10 percent mentioned by the discussion draft as the limit on acceptable administrative expense).

6. Independent audits or reviews. In addition to being unnecessarily burdensome, the proposed requirement that a tax-exempt organization with over $250,000 in annual gross receipts change its independent auditing firm every five years would result in substantially higher auditing fees for the exempt organization. It always takes a new auditing firm significant time to become familiar with a new organization when it conducts an initial audit, *e.g.*, reviewing the organization's accounting system, computer programs, and internal controls. Curiously, a new auditing firm probably would be less able to spot problems than one which had experience with the organization. See comments to section E.5., *supra*.

7. Enhanced disclosure of related organizations and insider transactions. Requiring organizations to give up their confidentiality in seeking legal advice would discourage both boards and management from seeking advice. As often as not, requests for legal advice reveal that what is contemplated cannot and should not be done, normally leading to abandonment of the suggested course and adoption of an acceptable approach. If an organization wishes to rely upon opinion of counsel to protect it or its leaders from penalties, the opinion letter is expected to be shown to third parties, and will be drafted with that in mind. Not all opinions, however, are sought for this purpose, and only those designed to support exemption from a penalty should be subject to view even by the Service, let alone the public.

8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements. This suggestion infringes upon the existing State governmental regulatory role of internal management of nonprofits; for more of the same, see comments to section G, *infra*. There is no reason to believe that donors would rely upon this information in making decisions about giving; if they wanted this, they would let nonprofits know about it by refusing to give donations until this information were forthcoming. The only thing sure to come from this proposal would be more expense for more data that will either go unused or be manipulated by groups opposing or supporting a nonprofit to their own ends.

9. Disclose investments of public charities. It is not clear what, if any, legitimate goal this additional requirement would further.

F. Public Availability of Documents

1. Disclosure of financial statements. Curiously, this could put more pressure on auditors to "bend the rules," much as they did during the bull market of the 1990's; at the same time, it could open public accounting firms to private suits, thus further increasing the cost of audits.

2. Web-site disclosure. This would be a good suggestion only if it (a) were inexpensive to post such materials — as where Guidestar or the federal government agreed to do the publication — and (b) did not disadvantage the electronic medium by imposing required speech while printed media were exempt. Even if all media were to be subject to such a rule, it is not clear that such a mandatory speech requirement is supported by sufficiently strong government goals that could not be achieved by other means, such as requiring those who want the information to request it.

3. Publication of final determinations. Giving the Service the ability to disclose audit results would give them the ability to intimidate nonprofits into agreeing with their position or doing anything else the Service wished them to do under threat of publishing unfavorable conclusions to damage the nonprofit's image. If one believes such abuses cannot occur, the record of the SSS ("Special Services Staff"), which allegedly compiled the nonprofit enemies list under the Nixon Administration, should be researched.

4. Require public disclosure of Form 990-T and affiliated organization returns. It is clear the Staff believes that nonprofits must have absolute transparency in all matters to be accountable. Thus, mistakes in judgment, such as investing in poorly performing assets, or trying to start a new program that requires lots of start up capital but provides few returns, will be done in full public view. The criticism this would produce may discourage innovation. It would be simple to reduce the consequences for this type of mandatory disclosure to absurdity. For example, tax returns of public companies and private individuals, even of elected officials, are not subject to public scrutiny to avoid such embarrassment; why should the tax returns of nonprofits be different? Extending such forced disclosure to affiliated organizations (depending

upon the definition of that term) could make contractors think twice about providing services to nonprofits. Would this be in the public interest?

5. Require public corporation filing of charitable giving return. Corporations already get little benefit from charitable contributions, their deductions for which are limited to 10 percent of taxable income; most use their advertising budgets for charity for this reason. To create yet another disincentive to corporations to support charity would give them another excuse to shirk their responsibility to the community in which they operate.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

This entire section would preempt the role of State Attorneys General in setting the performance standards of nonprofit boards. But would the IRS even make the key determinations in this process? No. The discussion draft would farm the governmental duty of determining whether a nonprofit were tax exempt and properly run to "accredited" watchdog groups. Government agencies would also give preference to these private determinations in granting government contracts. This unprecedented preemption and delegation of government responsibility and authority to private institutions and individuals would be an unconstitutional arrogation of power to the Federal government, would constitute a denial of due process, and would delegate non-delegable government functions.

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

Payment for the government's costs under the discussion draft would be laid at the doorstep of private foundations, the group least frequently in the news lately and, until recently, hailed by the Service as the most compliant segment of the nonprofit community. In the alternative, filing fees would be imposed that would further exacerbate the administrative cost problems faced by nonprofits under the proposals. Aside from the basic unfairness of either approach, the dollars it is estimated to raise would fall far short of what an active enforcement program would require. Even these costs, however, pale into insignificance next to the costs that compliance with these rules would place on nonprofits. In short, the resources to be extracted from the nonprofit community to provide added information and see to its proper use would far exceed any benefit that community or the public at large could reasonably expect to gain from the exercise. Were all of the funds to be raised by this proposal dedicated to enforcing current rules without imposing further costs of the nonprofit sector, the public would be far better served.

I. Tax Court Equity Authorities, Private Relator and Valuation

1. Tax Court Equity Authorities. The proposal to invest the Tax Court, an Article I Court, *i.e.* a court of law (Freytag v. Commissioner, (501 U.S. 868 (1991)), but not necessarily

a court of equity, with injunctive powers may be unconstitutional. Any such authority would be more appropriately placed with district courts, which clearly have equitable powers under our combined American system of jurisprudence.

2. Private Action - Directors. Aside from providing another avenue for litigation attorneys to ply their trade, there is little to recommend using overburdened courts to deal with internal director disputes. Directors already have the right and duty to litigate such actions in local court if they believe it would help. If they merely wish to resign and walk away, this new procedure is unlikely to convince them to take the chance of having to pay defendants' fees if they lose. If a resigning trustee or director sent a letter to the IRS, it likely would result in an old-fashioned audit, the remedy most sadly lacking any attention in the discussion draft.

3. Private Relator Action - Individual. The law has long denied standing to private citizens seeking to hold charities to account for violating federal tax exemption provisions (*see* Catholic Conf. v. Abortion Rights Mobilization, 487 U.S. 72 (1988)), and for good reason. This is the role of the Service, and opening enforcement of these public rules to private attorneys general will produce far more mischief than it would true oversight. This is regulation on the cheap until you consider the administrative and judicial resources that would be consumed, not to mention the cost to the nonprofit. The most likely result that would flow from implementing this proposal would be abuse of process, and even $10,000 fines would not prevent the use of this provision to punish or occupy the resources of a nonprofit with which well-funded interests, on either side of a heated issue, disagree.

4. Valuation Resolution. The proposal to use "baseball arbitration" techniques to resolve valuation issues in charitable contribution cases is irrational. Taking the appeals office out of negotiations with the taxpayer, when the relative strengths of their positions on valuation is often the most significant litigation hazard in the case, is at odds with the essential role of Appellate, namely to sort out weaker cases that are factually driven so as to avoid wasting court time on often imponderable issues, such as value. Making the auditor the taxpayer's only chance to compromise is contrary to the very essence of the appellate process at the Service.

Respectfully submitted,

Mark B. Weinberg
Weinberg & Jacobs, LLP
Co-Counsel to Free Speech Coalition, Inc.
paladin@wjlaw.com
301-468-5500

William J. Olson
William J. Olson, P.C.
Co-Counsel to Free Speech Coalition, Inc.
wjo@mindspring.com
703-356-5070