

April 5 Senate Finance Committee Hearing on Charities and Charitable Giving: Proposals for Reform

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The Senate Finance Committee held a hearing on April 5, 2005, titled “Charities and Charitable Giving: Proposals for Reform.” According to Finance Committee Chairman Charles Grassley (R-IA), the hearing was intended to address noncompliance and tax schemes within the nonprofit sector and to assist in strengthening the charitable sector by considering proposals for legislative reforms that would take meaningful steps to improve governance of nonprofit organizations and curb tax evasion and abuse.

In his opening statement, Sen. Grassley commented that he was particularly concerned about overvaluation of gifts of closely held stock and real and tangible property. He also noted that IRS Commissioner Mark Everson had written to the Finance Committee to observe that no serious review of the laws governing exempt organizations had occurred since 1969. Sen. Grassley stated that it is time for Congress to revisit this area. He explained that it is his hope that the Finance Committee can act on legislative reforms of nonprofit organizations that can be used to offset the costs of the CARE Act, which includes several widely supported proposals intended to increase charitable giving.

Several senators, including Sen. Jay Rockefeller (D-WV), who delivered an opening statement on behalf of Ranking Member Max Baucus (D-MT), expressed their support for Sen. Grassley’s general objectives, but noted that they were concerned that sweeping legislative reform of the nonprofit sector might be less effective than targeted reforms combined with meaningful IRS enforcement of existing laws. In particular, Sen. Rick Santorum (R-PA), commented that he had learned that most of the abuses reported at the June 22, 2004, Senate Finance Committee hearing on reform in the nonprofit sector were already illegal under current law, and that he has reservations about comprehensive legislative reform when it was not clear that current laws were adequately enforced. In addition to Senators Grassley, Rockefeller, and Santorum, several Finance Committee members attended the hearing and asked questions, including, Jim Bunning (R-KY), Orrin Hatch (R-UT), Jim Jeffords (D-VT), Blanche Lincoln (D-AR), Charles Schumer (D-NY), and Ron Wyden (D-OR).

The witnesses at the hearing were as follows:

- Mark Everson, Commissioner of the Internal Revenue Service;
- George K. Yin, Chief of Staff, Joint Committee on Taxation;
- Leon Panetta, Director, Panetta Institute for Public Policy;
- Mike Hatch, Attorney General, State of Minnesota;
- Jane Gravelle, Senior Specialist in Economic Policy, Congressional Research Service;
- Richard Johnson, Member, Waller Lansden Dortch and Davis, PLLC;
- David Kuo, Former Special Assistant to the President and Deputy Director, White House Office of Faith-Based & Community Initiatives;
- Brian Gallagher, President, United Way; and
- Diana Aviv, President and CEO, Independent Sector.

Witness statements can be found on the Senate Finance Committee website at:
www.senate.gov/~finance/sitepages/hearing030505.htm

Commissioner Everson testified that the IRS has observed increasing indications of the “twin cancers of manipulation and abuse” spreading from the for-profit sector to pockets of the nonprofit sector. He cited several factors for the rise of noncompliance including, a rapid increase in the size and complexity of the sector, lack of adequate IRS enforcement in recent years, lax attitudes towards governance, and the rise of abusive transactions. He stated that the IRS’ enforcement budget has not kept pace with the growth of the nonprofit sector, but explained that the IRS Strategic Plan for 2005-2009 recognizes the significance of tax enforcement in this area by making deterrence of abuse in the charitable sector one of the IRS’ top four priorities. He noted that the increased focus on enforcement is beginning to have results, citing as an example the fact that the number of credit counseling organizations currently being examined accounts for over 50% of the industry based on revenues. Commissioner Everson commented that the IRS does not always have sufficient flexibility to respond appropriately to compliance problems, noting that the IRS often can impose only “de minimis” penalties or revocation of exemption.

He commended the Panel on the Nonprofit Sector, convened by Independent Sector, for its interim report recommending actions to strengthen governance and oversight of charitable organizations. Finally, he highlighted the importance of promoting transparency in the nonprofit sector by removing limitations on the IRS’ ability to communicate with state officials and other regulatory agencies and by increasing the number of organizations that file information returns electronically.

George Yin testified regarding the exempt organization proposals in the recent Joint Committee on Taxation staff report, “Options to Improve Tax Compliance and Reform Tax Expenditures” (the “JCT Report”). The JCT Report presented a range of proposals to address many potential causes of noncompliance in the tax system. He commented that in the case of charitable contributions, the report focuses on the most significant area of potential noncompliance: the valuation of noncash charitable contributions. He explained that challenging taxpayer valuations is a very resource-intensive process for the IRS.

Mr. Yin reviewed the proposals in the JCT Report that would limit deductions for contributions of property other than publicly traded securities. The first proposal suggests that the charitable deduction be equal to the taxpayer’s basis in the property. As an alternative, taxpayers would be permitted to

claim a fair market value deduction for gifts of property related to the recipient's exempt function; gifts unrelated to the exempt function would be limited to a basis deduction.

Mr. Yin's comments on eliminating the fair market value deduction for contributions of appreciated property were among the most controversial issues at the hearing. Senators Jeffords, Wyden, Bunning, Hatch, and Schumer all expressed concern about the proposals, and several pressed Mr. Yin on whether there might be other effective solutions to the problem of overvaluation of contributions of appreciated property other than publicly traded securities. In each case, Mr. Yin explained that the proposals presented in the JCT Report were the most effective means of eliminating the problems associated with overvaluation.

Mr. Yin also testified regarding noncompliance by exempt organizations through deviation from an organization's mission that was the basis for the IRS' original determination of tax-exempt status. He discussed the proposal in the report to require charitable organizations other than churches to file information with the IRS every five years that would enable the IRS to determine whether the organization continued to be operated for exempt purposes. He also noted the need for a federal enforcement mechanism to ensure that charitable assets continue to be dedicated to charitable purposes upon the dissolution of a charity.

Leon Panetta testified in his capacity as a member of the Citizens Advisory Group to the Panel on the Nonprofit Sector. He testified regarding the essential role of nonprofit organizations and stated that the vast majority of the tax-related abuses in the sector are already illegal and can be solved by improving enforcement of existing laws and regulations. He also encouraged the Committee to consider all of the recommendations developed by the Panel on the Nonprofit Sector before taking any formal action. Finally, he suggested the formation of a national council on nonprofit accreditation, which would develop common standards on governance, transparency, and accountability, with which nonprofit organizations would have to comply in order to receive accreditation.

Minnesota Attorney General Mike Hatch's comments focused on excessive compensation and inappropriate benefits provided to executives in the nonprofit sector. In particular, he noted problems with nonprofit hospitals in Minnesota. He stated that self-regulation of nonprofits alone would be insufficient to curb abuses in the sector. He testified that his office frequently encounters boards of nonprofit organizations that are insufficiently independent from the organizations' officers and staff and that are unwilling or unable to provide meaningful oversight of the organizations' finances and activities. He stated that he supports proposals in last year's Senate Finance Committee Staff Discussion Draft intended to improve governance.

Mr. Hatch also testified that he supported the proposal in the JCT Report to repeal the "rebuttable presumption of reasonableness" in the Section 4958 intermediate sanctions provisions, because the presumption procedures are too easy to manipulate and make it too difficult for the IRS and state charity officials to challenge the reasonableness of salaries. He commented that he believes compensation consultants hired to provide comparability studies for purposes of compensation determinations by boards are not sufficiently independent from the executives of the nonprofits and that their conclusions are influenced by their desire to please the executives so as to be hired again in the future. Finally, he testified that self-regulation will not be sufficient to solve the problems in the nonprofit sector and that Congress must promote strong government regulation.

Jane Gravelle of the Congressional Research Service testified on two types of entities that she characterized as permitting individuals to deduct contributions without the gift actually going to charity: donor advised funds (“DAFs”) and supporting organizations. She explained that DAFs and supporting organizations allow the tax-free accumulation of assets intended for charitable purposes, similar to private foundations, but are not subject to private foundation rules, such as minimum payout requirements and restrictions on self-dealing. Accordingly, she stated that DAFs and supporting organizations are uniquely tax favored. She noted that assets held in DAFs and supporting organizations have grown rapidly and that “concerns that funds may not be paid out for charitable purposes appear justified.” She commented that while it is possible that DAFs and supporting organizations may encourage increased giving, the benefits may be outweighed by the tendency of donors to leave the donated assets in the DAF or supporting organization so that distributions to charities are delayed.

Dr. Gravelle also commented on the use of DAFs and supporting organizations for personal benefit because of the absence of self-dealing restrictions. She mentioned several reported instances of abuses by donors of DAFs and supporting organizations. She concluded by suggesting several possible policy options, including eliminating the tax benefits of DAFs by taxing the earnings in the fund and delaying a deduction until distributions are made. Alternatively, she suggested imposing the private foundation rules on DAFs.

Richard Johnson, a lawyer in Nashville, Tennessee, testified regarding abuses by a trustee of a private foundation that were reported in February in the New York Times. Mr. Johnson commented that the abuses occurring in the Maddox Foundation highlighted the need for legislative reform requiring strong oversight of exempt organizations. Mr. Johnson reviewed several of the proposals in the Finance Committee Staff Discussion Draft that might have mitigated or prevented the abuses seen in the Maddox Foundation.

David Kuo pressed for passage of the CARE Act and cautioned the Committee that, while there might be some legitimate areas in which to legislate reforms for the nonprofit sector, “without dramatic enforcement enhancements” little will be solved.

Brian Gallagher of the United Way of America testified regarding his efforts to address problems and improve operations at local United Way entities through an extensive overhaul of membership standards. He stated his support of several of the proposals in the Finance Committee Staff Discussion Draft, including requiring that the CEO and CFO of a nonprofit should sign the Form 990, IRS review of a nonprofit’s exempt status every five years, and increasing funding for IRS enforcement. He noted, however, that he did not agree with the Discussion Draft’s proposals to limit the size of nonprofit boards and to create mandated accreditation for nonprofits.

Diana Aviv of Independent Sector concluded the witness testimony by reviewing several of the recommendations made by the Panel on the Nonprofit Sector in its interim report issued in March. She explained that the Panel will offer many more recommendations in its final report, which is to be issued in June, and requested that the Committee delay introducing a bill until it had an opportunity to review the final report.

Sen. Grassley ended the hearing by commenting that the testimony made it clear that there is need for reform, but that reform should be accomplished without unduly burdening the “vitality” of nonprofits, particularly small charities and churches. He noted that given the limited time frame, he encouraged the Panel on the Nonprofit Sector to focus on the areas of self-dealing, governance, and pay and benefits.

He stated that he hopes that the Committee's "experiment" of reaching out to Independent Sector to form the Panel will prove to be successful.

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The Finance Committee began its scrutiny of the nonprofit sector last summer, and intends to continue the examination for the foreseeable future. The Committee has been asked by Independent Sector to wait until the Panel on the Nonprofit Sector releases its final report in June before introducing any legislation. Please contact Celia Roady (202-739-5279/croady@morganlewis.com) or Carolyn Ward (202-739-5988/cward@morganlewis.com) if you have any questions or comments.

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