

**INDEPENDENT SECTOR
Comments
In Response to
Announcement 2002-87**

America's "independent sector" is a diverse collection of more than one million charitable, educational, religious, health, and social welfare organizations. It is these groups that create, nurture, and sustain the values that frame American life and strengthen democracy. In 1980, a group of visionary leaders, chaired by the Honorable John W. Gardner, became convinced that if the independent sector was to continue to serve society well, it had to be mobilized for greater cooperation and influence. Thus a new organization, named to celebrate the independent sector's unique role apart from government and business, was formed to preserve and enhance and protect a healthy, vibrant independent sector.

Today, INDEPENDENT SECTOR ("IS") is a coalition of more than 700 national organizations and companies representing the vast diversity of the nonprofit sector and the field of philanthropy. Its members include many of the nation's most prominent nonprofit organizations, leading foundations, and Fortune 500 corporations with strong commitments to community involvement. This network represents millions of volunteers, donors, and people served in communities around the world. IS members work globally and locally in human services, education, religion, the arts, research, youth development, health care, advocacy, democracy, and many other areas. No other organization represents such a broad range of charitable organizations and activities.

IS very much appreciates the opportunity to submit comments in response to IRS Announcement 2002-87. IRS Form 990 is the paramount source of current information on the operations of many types tax-exempt organizations, including charitable organizations. Therefore, IS is particularly interested in ensuring that the Form 990 provides a clear and accurate picture of organizations' operations while avoiding the imposition of unduly burdensome reporting requirements.

I. General Comments

In general, IS believes that the efforts to revise the Form 990 are important steps in improving the quality and consistency of the information charities provide to the IRS and to the general public on an annual basis. Measures to increase tax-exempt organizations' transparency and accountability by revising the Form 990 must strike an appropriate balance among multiple goals: providing sufficient data to determine compliance with the applicable tax laws, informing donors and the general public, and minimizing organizations' administrative burdens. Accordingly, we particularly appreciate attempts to improve the reliability of fund-raising expenditure reporting and increased disclosure with respect to corporate governance procedures, since this information is vital to improving public confidence in the nonprofit sector. At the same time, we caution against imposing onerous requirements on all tax-exempt organizations with foreign operations because we believe that such requirements are neither an efficient nor an effective means for preventing the few instances where exempt organizations may have provided funding to inappropriate foreign organizations or activities. In addition to supporting revisions to the Form 990 itself, we also encourage the IRS to improve public access to Form 990

information by providing electronic filing of the Form 990 and offering public access to such filings on the IRS website as soon as possible.

II. Specific Comments

We have the following specific comments with respect to the various changes.

A. Compliance with SOP 98-2.

We agree with requiring the use of SOP 98-2 for certain 990 filers as a means of improving the accuracy of fundraising information and further reconciling the Form 990 reporting with organizations' audited financial statements. There is a clear legal basis for this requirement, since the proper reporting of such expenditures is necessary to evaluate whether an organization conducts exempt activities commensurate with its resources and to ensure that no private party is receiving an undue benefit from use of the organization's assets.

Given the significant additional administrative burden that SOP 98-2 imposes in assessing whether expenses meet the three-pronged test for allocating expenses between fundraising and programmatic or administrative purposes, we recommend, however, that compliance with SOP 98-2 should only be mandatory for 990 filers with gross receipts in excess of \$1 million dollars for the tax year in question. This \$1 million dollar threshold for imposing additional responsibilities on exempt organizations is used elsewhere in the Code and the Treasury Regulations. For instance, Section 6652(c)(1)(A) imposes an enhanced penalty for failure to file the Form 990 on organizations with gross receipts exceeding \$1 million dollars for the tax year. Similarly, Treas. Reg. section 53.49458-6(c)(2)(ii) provides a special rule for public charities with gross receipts of less than \$1 million dollars in meeting the rebuttable presumption of reasonableness with respect to the compensation of disqualified persons.

B. Recommendations for Requiring Additional Fundraising Information

1. Disclosure of Allocation Method Used

In addition to the SOP 98-2 requirement, we also recommend that the Form 990 require filers with over \$1 million in gross receipts to identify the nature of the costs and the allocation methods that they have employed in reporting costs for activities with joint purposes. Identifying the allocation methods used is another important step in obtaining a clear understanding of expenditures and determining whether organizations are characterizing them appropriately. There are three allocation methods that are typically used for determining fundraising costs: the physical units methods, the relative direct cost method and the stand alone joint-cost accounting method. As a recent GAO report on tax-exempt organizations points out, "Each method can produce a different financial portrait, and no one method is appropriate in all circumstances."¹

¹ "Tax-Exempt Organizations: Improvements Possible in Public, IRS and State Oversight of Charities", GAO-02-526 (April 1, 2002). The report illustrates how the choice of allocation method can affect the accuracy of expense reporting. For instance, if an organization pays an outside fundraiser \$1 million dollars to conduct a direct mail solicitation by using a letter containing 90 lines of public education and 10 lines of fundraising, the physical units method would allow the organization to allocate \$900,000

2. Explanation of Fundraising Costs

We recommend that Part II of the 990 provide a space for organizations to explain their fundraising expenditures, if they choose to do so. This will give organizations an opportunity to describe the factors that may make their fundraising program particularly costly and will help to prevent donors from making unfair judgments about an organization's performance on the basis of assumptions about its spending efficiency.

C. Foreign Grants

We oppose requiring separate schedules for grants made to foreign recipients and imposing any other additional reporting obligations on exempt organizations with foreign operations, foreign grant-making programs and other types of business relationships with foreign parties. While we understand the interest in protecting against the risk that exempt organizations' funds could be diverted for terrorist or other inappropriate activities, we do not believe that there is any basis for the IRS to impose such significant burdens on all exempt organizations that have ties to foreign countries. Despite the large scale of US charities' activities in foreign countries--from aid and missionary organizations to university branches and scientific research organizations--and the substantial amount of US charities' expenditures in foreign countries, there is no evidence to indicate widespread abuse of such funds for terrorist purposes.

For purpose of the tax rules, the locus of an exempt organization's activities is irrelevant, so long as such activities are conducted for exempt purposes. It is well established that charities may conduct some or all of their exempt activities in foreign countries, including by making grants to foreign organizations for charitable purposes. Rev. Rul. 71-460, 1971-1 C.B. 231 (activities in a foreign country permitted); Rev. Rul. 66-79, 1966-1 C.B. 48 (grants to foreign organizations permitted). The Form 990 already requires organizations to describe the nature of their exempt activities. Requiring organizations to provide separate lists of foreign grants, as well as more specific information on foreign funding and other transactions with foreign parties, imposes an undue burden on thousands of legitimate organizations-- from organizations funding a single missionary to large universities operating branches in foreign countries. More importantly, it is highly unlikely that including these questions on the Form 990 would cause any organization to reveal plans to illegally divert funds for terrorist use or other inappropriate purposes.

D. Corporate Responsibility

We agree that exempt organizations should be required to disclose on Form 990 whether they have adopted conflict of interest policies or have independent audit committees. Such

to program expenses and \$100,000 to fundraising. However, such an allocation would clearly be inappropriate if 90 percent of the \$1 million fee was for the development of a mailing list.

information indicates whether organizations have established procedures that protect against the misuse of their assets.

The Instructions to the Form 990 should provide a definition of “independent audit committee” for this purpose. We recommend the following definition:

For purposes of the Form 990, an independent audit committee is a committee comprised solely of independent directors of the organization. In order to be considered “independent,” directors must meet the following criteria. The director or any member of his or her family, as defined by section 4958(f)(4), must not: (1) be compensated by the organization (other than fees received for being a director), (2) be employed by a present or former auditor of the organization, and (3) must not be part of an interlocking directorate in which an executive officer of the organization serves on the board of another organization that concurrently employs the director in question.²

E. Additional Changes to Improve Public Information and Increase Public Confidence

1. Disclose Related Directors.

We recommend that Part V of the Form 990 include a question asking whether officers, directors or trustees are related to each other, through either family or business relationships. This question currently appears as question 2 of Part III of the Form 1023. It is important to repeat it on the Form 990 because many organizations change the composition of their boards on a regular basis. We recommend that the Form 990’s instructions provide the following definitions of the terms “family relationship” and “business relationship”:

For “family relationship,” we recommend that the instructions provide that an individual has a family relationship with his or her spouse, ancestors, children, grandchildren, great grandchildren, and siblings (whether by whole or half blood), and the spouses of children, grandchildren, great grandchildren and siblings. This definition follows the intermediate sanctions definition of “family members” found in section 4958(f)(4).

For “business relationship,” we recommend that the instructions provide a definition that encompasses both “direct” business relationships and “indirect” business relationships. An officer, director, trustee or key employee would have a direct business relationship with another officer, director, trustee or key employee if they have an employer-employee, independent contractor, lessor-lessee or other direct contractual relationship.

² This definition of “independent director” is derived from a rule proposed by the New York Stock exchange (“NYSE”), requiring all companies listed on the NYSE to have a majority of independent directors. NYSE Listed Company Manual § 303A.01 (proposed).

An indirect business relationship would exist through a “35-percent controlled entity.” The term “35-percent controlled entity” should be defined as in section 4958(f)(3), except that for these purposes the definition should be based only on ownership by officers, directors, trustees, key employees and their family members, thereby avoiding the need for applicants to determine if anyone else exercises “substantial influence” over the applying organization.

An officer, director, trustee or key employee would then have an indirect business relationship with another officer, director, trustee or key employee if:

- the individuals are both owners of a 35-percent controlled entity;
- one individual is an employee, independent contractor or otherwise has a contractual relationship with a 35-percent controlled entity owned in part or in whole by the other individual; or
- one individual is the owner, in part or whole, of a 35-percent controlled entity that is an independent contractor or otherwise has a contractual relationship with another 35-percent controlled entity owned in part or in whole by the other individual.

While this definition would require the exempt organization to identify all 35-percent controlled entities, almost all exempt organizations will have no more than a few such entities.

2. Annual Reports and Audited Financials Available to the Public

We recommend that questions N and O be added to the introductory section of the Form 990, as follows:

N. Does the organization publish an annual report? Is it made available to the general public?

O. Does the organization produce audited financials? Are these financials made available to the general public?

These questions will alert the public as to whether there are additional sources of information available that will be helpful in evaluating the organization’s performance.

3. Allowing Consolidated Returns for Affiliated Organizations

We recommend that the Form 990 provide a parent organization the option of filing a combined Form 990 for itself and all affiliates that are subject to its supervision and control, and that meet the current criteria for filing a group return. Presently, where an organization has a group exemption ruling, the parent must file at least two returns-- one for itself and one for the organizations covered by the group exemption. These separate Form 990’s include material inter-company income, expenses, assets and liabilities that distort the overall operations and financial position of the organization and make it difficult for donors and others to use the information return data. The distortion of organizational data is exacerbated when oversight organizations evaluate charities based solely on statistical analysis of Form 990’s. Using raw unconsolidated data in cases where the related entities perform separate but complementary

functions can lead to highly erroneous conclusions about organizational performance. Allowing a parent and its closely controlled affiliate charities to file a combined Form 990 would provide meaningful financial information for the entity as a whole; and preclude the public from making erroneous judgments based upon fragmented information that is now required under IRS guidelines.

III. Conclusion

We appreciate the IRS' efforts in revising Form 990 and the IRS' invitation to comment on the proposed changes. We are available to discuss any of our comments if desired.