

Welcome! *The Emerging Strategies for Protecting Nonprofits* event will begin shortly..

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Presented by

**Weldon Rougeau
& Deanne Ottaviano**

July 28, 2005

Arent Fox PLLC
Washington, DC

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Emerging Strategies for Protecting Nonprofits: *Update on Legislative Issues*



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Agenda

- **Part I: What Has Caused the Scrutiny of Nonprofit Organization Activities?**
- **Part II: The Impacts of Sarbanes-Oxley and State Legislative Activity on Nonprofit Governance**
- **Part III: Current Proposals for Legislative Change on the Federal Level**
- **Part IV: Q&A**

What is your view?

AUDIENCE POLL:

What type of tax-exempt organization is your nonprofit?

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Part I: What Has Caused the Scrutiny of Nonprofit Organization Activities?

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

Investigations Into Accounting Fraud/Misuse of Funds/Self-Dealing by Executives, Officers and Board Members in the *For-Profit* Sector



- Leads to Sarbanes-Oxley Act of 2002

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

Investigations Into Accounting Fraud/Misuse of Funds/Self-Dealing by Executives, Officers and Board Members in the Nonprofit Sector



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Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

Investigations Into Accounting Fraud/Misuse of Funds/Self-Dealing by Executives, Officers and Board Members in the Nonprofit Sector

- Minnesota Attorney General health-related nonprofit investigations



- Other state investigations

What is your view?

AUDIENCE POLL:

Does your organization have a conflicts of interest policy covering board and staff?

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

Significant Growth in Nonprofit Sector

- Since 1995, the number of tax-exempt organizations on file with IRS has increased by over 500,000 to 1.8 million, a increase of over 60%.*
- In the period from FY 1998 to FY 2002, the reported value of the assets of nonprofits has increased from approximately \$2 trillion to more than \$3 trillion — and making them an inevitable target for IRS scrutiny.*

* According to a March 30, 2005 Letter from Mark W. Everson, Chairman, IRS to Senate Finance Committee.

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

IRS Enforcement Decreases in Nonprofit Sector

- Since 1998, IRS has cuts its annual audits of nonprofits 44%.
 - In 2003, IRS audited only 5,754 nonprofit organizations.
- 64% of 501(c)(3) organizations have annual budgets of less than \$500,000/year; but only 6% have annual budgets of more than \$10 million.



Internal Revenue Service **IRS.gov**

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Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

IRS has a strategic plan over the next five years to target:*

- Charities established to benefit the donor;
- Nonprofit hospitals;
- Abusive credit counseling organizations;
- Regulation and reporting of political activity of nonprofits;
- Misuse of charities for charitable deductions, e.g., conservation easements and non-cash contributions;



Internal Revenue Service IRS.gov

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* According to a March 30, 2005 Letter from Mark W. Everson, Chairman of IRS, to Senate Finance Committee, and April 5, 2005 Testimony of Mark W. Everson Chairman of IRS, to Senate Finance Committee.

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

IRS has a strategic plan over the next five years to target (cont'd):*

- Abusive tax shelters;
- Compensation issues, especially inconsistent methods for determining executive compensation; and
- Funding of terrorism.



Internal Revenue Service IRS.gov

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* According to a March 30, 2005 Letter from Mark W. Everson, Chairman of IRS, to Senate Finance Committee, and April 5, 2005 Testimony of Mark W. Everson Chairman of IRS, to Senate Finance Committee.

Part I - What Has Caused the Scrutiny of Nonprofit Organization Activities?.....

Lessons from the For-Profit and Nonprofit Scandals:

- Some CEOs of nonprofits have exercised such unfettered control by inattentive boards, that they have been able to get away with siphoning money from the organization for years through:
 - Self-dealing
 - Excessive and improper payments for retirement pay, vacation and sick leave, business expense reimbursements
 - High salaries and personal loans
- Without proper controls, nonprofit board members may steer business and profit opportunities to themselves.
- Charitable contributions, and especially non-cash contributions, may have been overvalued when taken as tax deductions.

What is your view?

AUDIENCE POLL:

Should Congress increase the resources of the IRS and the states to improve enforcement and oversight of tax-exempt organizations and their practices?



Part II: The Impacts of Sarbanes-Oxley and State Legislative Activity on Nonprofit Governance

Part II - Sarbanes-Oxley and State Legislative Activity

Corporate Governance Reforms

- The corporate governance reforms of the Sarbanes-Oxley Act of 2002, while mostly not directly applicable to nonprofits, have set a baseline of recommended or best practices many nonprofits have strived to achieve. Some examples include:
 - Director Independence
 - Conflict of Interest Policy for Board/Officers/Senior Staff
 - Certification of Financial Statements by Top Management
 - Executive and Director Compensation/Loans/Expense Reimbursement
 - Audit Committees/Audit Firm Change Every Five Years

Part II - Sarbanes-Oxley and State Legislative Activity

Corporate Governance Reforms

- Some of the reforms of the Sarbanes-Oxley Act of 2002 do apply to nonprofits, including:
 - Whistleblower Policy
 - Document Retention Policy Requirements

Part II - Sarbanes-Oxley and State Legislative Activity

Corporate Governance Reforms

- In the wake of Sarbanes-Oxley state governments have acted to codify some of the lessons from Sarbanes-Oxley and from examples of for-profit and nonprofit corporate misconduct. Some examples include:
 - The Charity Integrity Act, California Senate Bill 1262 (effective January 1, 2005)
 - New York Senate Bill 4836 (2004)
 - Legislative proposals in 17 other states

Part II - Sarbanes-Oxley and State Legislative Activity

Lessons from Sarbanes-Oxley and State Initiatives:

- Governments and the public expect the same level of accountability from nonprofit corporations as from for-profits.
- Nonprofit directors need to be more vigilant than they have been traditionally about financial controls, audits, expenditures – for fear of personal liability as well as for the good of the organization.
- There will likely be more federal and state regulation and enforcement, but even in the absence of these, nonprofits are well-advised to incorporate best practices into their governance scheme.

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Part III: Current Proposals for Legislative Change on the Federal Level

Part III - Current Proposals for Legislative Change on the Federal Level

Key Players in Federal Legislative Process:

- Senate Finance Committee
- House Ways & Means Committee
- Joint Committee on Taxation
- Panel on the Nonprofit Sector convened by Independent Sector
 - Comprised of a number of large Foundations, including the Ford Foundation, Bill & Melinda Gates Foundation, the Robert Wood Johnson Foundation, and The Rockefeller Foundation.
 - Interim Report to Senate Finance Committee on March 1, 2005
 - Final Report to Senate Finance Committee on June 22, 2005
 - Supplemental Report in Fall 2005

Part III - Current Proposals for Legislative Change on the Federal Level

Key Players in Federal Legislative Process (cont'd):

- President's Advisory Panel on Tax Reform
 - Report due July 31, 2005 and expected to at least address charitable contributions.
- State Attorneys General
- White House Office on Faith Based and Community Initiatives
- Panetta Institute for Public Policy

Part III - Current Proposals for Legislative Change on the Federal Level.....

Some of the key proposals of concern to nonprofits:

- Mandatory review of tax exemption status every five years;
- Enhanced Form 990 and 990-PF reporting;
- Imposition of penalties on board members, foundation executives and other managers of charitable organizations, in their individual capacities;
- Additional limitations on the deductibility of non-cash contributions;
- Increased funding for federal and state enforcement of tax laws against tax-exempt organizations;

Part III - Current Proposals for Legislative Change on the Federal Level.....

Some of the key proposals of concern to nonprofits:

- Strict regulation of donor-advised funds;
- Elimination or increased regulation of Type III supporting organizations; and
- Mandatory auditing by a public accountant of financial statements of all charities with more than a \$1 million budget.

What is your view?

AUDIENCE POLL:

Should Congress require a five-year review of exempt status by the IRS to verify that organizations continue to meet requirements?

Part III - Current Proposals for Legislative Change on the Federal Level.....

What Some Interested Parties Are Saying:

- Concerns about increase in compliance costs for nonprofits with annual budgets of less than \$2 million, from such groups as Focus on the Family and the Alliance for Charitable Reform.
- National Committee for Responsive Philanthropy has commented that the Senate Finance Committee and Nonprofit Sector recommendations do not go far enough.

Part III - Current Proposals for Legislative Change on the Federal Level

The Timetable for Consideration:

- Some revenue-raising proposals that may be considered as part of budget reconciliation – before October 1, 2005, commencement of FY06:

Revenue Projection (in billions)*	Proposed Change
2.5	Reform rules for charitable contributions of property.
1.9	Limit charitable deduction for contributions of clothing and household items.
1.0	Modify charitable deduction for conservation and façade easements.
0.5	Limit tax exempt status of fraternal beneficiary societies that provide commercial-type insurance.

Part III - Current Proposals for Legislative Change on the Federal Level

The Timetable for Consideration:

- Some revenue-raising proposals that may be considered as part of budget reconciliation – before October 1, 2005 commencement of FY06 (cont'd):

Revenue Projection (in billions)*	Proposed Change
0.4	Tax involvement by exempt organizations in tax shelter transactions.
0.2	Reform intermediate sanctions and extend certain reforms to private foundations.
0.2	Expand the base of the tax on private foundation net investment income.
0.1	Establish additional exemption standards for credit counseling organizations.

* From January 27, 2005, Report of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures."

Part III - Current Proposals for Legislative Change on the Federal Level.....

The Timetable for Consideration:

- Some proposals may be considered as part of the Charity Aid, Recovery, and Empowerment (“CARE”) bill proposed by Senator Rick Santorum (R-PA), who is also a member of the Finance Committee. That bill might come up in November if the Senate is still in session.
- Other proposals to be considered over the legislative term.
 - Panetta Institute proposal to establish an independent accrediting agency for nonprofits.
 - The possibility of a dual system of regulation based on annual revenues or amount of assets owned by a nonprofit.

What is your view?

AUDIENCE POLL:

Have you discussed problems facing tax exempt organizations with your elected representatives?

Part III - Current Proposals for Legislative Change on the Federal Level.....

How Can Nonprofits Affect the Process:

- Key Senate and House Committee Members
- Locally elected federal representatives
- Hearings
- Mark-Ups
- Working with a Coalition
 - Letter writing
 - Meetings

Please join us at these upcoming nonprofit seminars featuring Arent Fox speakers:

Ethical Practices: Legal Pitfalls and How To Avoid Them

August 15, 2005 - 10:30 am to noon, at American Society of Assn Executives Annual Meeting

Understanding and Preparing for Nonprofit Governance Legislation

August 23, 2005 - 1:00 pm to 2:00 pm EDT, Webinar sponsored by EthicsPoint

Emerging Strategies for Protecting Nonprofits – Part II

October 6, 2005 - 2:00 pm to 5:30 pm, Hosted by Arent Fox, Washington, DC

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Part IV: Q&A

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