


# NONPROFIT EXAMINER

Financial & Management Issues for Nonprofit Organizations & Their Boards

## Senate Seeks Nonprofit Reform

 In June of this year, Senator Chuck Grassley, Chairman of the US Senate Committee on Finance, held ground-breaking hearings on charity oversight and reform. Long a proponent of increasing the responsibility for board management, Senator Grassley's committee convened experts from across the nation to discuss problems being experienced in the nonprofit sector. In his opening remarks, Grassley said that he understood the importance of preventing the manipulation of nonprofits while not overwhelming the ability of charities, especially small charities, to achieve their important mission. He noted, "Finding that balance will be the task in the weeks ahead, ...my hope is to work with the nonprofit sector to find that balance. Then, I hope to introduce legislative reforms this fall and maybe even earlier for some provisions."

Prior to convening these hearings, the staff of the Finance Committee, on a

bipartisan basis, had produced a discussion draft that served as a very useful beginning point to consider possible broad reforms. These reforms will benefit all charities—particularly the strong majority of charities that do their job, do it well and play such a vital role in our nation.

We believe that all nonprofit organizations would benefit by getting a copy of the proposed reforms, some of the major ones we discuss below. One of the reforms would require board members responsible for managing the charity, to do so in a manner they reasonably believe

*(Continued on page 2)*

### IN THIS ISSUE

- Treasury and IRS Issue Guidance on S Corporation, Tax Exempt Entity Transaction
- Tax-Exempt Bonds: Abusive Tax Avoidance Transactions

**KW&S** KAMEROW  
WEINTRAUB  
& SWAIN, LLP  
Certified Public Accountants and Business Advisors

11400 Rockville Pike, Suite 800  
Rockville, MD 20852-3004  
Phone: 301/468-2424 • Fax: 301/468-2480  
Email: [consult@kwscpa.com](mailto:consult@kwscpa.com) • [www.kwscpa.com](http://www.kwscpa.com)



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(Continued from page 1)

to be in the charity's best interest and to use any skills or expertise they might have. Failure to do so would risk as yet unspecified federal liabilities.

The reforms would also require that on every fifth anniversary of the IRS's determination of tax-exempt status of an organization, the organization would be required to file with the IRS information that would enable them to determine whether the organization continues to be organized and operated exclusively for an exempt purpose—should the original determination letter remain in effect.

Furthermore, the reforms would require better and broader financial disclosure forms—including requiring the charity's chief executive officer to sign the forms—and better public access to information about the charity. Indeed, there is extensive discussion about improving the quality and scope of Forms 990 and financial statements of nonprofit entities. In addition to requiring the signature of the chief executive officers, penalties would be imposed for the failure to file complete and accurate 990s. Although present law provides for a penalty for failure to file or to include required information, under the proposal the penalty for failure to file would be doubled; and for organizations with gross receipts over \$2 million per year, the present law penalty would be tripled. In addition, a separate penalty would apply to each failure to include required information on a filed 990.

Additional penalties could be brought against a CEO who signs the return as well as against a paid preparer, including employees. The reform proposals also recommend penalties for failure to file a timely 990. Under the proposals, extensions of greater than four months would be considered a failure to file. Additional information in this category discusses the standards for filing and the requirement for an independent audit or review. Under the reforms, the auditor's report would be attached to the Form 990 and would become a public document. In addition, for an exempt organization with over \$250,000 of gross receipts, an independent audit of the organization's financial statements would be required, including certification regarding the organization's exposure to the unrelated business income tax.

Mirroring other government related legislation, charitable organizations with over \$250,000 in

gross receipts would be required to include in the Form 990 a detailed description of the organization's annual performance goals and measurements for meeting those goals for the past year (to be established by the board of directors) along with goals for the coming year. The purpose of this requirement would be to assist donors to better determine an organization's accomplishments and goals in deciding whether to donate, and not as a point of review by the IRS. This would necessitate charitable organizations to disclose material changes in activities, operations or structures.

A further reform would curb tax sheltering. Charities that are found to "accommodate" tax shelters listed with the IRS would lose the right to receive deductible donations for a year and would face a 100% tax on any fees or benefits they accrued for accommodating the tax shelter (see *Treasury and IRS Issue Guidance on S Corporation, Tax Exempt Entity Transaction*).

Another reform would place restrictions on "donor advised funds." These donor advised funds, in many cases run by big mutual fund companies, allow donors to contribute and take an immediate deduction but then direct the distribution of the donation to charities over time. These funds are not defined in current law and are not subject to any special rules. Reforms under discussion include requiring donated assets other than cash and publicly traded securities to be sold promptly and requiring minimum annual distribution amounts.

The staff discussion draft is organized along six different categories that address reforms and a section on best practices for exempt organizations. The reform categories address: exempt status reforms, insider and disqualified person reforms, grants and expense reforms, federal-state coordination of actions and proceeding reforms, improving quality and scope of Forms 990 and financial statement disclosure reforms, and public availability of documents. The final section addresses best practices and focuses on encouraging strong governance detailing board duties, composition, officer removal, accreditation and prudent investor rules. Copies of this document are available online at <http://finance.senate.gov>. If you are unable to download the information or would like to receive a copy from our office, please use the enclosed form and fax your request to us. If you are interested in learning how some of these reforms might impact your organization, please call one of our nonprofit service group representatives today.

# Treasury and IRS Issue Guidance on S Corporation, Tax Exempt Entity Transaction



Earlier this year, the Treasury Department and the Internal Revenue Service issued guidance on certain kinds of abusive tax avoidance transactions involving S corporations and tax-exempt entities, such as charities. These transactions are structured to improperly shift taxation away from taxable S corporation shareholders to an exempt party, for the purpose of deferring or avoiding taxes.

In Notice 2004-30, the IRS said that it “intends to challenge these transactions on a number of grounds.” It further declares that these abusive transactions are considered “listed transactions.” Participants in a listed transaction who are required to file tax returns must disclose their participation to the IRS. In addition, promoters of listed transactions must keep lists of investors and, in certain cases, register those transactions with the IRS.

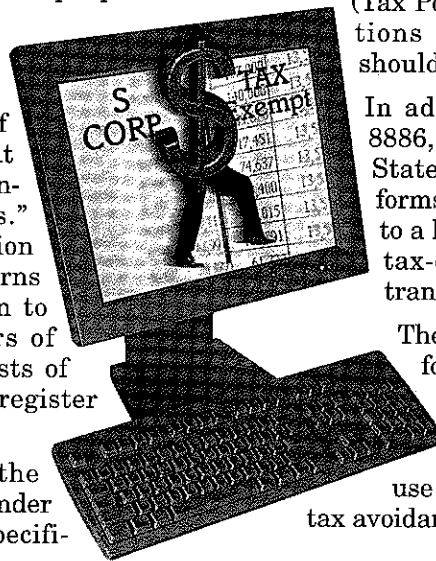
This notice is the first time the IRS has exercised its authority under the tax shelter regulations to specifi-

cally designate a tax-exempt party as a “participant” in a tax avoidance transaction.

“These transactions are structured to eliminate tax on certain S corporation shareholders by inappropriately shifting income to a tax-exempt organization. This abuses the special status that the law gives to tax-exempt organizations,” said Gregory F. Jenner, Acting Assistant Secretary (Tax Policy). “Use of tax-exempt organizations as mere accommodation parties should not be permitted.”

In addition, the IRS will amend Form 8886, Reportable Transaction Disclosure Statement, to require parties filing the forms to identify the names of all parties to a listed transaction. This includes any tax-exempt parties that facilitate the transaction.

The tax-exempt area is one of the IRS’s four top service-wide priorities. The IRS will discourage and deter non-compliance within tax-exempt and government entities and the misuse of such entities by third parties for tax avoidance or other unintended purposes.



## Tax-Exempt Bonds: Abusive Tax Avoidance Transactions



The legislative history to the 1989 Tax Reform Act specifically provides that the terms “investment plan or arrangement” and “other plan or arrangement” include Tax Exempt Bonds (TEB) issued by state or local governments with regard to the use of those terms in Section 6700 of the Internal Revenue Code. In 1993, the General Accounting Office encouraged the IRS to use the provisions of Section 6700 of the Code to counter the growing use of tax-exempt bonds for improper purposes. Since the inception of the current TEB examination program, TEB agents have uncovered a significant level of arbitrage-motivated bond transactions.

Examination of abusive transactions has been identified as an examination priority/focus area in all of the TEB workplans. In 2001, a senior TEB group manager was appointed as the TEB Fraud Coordinator; and he has been working closely with the fraud coordinators of the other IRS business units. This manager is also the “TEB IRC 6700 Coordinator” and is responsible for assisting other managers in the development of cases having IRC 6700 as a potential issue.

To the extent permitted by the disclosure provisions of the Internal Revenue Code, the Office of TEB works cooperatively with its counterparts at the Securities and Exchange Commission (SEC),

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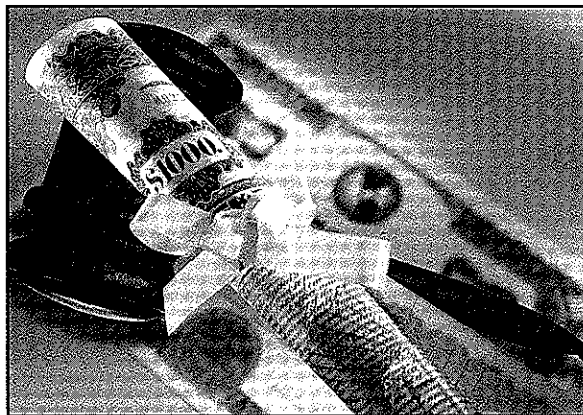
## Tax-Exempt Bonds:

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National Association of Securities Dealers (NASD), Municipal Securities Rulemaking Board (MSRB), Office of State Auditors and Treasurers and other agencies to identify abusive arbitrage-motivated transactions. TEB also researches the internet, newspapers and trade journals, such as the Bond Buyer and the Wall Street Journal, to identify potential abusive transactions.

During fiscal year 2004, TEB has been focusing on the following types of abusive tax schemes:

- Pooled financing where the issuer's expectations to loan the proceeds of the bonds to conduit borrowers were unreasonable and most of the proceeds were not loaned. Also, payments to third parties involved in multiple financial transactions, such as Guaranteed Investment Certificates (GICs), and "swaptions" to divert arbitrage earnings to pay up-front issuance costs;
- Put options purchased by the issuer simultaneously with the purchase of escrow securities in connection with advance refunding bonds. The



cost of the put option is a diversion of the arbitrage earnings on the escrow securities to the seller of the put option and violates the requirements of Section 148 of the Code;

- The payment of unreasonable, excessive GIC broker fees or Swap broker fees in connection with the GICs or Swaps purchased by issuers of certain bonds;
- Payment of more than fair market value for the escrow securities acquired with the proceeds of advance refunding bonds. As a result, the yield on the escrow securities is artificially reduced to meet the requirements of Section 148 of the Code;
- Issuance of Tax and Revenue Anticipation Notes (TRANs) where the issuer manipulates its accounting methodology in order to issue a greater principal amount of TRANs than allowable; and
- Land based financings with inflated valuations.

For more information on abusive transaction in TEB, visit the TEB website at [www.irs.gov/bonds](http://www.irs.gov/bonds) or call our office.

The *Nonprofit Examiner* has been created to serve your needs. We are available to answer any questions you have, whether on your business or personal affairs. If there are topics you would like to see covered in the *Nonprofit Examiner*, please let us know.

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**KW&S** KAMEROW  
WEINTRAUB  
& SWAIN, LLP  
Certified Public Accountants and Business Advisors

11400 Rockville Pike, Suite 800  
Rockville, MD 20852-3004

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