

Oversight By Whom?

By Stuart Kahan. *The Nonprofit Times*
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Regulators finding NPO enforcement is difficult

"This has been a very useful hearing," said Sen. Charles Grassley (R-Iowa), chairman of the Senate Committee on Finance, at the conclusion of a recent hearing on reform proposals for charities and charitable giving. "The testimony today has made it clear that there is a need for reforms to deal with this part of the tax gap."

Grassley has been spearheading an effort for sweeping reform measures in the \$900 billion nonprofit sector. He said that he plans to introduce a bill, which some observers claim has already been drafted, that would significantly increase how the government monitors nonprofit organizations.

What this might mean for the tax-exempt world would be stronger penalties for nonprofit executives who commit crimes, more detailed reporting to the Internal Revenue Service (IRS), and stricter corporate-governance standards, among other measures. Unquestionably, nonprofits fear a crackdown similar to the sweeping reforms imposed on publicly traded corporations after the spectacular collapses of Enron and WorldCom.

"Many not-for-profit organizations have become quasi-governmental organizations and should be held to the highest standards, including accounting to the public about how much their employees are receiving as compensation," Grassley has written.

Grassley has gotten support from IRS Commissioner Mark Everson, who said, "We can see that abuse is increasingly present in our sector, and we must work to address it." In testimony before the Senate Finance Committee, he went on to state that some entities are "wantonly abusing the generosity and faith of the public." To unleash the IRS in an enforcement effort would, noted Everson, require an eight percent increase in its enforcement budget.

According to Everson, the IRS's exempt organization master-file lists 1.8 million tax-exempt entities, although he admitted that number is imprecise. "More than 200,000 entities have been added to our rolls since the year 2000."

One objective in the IRS's Strategic Plan for 2005-2009 is to deter abuse within tax-exempt and governmental entities and alleged misuse of such entities by third parties for tax avoidance and other unintended purposes.

But, by the same token, he readily admitted that the IRS's enforcement budget has not kept up with its growth. In fact, from 1995 through 2003, he said there was an increase of more than 40 percent in the number of exempt organizations' returns filed, yet IRS staffing of the exempt organizations' function steadily declined. He expects, though, to turn this around and by September seek a 30 percent increase in enforcement personnel for the Exempt Organizations Division.

Clearly, even the commissioner recognizes that the IRS lacks adequate resources to handle the abuses. "Since 1969, there has been only limited review of the rules relating to tax-exempt status," said Everson.

In return for tax-exempt status, the IRS requires nonprofits to file annual tax returns. But there are few other federal regulations governing the sector. Even the tax filings get little scrutiny because the IRS lacks the staff to look at even one percent of the forms, a staff aide to the Senate Finance Committee said.

Marcus Owens, who spent more than a decade running the IRS's Exempt Organizations Division and who is now an attorney in the Washington, D.C. law firm of Caplin & Drysdale, pointed out that it is quite true the IRS audit rate is very low. "Whether calculated as a percentage of the universe of tax-exempts or in real numbers -- probably around 1,500 entities per year -- that number is larger than the number of investigations conducted by the states."

Said Owens, "There are probably fewer than 15 states that even have one attorney charged with monitoring tax-exempts full-time. So in effect, there are fewer regulators at the state level than are in the Washington office of the IRS Exempt Organizations Division alone, much less counting the field offices."

He explained that the states are not precluded from announcing their investigations publicly, so there is an appearance of greater enforcement. IRS employees who disclose the existence of an audit could face criminal prosecution, he said.

Tracy McGinnis, president of the National Association of State Charity Officials (NASCO), said that most states have a division or unit that actively regulates nonprofits and charities to some extent. "The scope of the regulation and the authority of the state regulatory officials vary greatly from state-to-state. Most states require some level of charity registration and most states have adopted state laws that provide some degree of regulation of governance-type issues."

Owens said he believes that the real question centers around whether the IRS is the best place for housing the monitoring function or whether a better system exists or can be established, perhaps modeled on the way the Securities Exchange Commission (SEC) regulates the securities industry. The SEC regulates through its investigations and its indirect regulation through the National Association of Securities Dealers, which has been delegated certain enforcement powers by the SEC. Funding of the NASD comes directly from the regulated, without being subject to the whims and politics of the federal budget process.

A law for all?

According to Andrew Lang, president of LangCPA Consulting in Potomac, Md., some type of legislation affecting tax exempts is inevitable whether through federal legislation or through the states.

Lang, a well-known speaker, author, and conference presenter, said he believes that organizations over a certain size should be audited but it shouldn't apply to all organizations. "For-profits got hit with strong legislation because a number of large entities went beyond the bounds of ethical behavior and too many investors were hurt. This has not happened to a significant extent in the nonprofit sphere, but unfortunately the sentiment for strong regulation has been carried over."

He maintained that audits are reasonable and even appropriate for nonprofits that have annual

budgets of \$1 million and more, or assets in excess of \$10 million. "That's okay, but truly small nonprofits simply can't afford the cost. This would involve placing an unreasonable burden on smaller organizations in the nonprofit world. Essentially, precious funds would be diverted from programmatic activity by requiring the auditing of all nonprofits. While cheats exist, they tend to inhabit certain niches already known to the IRS; otherwise they are really few and far between. Simply put, overlaying solutions to large for-profit problems onto all nonprofits is simply not a good idea."

He added that he is especially concerned about the costs of reporting on internal controls. "The smaller nonprofits, which make up the bulk of nonprofits in this country, are shuddering at the prospect. How can they afford such audits?"

As to Grassley's pressure on the IRS, Lang said he hopes it will subside. "I can see that there is a gathering storm here, but, unless a major scandal pops up such as United Way which was some 15 years ago, we may yet escape with only modest regulations." He said he believes that there may be a more effective use of funds, such as expanding the reporting on Form 990 which, he said, would be a valid exercise of federal responsibility.

How this has all taken root and what may be behind all the machinations are still to be unraveled.

Is legislation necessary?

According to Gary Bass, founder and executive director of OMB Watch in Washington, D.C., "We still need to know what part of the wind Grassley is pushing against. Is it donor-advised funds and nature conservatory on land holdings?, " he said.

Bass asked, "And, what's the problem the Independent Sector is trying to resolve? Is it really corruption? Laws, that's something else. I'm not at all clear what the problem really is. Maybe we should take a portion of tax money raised to go to more enforcement by the IRS or grants to the states," said Bass.

Lester Salamon, director of the Johns Hopkins Center for Civil Society Studies, which oversees the Listening Post Project, pointed to a recent survey distributed to more than 600 nonprofit organizations in the United States. It shows that 95 percent reported regularly distributing financial statements to their boards of directors and 97 percent responding they had undergone an audit within the past two years. "What this shows," noted Salamon, "is that the nonprofit sector is already adhering to many of the financial disclosure practices that have been the subject of recent Senate Finance Committee hearings."

Also, according to Rick Cohen, executive director of the National Committee for Responsive Philanthropy, a watchdog group in Washington, D.C., "There's been a major change since Congress began to shine a light on how foundations were actually spending their money."

In another survey of the nation's nonprofit organizations, almost half the respondents said they have voluntarily tried to comply with at least some of the Sarbanes-Oxley requirements imposed on the corporate sector. The law aims to make executives and board members more accountable for their company's financial statements and dealings.

Moreover, the Alliance for Charitable Reform (ACR) has urged Congress to proceed with caution and to be mindful of the important work done by America's charitable foundations in communities across the country. Said ACR co-founder Dan Peters, "We recognize the seriousness of Congress' intent to put a stop to the abuses and we applaud their resolve." However, he does serve up the notice that, "but for the efforts of America's private foundations and charities, many of our most vulnerable citizens would suffer greatly." In that respect, he cited his concern with any proposals affecting nonprofit organizations and private foundations that would interfere with their decision-making freedom and impose new burdensome regulatory requirements.

Regardless, it certainly appears from Grassley's tenacity that proposed legislation governing a wide range of nonprofit practices is on the way. Proposals could include limits on how much nonprofits can pay trustees to closing loopholes that allow some types of nonprofits to spend little money on charitable activities. There is also no question that many nonprofit advocates are concerned about smaller agencies being overly burdened by so many extra regulations. More than 80 percent of nonprofits have an annual budget of less than \$500,000, according to the IRS.

Although it is pretty much agreed that government oversight is perfectly proper within a civil

society, there are many other sources to consider, especially under the nonprofit umbrella. For instance, Ministry Watch is known for collecting basic information and listing by name those ministries that do not provide financial statements of any kind. The Better Business Bureau's Wise Giving Alliance does much the same for charities. The Evangelical Council for Financial Accountability is a membership organization that sets high financial standards and only makes claims they can substantiate for members.

The real test of accountability may not be in a government form, or even in the eye of a faith-based evaluator. Richard Harwood, in a Foundation Center article about nonprofit sustainability, gets to the long term, most dependable source of nonprofit, and accountability with three simple words: "It lies within."

According to Harwood, a significant piece of accountability must come from within. He asked rhetorically, "What promises have I made to people? What claims can I make about my work? Does it have integrity? What about my organization? Is it truly and consistently serving the public good, and if not, why not?"