



**The Hauser Center**  
for Nonprofit Organizations

**Charity Oversight:  
An Alternative Approach**

**by  
Marcus S. Owens  
Caplin & Drysdale, Chartered**

*The Hauser Center for Nonprofit Organizations  
Harvard University*

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## **Abstract**

In this paper, a former director of the Internal Revenue Service's Exempt Organization Division argues that the IRS is structurally ill suited for the task of providing vigorous oversight of the nation's growing number of nonprofit organizations. The author proposes a new, national institution, modeled loosely on the corporate sector's National Association of Securities Dealers that would, among other features, derive sufficient funding for vigorous oversight through contributions from nonprofit organizations. The author envisions an amendment to the Internal Revenue Code that would enable the nonprofit organizations to take a credit against excise taxes, particularly the excise tax on the net investment income of private foundations, they would otherwise pay to the federal government.

If one has a concern about the adequacy and sophistication of oversight of the tax-exempt sector, and charities in particular, recent media reports of abuses and resulting overbroad legislation suggest that it might be appropriate to consider alternative structures to the Internal Revenue Service-based system currently in place. Specifically, with the tax-exempt sector, and charities in particular, under scrutiny, the sector needs an institutional voice within or close to the federal government that is equipped to address issues from a more holistic perspective and not the narrow structure of the federal tax law. This paper briefly explores the idea of creating a new quasi-public/private entity that would function in tandem with the IRS in the way securities market regulation occurs through the Securities and Exchange Commission and the National Association of Securities Dealers.

Thirty-five years have passed since the Tax Reform Act of 1969 dramatically expanded the oversight role of the Internal Revenue Service with regard to private foundations and an equal number of years have passed since then-IRS Commissioner Randolph Thrower committed to an expansion of the resources that the agency devoted to the task, including the designation of “Key Districts” to better focus the resources.<sup>1</sup> The oversight activity that the Commissioner pledged to increase had resulted in the examination of 13,000 tax-exempt organization returns in 1966, up from 2,000 in 1962; by 1970, however, the number had fallen to 8,500 returns.<sup>2</sup>

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<sup>1</sup> In 1969, Commissioner Randolph Thrower committed to 1) examination of all large private foundations at least once every two years, 2) examination of all other foundations every five years, 3) doubling the number of revenue agents assigned to examinations of tax-exempt organizations, and 4) establishing a “key district” system in the National Office Audit Division under the Assistant Commissioner (Compliance) to better focus examination resources. In analyzing IRS statistics regarding examination activity, it is important to note that the data are sorted by returns examined, not taxpayers or tax-exempt organizations, so the examination of a single tax-exempt organization for two years will be reflected in IRS statistics as two returns having been examined. The data also reflect examinations closed in a particular fiscal year, regardless of when they are begun, and the data do not include examinations that are underway in a given year but do not close that year. As a result, the data can not be used to calculate the percentage of tax-exempt organizations reviewed each year. Because of consistent sorting over time, however, the data do provide an approximate measure of the level of examination activity that can be compared year to year. Vol. V, Research Papers, The Commission on Private Philanthropy and Public Needs, p.2585

<sup>2</sup> Id. at 2584.

Congressional concern with maintaining effective oversight was memorialized in the legislative history of section 4940 which linked the level of funding of IRS oversight to the amount of taxes collected through the excise tax on the net investment income of private foundations.<sup>3</sup>

Thirty years have passed since Congress created the position of Assistant Commissioner (Employee Plans and Exempt Organizations) to ensure institutional attentiveness to the task of administering the tax laws applicable to pensions and tax-exempt organizations.<sup>4</sup> Other high-level positions, known as “Assistant Regional Commissioners (EP/EO)” were created to oversee field operations. At the time ERISA was passed by Congress, the total number of tax-exempt organizations on the IRS master file was 643,586 of which 220,074, or approximately 34% were recognized as exempt under section 501(c)(3) of the Code.<sup>5</sup>

Over 25 years have passed since the IRS began reducing the size and scope of its oversight structure for pension and tax-exempt organizations matters. The initial step was taken in 1978, with the elimination of the seven Assistant Regional Commissioner positions by merger into the positions of Assistant Regional Commissioner (Examination), each with broad oversight responsibility for all IRS examination programs in a given Region. In the 1980’s, the 21 Key Districts were reduced to seven, with each EP/EO Division Director in a Key District reporting to a District Director who had responsibility for all federal tax matters in the Key District. As a result of the 1999 reorganization, there are now six EO Area Offices with responsibility for

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<sup>3</sup> Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969, p. 29 (December 3, 1970).

<sup>4</sup> The Employee Retirement Income Security Act of 1974 (“ERISA”) created section 7802(b) of the Internal Revenue Code which brought together, under the new Assistant Commissioner (EP/EO), oversight functions regarding pensions and tax-exempt organizations that had formerly existed as branches and other subunits of IRS offices with broader functional responsibilities. In addition to the Office of the Assistant Commissioner (EP/EO), the administrative structure included a field office component operating under a network of seven “super-grade” (GS-16 and higher) Assistant Regional Commissioners (EP/EO) at the IRS Region level and twenty-one EP/EO Divisions at the Key District Office level. The EP/EO function had been authorized 21 dedicated super-grade positions, although that number of higher graded positions was never implemented.

<sup>5</sup> Annual Report of the Commissioner of Internal Revenue 1969, p. 14

examinations of tax-exempt organizations, roughly corresponding to the former key districts, and a separate office for processing of applications for exemption, all of which report to the Director, Exempt Organizations Division.

In 2005, the most recent year for which the IRS has published statistics, the number of tax-exempt organizations listed on the master file was 1,709,205, of which 1,045,979 were exempt under section 501(c)(3).<sup>6</sup> The IRS reported that it examined 2,764 returns filed by tax-exempt organizations in that same year.<sup>7</sup> In addition to the expansion in the number of tax-exempt organizations each year, the scope of the responsibility of the Exempt Organizations component of the IRS has been increased to include political organizations described in section 527, further increasing the total number of organizations beyond the numbers reflected in the master file data.

The IRS faces a number of significant challenges in meeting its oversight responsibilities for tax-exempt organizations. In many respects, the challenges have remained essentially unchanged in the 30 years since the general framework for current oversight was put in place by ERISA in 1974. While the level of funding by Congress and the Executive Branch is, perhaps, the most common concern expressed by commentators, other factors have equal impact on IRS oversight of tax-exempt organizations.

The challenges include:

- **Inadequate Funding**

The number of tax-exempt organizations continues to grow and there is every indication

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<sup>6</sup> Table 22, “Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2002-2005,” Internal Revenue Service Data Book 2005.

<sup>7</sup> *Id.*, Table 15, “Returns of Tax-Exempt Organizations, Employee Plans and Tax-Exempt Bonds Examined, by Type of Return.” The total of 2,764 was composed of 2402 Forms 990 and 990-EZ, 346 Forms 990-PF, 5227, 1041A, and 1120, and 16 Forms 1120-POL.

that the number will continue to increase.<sup>8</sup> IRS staffing and other resources dedicated to tax-exempt organizations oversight have fallen or remained stagnant, and there is no evidence that historic levels have been adequate to ensure that significant abuses can be addressed in a timely manner.<sup>9</sup> Because of the dynamic of the federal budget process, noted as far back as 1977 by the Filer Commission,<sup>10</sup> the original intention that an amount of funds equivalent to the amount collected under the section 4940 tax be spent on tax-exempt organizations oversight has never been realized. Executive Branch budget requests and Congressional appropriations, to the extent that they identify amounts for oversight of tax-exempt organizations, bear no relationship to the section 4940 tax. As resources devoted to tax-exempt organizations oversight are not regularly published, no comparisons over time of the amount collected under the section 4940 tax and the amount of resources allocated to tax-exempt organizations oversight can easily be made. However, the data available for 2001 through 2004 indicate that \$61,000,000 was devoted to the Exempt Organizations Division in 2001, \$65,000,000 in 2002, \$68,000,000 in 2003, and rising to \$72,000,000 in 2004. Data on section 4940 taxes indicate that \$720,047,000 was collected in 2001, \$490,425,000 in 2002, and \$262,662,000 in 2003, the most recent year for which data are available.<sup>11</sup> The section 4940 tax, not surprisingly, seems to reflect the general state of financial markets.

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<sup>8</sup> IRS Data Book Tables reflect an unbroken pattern of increasing numbers of applications for recognition of exemption being filed each year.

<sup>9</sup> Indeed, the periodic statements by Treasury and IRS officials, such as those made by Commissioner Thrower, suggest that the level of oversight is consistently inadequate to police marginal tax behavior by tax-exempt organizations.

<sup>10</sup> Supra note 3 at 2621.

<sup>11</sup> Supra note 8 at Table 21.

- **Civil Service Constraints**

A separate and more significant challenge, over and above the question of annual budgets, is the larger issue of the ability of the federal government to be competitive in hiring qualified personnel. Effective tax administration requires highly trained accountants, attorneys and other professionals to review increasingly complex financial relationships. The compensation that can be offered by the IRS is set on a government-wide basis, and while adjustments can be made based on geographic differences in the cost of living and through careful drafting of job descriptions, historically, it has been very difficult for the IRS to compete with the private sector for specialized personnel, particularly in large metropolitan areas. From time to time, however, the IRS has fortuitously received hiring authority during periods in which other economic factors have facilitated entry-level hiring. For more senior or experienced positions, salary differentials with the private sector can be significant. For example, the maximum compensation of the Senior Executive Service, the highest level of career employee in the federal government, is currently fixed at approximately \$145,000, or approximately the salary of a first or second year associate in a large law firm.<sup>12</sup>

- **Institutional Constraints**

The primary functional role of the IRS is to ensure that taxpayers, whether individuals or businesses, pay the appropriate amount of federal income tax. As a result, IRS systems and procedures are designed to support that tax-collecting role. Historically, internal management information systems have been designed to track tax returns and related

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<sup>12</sup> “NALP Survey Details Private Practice Compensation Ranges,” National Association for Law Placement, Press Release (August 31, 2004).

matters, and then adapted to address management information requirements of the tax-exempt organizations function. Other systems follow this pattern of development, as well. For example, electronic filing systems and procedures for the Form 990 series returns, despite the unique public nature and function of the returns, has been a function of the planning, development and implementation process of the electronic filing of the Form 1120. Even the development of formal guidance in interpreting federal tax law applicable to tax-exempt organizations must compete for institutional attention with revenue-producing matters at top levels within the IRS and at the Department of the Treasury.

- **Tax Law Anomalies/Reliance on Tax-Based Oversight**

The authority of the IRS in serving as the sole nationwide regulatory function for tax-exempt organizations is a function of the particular language and scope of the Internal Revenue Code. As a result, certain provisions, by their terms, actually hamper efficient and effective administration involving tax-exempt organizations, in comparison to the opposite effect they have on tax administration for other tax entities. For example, section 6103 dealing with the privacy of taxpayer information, while permitting close cooperation and information sharing between the IRS and state revenue offices with regard to income tax matters, effectively precludes a similar level of coordination between the IRS and state charity regulators, a function that is not placed in revenue agencies at the state level.

The enforcement of more substantive tax-law provisions intended to discourage, rather than subject to tax, certain behavior, such as section 4958 dealing with excess



benefit transactions, section 4941 involving self-dealing, and section 4944 regarding investment policy, are tied to the system of annual filing of tax returns rather than being linked to a more timely oversight/reporting mechanism tailored to the events in question. Depending on the date of filing, a return for a year in which a particular financial transaction occurs or investment is made might be filed as much as ten months and fifteen days after the close of the year in which it occurred and as much as nearly two years after the actual occurrence for events that take place early in a given tax year. An oversight system that relies on an annual tax return filing as its core decision-making document will be structurally incapable of timely addressing issues of concern.

- **From the Standpoint of Charities**

With oversight of tax-exempt organizations at the federal level located in the tax-collecting agency and with the extent of oversight dictated by the Internal Revenue Code, despite the significant percentage of economic activity represented by tax-exempt organizations, there is no institutional champion of the sector within the federal government able to address broader issues and concerns that other types of economic entities have in various departments and bureaus. No Department of Commerce, for example, serves to provide information, such as general statistical data, to support informed decision-making by policy makers. As a recent example, in 2002, when the Treasury Department decided to develop “voluntary guidelines” for charities that engage in international grant-making, there was no governmental source to which it could turn for advice that could opine with authority on matters beyond the relatively narrow scope of the tax law. As a result, the agency drew on private sector sources that were not

intended or prepared to serve in such a role. The standards ultimately developed are, based on comments submitted by a variety of commentators, of questionable legal import and difficult, as well as costly, to implement even by the most well-intentioned tax-exempt organization.

It is clear from the challenges facing the current IRS-based oversight structure that simply increasing the resources available to the agency will likely not result in a significantly more sophisticated system of oversight, certainly not one that is capable of addressing the sorts of issues and financial structures present in the charitable sector. Regulation and oversight are, however, conducted in many areas of the federal government using a variety of structures and mechanisms. Structures such as that employed by the Federal Election Commission to oversee the financial aspects of federal political campaigns are similar to the existing IRS approach. A different approach has been taken with regard to aspects of the oversight of securities markets. The core agency for securities regulation is the Securities and Exchange Commission; however, the SEC is assisted in its responsibilities by a series of related private-sector organizations that exercise regulatory responsibilities that include establishing and enforcing requirements for conduct of the activities in question. For example, the National Association of Securities Dealers regulates brokers and brokerage firms. The Municipal Securities Rulemaking Board plays a similar role with regard to participants in municipal capital markets. The new Public Company Accounting Oversight Board has been established to oversee audits of public companies and their auditors. All three entities share the common characteristics that they are not structurally part of the federal government, yet all exercise oversight authority, including the ability to sanction those who transgress their rules, including the levying of fines, by virtue of their relationship with the SEC.

The National Association of Securities Dealers derives its enforcement powers from the fact that the Securities Exchange Act of 1934, as amended, authorizes the SEC to approve NASD-promulgated standards and rules thereby giving them power and effect similar to governmentally promulgated regulations. Through that mechanism, the NASD oversees more than 5,300 brokerage firms, approximately 90,000 branch offices of the firms, and over 660,000 registered securities representatives, numbers that approach the magnitude of the number of organizations in the tax-exempt sector. By statute, the firms and representatives are required to be members of the NASD. NASD operating funds are derived from the private sector through a system of fees and assessments. The fees and assessments support an annual budget of \$500,000,000 and a staff of 2,200 that handles more than 7,000 cases per year. Enforcement actions taken by the private agency can be appealed to the SEC or to the courts. The governing body has a majority of members drawn from outside the securities industry, thus helping to ensure public involvement and transparency in its operations.

Transposed to the tax-exempt sector, a NASD-patterned agency could have a relationship to the IRS that mirrors that of the SEC and the NASD. Such an agency could have the following characteristics that would address all the challenges presented by the IRS structure:

- The organization could be chartered by Congress as an entity exempt from federal income tax under section 501(c)(1), ensuring exemption of its income from tax and the deductibility of contributions.
- Private sector funding could be encouraged by the amendment of section 4940 to permit a credit against the excise tax on net investment income for payments made to the entity. An incentive for private foundations to make such payments could be created by permitting a slightly larger credit than would be indicated by a strict dollar-for-dollar

arrangement or the tax itself could be calculated at a lower rate if payment was directed to the oversight entity. A similar mechanism could be incorporated into other excise taxes. An alternative mechanism would be to mandate a licensing process for charities and private foundations over a certain size or according to a sliding scale to avoid undue hardship for smaller organizations. Either of the preceding funding mechanisms would eliminate the dislocations caused by the current federal budget process by severing the link to the appropriations process.

- Independence from the regulated community could be ensured by specifying that the governing body, or a majority of the governing body, of the organization be appointed by the IRS Commissioner and the National Association of Attorneys General. Minority members or advisors could be appointed by a process such as designation by the majority and minority leaders of the Senate, or the Senate Finance Committee. Attentiveness to the impact of the organization's oversight would be ensured by the relationship between the organization's funding and the overall financial health of the sector as reflected in the investment experience of private foundations. As a private entity, the application of the privacy rules in section 6103 could be modulated to permit greater disclosure of enforcement actions in a manner analogous to the publication of NASD enforcement actions. For example, the NASD operates the BrokerCheck program that enables the general public to access information about the professional background, business practices, and conduct of NASD-registered firms and brokers. The BrokerCheck system receives over 2.4 million requests per year and according to the NASD website, responds to "most within minutes." In contrast, section 6103 effectively shields information

regarding a tax-exempt organization's behavior from public scrutiny until the behavior is so violative of federal tax rules that exempt status is revoked.

- The current privacy structure in the Internal Revenue Code that prevents information-sharing and collaboration between the IRS and state regulators would no longer prevent coordination and could reduce arbitrage planning around differing levels of enforcement at the state level.
- The organization could be authorized to process applications for exemption, as well as conducting oversight through examinations. The user fees currently paid to the U.S. Treasury could be channeled to the oversight entity. Other user fees could be required for other services and activities. As with NASD enforcement actions, adverse findings by the oversight body could be appealed to the IRS or to the courts.
- Transparency in the oversight body's actions could be achieved by requiring that its records of its operations be made public, together with its finances and other operations. Regular audits could be conducted by the General Accounting Office or the Treasury Inspector General for Tax Administration. Certain enforcement proceedings could even be open to the public, to ensure full disclosure to potential contributors deter other tax-exempt organizations from similar conduct.
- The oversight entity could be empowered to promulgate rules applicable to both tax-exempt organizations, as well as advisors to tax-exempt organizations, much as Circular 230 governs practice before the IRS. As with the SEC/NASD relationship, the rules could be given official status by virtue of an approval process at the IRS. As a private body whose authority would not have to flow exclusively from the Internal Revenue Code, the oversight group could regulate conduct in a broader way, much like a state

attorney general. At the same time, the absence of a mandatory link to Internal Revenue Code provisions would facilitate the development of standards and safe harbors that need not necessarily require a tax or other financial sanction on the organization, potentially leading to more nuanced oversight that might facilitate dealing with sensitive oversight issues related to the First Amendment, such as religion, and the emergence of complex financial arrangements involving the tax-exempt community.

- As a private sector entity, the organization could be freed from the idiosyncratic limitations inherent in using systems and procedures developed to administer the tax-collecting provisions of the Internal Revenue Code. In particular, timely public access to information about tax-exempt organizations through electronic filing of the Form 990, or some variation, would be greatly expedited by severing the link to the filing mechanisms and protocols for other returns. Indeed, an electronic filing system independent of the other IRS tax return filing systems was developed by the National Association of State Charity Officials and the Urban Institute with less cost and well before the IRS system was put in place. Other efficiencies could be achieved as well, such as the elimination of the Form 990-T through an expansion of Part VII of the Form 990 to incorporate the calculation of the unrelated business income tax into the Form 990. This would necessitate the amendment of section 6104 to include returns filed by tax-exempt organizations pursuant to section 6012 to complement the section's current reference to returns required by section 6033. Quarterly public financial statements could be required for tax-exempt organizations by size or activity, much as required from publicly traded corporations, once the link between public tax return filings and tax exempt organization oversight has been revised.

- As a private organization, the oversight group would be able to pay true market-rate compensation and recruit based on its needs, rather than on federal budgeting cycles. Setting staffing at levels dictated by the workload could greatly reduce delays in the issuance of rulings or other interpretative opinions, providing enhanced and timely assurance to the regulated community. Abuses or other concerns could be more quickly addressed.
- A stable funding source and independence from federal contracting requirements would permit the implementation of state-of-the-art support systems not currently attainable within the IRS structure and mission.

Many of the preceding concepts require statutory change, and while such significant change does not occur frequently in federal tax law, the advantages and opportunities of a privatized oversight mechanism along the lines of the NASD seem clear. The advantages of maintaining the current system seem unclear at best. The current environment provides a window of opportunity to consider a proposal like the preceding. With the Senate Finance Committee, the House Ways and Means Committee both focused on the sector, the future of the current array of rules is uncertain. With the spotlight on the inefficient, inadequately funded structure in place, those interested in the strengthening the sector's health and welfare should seize the moment to advance the dialogue to the next level. Certainly, the creation of a new oversight entity will provide the opportunity to address the inefficiencies and anomalies that have been exposed by 35 years of experience with the current system.