

Statement of the
National Association of State Charity Officials
to the
United States Senate, Committee on Finance
*“Charity Oversight and Reform: Keeping Bad Things
from Happening to Good Charities”*

June 22, 2004

Mr. Chairman and Members of the Committee:

Good morning. My name is Mark Pacella and I am here today as the President of the National Association of State Charity Officials, or “NASCO” as it is more commonly known. NASCO is affiliated with the National Association of Attorneys General and serves as a forum for state charity officials to exchange views and experiences relating to the regulation of public charities as well as to foster interstate cooperation regarding charitable enforcement efforts.

On behalf of NASCO and its members, I thank the Committee for the opportunity to participate in today’s important proceedings as well as our NASCO members from New York for their hard work with the Committee.

Mr. Chairman, I respectfully request permission to submit this statement for the record.

State charity officials serve as the primary regulators over public charities and are the parties most likely to pursue breaches of the fiduciary duties of loyalty, care and good faith that our state and common laws impose upon the directors, officers and trustees of charitable assets. These actions include, but are not limited to, administering state registration and reporting requirements; correcting inaccurate and misleading financial reports; redressing fraudulent and deceptive charitable solicitations; recovering diverted charitable assets; imposing fines and penalties for violations of state law; and, most notably of late with respect to health care entities, overseeing corporate mergers, conversions, and asset sales.

Despite their broad authority over charitable assets and fiduciaries, many states lack the resources to effectively regulate the charitable organizations operating within their jurisdictions. Of our fifty states, less than half are able to be regular and active participants in NASCO's annual conferences and most do not have personnel dedicated to the exclusive regulation of charities.

Given the relative scarcity of enforcement resources, it is important that we make the most efficient use of the resources that we have. Toward that end, NASCO encourages reforms in three general areas: 1.) reporting and accountability; 2.) information sharing and cooperation among state and federal regulators; and 3.) exploiting technology in the areas of electronic filing and the internet.

1. Reporting and Accountability.

With regard to reporting and accountability, NASCO encourages the Committee to support reforms that strengthen the accuracy and timeliness of the IRS Form 990 that charities are obliged to file. The IRS Form 990 serves as the initial source of information for both the general public and regulators about a charity's finances. Unfortunately, the 990's submitted by organizations so often contain inaccuracies and in-completions that it is difficult to differentiate "bad actors" from the simply inept. Moreover, these returns are often filed one or more years after the fiscal period to which they relate, which frustrates the ability of state and federal regulators to identify problems on a timely basis.

Through an attachment to this statement, NASCO is offering a number of recommendations for specific changes concerning 990 reporting. These recommendations, too numerous to discuss here, propose substantive changes to the instructions for completing the form as well as to the form itself. They are intended to tighten the parameters within which charities report their financial activities to promote greater accuracy and consistency in 990 returns.

One material recommendation is to mandate that the information reported in an organization's IRS Form 990 be consistent with its financial statements. For larger organizations required to provide audited financial statements, the requirement will have the effect of subjecting the information reported in their 990's to the review of an outside, independent auditor, promoting greater accuracy and consistency. Conversely, for most smaller locally based organizations not required to have audited financial statements, the requirement will serve to enhance the accuracy and consistency of their financial statements.

These recommendations do not require changes to Generally Accepted Accounting Principles, nor are they intended to extend those principles blindly into Form 990 reporting requirements. NASCO's fervent belief is that the Form 990, with

appropriate reforms, can be the most effective vehicle driving improvements in the accuracy, consistency and usefulness of the financial reports submitted by charitable organizations. We believe such reforms are achievable within existing accounting principals and are optimistic that the accounting profession will welcome the opportunity to improve the accountability of our charitable community.

2. Information Sharing and Cooperation among State and Federal Regulators.

Concerning the sharing of information and cooperation among state and federal regulators, NASCO strongly supports the reforms contained in the Senate version of H.R. 1528. It is important that state charity officials and the IRS be able to share information pertinent to the regulation of charities. At the present time, the rules of confidentiality imposed on the IRS effectively preclude the service from any meaningful cooperative enforcement actions with state regulators. States are free to make referrals to the IRS, but the IRS is precluded from sharing any information as to what action, if any, it may take as a result of such referrals. Ironically, states pursuing an active investigation are far more likely to discover the extent of IRS activity through the target of the investigation rather than the agency

itself. The existing dynamic is regrettable since state charity officials and the IRS share many of the same enforcement interests.

As an example, pursuant to Section 6104(c) of the Internal Revenue Code, state charity officials receive final determination notices from the IRS when it has denied or revoked an organization's tax-exemption under Section 501(c)(3) of the code. State regulators can compare those notices to existing case files to see if they match any ongoing investigations as well as to see if organizations should have notified us concerning the disposition of the organization's assets upon termination. While an important example of how state regulators and the IRS can work together, these notifications barely scratch the surface of the benefits that broader information sharing and cooperative enforcement actions could yield.

3. Exploiting Technology in the Areas of Electronic Filing and the Internet.

With respect to technology and utilizing the potential of the internet to leverage regulatory resources, NASCO strongly supports the IRS's development of electronic filing of its Forms 990 as well as a state retrieval system which could serve as a single point filing system that would be available to all state regulators.

Charitable organizations are required to comply with a variety of registration and reporting requirements at both the state and federal levels. They have historically satisfied those reporting requirements by completing paper forms and submitting them separately to appropriate state and federal officials. Due to the ever increasing number of charitable organizations reporting information, however, regulators are finding it more and more difficult to effectively process the paperwork they receive. As a result, it is not uncommon for material omissions and inaccuracies in state registration materials and Forms 990 to go undiscovered unless circumstances draw attention to an organization's filings.

Since the software underlying electronic filing will, among other things, require the completion of requisite data fields and check for mathematical errors, electronic filing promises to materially improve the quality of nonprofit accountability. Charitable organizations will benefit from the efficiencies and cost savings inherent in electronic filing and the donating public and regulators will benefit from the increased accuracy, timeliness and access to information.

In order to further promote the effective use of the data that electronic filing will make available, NASCO has been working with Guidestar, a private, nonprofit

organization, to develop NASCO's web site into a national on-line charity information system. "NASCONet" as the project is known, has been funded through a \$1.3M Commerce Department Technology Opportunities Program grant awarded to Guidestar in the fall of last year.

If the project is successful, state regulators will be able to efficiently post and share documents and information about their enforcement activities, enabling them to concentrate more time on substantive enforcement initiatives such as conducting data base searches to assess the reasonableness of executive compensation or identifying related parties among organizations. The site will also provide a convenient information source for the general public about what, if any, legal or administrative enforcement actions have been taken against an organization and how those actions have been resolved.

A resource such as NASCONet, when used in conjunction with the IRS's electronic filing and state retrieval system, would extend the availability of "state-of-the-art" information technology and enforcement tools to all state regulators, including those lacking the financial wherewithal or technical expertise to develop such

capabilities on their own. NASCO and Guidestar hope to have certain aspects of the site functional by the end of this year.

Finding a way to sustain the financial viability of the project after the grant funding expires in the fall of next year is a critical matter yet to be resolved. As such, NASCO strongly supports restoring the use of funds generated through the 2% excise tax on the net investment income of private foundations on charitable oversight, and hopes that some of that funding can be dedicated to state regulators as proposed in the Committee's white paper. As set forth in our March 11, 2004 letter to Chairman Grassley, NASCO believes this additional funding would enable state charity regulators to become more effective in identifying, investigating and correcting the financial and other abuses becoming more prevalent in our nonprofit sector.

NASCO is a ready volunteer to assist the Committee with its important work in all of the areas being discussed today and greatly appreciates the opportunity to share some of our thoughts during today's hearing.

Thank you.

ATTACHMENT

A. REQUIRE 990 FORMS TO CONFORM TO FINANCIAL STATEMENTS. As an “informational return,” the 990 should be conformed to an organization’s financial statements to promote consistency and enhance the usefulness of the form to the general public and regulators alike.

1. Instructions for Form 990, Section G – Accounting Methods:

Instructions for this Section should be changed *to require* that the information reported in 990’s conform to an organization’s financial statements (additions are underlined):

Accounting Methods

Unless instructed otherwise, the organization ~~should generally~~ must use the same accounting method on the return to figure revenue and expenses as it regularly uses to keep its books and records. To be acceptable for Form 990 or Form 990-EZ, reporting purposes, however, the method of accounting used must clearly reflect income. The Form 990 and Form 990-EZ revenue, expenses and balance sheet should be prepared in accordance with the financial statements prepared by the organization. The revenue, expenses and balance sheet items on a Form 990 for an organization having audited financial statements will be the same as the audited financial statements; for an organization having reviewed financial statements the revenue, expense and balance sheet items on Form 990 will be the same as the reviewed financial statements; and for organizations with compiled or other internal financial statements, the revenue, expense and balance sheet items on the Form 990 will be the same as these financial statements.

2. Form 990, Part IV-A/IV-B – Reconciliation with Audited Financial Statements:

Based on our general recommendation that the Form 990 be prepared using the same accounting method an organization uses to keep its books and records (*See Recommendation # 1*), this Section of the Form 990 should be changed to reconcile the organization’s financial statements figures (*i.e.*, the figures reported on Form 990) with a “Tax Basis” calculation.

If our **Recommendation # 1** is not adopted, this reconciliation should be changed to include the reconciliation of reviewed financial statements.

3. Form 990, Part II – Joint Costs at variance with Financial Statements:

At present, a substantial difference in joint cost allocation reporting between an organization’s financial statements and Form 990 is permissible.

Absent adopting **Recommendation # 1**, how can the Form 990 instructions be improved to head off this tactic in the future?

Example: On a 2002 Form 990, Charity A allocated 65% of joint costs to program services although, due to the provisions of SOP 98-2, all joint costs were allocated to fund raising in its audited financial statements.

The organization eventually amended its return when threatened with denial of a state solicitation license, but its accountant found sufficient flexibility in the IRS instructions to feel that they were justified in preparing the Form 990 in this manner despite the substantial variation from the audit.

B. TIGHTEN REQUIREMENTS FOR IDENTIFYING RELATED PARTIES. Organizations are materially influenced by the personal relationships that may exist among other organizations. This is particularly true when smaller boards are involved that share a common director and/or when individual members of distinct boards are related by blood or marriage.

4. Form 990, Part VI, Lines 80a/b – Related Parties:

Change the criteria for identifying related parties to those organizations having one or more of the same individuals serving as officers or directors and delete the current requirement of *more* than 50% “commonality”. Percentage assessments do not always reflect the **actual** control of the organization. A suggestion would be to use the GAAP standards for related party disclosures, which generally define a related party as an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be

prevented from pursuing its own interests. A related party may be any party the entity deals with that can exercise that control. Examples of related parties include (a) affiliates, (b) investments accounted for under the equity method, (c) trusts for the benefit of employees (for example, pension or profit-sharing trusts), and (d) principal owners and members of management and their immediate families.

5. Form 990 Part V, Question 75:

Change requirements to include payment arrangements to an officer/director/trustee/key employee by a related organization(s) *even if* the reporting organization did not pay any compensation directly to this individual, as long as the entities are related using the criteria detailed in ***Recommendation # 4.***

6. Schedule A, Form 990, Part II:

Schedule A, Part II should include the reporting of payments over \$50,000 paid to related entities (including other non-profits) including, but not limited to, payments for administrative services (including shared services).

7. Schedule A, Form 990, Part III:

Schedule A, Part III should be changed to require the reporting of related party transactions that involve tax-exempt entities (*i.e.*, a charity could lease space to its (c)(3) affiliate at a "special" rate, Charity A pays or reimburses Charity B for administrative costs and Mr. Jones is the President of both Charity A and Charity B).

8. Form 990, Part VI, Lines 80a/b – Related Parties:

If changes cannot be made as discussed in ***Recommendation # 4***, the existing instructions need to be clearer, with real world examples given, including those types of relationships that are set-up to avoid disclosure.

C. STRENGTHEN THE INFORMATION PROVIDED REGARDING THE IDENTITY AND COMPENSATION OF EXECUTIVE MANAGEMENT.

9. Form 990 Part V:

- a. Require the city and state that the officers/directors/trustees/key employees reside in, so that information can be found easier on these individuals for the service of law suits, civil investigative demands and other kind of legal papers;
- b. For compensation of officers, directors, trustees and key employees, require that the organization indicate whether it has complied with the “safe harbor” provisions of the Internal Revenue Code.
- c. Require the disclosure of the existence of any contracted labor agreements/arrangements for all individuals, or at least the officers, directors, trustees and key employees and require detail of these agreements/arrangements; and
- d. Add a column that requires the disclosure of the dollar amount of all loans to/from each of the officers/directors/trustees/key employees listed.

D. MISCELLANEOUS REVISIONS TO THE INSTRUCTIONS TO FORM 990.

10. Instructions - General Issues:

- a. Instructions should make clear all potential penalties that could be assessed against the reporting organization related to the Form 990 (i.e. filing a false tax return);
- b. Instructions should clearly indicate the procedure for reporting all aspects of a thrift-store’s transactions – to assure uniform reporting.

- c. Instructions should include a simple-to-follow “check-list” of items that must be completed or the Form 990 would be returned with a processing/penalty charge. These items should include:
 - i. Form 990, Page 6, Signature of Officer;
 - ii. Form 990, Page 1, Line 9, special events with detail must be attached if more than zero;
 - iii. Form 990, Page 2, Line 22, Grants & Alloc., detail must be attached if more than zero;
 - iv. Form 990, Page 4, Part V – if organization answers any question by referring to an attached list or statement and it is not attached.

11. Form 990, Line 1a – Direct Public Support:

If our general *Recommendation # 1* is not adopted, the instructions for this Line should be rewritten to include the IRS’s position on the reporting of:

- a. Agency Transactions -- the general accounting rule is that an agency transaction occurs when resources received via transactions in which a non-profit organization is acting merely as an agent, trustee or intermediary for another organization. These resources (i.e., cash, non-cash goods) are generally not considered as revenue or expenses to the non-profit, but an increase to its assets and liabilities.
- b. Non-Agency Transactions -- With regard to resources received from another nonprofit, the general accounting position is that the decision to report the transfers (i.e., the receipts and the subsequent distributions of resources) as an increase to the non-profit’s assets and liabilities (an agency transaction) or an increase to its contribution revenue and expenses depends on the extent of the discretion the reporting organization had over the use or subsequent disposition of the assets.
- c. Sales Transactions -- Sales revenue used to support the charitable mission of the organization should be reported as revenue on Line 2 or Line 10. Sales revenue not used to support an organization’s

charitable mission should be reported as unrelated business income on Line 78a.

12. Form 990, Line 1c - Government contributions (grants):

It is unclear whether Line 1c includes grants from foreign governments or just U.S governmental grants. The instructions should clearly state whether or not foreign government grants should be included on Line 1c. If foreign grants do not get reported on Line 1c, the instructions should indicate where they should be reported.

13. Form 990 Part V:

Instructions should be modified to reduce the underreporting of deferred compensation arrangements. Examples in the instructions should include:

- a. A nonqualified deferred stock plan and how to value it;
- b. When large bonuses are spread out over a number of years – how should they be prorated, how should they be valued (i.e. present value);
- c. An arrangement where there is a significant potential for forfeiture (no legal right to money);
- d. Examples of different methods for valuation or suggest a method and require disclosure if it varies from the IRS suggestion;
- e. Require disclosure if changes in valuation occur from a prior year.

14. Schedule A, Form 990, Part III, Line 2d:

Instructions should indicate the exclusion of amounts already reported in Form 990, Part V.

15. Form 990 – General Issues:

- a. Disclose aggressive tax positions taken (similar to the disclosures required by Form 8275);

- b. Require more types of organizations filing Form 990 to submit Schedule A (*i.e.*, 501 (c)(4)'s);
- c. Require all organizations filing Form 990 to fill out all sections of Part II and Page 1, Lines 13-15; and
- d. Require all organizations to report their gross professional fundraising fees on Line 30.

E. GENERAL RECOMMENDATIONS REGARDING FORM 990.

16. Amended returns and Guidestar. At times, a state may require an organization to amend its Forms 990 to be compliant with IRS instructions. Sometimes the amended return may be required to correct potentially misleading accounting information or it may involve providing meaningful disclosure of information that had not been made. However, in most, if not all, cases, these amended returns do not appear on the Guidestar website thus leaving open the possibility that the public viewers of the returns at the website may either be misled or not have pertinent information. We recommend that a procedure be instituted with Guidestar to expeditiously post amended returns on Guidestar's website.

17. Form 990, Line 1c - Government contributions (grants):

Change Form 990 to require a list of government grants received. This would insure that the contributions are from actual governmental agencies and not just "grant money" from private foundations or other entities, like the Combined Federal Campaign, erroneously reported as government grants.

18. Form 990, Line 9a/b – Special Events Reporting:

Form 990 should have separate lines for reporting gambling income and expenses.

19. Form 990, Part II, Line 25a (Proposed New Line):

Require disclosure of any cash benefits (or the value of any non-cash benefits) paid to individuals that were for the "convenience" of the employer (excluding de minimis fringes). This could reveal anything that could potentially be taxable income to the individual (*i.e.*, employer-

provided housing or meals) and reportable elsewhere on Form 990 (i.e. as compensation on Part V).

20. Form 990, Part VI, Question 90a – States with which a copy of return is filed:

- a. In addition to, or instead of this question, require a list of states and governmental agencies that have conducted investigations, audits or reviews of the filing organization and require the organization to attach a description of the results and any action taken;
- b. In addition to, or instead of this question, ask for a list of states and federal governmental agencies with which amended Forms 990 were filed during the last 3 years;

21. Form 990, Part II - Proposed New Line:

Require the disclosure of any fraud, misappropriation, and /or embezzlement found by an organization (or its agent), perpetrated by any of the organization's officers, directors, trustees, employees, or independent contractors;

22. Form 990, Page 6, Signature:

Incorporate some of the accountability requirements of Sarbanes-Oxley to send a warning signal that certain individuals within the reporting organization have fiduciary responsibilities.

For example:

- a. Require the Form 990 to be signed by the chairperson of the board and the highest officer;
- b. Include an affidavit section indicating that the chairperson and officer have personally reviewed the tax form and supporting financial information and personally verify its accuracy; and
- c. Include a provision that makes them personally responsible for the content, and makes them personally responsible for due diligence in verifying the content.

23. Do not accept Forms 990 using the phrase “Available Upon Request” or similar phrases.
24. Have an identification number assigned to each state by the IRS so when the state representative calls the toll free tax exempt #1-877-829-5500, the IRS Agent would be allowed to give some public information, but it wouldn’t require 6-8 weeks of waiting for a copy of the 990, Form 1023, determination letter, etc.
25. Make it mandatory for an organization to respond in writing (e.g. a small postcard already formatted by the IRS) stating that the organization is under \$25,000 in gross receipts for a particular year and therefore is not required to file a 990 or 990-EZ.