

THE ALLIANCE FOR ADVANCING NONPROFIT HEALTHCARE

SUMMARY AND ANALYSIS OF THE INDEPENDENT SECTOR NONPROFIT PANEL'S JUNE 2005 REPORT TO THE CONGRESS ON STRENGTHENING GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS

July 1, 2005

BACKGROUND

On June 22, 2005 the Independent Sector's Nonprofit Panel presented a final report at a special event on Capitol Hill to Senate Finance Committee Chair Charles Grassley on strengthening governance, transparency and accountability of charitable organizations. The report presents recommendations for actions that should be taken by Congress, the IRS and charitable organizations themselves.

While the primary impetus for the Senate Finance Committee's scrutiny has been concerns over potential fraud and abuse within some public charities and private foundations, not nonprofit healthcare organizations, there is clearly the potential for some spill-over impacts on nonprofit healthcare organizations, especially those with 501(c) (3) federal tax exemptions, whether they have private foundations or not. Moreover, the Senate Finance Committee Chair announced in late May 2005 that as part of his Committee's scrutiny of public charities and private foundations, he had just written to ten hospitals or health systems requesting extensive information by on their patient billing and collection practices, charity care and other community benefit activities and expenditures. Nine of the twenty-one questions focused on the nature and extent of joint venture arrangements with other nonprofit health care organizations, physicians and for-profit companies, and on the implications of those arrangements for the organization's activities and expenditures for charity care and other community benefits. Detailed information was also requested on the compensation and travel expense reimbursement for the organization's five top executives.

To follow is an Alliance summary of the Panel's key recommendations. The full report is available on the Panel's Web site, www.nonprofitpanel.org, and provides its own more detailed summary on pages 85 through 91. The Panel's recommendations on Type III Supporting Organizations, Penalties for Self-Dealing, Donor-Advised Funds, and Tax Shelters are not included in this summary as they are unlikely to apply to, or be matters of concern for, most nonprofit healthcare organizations.

While this report is labeled "final", it indicates that the Panel intends to issue a supplemental report to Congress in the fall of 2005 on a number of other matters, including but not limited to: specific improvements in Form 990, whether the federal government should have any role in regulating conversions to for-profit, and sample policies on conflict of interest and travel.

The Independent Sector Nonprofit Panel is to be commended for its extensive study

efforts and thoughtful recommendations developed under tight time constraints. Its recommendations are generally consistent with the guidance document that the Alliance Board approved in May 2005 to assist its members and others in the nonprofit health care sector to improve their governance practices. There are a few areas where the recommendations could be improved, such as:

- The Panel proposes that charitable organizations be required to have at least one-third of its board members being independent, whereas in an earlier draft it recommended at least one half being independent
- The Panel proposes that all charitable organizations be required to disclose on their 990 returns which board members are independent, but not also their definition of independence
- The Panel encourages charitable organizations to have the board or a board authorized committee annually approve the compensation of the CEO, whereas in an earlier draft it proposed that this be a requirement
- While the Panel proposes that charitable organizations be required to indicate on Form 990 whether they have conflict of interest or travel policies, it does not propose that they be required to have such policies
- The Panel encourages boards using compensation consultants to have the consultant independent and hired by and reporting to the board or a designated board committee, whereas in an earlier draft it proposed that this be a requirement

The Alliance is very pleased that the Panel opposes mandatory periodic review of 501 (c) (3) status. Such a requirement would not be practical or cost-effective for the IRS or the affected charitable organizations, and would be very disruptive to, or even disastrous for, the tax-exempt bond market, the primary source of capital for many nonprofit health care organizations.

Please direct any questions or comments you may have on this to Bruce McPherson, Alliance Executive Director: mcpersonbruce@aol.com or 301-467-8014.

RECOMMENDATIONS

REVISION OF THE 990 FORMS:

- The IRS should revise the Form 990 series to ensure accurate, complete, timely, consistent and informative reporting
- Requested financial and program descriptive summary information should be clear and consistent throughout
- Information relevant to only particular types of organizations should be separated into distinct sections or schedules
- Information about the charitable purpose and key program achievements should be on the first page
- Definitions of terms should be clear and consistent throughout
- Compensation for board members, the CEO, the top five employees and employees

- related to board members or officers paid more than \$50,000 should be separately reported
- Expenditures for programs, grant-making, administration and investments should be separately reported

CERTIFICATION OF IRS INFORMATION RETURNS (990 SERIES):

- Returns must be signed, under penalties of perjury, by the CEO, CFO, or the highest-ranking officer, or if a trust, by a trustee (Currently the IRS requires an any authorized officer to certify under penalty of perjury, as well as anyone paid to prepare the return)
- As a best practice, the board or an appropriate committee should review the Form 990 return filed annually

PENALTIES FOR INACCURATE OR INCOMPLETE FORM 990 RETURNS:

- Existing financial penalties on organizations or managers for failure to file complete and/or accurate returns are sufficient and should be enforced
- Present law tax penalties imposed on the preparers of income tax returns should be extended to preparers of Form 990 series returns.
- Failure to file complete or accurate Forms 990, 990-EZ or 990-PF for two consecutive years should result in suspension of tax-exempt status (Current law provides for automatic revocation of tax-exempt status for failure to file after three years)

ELECTRONIC FILING OF FORM 990 RETURNS:

- Congress should authorize funds to enable the IRS to proceed as quickly as possible with mandatory electronic filing of Form 990 series returns and Form 1023, the application for recognition as a 501(c) (3) tax-exempt organization.
- Changes need to be made in Form 990 and 990-PF to accommodate e-filing.
- The IRS should be required to coordinate Form 990 e-filing with state officials

NOTIFICATION REQUIREMENT:

- All charitable organizations not already required to file the 990 series returns should be required to file annually an information return (incorporated into the Form 990 series returns) with the IRS listing the organization's name, address and other contact information, taxpayer ID number, name and address of principal officer, statement of mission, total revenues and expenses, and indication if it has terminated operations. It would be required to be disclosed to the public in the same manner as the Form 990, with tax exemption suspension (to be phased-in) for failure to file for three consecutive years, with e-filing to become mandatory by the IRS as soon as possible.

- Charitable organizations should be required to notify the IRS if and when they cease operations and file a final Form 990 series return, within a specified time of cessation of operations

PUBLIC DISCLOSURE OF FINANCIAL STATEMENTS:

- Charitable organizations that are required by law to file Form 990 or 990-PF and that have \$1 million or more in total annual revenues should be required by law to have a financial audit, while those with total annual revenues of at least \$250,000 but less than \$1 million should be required to have their financial statements reviewed by an independent public accountant

- Audited financial statements should be required to be made available to the public on the same basis as Form 990 returns

- Those charitable organizations having audited financial statements should be required to attach them to their Form 990 or 990-PF

STATE ENFORCEMENT OF FEDERAL LAWS:

- Charitable organizations encourage states to incorporate federal tax standards for exempt organizations, such as prohibition of excess benefit transactions, into state law so that they can enforce those standards as part of state law

INFORMATION SHARING BETWEEN FEDERAL AND STATE OFFICIALS:

- State attorneys general and any other state officials charged with overseeing charitable organizations or charitable solicitations should have the same access to IRS information that state revenue officers have under current law

WHISTLEBLOWER PROTECTION:

- As a matter of best practice, charitable organizations should establish policies and procedures that encourage and protect from retaliation individuals coming forward with credible information on potential illegal or practices or violations of organizational policies

- A sector-wide educational effort should be undertaken to encourage and assist individual nonprofit organizations in establishing these policies and procedures

CONFLICT OF INTEREST POLICY DISCLOSURE:

- As a matter of best practice, charitable organizations should have and enforce a conflict of interest policy as well as a travel policy, and should be required to report on the Form 990 series return whether they have such policies. The forms should be revised to enable this disclosure

- A sector-wide educational effort should be undertaken to encourage and assist individual nonprofit organizations in establishing and enforcing these policies

AUDIT COMMITTEES:

- All public charities and private foundations that have an independent audit (corporations, not trusts) should consider having an audit committee of the board. If the board does not have sufficient financial literacy it may use non-voting, non-staff advisors rather than board members
- Charitable organizations should include on their boards individuals with some financial literacy, and paid staff should not be included in the audit review process. If there is insufficient financial literacy, the board may want to form a committee comprised of non-voting, non-staff advisors if permitted under state law

STRUCTURE, SIZE, COMPOSITION AND INDEPENDENCE OF BOARDS OF DIRECTORS:

- With limited exceptions (e.g., houses of worship), the IRS should require that, to be recognized permanently as a public charity, the organization must have at least three directors, with at least 33% being independent, defined as individuals who:
 - Are not being compensated and who have not been compensated within the past 12 months as an employee or independent contractor, except for reasonable compensation as a director;
 - Whose own compensation, except for board services, is not determined by individuals who are compensated by the organization;
 - Who do not receive directly or indirectly material financial benefits (i.e., service contracts, grants, or other payments) from the organization; or
 -

responsibilities, number of hours of expected work, and any special services provided) in return for the compensation and the method used to determine the reasonableness of compensation

- Compensation paid for board service should be separated from compensation paid for staff performance or for independent contractor services
- Compensation for general board service should be separated from any additional amounts a board member may receive for committee service or taking on special assignments
- Any compensation to corporate officers who are not board members should be separately reported
- The names and city of residence of board members should be required to be reported on the 990 series returns
- Penalties should be increased for board members or consultants who approve self-dealing or excess benefit transactions, including unreasonable board compensation
- Loans to board members should be prohibited
- As a matter of best practices, in order to establish the reasonableness of compensation to board members, charitable organizations should consult reports or gather information on the compensation provided by comparable organizations. They should also make available their practices to peer organizations requesting such data for a similar purpose

EXECUTIVE COMPENSATION:

- Boards of charitable organizations are strongly encouraged to incorporate into their bylaws, charter or other appropriate governing documents a provision that the full board or an authorized committee must approve the compensation of the CEO annually unless there is no change in compensation other than an inflation or cost-of-living adjustment
- The full compensation of the CEO, other officers, the top 5 compensated employees and any employees related to board members or officers paid more than \$50,000 that year should be clearly reported on Form 990, with the form revised to require organizations to report base salary, all benefits, bonuses (including criteria for awarding them), long-term incentive compensation, deferred compensation and other financial arrangements or transactions (e.g., interest-free loans, payment of a spouse's travel expenses)
- If the board chooses to use a compensation consultant to evaluate the compensation for the CEO, as a best practice the consultant should be hired by and report to the board or a designated board committee and the consultant should be independent
- Penalties should be increased for board members, executives or consultants who knew or should have known that executive compensation was improper, failing to exercise reasonable care such as not following the "rebuttal presumption" procedures
- Form 990 should be revised to require organizations to report whether they followed the rebuttable presumption procedures in determining compensation for key executives

- As a best practice, boards should periodically review the organization’s staff compensation program, including the salary ranges for particular positions and the benefits provided

TRAVEL EXPENSES:

- Payment of travel expenses for spouses, dependents or others accompanying individuals conducting the business of the organization (not including minimus expenses for those accompanying who join the employee or board member at an official meal function) should be prohibited, unless the accompanying spouses, dependents or others who are also conducting the business of the organization during travel or the event
- Forms 990 should be amended to separate travel expenses incurred by or on behalf of board members and those incurred by or on behalf of employees, or others conducting the business of the organization. The instructions to the Form should be amended to provide specific information regarding costs that are not permitted and that should be reported as taxable income to the individual receiving the reimbursement, using as a guide IRS Publication 463: Travel, Entertainment, Gift and Car Expenses to avoid “lavish or extravagant” expenditures
- Charitable organizations should be required to disclose on Form 990 whether they have a travel policy for board members, employees, volunteers or others traveling to conduct the business of the organization
- As a best practice, charitable organizations that pay or reimburse for travel should have policies that provide clear guidance regarding their rules, types of expenses that can be reimbursed, and documentation required to receive reimbursement

PERIODIC REVIEW OF 501 (C) (3) STATUS:

- Periodic review of this tax status should not be required
- Form 990 should be revised to enable and require clearer reporting on material changes in organizing or governance documents
- More funding should be provided to the IRS to improve the 990 series forms, review the information reported, and conduct audits as needed
- As a best practice, the board of every charitable organization required to file a Form 990 should undertake a full review, at least once every 5 years, of its organizational (e.g., articles of incorporation, by laws) and governance instruments, key financial transactions, and conflict of interest and compensation policies and compliance there with

