THE NEW YORK COMMUNITY TRUST NYCT

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

March 2005

## 1 Legislative Proposals to Reform Charities: Chapter I

Two years ago, the *Boston Globe* did a series on fraud and abuse at foundations. One of the more egregious acts was found at a family foundation, where the president had given himself a substantial raise to pay for his daughter's wedding. Other papers across the country followed suit, and the stories led Senators Charles Grassley and Max Baucus, chairman and ranking member of the Senate Finance Committee, to shine a spotlight on the entire nonprofit sector. In June 2004, committee staff released a discussion draft of legislative proposals designed to tackle a number of alleged abuses. The senators also invited the Independent Sector, an association of nonprofits and foundations, to convene a panel to recommend measures to ensure that the sector operates openly and accountably. A number of other groups have submitted responses to the discussion draft, including the Council on Foundations, the American Bar Association Section on Taxation, and the American Institute of Certified Public Accountants (AICPA). And in the middle of this beehive of activity, on January 27, 2005, the Joint Committee on Taxation (JCT) released its own recommendations for tax reform, "Options to Improve Tax Compliance and Reform Tax Expenditures," some of which are likely to have an impact on nonprofit organizations and individuals' deductions for charitable contributions.

This issue of *Professional Notes* will highlight some of the most significant proposals, as well as some of the responses. Succeeding issues will report on their legislative progress.

### Donor-Advised Funds

***Definition.*** Donor-advised funds have grown exponentially in the last 10 years, but they have never been defined by law. None of the proposals includes a definition, but virtually all commentators agree on the need for one.

***Private foundations and donor-advised funds.*** The Finance Committee staff proposes prohibiting grants from a donor-advised fund to a private foundation (other than an operating foundation). The apparent concern is that donors will use a public charity donor-advised fund to evade the more stringent limitations on deductions that apply to contributions to private foundations. Most reputable donor-advised fund programs, including that of The New York Community Trust, already prohibit such grants or apply a case-by-case analysis before approving them, and we believe that there will be few objections to this proposal.

**ISSUES IN THIS SERIES**



By Jane L. Wilton, general counsel, The New York Community Trust

Senate Finance staff would also prohibit private foundations from making grants to donor-advised funds, apparently because of a perception that private foundations make such grants to circumvent the payout requirements. Acknowledging the potential for abuse, commentators have noted that private foundations also make grants to donor-advised funds for appropriate reasons. For example, The New York Community Trust operates several donor-advised "collaborative" funds, in which a number of grantmakers work together on grants directed at a particular issue. An alternative approach suggested by some responders would be a requirement that assets in such funds be re-granted in a specified time period. This proposal, however, fails to take into account that some of these funds properly last a long time given the problems they address and that community foundations are expected to build a permanent endowment for their community.

***Grants to foreign charities and individuals.*** Despite increased interest in grants to aid foreign charities, the proposals would impose a stricter rule than for private foundations, and would prohibit grants to foreign charities out of donor-advised funds unless the grantee is approved by the IRS. The proposals also would prohibit grants to individuals. Typically, donor-advised fund grants to or for individuals are for scholarships; responses to the proposals have suggested further study to determine whether, in fact, such grants are being made to individuals for non-charitable uses and that, in the interim, existing private inurement rules be enforced.

***Preventing personal benefit.*** The proposals also would require that recipients of grants from donor-advised funds acknowledge that no part of the grant inures to the benefit of a donor or advisor associated with the fund. Most donor-advised fund programs, including The Trust's, include language with grant checks prohibiting use of the grant for the benefit of anyone associated with the fund; cashing the check is tantamount to acceptance of these conditions. In our experience, it would pose a tremendous burden on a charity if it were required to track acknowledgements for every grant from a donor-advised fund.

***Payout requirement.*** Community foundations and public charities that offer donor-advised funds are not now subject to the 5 percent payout required for private foundations. The discussion draft proposes a 5 percent payout, in the aggregate, to donor-advised fund assets of a given charity, and that individual donor-advised funds meet a minimum activity threshold.

A fixed payout requirement may pose a problem for public charities that subject their endowments to a spending policy rate of less than 5 percent. If the goal of the proposal is to avoid donors "parking" assets, the ABA comments suggest that a minimum activity requirement would address this problem. It is widely agreed that tax-exempt organizations that administer donor-advised funds should disclose that fact on the Form 990—a change already included on the current form.

***Other.*** Other proposals related to donor-advised funds would require that money managers be hired at arm's length, that individual donor-advised funds not make expenditures to the donor or his or her family members for grant reviews, and that fees for referrals be prohibited or limited. Interestingly, the proposals would permit charitable pledges to be satisfied with grants from donor-advised funds.

## Type III Support Organizations

The Finance discussion draft proposes eliminating Type III support organizations, stating that this has been "an area of significant abuse." One concern seems to be the creation of a Type III organization without the public charities' knowledge or consent, with the donor then borrowing the assets back from that organization.

## Contributions of Property

***Income tax deduction for contributions of property other than cash or publicly traded stock.*** Many community foundations are able to accept complicated assets and convert them for charitable uses. The discussion draft proposes that contributions of property to donor-advised funds other than cash or publicly traded securities be sold within one year, and that a plan for sale must exist at the time of the gift. One concern of the Finance Committee staff, we are advised, is a failure of the independent appraisal requirement that currently is in place. Under current law, the donor of a gift of property other than cash or publicly traded securities worth more than $5,000 ($10,000 in the case of non-publicly traded securities) must obtain an independent appraisal and report it on Form 8283 with his or her tax return. Another apparent concern is the illiquid nature of such gifts. But a charity looking to build assets to meet tomorrow's needs as well as today's is willing to wait to cash out its interest. Commentators note that any changes in the treatment of appreciated property gifts should be considered for all public charities, and not donor-advised funds only.

The JCT report goes well beyond the Finance discussion draft and proposes in the alternate, to (1) limit the income tax deduction to basis for contributions to charity of any property other than publicly traded stock or (2) limit the income tax deduction to basis for contributions of property other than publicly traded stock

or "exempt-use" property used to further the charity's exempt purposes. Exempt-use property generally would be required to be used by the charity for three years. This proposal discourages gifts by the large number of people whose wealth is in their own businesses, closely held investment vehicles, or real estate, not in cash or public securities. It is likely that these proposals will reduce contributions to charity at a time of increased reliance on the charitable sector to address social welfare needs.

> . . . 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.

***Valuation of gifts.*** The discussion draft proposes the use of a so-called baseball arbitration process to determine the tax value of gift assets in case of a dispute. An arbitrator would be presented with the value used by the taxpayer for his tax return and a valuation determined by the IRS. The auditor would choose one of those two figures. This proposal does not give consideration to how the arbitrator would be chosen.

## Reporting and Governance

***Exemption renewal requirement.*** The Finance Committee staff proposes that tax-exempt organizations be required to re-apply for exemption every five years. Although the Service would not be required to review all such filings, the failure to file would mean loss of tax-exempt status.

The JCT report offers a similar proposal, stating, "as a practical matter, the initial tax exemption application has become the only procedure through which an organization must justify its claim to tax exemption." However, unlike the application for exemption, neither the JCT report nor the Finance discussion draft requires that the IRS take action with respect to the 5-year review filing. The JCT proposal would not apply to organizations that are more than 10 years old.

Comments filed by the ABA Section on Taxation note that there are more than 1.6 million domestic tax-exempt organizations. The AICPA commented that such filings would impose a significant burden on organizations to prepare information that the IRS does not have the resources to review.

***Insiders and disqualified persons.*** The Finance discussion draft proposes extending the private foundation self-dealing rules to public charities. These rules preclude any sale, exchange, or lease of property by a disqualified person, including a loan to the charity, even if on terms advantageous to the charity. In addition, the proposals would expand the definition of a disqualified person for public charities to include a corporation or partnership in which the disqualified person exercises substantial influence.

The Finance discussion draft also proposes prohibiting compensation to trustees of private foundations or permitting only a statutorily prescribed amount. This seemingly ignores the existence of corporate trustees, such as banks. It also proposes that other disqualified persons of private foundations (other than those disqualified by reason of employment) be limited to federal government rates for compensation; compensation above the level would trigger additional disclosure requirements.

The JCT report recommends major revisions to the intermediate sanctions rules, also known as the excess benefit rules, as well as increases in the applicable penalties or excise taxes. Significantly, the report proposes eliminating the rebuttable presumption of reasonableness with respect to certain compensation arrangements and property transfers, and provides that the procedures that currently give rise to such a presumption or safe harbor instead be deemed merely to establish a minimum standard of due diligence.

The JCT report also proposes to eliminate the current rule that protects a manager who relies on professional advice. In addition, it would eliminate the so-called initial contract exception under which a person who is not a disqualified person immediately prior to entering into a contract but becomes one as a result of the contract—such as the initial employment contract with a new chief executive officer—so that such a contract potentially is covered by the intermediate sanction rules.

There is broad concern about these proposed changes as the intermediate sanction rules were carefully developed over a long period of consideration, were promulgated in 2002, and have not proven ineffective. Many commentators share the sense of the ABA Section on Taxation, which commented, "for both taxable expenditures and self-dealing, we believe that rigorous enforcement of existing law by the IRS . . . is the most effective deterrent to abuse." Another frequent comment was that it was too soon to judge the effectiveness of the intermediate sanctions under Section 4958.

***Grants and expenses.*** Currently, private foundations generally are required to pay out at least 5 percent of their assets annually; amounts considered for this purpose include certain expenses. The

proposals would impose additional reporting when administrative expenses (other than actual grants) of a private foundation exceed 10 percent of total expenses. Such reports would be subject to IRS review to determine whether the expenses were "reasonable and necessary." Administrative expenses in excess of 35 percent of a foundation's total expenses would not be treated as qualifying distributions.

Under the proposals, a private foundation that pays out more than 12 percent would not pay excise tax. This clearly demonstrates discomfort on the part of the Senate Finance staff with perpetual private foundations as it is highly unlikely a 12 percent payout rate could be sustained for any period of time without eroding principal.

***Tax shelters.*** The discussion draft proposes to penalize charities that are determined by the Service to be "accommodating parties" to tax shelters with a 100 percent penalty and to disallow tax deductions on contributions to the organization for one year.

The JCT report proposes extending penalties to tax-exempt entities that participate in transactions either knowingly or with reason to know that the transactions are prohibited tax shelter transactions. Penalties would be imposed both on the entity and its managers. If a transaction subsequently is determined to be a prohibited tax shelter, any income allocated to it after such determination would be taxed at the highest UBIT rates.

The commentators urge careful definitions of organizations' obligations because of the possibility of inadvertent or limited involvement in such transactions.

***Non-profit conversions.*** The JCT report proposes a tax on conversion of a tax-exempt organization to a taxable entity out of concern that charitable assets may be transferred to for-profit companies for less than fair market value, that excess compensation or severance may be paid to employees of the charity, or that the charity's assets may not be used for their intended purpose. The proposal seemingly is directed at conversions of nonprofit hospitals, but would apply both to public charities and private foundations. The tax would equal the value of the organization's net assets that are not dedicated to charitable purposes following the liquidation or conversion, and thus would not be owed if the entire value of the charity's assets remain dedicated to charitable purposes.

The proposal calls for qualified appraisals of the assets' value as of both the first day on which action with respect to the liquidation or termination is taken and the date of the liquidation or termination transaction, apparently to prevent avoidance through multi-step conversions. In addition, each party must obtain its own appraisal.

***Form 990 and financial statements.*** Citing a 2002 GAO report, the Finance discussion draft asserts that there are "significant problems in the accuracy and completeness of Form 990" and proposes many changes including the following:

- Signing by CEO under penalties of perjury;
- Doubling of penalties for failure to file, loss of exemption for failure to file for two consecutive years or for three of four years, and penalties for failure to include required information;
- Limiting extensions of time for filing;
- Requiring electronic filing;
- Requiring the IRS to promulgate standards for completing Form 990s;
- Requiring an independent auditor to review a charity's Form 990 and a report that would become a public document;
- Requiring audited financial statements annually and change of auditors every five years for charities with more than $250,000 in gross receipts;
- Including a description of annual performance goals and material changes in activities;
- Public disclosing of investments by public charities;
- Requiring greater disclosure regarding affiliated entities and opinions obtained regarding transactions with insiders or conflicts of interest.

To facilitate public oversight, the Finance discussion draft would require:

- Disclosure of financial statements, returns, application for exemption, IRS determination letter and five years' worth of financial statements to be available on the organization's Web site, if it has one;
- Disclosure of the results of audits and closing agreements without redaction;
- Disclosure of Form 990-T (relating to unrelated businesses);
- Disclosure of all contributions from publicly traded corporations in excess of $10,000.

These proposals all are aimed at increasing transparency in the nonprofit sector. However, many of these provisions, including

mandatory changes of auditors and limited extensions for filing, would unfairly burden small nonprofits; disclosure of investments would impose financial burdens across the sector.

## Government Oversight

***Governance and "best" practices.*** The Senate Finance Committee staff proposes that federal law, rather than local law, provide standards for governance, including the standard of care applicable to board members or trustees of charities, and adoption of a federal prudent investor standard. The proposal calls for holding directors with special expertise to a higher duty of care.

Some proposals already are encompassed by the standard of care imposed under various states' laws; others unreasonably go beyond current local and federal requirements. Many states already have common law or statutory standards of care and it is unclear what would be gained by the imposition of a federal standard. Imposing a higher standard of care on board members with special skills—such as legal, investment, or accounting expertise—may have the effect of driving away such board members.

***Board size; removal of members.*** In addition, the Senate proposal dictates board size (3 to 15 members), permits only one board member to be compensated, and prohibits any person who cannot serve on the board of a publicly traded company from serving on the board of an exempt organization. Under the proposals, the IRS would have authority to remove any board member found to have violated self-dealing, conflict of interest, excess benefit, private inurement or charitable solicitation rules, and could prohibit such individuals from serving on a board for a period of years. Any organization that knowingly retained a person not permitted to serve would lose its tax exemption.

Under current law, the IRS does not have authority to remove officers and directors. Generally, conflict of interest rules do not give rise to federal financial penalties unless either Section 4941 (self-dealing rules) or Section 4958 (intermediate sanctions) are violated.

The ABA comments suggest that allowing the IRS to remove an officer or director for *any* violation "appears to be overbroad, since the self-dealing and intermediate sanctions rules provide an appropriate remedy . . ." However, the ABA comments also suggest that giving the IRS such authority in the case of repeated and willful violations may be appropriate, particularly if the only alternative would be to revoke the organization's tax-exempt status.

***Accreditation.*** The Finance discussion draft proposes that the IRS accredit charities that meet best practices. While laudable in theory, "best" practices are not the "only" practices, and traditionally are voluntary efforts. A host of questions are raised by commentators: Who would determine best practices? Would standards be national, or state-by-state? Would different standards apply to different charitable sectors?

As noted in the ABA comments, "The challenge is to determine how best to achieve the goals of the Finance discussion draft . . . within a sector that is considerably more diverse than public companies . . . 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." Other commentators noted that the IRS lacks the capacity to administer the governance and best practices recommendations.

## Conclusion

When charities do good, it is not newsworthy. After all, they are supposed to do good. But revelations by the press of foundation and public charity wrong-doing over the last few years cry out for intervention. Unfortunately, government-imposed solutions to the problems of a large and diverse sector traditionally have been heavy-handed. And when the sector is poorly understood by the public and public officials, inevitably there are unintended consequences.

Fortunately, the Senate Finance Committee has actively sought input from the sector, and nonprofit organizations are responding. We invite your comments and questions about the proposals and the process. Please contact Jane L. Wilton at 212-686-0010, Ext. 379 or janewilton@nyct-cfi.org.

**For further reference, see:**

ABA Section of Taxation letter to Senate Finance Committee dated July 19, 2004 and Supplemental Response dated September 15, 2004. (www.abanet.org)

AICPA Tax Executive Committee Letter to Senate Finance Committee dated July 19, 2004. (www.aicpa.org)

Council on Foundations Comment on Proposals in the Staff Discussion Draft Affecting Donor-Advised Funds and Supporting Organizations dated August 13, 2004. (www.cof.org)

Marion R. Fremont-Smith, The Hauser Center for Nonprofit Organizations, Harvard University, Letter to the Senate Finance Committee dated July 13, 2004. (www.ksg.harvard.edu/hauser)

Independent Sector (www.independentsector.org)

Joint Committee on Taxation (www.house.gov/jct)

Senate Finance Committee (finance.senate.gov/fin-comm.htm)

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## About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of more than $1.8 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee—three-tenths of 1%, i.e., 30 basis points; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

**For more information, call:**
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