ON THE PATH TO PHILANTHROPIC REFORM:

CONCRETE STEPS TOWARD PUBLIC AND PRIVATE ACCOUNTABILITY AND OVERSIGHT

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About NCRP

The National Committee for Responsive Philanthropy is an independent nonprofit organization founded in 1976 by nonprofit leaders across the nation who recognized that traditional philanthropy was falling short of addressing critical public needs. NCRP's founders encouraged foundations to provide resources and opportunities to help equalize the uneven playing field that decades of economic inequality and pervasive discrimination had created. Today NCRP conducts research on and advocates for philanthropic policies and practices that are responsive to public needs.

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On the Path to Philanthropic Reform: Concrete Steps toward Public and Private Accountability and Oversight

by Rick Cohen

The significance of the Senate Finance Committee hearings on charitable abuses, held on June 22nd, and today's opportunity to address specific proposals from the Committee staff's white paper is that both constitute significant steps toward long-needed action. It is time to be serious about doing what many people have long known should have been done to buttress the accountability of the nonprofit and philanthropic sectors. We are aware of the push-back from some charities, suggesting that the white paper leads Congress in the direction of overregulation, citing the specter of a return to "1969 all over again". In philanthropy, the 1969 Tax Act generated a minimum required payout and began the movement of philanthropy toward increased disclosure and reduced self-indulgence. The Committee's partnership with the nonprofit sector will hopefully find the right mix of self-regulation, government regulation, and enforcement to meet the needs of the public's interest in charities and philanthropy.

The Committee is concerned about tax-exempt resources. Every American citizen and taxpayer is a shareholder in tax-exempt institutions and deserves to see nonprofit institutions protect the interests of the sector's societal shareholders. The solution to improved nonprofit sector accountability and probity requires an appropriate mix of reinvigorated sectoral self-regulation, updated and strengthened statutory and regulatory standards, and increased resources devoted to oversight and accountability by the Internal Revenue Service, state attorneys general, and the sector itself. We do not consider the Committee's explorations to be, as has been charged, an unjustifiable intrusion into the internal affairs of private organizations, not when these organizations are the stewards of tax-exempt resources.

For too long, the response of some of the sector's leadership organizations has been to temporarize, to acknowledge and even bemoan the problems, but to avoid committing to specific recommendations and solutions in the hope that the attention of lawmakers and the press would wane. Fortunately, this Committee's diligence, abetted by some solid investigative research by reporters at major newspapers around the nation, has kept the public's attention fixed on the problems and how to solve them.

For more than 30 years, the National Committee for Responsive Philanthropy (NCRP) has been part of the small but growing camp of national organizations calling for action instead of procrastination. With a membership consisting of activist nonprofits and foundations, with a constituency of grassroots organizations around the nation that are dismayed by the behavior of a small number of malefactors in the sector, NCRP has constantly advocated for policies that advance the accountability of philanthropic institutions. We have led in the advocacy for accountability and transparency, promoting foundation reporting, advocating for the creation of the 990PF and then advocating that the 990PFs be publicly available, contrary to the sentiment of some foundation leaders. We have conducted research on the payout behavior of private foundations, on foundations' grantmaking for nonprofits' core operating support needs, on the experience of a small number of foundations in "spending down", on corporate grantmaking for racial and ethnic groups, and on ideas for foundations interested in engaging in mission-related investments. With limited resources, NCRP constantly generates research on philanthropy that we hope contributes to an elevation of the substance and quality of the public dialogue on improving philanthropy in the U.S.

The focus of NCRP's comments is narrowly aimed at the recommendations specific to philanthropic institutions contained in the Senate Finance Committee's discussion paper. We commend the Committee staff for a credible effort aimed at addressing some of the issues affecting grantmaking philanthropic institutions. Overall, on philanthropy, the white paper touches on a number of critical points in generally logical ways. It would be disappointing to see institutional philanthropy's leadership institutions return to past temporizing behavior, picking at recommendations based on "exceptionalism", finding the examples that don't work rather than trying to find ways of refining the recommendations to make them work for the sector and for the American public.

For the purpose of this paper, these comments track the white paper's recommendations, with reference to research conducted by NCRP on some of these issues and data available from third party sources:

Donor advised funds: NCRP testified to its concern that donor-advised funds should meet some minimal standards for accountability, transparency, and distributions. NCRP's research has uncovered a variety of practices, even among community foundations which to us appear to be the leaders for the most part in providing some minimal level of accountability for this field. A survey of less than 200 community foundations revealed for Fiscal Year 2000 more than $5.17 billion in DAF assets and a payout (in value of grant dollars) of more than $695[1]

1. According to Luck and Feurt's survey, 189 community foundations held 17,213 donor-advised funds with total assets of $5,177,259,701 as of fiscal year 2000. Cf. James L. Luck and Suzanne L. Feurt, "A Flexible and Growing Service to Donors: Donor-Advised Funds in Community Foundations" (September 2002).

million. However, that represents less than one-third of the more than 650 community foundations in existence. Add to that the DAFs held by commercial gift funds and others, the total of DAF assets has been estimated to be around $12 billion, but we are frankly not convinced by the reliability of the estimates.

Unfortunately, DAFs are marketed to donors based on their minimal reporting requirements, low level of IRS oversight, higher tax deductibility (than foundations) for donations of cash, stock, and real estate, and exemption from annual required distribution standards. Even among many community foundations and other managers of DAFs, there are inconsistent standards regarding what they require of the funds they manage concerning due diligence, reporting, and annual distributions. Some reported cumulative DAF distributions by fund managers disguise and cloak the minimal charitable activity of some funds behind the high payouts of a few. In some cases, community foundations require their DAFs to maintain a specified minimum payout level; others are quite satisfied with little or no activity, so that the managing agency can benefit from administrative fees and investment returns with little or no charitable output to the public.[2]

NCRP has called for an end to the creation of a tax-preferred structure of philanthropy immune from public disclosure and immune from basic requirements of minimum charitable distributions. For the donor, as the promoters are wont to say, "a DAF is better than a private foundation in almost every respect."[3] For the public, that is demonstrably untrue. While the recommendations in the white paper merit additional refinement, and some (such as the grantmaking to nondomestic organizations) are probably not specific to DAFs and should be left to other parts of a bolstered philanthropic regulatory scheme, the intent to bring DAFs into the sunlight of transparency and accountability—and into the mainstream of making grants to benefit the nonprofit sector rather than simply accumulating assets—is laudable.

Supporting organizations: If the sector knows relatively little about donor-advised funds, it is in a similar situation with supporting organizations. IRS Statistics of Income (SOI) data suggest that the number of returns identified as 509(a)(3) supporting organizations rose from 19,132 in tax year 1997 to 20,453 in tax year 2001, but the assets and expenditures of supporting organizations are difficult to distinguish, much less whether they are Type I, Type II, or Type III supporting organization.[4] NCRP has seen no reliable information on 509(a)(3), much less Type III, assets and distributions nor any classification of the designated public charities (DPCs) these supporting organizations are meant to assist. Like donor-advised funds, they are marketed by many of the same entities that

2. Fees charged by community foundations are generally from 0.65 to 1.75% and by commercial sponsors from 0.65 to 2.75%, the sliding scale rising with the size of the DAF assets. Cf. Elfrena Foord, "Philanthropy 101: Donor-Advised Funds", *FPA Journal* (November 2003).

3. Eric Lee Smith, "An Introduction to Donor-Advised Funds" (2001)

4. Type I is referred to as "operated, supervised, and controlled by"…the supported organization, Type II is "supervised or controlled in connection with"…the supported organization, and Type III is "operated in connection with"…the supported organization. Cf. Janet E. Gitterman, "Supporting Organization Reference Guide: IRC 509(a)(3) Foundation Status Classification"

pitch for DAFs precisely because of their relative immunity from the reporting and distribution requirements of private foundations.[5]

Defenders of Type III supporting organizations suggest that the minimal prosecution of supporting organizations by the IRS is testament to the minimal abuse of the designation. It is NCRP's belief that so little is known about supporting organizations, especially with their frequent use in conjunction with hospitals, that it would be incumbent for the Committee to call for an immediate and in-depth accounting of the three types of 509(a)(3) supporting organizations, their designated public charities, their grants distributions, and their non-grant programmatic expenditures. At a minimum, full disclosure of the activities of these foundation-like entities is warranted, with distribution requirements comparable to private foundations to ensure that Type III supporting organizations do not become simply another type of tax exempt abuse.

Compensation of foundation trustees: The Committee's white paper tracks the position NCRP has long advocated, that foundations trustees should not be paid compensation for their voluntary service to philanthropy, but if Congress deems that some measure of payment should be permitted, then it should be a de minimus level of compensation. In the Georgetown University study on trustee fees, 64 percent of the larger foundations and 79 percent of the smaller foundations in the study sample of 238 foundations paid their trustees (beyond compensation for travel and accommodations), in 1998 totaling $31 million in trustee fees for this very small number of foundations.[6]

There are arguments for limiting trustee compensation to a low figure, $8,000 annually recommended by the Georgetown University study authors, or rejecting the concept of trustee payment entirely.[7] However, there is no reason to countenance the language of the amended Charitable Giving Act of 2003 which passed the U.S. House of Representatives last year, which would have given foundations the green light to trustee fees of up to $100,000 per person per year to count toward private foundations' qualifying distributions.[8] That would be a cue for foundations concerned about the appropriate level of trustee fees, telling foundations that $100,000 fees would be seen as appropriate, hardly extraordinary.

Unfortunately, the fees paid to the trustees of nonoperating private foundations are only part of the story of funneling philanthropic assets to the individuals serving as members of the foundations' governing bodies. The white paper's discussion of self-dealing, basically in public charities, misses the point that private foundation trustees are frequently awarding themselves contracts for profession-

5. A supporting organization either has to make some sort of annual distribution, based on the income earned from the supporting organization's investments, or perform a tax-exempt function that would otherwise have been performed by the supported public charity.

6. Christine Ahn, Pablo Eisenberg, and Channapha Khamsvongsa, *Foundation Trustee Fees: Use and Abuse* (Georgetown Public Policy Institute, Center for Public and Nonprofit Leadership, September 2003).

7. Rick Cohen, "Time to Stop Excusing the Inexcusable: Foundation Trustees Who Play by Their Own Rules," *The Nonprofit Quarterly* (Winter 2003)

8. Rick Cohen, "From Reform to Retreat: House Committee Caves to Pressure on Foundation Spending Provision", *Responsive Philanthropy* (Fall 2003)

al services, particularly investment services performed for their foundations. The loophole that allows these foundations to escape the self-dealing provisions is that these services are delivered at a reasonable rate, at or below the terms offered by private competitors.

The most recent example is that of the Bielfeldt Foundation in Peoria IL, whose trustees—or businesses closely associated with them—have been providing investment services consuming significant portions of the foundation's annual spending. An IRS auditor might not know about these self-interested vendors, because foundations only list their top 5 vendors in their 990PFs, and the trustees' relationships with many could be hidden because of the vendors' business names (i.e., "doing business as…"). Just recently, the Bielfeldt trustees—named Bielfeldt by in large—reduced the size of their personal and business consumption of their foundation's assets,[9] not because of an IRS audit or an attorney general's investigation, because although odious, this kind of foundation self-dealing is apparently legal (or not odious enough to warrant government prosecution). The Bielfeldts reduced their take because of the continuing scrutiny of Peoria's local newspaper.

This kind of self-dealing is routinely tolerated by the leadership of the foundation sector and often by the public. In the sector, foundation leaders view their institutions' assets as private money, their money. It is the only possible explanation for turning a sectoral blind eye to the Bielfeldt behaviors as documented in the *Peoria Star-Journal* articles. It is the only possible explanation to IRS sidestepping the issues in the self-dealing and conflict of interest battle taking place over the Gilbert M. and Martha H. Hitchcock Foundation in Nebraska, where there is substantial evidence of transactions by the foundation benefiting certain foundation trustees and their business associates.[10]

Private foundations' administrative expenses: Unless there was a compelling, unitary definition of what might be construed as charitable expenses versus administrative expenses, one that was precise enough to permit effective and reliable IRS review, we could be attracted to classifications and limitations on foundations' administrative expenses. However, the experience of "the .65 rule" in the 1980s should constitute a cautionary tale. In the 1980s, foundations had to cap their grantmaking-related administrative expenditures at 0.65 percent of assets, but a 1990 Treasury Department study of foundations' compliance with the rule found that nearly everyone got it wrong, either attributing too much or too little to their qualifying distributions. Most knew that the rule didn't work, and eventually Treasury and the foundations scrapped it.[11]

9. Dori Meinhart, "Bielfeldt Foundation to Make Changes to Avoid Legal Action", *Peoria Journal-Star* (July 1, 2004)

10. Cf. Stephanie Strom, "Battle in an Omaha Charitable Group Relfects Issues Raised in Corporate Scandals", *New York Times* (January 9, 2004).

11. Cf. Rick Cohen, "From Reform to Retreat: House Committee Caves to Pressure on Foundation Spending Provision", *Responsive Philanthropy* (Fall 2003)

The proposed return to this kind of categorization between charitable and administrative costs in the amended Charitable Giving Act of 2003 was contrary to the 1990 Treasury Department, destined to fail as comprehensively as the 0.65 rule. The white paper's recommendations on this issue, while well intentioned to generate more grantmaking and less administrative self-indulgence, we believe will simply generate lots more paper-generation and record-keeping than necessary, probably across the board generating more administrative expenditures on the part of foundations rather than less. The alternative proposed in the original version of the Charitable Giving Act of 2003 still seems logical and simple: Exclude administrative costs from foundations' qualifying distributions, so that they are all held to a comparable base of charitable distributions in the form of grants and program related investments. If foundations then choose to devote more or less administrative or non-grant expenditures on top of that base of distributions, that is their decision based on their approach to grantmaking, the mission of the foundation, the topical focus of the foundation, etc. In 2001, the Joint Committee on Taxation called for simplifying, though not weakening, the rules on foundations. If the unintended result of the white paper is to unnecessarily complicate the regulatory scheme, the Committee will have undermined its otherwise laudable intent.

Private foundations grantmaking: Foundations have long argued that the 2 percent foundation excise tax was a disincentive for grantmaking. They contend that by reducing and consolidating the excise tax to 1 percent will induce grantmaking above the 5 percent annual minimum, though the foundation leadership sector has rebuffed opportunities to explore, test, and monitor the assumption. While NCRP has long advocated the reduction and consolidation of the excise tax—with a dedication of the remaining tax paid to the original functions of the tax, paying for the oversight costs of the sector—we harbor no illusion that the excise tax is dispositive in shaping foundation grantmaking behaviors. When foundations argue to keep the payout rate at 5 percent, they do not cite the disincentivizing effects of the excise tax for their predisposition toward asset accumulation over grants distributions.

While NCRP appreciates the interest of the Committee in promoting increased grantmaking, a trade of the private foundation excise tax for a foundation making a 12 percent payout is not the answer. The number of foundations that might be induced by the excise tax reduction is just about nil. The trade is a bargain that will not achieve the Committee's desired objectives. The key is to give foundations a higher standard of grantmaking to achieve. Currently, with the minimum set at 5 percent of assets, it is no surprise to any observer of public policy that the sector

has turned the 5 percent floor into a ceiling. NCRP has long written about the potential of foundations to increase their grantmaking, including the fact that their income is not limited to returns in the stock market, and challenging the mechanical formulas that the foundation sector uses to justify its lockstep adherence to 5 percent payout (or its advocacy of even lower payout requirements).[12]

In 2003, when the nation was still caught in a widespread economic recession, charitable giving by individuals increased, charitable giving by bequest increased, charitable giving by corporations increased, but charitable giving by endowed foundations declined compared to the previous year.[13] Recent information on market performance shows foundations doing well in the market, with a total annual return of 17 percent net of fees in fiscal year 2003 for all foundations, a return of 17.8 percent return for independent foundations (as distinct from community foundations and public foundations), and a return of 20.5 percent for foundations with assets over $1 billion.[14] The combination of societal needs and foundations' economic performance underscores the pragmatic attractiveness of NCRP's longstanding proposal to increase the foundation payout rate to 6 percent and to exclude administrative costs from that calculation.

Public corporation filing of charitable giving return: Corporations have a variety of motives for giving to charity—tax breaks and a genuine concern for the public good enter into the calculations of corporations trying to be good corporate citizens. Unfortunately, there are corporations that have misused their charitable giving in ways that look almost like bribes meant to encourage corporate directors to overlook financial improprieties, to encourage corporate directors to approve enormous CEO salaries, and to use charitable giving simply to enhance the public images of some corporations attempting to fend off scrutiny of their non-charitable activities.[15] Corporate giving through corporate foundations is disclosed through 990PFs like other private foundations, but the disclosure of corporate giving directly from the corporation—through the CEO's office, through the marketing department, etc.—is a voluntary decision of the corporation, not required by the Securities and Exchange Commission, which considers charitable giving too paltry an amount to be concerned with, and not required by other public bodies. In 2003, corporate foundation grantmaking actually decreased (by 2.0%) while overall corporate grantmaking increased by 4.2 percent,[16] meaning that the increase in corporate giving is occurring outside of the scrutiny of the public. Some time ago, NCRP estimated that as much as half of corporate grantmaking was not disclosed to the public, an estimate we think is still reasonable today. For years, nonprofit leadership institutions have opposed disclosure of corporate grantmaking, citing corporate record keeping burdens

12. *Helping Charities, Sustaining Foundations* (NCRP: June 2, 2003); *A Billion Here, a Billion There: The Empirical Data Add Up* (July 8, 2003).

13. Cf. *Giving USA 2004*

14. Commonfund Institute, *U.S. Foundations Bounce Back in Fiscal Year 2003: Average Annual Total Return Rises to 17 Percent* (June 23, 2004)

15. Porter and Kramer cite the example of Philip Morris which spent $75 million on charitable contributions in 1999—and an additional $100 million to publicize these donations, obviously at a time when the tobacco companies were facing Congressional and legal challenges (cf. Michael E. Porter and Mark R. Kramer, "The Competitive Advantage of Corporate Philanthropy," *Harvard Business Review* (2002)

16. *Giving USA 2004*

and the potential chill from public scrutiny. NCRP does not agree and believes that the white paper's recommendation of disclosure of corporate grantmaking above $10,000 in the aggregate is entirely reasonable.

Nonprofit conversions: NCRP was pleased to see attention to the issue of nonprofit conversions. While NCRP has not taken a specific position on the conversion issue, we have written about conversions in the past, raising serious questions about whose interests were being served in questionable conversions such as the Empire Blue Cross/Blue Shield situation.[17] Evidence is not convincing that the automatic creation of a charitable foundation from the assets of a nonprofit hospital or health insurance provider suffices to "serve the public interest and…the interests of the intended beneficiaries of the organization's assets." The white paper's call for greater public scrutiny and expanded IRS roles and interventions in conversions is timely and useful.

Resources for oversight and enforcement: We are pleased that the Committee's white paper outlines an increase in resources and a potential allocation. While a positive step in the right direction, we view the resource allocation as too low. NCRP's proposal, issued early in 2004, suggested the following:

1. Reduce the foundation tax to a simplified, consolidated 1 percent of private foundation investment income, require that the money that foundations "save" from the tax reduction go to nonprofit organizations in the form of grants, and dedicate the remaining excise tax payment (by our estimate, some $350 million) for oversight and accountability
2. Dedicate 20 percent of the remaining excise tax payment to the budget of the Tax Exempt/Government Entities division of the Internal Revenue Service, more than doubling its current budget of less than $60 million to approximately $130 million, to enable the division to more effectively oversee and audit private foundations, public grantmaking foundations, donor advised funds, as well as nonprofits.
3. Dedicate 40 percent of the remaining excise tax to create a fund of $140 million which the commissioner of the IRS can use to supplement the charity investigative and oversight arms of state attorneys-general offices.
4. Allocate 15 percent (or approximately $50 million) of the remaining excise tax to grants to nonprofit organizations whose research, ratings, and evaluation efforts complement and augment the oversight functions of federal and state agencies.
5. Use another 15 percent of the excise tax of the generation of IRS statistics on the finances of foundations and charities comparable with the research IRS

17. Cf. Jeff Krehely et al., "Health Care Conversion Foundations: Band-Aid Solutions?" *Responsive Philanthropy* (Summer 2003)

generates on other sectors of the economy.

6. Reserve the remainder of the excise tax revenues to support special initiatives of the Tax Exempt/Government Entities division of the IRS for additional research and data collection and dissemination.

The private foundation excise tax was originally meant to pay for the oversight of the nonprofit and philanthropy sector. Somehow the foundation excise tax became divorced from its intended purpose. The impact on the IRS is clear: the most recent *Internal Revenue Service Data Book* indicates that the IRS examined only 145 tax exempt returns that filed Forms 990PF, 5227, 1041A, or 1120,[18] suggesting that the number of audits conducted by the IRS on private foundations is pitifully low. Since the enactment of the private foundation excise tax, oversight of the nonprofit sector has changed, including a number of charity offices working for state attorneys general. Reflecting the enlarged scope of nonprofit and philanthropic oversight, the unfortunate reduction in IRS oversight, and the activism of a number of state attorneys generals in this field, a revival of appropriate levels of oversight and enforcement through adequate funding of the IRS TEGE division and increased support for the state attorneys-general is warranted.

Foundation board composition and behavior: We agree with the white paper's recommendation that individuals who have been by federal law or exchange law prohibited from serving on the boards of publicly traded corporations should be prohibited from serving on the boards of tax exempt organizations. NCRP's own research shows that even a brief survey of foundations reveals a number of corporate malefactors directing foundations.[19] Some might argue that many of these people are on the boards of family foundations, sometimes their own family foundations, thereby making the principle inapplicable. As we have stated above, foundations are tax-exempt institutions, regardless whether they are independent or family foundations, and the public has a stake in their management. In the wake of long-awaited Enron prosecutions, the public is acutely aware that there are some corporate wrongdoers whose presence should not taint the good work of private corporations—and that should extend to private and public foundations.

As there were in 1969 and in every year when Congress devotes some attention to the nonprofit sector, there are doomsayers, predicting the worst possible results. But the Senate Finance Committee's white paper, at least as applied to philanthropy, does not seem geared to, much less motivated by intentions of reducing charity and philanthropy. But when surveys show that nearly 19 percent of households are considering or using donor funds at community founda-

18. *Internal Revenue Service Data Book* 2003, p. 26.

19. John Barkhamer, Rick Cohen, and Jeff Krehely, *Serving Time…on Foundation Boards* (NCRP: May 2004)

tions or other nonprofits and more than 10 percent are considering or using charitable gift funds at commercial financial institutions,[20] it is well within the purview of Congress to pay attention and determine how to appropriately monitor and guide these allocations of tax exempt resources. Similarly, when independent foundations, family foundations, operating foundations, community foundations, and others sit on some $500 billion in assets, allocating only a small proportion to nonprofits, Congress can and should pay attention.

These are public issues, not limited to self-regulation by the sector or by shards of the nonprofit sector, when there are more than 65,000 grantmaking foundations and over 1.4 million nonprofit organizations. Self-regulation and self-policing are important, but they do not take the place of the role of the public sector in ensuring that tax exempt resources get protected and used for charitable purposes.

20. Lucy Bernholz, "The Edge of Change: Philanthropy Enters the 21st Century" (presentation to Social Venture Partners in Seattle, October 20, 2003)

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