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NEW FEDERAL NONPROFIT ACCOUNTABILITY LEGISLATION CLOSER TO INTRODUCTION

On June 22, 2005, the *Panel on the Nonprofit Sector* formed by Independent Sector released its Final Report recommending to Congress and the nonprofit community 15 categories in which either legislation, regulatory changes, and/or voluntary "best practices" should be adopted to improve the operations and governance of tax exempt organizations. The proposed legislation is expected to take shape later this Summer or in the Fall. The Panel is hoping to maximize the impact of its Final Report by urging charitable organizations to unite by endorsing the proposals in their entirety. Highlights of the topics addressed in the Final Report are set forth below. For more details on the recommendations, go to www.nonprofitpanel.org or contact Perlman & Perlman.

1. **Federal and State Enforcement**. Federal and state oversight of tax exempt organizations is inadequate. There should be increased funding for enforcement, and steps should be taken to improve information sharing between the IRS and state charity officials.

2. **IRS Reporting**. To improve the accuracy and completeness of filings by charitable organizations, the Panel recommends (i) modifying Forms 990 and 990-PF, (ii) providing additional funding for the implementation of mandatory electronic filing and (iii) increasing penalties for incomplete or inaccurate returns. The Panel would also require the highest ranking officer to sign the 990 and certify to its accuracy

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SIMPLIFICATION OF DISSOLUTIONS FOR NEW YORK CHARITIES

The New York State legislature passed a bill in June of 2005, proposed by New York Attorney General Spitzer with widespread support in the not-for-profit sector, which provides for simplification and streamlining of the dissolution process for New York charities. For almost a decade, New York charities (with the support of the Association of the Bar of the City of New York and the Nonprofit Coordinating Committee) had been urging the State to simplify New York's cumbersome dissolution process, which had required charities with assets to make two court appearances. The major reforms contained in the current legislation (which is expected to be signed by the Governor) include the following:

1. A corporation seeking to dissolve <u>with</u> assets need only make a single court appearance (on notice to the AG) to have its plan approved, and is no longer required to return to court to demonstrate that its plan of dissolution has been implemented.
2. A corporation seeking to dissolve <u>without</u> assets may maintain a reserve of up to $25,000 for wind-up expenses (including legal and accounting expenses), so long as its liabilities do not exceed $10,000. Most significantly, Supreme Court review of "no asset" dissolutions will no longer be required; the AG is authorized to approve such dissolutions without a court order.
3. A dissolving corporation must ordinarily carry out its plan of dissolution and wind up its affairs

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and completeness under penalties of perjury. In addition, exempt organizations with annual gross receipts of $25,000 or less, which are not now required to file a 990, should be required to file an annual report with the IRS.

3. **Periodic Review of Tax Exempt Status**. The Panel disagreed with the Senate Finance Committee which proposed requiring a 5 year review by the IRS of tax exempt status for all charitable organizations on the grounds that such a review is not practical or cost-effective for government regulators.

4. **Financial Audits and Reviews**. Charitable organizations required to file Form 990 or 990-PF that have $1 million or more in total annual revenues should be required to have an audit conducted of their financial statements and operations and to attach audited financial statements to the Form 990. Organizations that have at least $250,000 and under $1 million in total annual revenues should be required to have their financial statements reviewed by an independent public accountant. Financial statements should be prepared in accordance with GAAP.

5. **Disclosure of Performance Data**. Although the Panel acknowledged the perceived problem that 990s do not provide the donating public with adequate information concerning the effectiveness of exempt organization programs, it recommended that no Congressional action be taken on this matter. As a "best practice" the Panel suggests that charitable organizations should provide detailed information about the effectiveness of their programs in annual reports, on websites, and in other media available to donors.

6. **Donor Advised Funds ("DAFs")**. DAFs should be regulated, including by (i) requiring the sponsoring charity to make an aggregate annual minimal distribution (among all of its DAFs) equivalent to 5% of asset balance at the end of the year; (ii) requiring 20% of DAF funds to be distributed to the sponsoring charitable organization's unrestricted account if the DAF is dormant for 3 consecutive years; (iii) requiring the sponsoring charitable organization to terminate DAF advisory privileges if dormant for 5 consecutive years; and (iv) requiring the sponsoring charity to disclose certain information concerning its DAFs on its Form 990.

7. **Type III Supporting Organizations ("SOs")**. The Panel does not recommend abolishing Type III Supporting Organizations. Instead, the Panel recommends (i) requiring Type III SOs to make 5% annual distributions to its supported organization; (ii) prohibiting grants, loans, compensation or other payments from Type III SOs for the benefit of the donor or any related party; (iii) prohibiting Type III SOs from supporting more than 5 entities; and (iv) requiring Type III SOs to attach to Form 1023 and 990 a letter from each organization it supports verifying that the supported organization agrees to be supported and explaining how it is supported.

8. **Abusive Tax Shelters** The IRS should clarify the requirement for tax exempt entities to report participation in listed and other reportable transactions and impose penalties for knowing failure to disclose such participation.

9. **Non-Cash Contributions** For gifts other than cash or publicly traded securities, the Panel recommends requiring a "qualified appraisal" and the implementation of more objective standards for establishing the fair market value of the donated property. A qualified appraisal would be defined as one prepared by a qualified appraiser in accordance with accepted standards and Treasury regulations. If the claimed value of the donated property exceeds the correct value by 50% or more, new penalties should be imposed on both the taxpayer and the appraiser.

10. **Board Compensation**. The Panel recommends (i) imposing stiffer penalties on board members and organization managers who approve self-dealing transactions if they "should have known" that such approval was improper and (ii) prohibiting loans to board members.

11. **Executive Compensation** Current rules for what is "excessive compensation" are not sufficiently clear, and the penalties for violating those rules may not be severe enough to deter such payments. The Panel would require disqualified persons who are charged by the IRS with receiving excessive compensation to demonstrate that the compensation is reasonable and impose penalties on board members and organization managers who approve compensation which is not reasonable if they should have known it was improper. They further propose modifications to the Form 990 to include additional disclosure of benefits and compensation paid to officers and key employees. If the board relies on a compensation consultant to evaluate the CEO's compensation, the consultant should be independent of, engaged by, and report to, the board.

12. **Travel Expenses** To address excessive expenditures on travel by charitable organizations, the Panel

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recommends requiring charitable organizations to implement travel policies to be adhered to by any person seeking reimbursement for travel expenses. As part of those policies, charitable organizations should generally prohibit reimbursement for spouses or dependents.

13. **Structure, Size, Composition and Independence of Governing Boards**. 501(c)(3) organizations should have a minimum of three directors. At least one-third of the board of a public charity should be "independent" and the names of the independent directors should be disclosed on the 990. In addition, individuals barred from service on boards of publicly traded companies or convicted of crimes relating to breach of fiduciary duties should be prohibited from serving on the board of a charitable organization for 5 years following conviction or removal. Each board should periodically review its size for effectiveness.

14. **Audit Committees.** As a matter of best practice, the governing boards of charitable organizations should include individuals with some financial literacy on their board of directors and every charitable organization which has its financial statements independently audited should consider establishing a separate audit committee.

15. **Conflict of Interest and Misconduct.** The Panel recommends requiring exempt organizations to disclose on 990 forms whether they have a conflict of interest policy. As a best practice, exempt organizations should adopt a conflict of interest policy in compliance with state law. In addition, exempt organizations should adopt policies and procedures that encourage employees to report wrongdoing.

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within 270 days, although it may seek extension of this time for up to one year for good cause.

3. Quorum requirements to approve a plan of dissolution are eased under certain circumstances for membership organizations unable to obtain a quorum.
4. The Secretary of State may dissolve a corporation by proclamation which has not filed annual reports with the AG for at least five years, where the AG certifies such corporation's non-filing after sending a certified mail notice to the defunct corporation during each of the prior two years (including one notice within six months of the AG's certification).

The enactment of this legislation is good news for New York charitable corporations, and should also streamline the New York AG's regulatory function. The bill becomes effective 180 days after it becomes law.

NEW YORK ATTORNEY GENERAL'S 2005 PROGRAM BILLS

The New York Attorney General's Charities Bureau has submitted a package of five bills for the consideration of the New York State Legislature. Two of the bills -- one on simplifying the dissolution process for New York charitable corporations (recently passed, *see* article on page 1), and one on tightening the provisions regarding transactions involving interested officers and directors of New York corporations -- are identical to prior AG bills which have received widespread support in the charitable community. Both bills have been endorsed by the Association of the Bar of the City of New York and the New York Nonprofit Coordinating Committee. The three new bills are more problematic. One of them, a radically scaled down version of what Attorney General Spitzer previously (but no longer) described as a Sarbanes-Oxley type bill for nonprofits, is designed to encourage best practices and the establishment of adequate internal controls by New York charities. While it is an improvement over the prior proposed bill, the questions remain: (i) whether it is a good idea to be legislating best practices, and (ii) whether anything in this bill might ultimately be inconsistent with legislative proposals likely to be made soon by the United States Senate Finance Committee and its chair, Senator Grassley.

One bill serves the laudatory purpose of attempting to ensure that charitable donations intended to benefit firefighter and correction officer support organizations are not improperly diverted to those engaged in fraudulent solicitations. The bill therefore brings firefighter support organizations within the regulatory framework of Article 7-A of the New York Executive Law, which requires registration with and financial reporting to the Attorney General by organizations that solicit contributions from the public. At the same time, however, that bill also would permit the Attorney General simultaneously to seek relief both in a court and in an administrative hearing against the same regulated entity for the same purported violations of law. We have reservations about the burden that such simultaneous proceedings could impose, particularly on smaller organizations.

Another proposed bill, the mislabeled "cleanup" bill in the charitable solicitations area, is even more troublesome. While making certain technical corrections in the law, it also has several questionable provisions that appear to be inconsistent with well established First Amendment limitations on the scope of state regulation of charitable solicitations, two of which are the most

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disturbing. The bill would increase the annual filing fee for professional fundraisers from $800 to $1,800, while eliminating the annual $80 fee for individual solicitors employed by such fundraisers. Although described as revenue neutral for the state, this drastic increase in fees could be devastating for smaller charitable fundraisers, while benefiting the larger organizations. As such, smaller fundraisers could be effectively precluded from soliciting charitable funds in New York (an apparent prior restraint on fully protected First Amendment activity). In addition, the bill would confer broad and seemingly unbridled discretion on the state to reject any registration if any bond, contract, interim or closing statement, report, or other document has allegedly not been filed in the past. Significant modifications of this proposed cleanup bill should be made before passage of the legislation is seriously considered.

Recently Passed State Bills

Connecticut Senate Bill 946 was enacted on June 7, 2005, and revises the registration requirements for charities and paid solicitors. The bill requires charities engaging in charitable solicitation in the state to register annually, and provides for a $50 annual registration fee. The annual registration application includes a registration statement, annual financial report, and for charities with gross revenues exceeding $200,000, an audited financial statement. The bill also increases the annual registration fee for paid solicitors to $500, and requires the Department of Consumer Affairs to publicize the terms of the solicitation contract, the dates of the solicitation campaign, and the percentage of the raised funds to be retained by the paid solicitor. The bill becomes effective October 1, 2005.

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