THE NEW YORK COMMUNITY TRUST

PROFESSIONAL TAX & ESTATE PLANNING NOTES

September 2005

Legislative Reform: Chapter III

Independent Sector, an association of charitable organizations, convened the Panel on the Nonprofit Sector at the request of Senators Charles Grassley, chairman, and Max Baucus, ranking member, of the Senate Finance Committee (the "Finance Committee"). The Finance Committee, which has been considering measures to reform nonprofit organizations, specifically asked Independent Sector to respond to legislative proposals put forward by its staff[1], as well as proposals of the Joint Committee on Taxation ("JCT") staff[2]. These proposals were discussed in our March 2005 *Professional Notes* column. Our July column focused on recommendations in the Panel's Final Report, issued on June 22[3], relating to donor-advised funds, gifts of appreciated property, and type III supporting organizations. This column will consider recommendations on governance, reporting, and oversight.

Governance

Executive and board compensation; travel expenses. Finance Committee staff proposed extending the private foundation self-dealing rules to public charities, which would not only apply to excess compensation but would have the effect of precluding any sale or lease of property by a disqualified person to or from the charity, even if on terms advantageous to the charity. The JCT report took a different tack, recommending major revisions to the intermediate sanctions rules, including eliminating rules that create a rebuttable presumption of reasonableness of compensation. A complete discussion of existing rules concerning compensation to CEOs and board members is beyond the scope of this article. However, it is necessary to briefly review existing law in order to understand the impact of those proposals and the response of the Panel.

1 *Tax Exempt Governance Proposals: Staff Discussion Draft*, June 2004, www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf
2 *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005 (JCS-02-05), www.house.gov/jct/s-2-05.pdf
3 http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf

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

ISSUES IN THIS SERIES

In the *private foundation* context, excise taxes—penalties—are imposed on a foundation manager under Code Section 4941 if the manager participates in a self-dealing transaction between a disqualified person and the private foundation if the manager knows it is an act of self-dealing, unless his or her participation is not willful and is due to reasonable cause. This includes excessive compensation paid to CEOs or board members. The penalty on the manager or board member who approved the transaction currently is 2.5 percent of the amount involved. In addition, the disqualified person who engaged in the self-dealing act is subject to a 5 percent tax. These penalty taxes commonly are referred to as "first-tier" excise taxes because if the act of self-dealing is not corrected, a second tax equal to 200 percent will be imposed on the disqualified person, and 50 percent on the foundation manager if he or she refused to agree to a correction of the self-dealing act.

> The Panel proposes increasing penalties on private foundation and public charity executives who are found to receive excessive compensation.... [It] also proposes expanding IRS authority to abate such taxes when participation was due to reasonable cause and not to willful neglect, particularly when the individual did not receive an excess benefit and the foundation was not harmed.

Under current law, *public charities* also are prohibited from providing compensation to board members, CEOs, and other key executives in excess of the value of services received, and extravagant travel expenditures are considered to be excess benefits unless treated as compensation. For public charities, excessive compensation or "excess benefits" are subject to penalties under the intermediate sanction rules of Code Section 4958.

Under the intermediate sanction rules, the recipient of an excess benefit will be required to disgorge the excess amount and pay a penalty equal to 25 percent of the excess benefit. A further penalty of 200 percent of the excess benefit is imposed on the recipient for failure to repay the excess benefit within the prescribed time period. Public charity managers and board members who approve a transaction knowing it provides an excess benefit also are subject to a 10 percent penalty, unless their participation is not willful and is due to reasonable cause. A presumption of reasonableness arises in favor of the recipient of compensation as well as managers of a public charity under certain circumstances (the so-called "rebuttable presumption"). In addition, reliance on a reasoned written opinion of a professional (e.g., legal counsel, a CPA, or a qualified independent valuation expert) generally exculpates a manager. However, board members who are compensated generally cannot take advantage of the rebuttable presumption rules because the requirement that such compensation be established by an independent body will not be met.

The Panel proposes increasing penalties on private foundation and public charity executives who are found to receive excessive compensation. With respect to private foundations, the Panel recommends that first-tier taxes be increased to 10 percent for compensation-related self-dealing, and 5 percent for other self-dealing transactions, with a $20,000 cap in either case. The Panel also proposes expanding IRS authority to abate such taxes when participation was due to reasonable cause and not to willful neglect, particularly when the individual did not receive an excess benefit and the foundation was not harmed. The rebuttable presumption of Treas. Reg. §53.4958-6 would be retained for the *public charity* board that approves executive compensation. However, executives of public charities and private foundations could not rely on that presumption and would be required to demonstrate that their compensation is reasonable if challenged by the IRS.

Rejecting proposals contained in the Senate Finance discussion draft, the Panel does not recommend that foundations and charities be prohibited from paying compensation to board members, nor does it recommend setting arbitrary limits on amounts paid for travel. However, the Panel Report does recommend that all charities be required to disclose the amount of and reasons for compensation paid to any board member or trustee and the method used to determine the reasonableness of compensation, and that loans to directors of public charities be forbidden, as is already the case for private foundations. The New York Community Trust reviews information on thousands of charities every year, and we have found that few public charities compensate board members for serving on their boards, although many reimburse direct expenses.

With respect to both private foundations and public charities, the Panel proposes an increase in penalty taxes on excess compensation received by a *board member*, as well as an increased penalty on board members and managers who approved the compensation. Similar to its recommendation regarding executives, the Panel Report recommends that board members whose compensation is challenged by the IRS as excessive be required to demonstrate the reasonableness of the compensation.

The penalty on the approving board members and managers would result not only if they knew that the transaction was improper, but also if they "should have known" that it was improper. The "should have known" standard differs from current law, and is intended to encourage boards to exercise appropriate due diligence, such as following the rebuttable presumption procedures or other appropriate procedures.

The Report also suggests that compensation paid for board service be distinguished from compensation paid for performance of full- or part-time staff duties or for services as an independent contractor. The Panel acknowledges that its recommendations fail to distinguish between institutional trustees—*i.e.,* banks and trust companies—and individual trustees, and has indicated its intent to give further consideration to this issue.

Form 990, the information return filed by nonprofits, already requires the name, title, and average amount of time spent on matters relating to the charity for every board member, officer, and senior employee, as well as their compensation, deferred compensation, employment plan contributions, expense accounts, and similar benefits. The Panel recommends greater disclosure of executive compensation, distinguishing base salary from benefits, bonuses, long-term incentive compensation, and deferred compensation. In addition, a charity would be required to disclose on its Form 990 whether it had followed the rebuttable presumption procedures of Code Section 4958.

The Panel recommends greater disclosure of executive compensation, distinguishing base salary from benefits, bonuses, long-term incentive compensation, and deferred compensation.

The Report also recommends that all charities be required to disclose on their Form 990s whether they have a travel policy, and that the IRS provide greater guidance about travel costs that are not permitted or that are reportable as taxable income.

Board size and structure. The Senate proposal would dictate a board size of 3 to 15 members. While rejecting a maximum board size, the Panel recommends that, as a best practice, organizations generally should have a minimum of 3 board members, with exceptions for religious organizations or existing trusts with a single trustee. In the case of public charities, the Panel proposes a requirement that at least one-third of the members be independent. The Panel notes that there is no general agreement on the ideal size of nonprofit boards, and that each charity must make that determination for itself. It is not uncommon for a trust-form private foundation to have a single institutional trustee; the implications for charitable trusts warrant further consideration.

The Panel concludes that audit committees should not be mandated by federal law. Rather, it notes that "oversight of the audit function is a critical responsibility of the board of directors…" and recommends that the decision of whether or not to delegate the audit oversight function to a committee be made by the board.

The Panel recommends that independent board members be identified as such on the Form 990, and defines an independent board member as one who has not received compensation from the organization in the previous 12 months except for reasonable compensation as a board member, whose compensation except for board service is not determined by other board or staff members, and who is not related to a person who received such compensation. Implicit in this definition is that board members who are compensated for board service would be deemed to be independent unless the IRS successfully challenged their compensation. In addition, the Panel recommends that individuals barred from service on boards of publicly traded companies or convicted of crimes involving breach of fiduciary duty be prohibited from serving on a charity board for a period of five years following conviction or removal. It is not at all clear whether it is reasonable to equate voluntary service at public charities with board service at publicly traded companies; however, crimes involving breach of fiduciary duty do seem to go directly to the ability of a board member to discharge his duties to the organization in good faith.

Conflict of interest policies. Noting that all states mandate that directors and officers owe a duty of loyalty to the organization, the Panel recommends that every organization have and enforce a conflict of interest policy, and that Form 990 include disclosure of whether an organization has such a policy. The Report stops short of recommending that conflict of interest policies be federally mandated, but proposes that in the course of their audit, outside auditors be required to report the absence of signed conflict of interest forms.

Whistleblower policies. The Panel noted that the provision of the Sarbanes-Oxley Act prohibiting retaliation against whistleblowers also applies to charitable organizations; it recommends that every charity have policies that encourage individuals with information on violations of law or the organization's own policies to come forward. The Report includes a recommendation that such policies should include a way to report such information anonymously. However, it may be impractical to expect an organization to follow up on anonymous complaints.

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Board review of policies. The Report recommends that, as a best practice, boards of charities regularly review their governing instruments, financial policies and practices, and programs, as part of the board's ongoing work. The Panel suggests that particular attention be paid to governing instruments to make sure they reflect the organization's current practices, and that compensation policies and conflict of interest policies are being followed.

Reporting

Exemption renewal requirement. The Panel rejects recommendations of the Finance Committee and JCT staffs that would institute a periodic review system to verify that a charitable organization continues to meet the qualifications for tax exemption. Noting that filing for renewal every five years would impose a significant burden on the resources of both charities and the IRS, the Report concludes that Forms 990 and 990-PF should be amended to provide sufficient information for productive review by the public and the IRS. The Report also recommends electronic filing of the application for tax exemption, Form 1023, to make it more readily available to the public.

For a number of reasons, including the cost and limited pool of experienced auditors specializing in nonprofits, the Report concludes it is not appropriate to require rotation of auditors, as recommended by the Senate Finance discussion draft.

Form 990 and financial statements. To ensure that the senior executive officers of charities take responsibility for the contents of their returns, the Panel recommends requiring that Form 990 be signed, under penalties of perjury, by the chief executive officer, chief financial officer, or if in trust form, by a trustee of the organization. The Report does not recommend increasing existing penalties for failure to file a complete and accurate Form 990, but urges increased enforcement of existing rules, and extension of penalties imposed on tax return preparers to Form 990 preparers. In addition, the Report supports mandatory electronic filing of Form 990, as well as the suspension of the tax-exemption of any charity that fails to file a required return for two consecutive years, after appropriate notice from the IRS. The Panel recommends, as a best practice, that the board (or other appropriate committee) of every charitable organization review its organization's Form 990 or 990-PF.

The Report also recommends that organizations not required to file Form 990 because their annual gross receipts are below the minimum (currently $25,000), be required to file an annual notice with the IRS that is available to the public. The notice would require minimal information, such as the organization's name and address, mission statement, and total revenues and expenditures. In this case, the Report proposes that failure to file for *three* consecutive years result in suspension of tax-exempt status. The extra year may reflect concern that there is a greater likelihood that these organizations may inadvertently fail to file.

The Panel recommends that charities required to file Form 990 (or 990-PF) that have at least $1 million in annual revenues also be required to have audited financial statements, which should be filed with the Form 990 and made available for public inspection. In addition, the Panel recommends that organizations with annual revenue between $250,000 and $1 million be required to have financial statements reviewed by an independent public accountant. This recommendation would have little impact in New York State, where organizations with more than $250,000 in revenues or $25,000 in contributions already are required to have audited financial statements.

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The Report calls for revisions to Form 990, "to improve transparency of governance and management practices, ensure consistency in financial data, assist state and federal regulators in law enforcement, and improve the clarity, comparability, readability, and usability of information for donors and the public." These goals must be balanced against the cost, in time and money, to charity. In addition to revisions to the Form 990 discussed elsewhere, and those in connection with donor-advised funds, support organizations and property gifts, which were discussed in our July Professional Notes issue, the Panel recommends:

- Disclosure when operations cease and filing of a final Form 990.
- Generally requiring use of the same accounting method on Form 990s as used for organizations' audited financial statements.
- Requiring grantmaking foundations to provide information about every grantee, as well as the amount and purpose of the grant.
- Use of a separate schedule, which would not be open to public inspection, to report grants to individuals, including information about the relationship between the grantee and any disqualified person with respect to the organization, a substantial donor to a fund from which the grant was made, or a member of an advisory committee that recommended the grant.

The Panel has indicated that it intends to include in a supplemental report to Congress further proposals to improve the accuracy and usefulness of the Form 990 and to achieve uniform financial standards.

Tax Shelters. Participants in certain tax avoidance transactions are required to disclose their involvement on their tax returns. The Senate Finance staff discussion draft reported that charities were participating as "accommodation parties" to certain tax shelters. These transactions are categorized as either "reportable transactions" or "listed transactions." Reportable transactions[4] include listed transactions compiled by the IRS[5] and substantially similar transactions. The Joint Committee on Taxation staff report, issued in January, echoed the Senate Finance accusation that charities were facilitating tax shelters, and went so far as to recommend penalizing charities and their managers for transactions that *subsequently* are determined to be abusive.

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While there was little evidence of widespread participation by charities in these tax avoidance transactions, the Panel's Final Report nonetheless concurs that charitable participants should be subject to the same disclosure requirements as taxable participants. The Final Report notes, however, the difficulty for a charity of determining whether a given transaction is a "reportable transaction", and does not propose penalizing charities for transactions subsequently determined to be reportable transactions.

The Panel recommends the imposition of penalties on the charity equal to 100 percent of the net income received from the tax shelter transaction, and further recommends significant penalties for failure to report involvement in a reportable transaction if the managers knew *or should have known* it was a reportable transaction (as much as $50,000; $200,000 if the transaction is a listed transaction). The Report proposes revocation of tax-exempt status of any organization that knowingly fails to disclose participation in a transaction that its

[4] See Treas. Reg. Sec. 1.6011-4 and Code Section 6707A. "Reportable transactions" also include confidential transactions subject to certain nondisclosure requirements, transactions with contractual protections to protect the taxpayer from loss if anticipated tax benefits are not obtained, as well as certain other transactions.

[5] www.irs.gov/businesses/corporations/article/0,,id=120633,00.html

managers knew was a listed transaction. Managers responsible for a charity's participation in the reportable transaction also would be subject to significant penalties, which would increase if they knew it was a reportable transaction and the transaction was not reported, and would further increase if the manager knew the unreported transaction was a listed transaction. Under the Panel's proposals, taxable participants in a reportable transaction would be required to notify tax-exempt participants in writing in advance that they would be engaging in a reportable transaction, or become subject to severe penalties. In addition, the IRS would have the authority to abate penalties if participation was due to reasonable cause.

> The Panel strongly urges Congress to increase the IRS budget for oversight and enforcement of charitable organizations, including earmarking certain penalties, fees, and excise taxes for this purpose.

Government Oversight

The Panel strongly urges Congress to increase the IRS budget for oversight and enforcement of charitable organizations, including earmarking certain penalties, fees, and excise taxes for this purpose. In addition, the Panel recommends that Congress provide funding to the states so that they can establish or increase oversight and education of charitable organizations under their purview, possibly by matching state funding.

It is widely acknowledged that the inability of the IRS to share information with state enforcement officials often means states are unaware of problems with charities they regulate. The Panel agrees with Senate Finance staff recommendations to permit information sharing by the IRS with state attorneys general, noting that this would "assist charitable organizations by reducing the burden they often face in responding to duplicative federal and state inquiries for information." In lieu of giving the states authority to enforce federal tax laws with approval of the IRS, as suggested by the Senate Finance staff discussion draft, the Panel encourages all states to incorporate federal tax standards into state law.

Conclusion

As the Panel on the Nonprofit Sector notes in its Report, "the charitable community remains a creative, vibrant, and unique feature of American life, with tens of thousands of organizations, large and small, working together to advance the public good rather than increase private gain. Any effort to address issues must take into account the sector's diversity and complexity and avoid the unintended consequence of stifling its ability to serve and innovate. Further, any policy changes must be aimed at strengthening the great American traditions of giving to, volunteering in, and serving as leaders, directors, and trustees of charitable organizations."

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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; investments 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.

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