

Form 990 as a Tool for Nonprofit Accountability

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October, 1997

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Section

A

Introduction

This paper examines how useful the Federal Form 990 can be for efforts to improve nonprofit accountability. It concludes that the 990 can be quite useful for addressing abuses such as self-dealing, although, because of the weaknesses of the enforcement system, its potential for addressing these problems has not been fully realized. Efforts at improving the system for arresting these kinds of abuses are referred to below as “negative accountability.” In contrast, efforts designed to determine whether an organization is doing anything useful or whether it is doing it effectively are referred to “positive accountability.” The paper for the most part addresses the 990’s usefulness as a tool for negative accountability and, while the point is not belabored, it questions the 990’s effectiveness as a tool for positive accountability.

A note on what this paper covers and what it does not. It examines the Federal Form 990 (**Federal Return of Organization Exempt From Income Tax**) as it applies to organizations exempt from Federal income taxes under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (“Code”) which are not private foundations.¹ 501(c)(3)s which are public charities in addition to filing the Form 990 must also file Schedule A (**Organization Exempt under Section 501(c)(3)**) to the Form 990.² This paper covers both the Form 990 proper and Schedule A. At the end of this paper copies of the Form 990 and its Schedule A are

¹ Section 501(a) of the Code exempts organizations described under subsection 501(c) of the Code and section 501(c)(3) of the Code covers organizations formed and operated for religious, charitable and educational purposes (and a few other purposes that are not important for this paper) that do not engage in more than an insubstantial amount of lobbying, no part of the net income of which inures to any private individual who is an “insider” of the organization in a position of control. Section 509 of the Code presumes that all 501(c)(3)s are “private foundations” unless they qualify under sections 509(a)(1)(2) or (3) of the Code. Organizations that so qualify are frequently referred to as public charities. This paper covers public charities.

² Private foundations organizations exempt under 501 (c)((3) need not file Schedule A.

reproduced. Because the paper does not deal with private foundations, no examination is made of Form 990-PF which private foundations must file each year. Nor does it deal with Form 990-EZ, which can be used by public charities with gross receipts of less than \$100,000 and total assets of less than \$250,000. Analysis of these forms is omitted largely because of constraints of time and space.³ However, much of what is contained in Forms 990-PF and 990-EZ is identical to what is found in the Form 990. The Federal Form 990 and Schedule A are referred to variously below as “Form 990” or just “990.” The Federal Form 990 alone is referred to as the “Form 990 proper.”

So what does nonprofit accountability deal with and why is there so much interest in the subject these days?

The executive director of a major national nonprofit -- perhaps the major nonprofit-- makes multiple trips from Washington to Florida, trips which not by the farthest stretch can

³ There is another reason why the 990-PF is not examined. The recently enacted Taxpayer Bill of Rights 2 (see Note56) in effect de-emphasizes the need to disclose 990-PFs. Part of the new law, now found at section 6104(e)(1) of the Code requires that public charities mail their 990s and 1023 within 30 days after receiving a request to do so. This requirement will become effective 60 days after the Treasury has promulgated regulations under section 6104 which among other things will explicate that part of section 6104 (e)(1) which provides that if a public charity has made its 990 widely available it need not respond to a request for written copies of its 990s or 1023. The regulations should indicate what constitutes being made “widely available.” It is hoped that at some point having 990s available on the Internet will satisfy the “widely available” requirement. Having all the 990s placed on the Internet and thus made available for anyone to see is referred to below as cyber-accountability. None of these new disclosure rules apply to private foundations. They are not required to mail their 990-PFs or 1023 and presumably will be under no obligation to make their 990-PF widely available. Section 6104(d) of the Code provides that 990-PF shall be made available by a private foundation at the principal office of the organization during regular business hours to any citizen on request made within 180 days after the date of the publication of notice of its availability. The notice must be filed no later than the day prescribed for filing the 990-PF in a newspaper of general circulation in the county in which the principal office is located. One may fairly ask how the average citizen will know when the 180 day period begins to run. Thus, when cyber-accountability is fully implemented, as things presently stand, private foundations will be left out of the program. One may legitimately wonder whether some public charities will convert to private foundation status to avoid the new disclosure requirements. (Note, however, that section 6104(e)(2)(A), requiring that organizations described in subsection (c) of section 501 make a copy of their exemption applications available by mail does apply to private foundations.)

be said to benefit his nonprofit. These trips and other personal expenses are paid for by his nonprofit. He installs friends to senior positions within the organization. Of a more serious nature, he has the organization spin off for-profit subsidiary corporations that are financed in part with funds from his organization. Some of these spin-off corporations hire friends and family of the executive director. Loans are made to for-profit spin-off corporations in which officers and friends of the executive director have a financial interest. A report by an investigative firm hired by the board after these abuses were revealed to the public concludes:

Generally, it was alleged that Mr. Aramony maintained a lifestyle exceeding the level of comfort and convenience which most people would accept from the leader of a charitable organization. Specifically it was alleged that Mr. Aramony used UWA funds, both directly and through the use of organizations which had been spun off from UWA operations to rent limousines, to take transatlantic flights on the Concorde, and to reward friends and family members with jobs, board memberships, and consulting contracts.⁴

Closer to home, the insurance brokerage firm of which the chairwoman of the board of directors of a Long Island university is president, receives a contract to place all the liability insurance coverage of the university. Over a decade her firm receives well in excess of \$1,000,000 in fees. Another board member receives over \$150,000 in commissions from advertisements placed on the university's behalf. In 1994 the board of the university, which

⁴ The Report to the Board of Governors of United Way of America, Executive Summary at 1 (1992). The Report was submitted by the law firm of Verner, Liipfert, Bernhard, McPherson and Hand on April 2, 1992. Most of the Report was published in the December 1991 and the January-February 1992 issues of The Philanthropy Monthly.

had been handpicked by its president,⁵ awarded the president a compensation package of \$523,636 in salary and deferred bonuses, making him the second highest paid university president in the country. A recent report states that he received \$837,000 last year.

Interestingly, it was the allegedly high salaries that were paid to these two men that was first seized upon by those reporting on these cases. These salaries were high by nonprofit standards, but there were other nonprofit leaders who were being paid similarly high salaries, and it was arguable that the success these gentlemen had achieved in running their organizations⁶ and the fairly complex nature of the institutions they ran justified their salaries. From a lawyer's viewpoint the almost certainly illegal use of the spin-off corporations in the one case and the arrant self-dealing by several board members in the other were much more serious offenses. But, to begin with, the newspapers went for the salaries.

Good reporters -- hard-news, hard-nosed reporters -- love nothing more than exposing such abuses. Seeming abuses by the nonprofit sector have fallen into their laps like an extraordinary gift. Folks who proceed under the banner of being "charitable," of being altruistic, of working for the good of the community as a whole and not for their own private advancement (in a word, do-gooders) turn out to be as acquisitive as the rest of us and to have agendas that appear to be primarily driven by self-interest. How exquisitely delicious for hard-news reporters to stumble on this stuff. How many people really like do-gooders? How often are do-gooders perceived as preaching virtue to us and urging us to do more for

⁵ The university is Adelphi University and the president is Peter Diamandopoulos.

⁶ During the Aramony regime, UWA's annual collection of charitable funds increased from \$700 million to \$3.11 billion. Diamandopoulos increased Adelphi's endowment from under \$5 million to over \$45 million.

the community, when we just want to be left alone. Thus, to expose do-gooders as abusing their trust, indeed, as being hypocrites, is a high and almost gleeful exercise for hard-news reporters.

And here, of course, is the problem. Immeasurable damage has been done to the nonprofit sector by these exposures. Public trust has been cracked. And this at a time when, for reasons largely having to do with the difficulty governments are having balancing their budgets, attacks are being made on our tax exemptions and cuts are being made in direct government funding to our programs.

While what follows is an obvious point, it must be made. Those groups and people who are abusing the charitable system are very few and they make up a small fraction of the whole large and ever-growing sector. It is, however, in the nature of things that the abuses by a few cause deep harm to all the rest who are doing what they should be doing. In any event, there are good and obvious reasons why accountability has become an important topic for the nonprofit sector. Because of the harm that the exposure of abuses does to the whole sector, what this paper calls “negative accountability” is of particular importance.

It is now necessary to more fully explain the distinction this paper makes between negative and positive accountability. By negative accountability reference is made to accountability failures that permit such things as self-dealing or quasi-looting to occur. That is, any improper diversion of funds that ought to have been used to advance some organization’s exempt purpose but which end up improperly in private hands where they can be used for some private, non-public interest. The examples described above then very well suggest what this paper means by “negative accountability.” In contrast, positive accountability refers to such things as whether an organization is being effective in carrying

out its mission. Donors, whether individuals or philanthropic organizations, when deciding on whom to give will tend to focus on positive accountability concerns (as well as negative accountability lapses). Government agencies in reviewing responses to their requests for proposals will also be concerned with positive accountability issues (as well as negative accountability lapses). Finally, the kinds of information elicited by positive accountability concerns might be useful to policy-makers, legislators and the like considering the role of the nonprofit sector in society.

It is understood that there is a gray area between the borders of negative accountability and positive accountability. In this gray area, for example, there might be included an organization which merely paid its staff high salaries and which accomplished so little of any good that it could be said that charitable funds were being wasted in a grossly negligent manner. It is also understood, given the fact that only a small number of nonprofits commit accountability abuses, that positive accountability in the larger scheme of things is arguably more important than negative accountability. Positive accountability is indeed important, very important, and it is hopeful that the many efforts now taking place to develop effective measurements of nonprofits' outcomes will be successful. In the meantime, there continues to be a problem with abuses and negative accountability concerns, and we believe that for these purposes the 990 is useful and will try to show how this is so.

As just implied, a further position of this paper is that, while there may be ways for developing positive accountability measures for nonprofits, the 990 will never be particularly useful in this regard.⁷ It is true that Part III (**Statement of Program Service Accomplishments**) of the 990 proper attempts to elicit information about what an organization actually does, but

many regard it as not especially effective for these purposes.⁸ The 990 is essentially a financial disclosure and tax regulation form eliciting mostly numerical information and “yes” or “no” answers. This kind of information is indeed compatible for a reporting form like the 990 and for forms where information about financial performance is being elicited. But when trying to measure or evaluate how successful an organization has been in achieving its substantive program goals, it is doubtful whether any kind of a report that relies on text can be useful.⁹

Today for a particular nonprofit the Exempt Organization Division (EO Division) of the Internal Revenue Service (IRS)¹⁰ and the state charities office¹¹ of the state in which it is located, will be the two major government oversight and enforcement agencies that exercise general jurisdiction over the organization¹² and enforce what might be called the nonprofit

⁷ Appendix B provides a brief analysis of the usefulness of the 990 as a positive accountability tool.

⁸ Many believe that qualitative/evaluative type information cannot be effectively caught on a report that is limited to text entries. It may be that only actual on-site visits can reveal this type of information. This seems right.

⁹ This point is somewhat expanded upon in Appendix B at pages 2-4.

¹⁰ That part of the IRS with principal jurisdiction over section 501(c)(3) nonprofits is the Office of the Assistant Commissioner for Exempt Plans and Exempt Organizations and in this office the Exempt Organizations Division concentrates on exempt nonprofit organizations.

¹¹ State charities offices, as previously mentioned in the text, are those offices which exercise jurisdiction over charities within their states. (Charities for these purposes are for the most part organizations that are described under section 501(c)(3) of the Code.) These offices vary widely both as to the parts of state government where they can be found and as to the level of resources that are devoted to them. Many are found in a state’s Attorney General’s office, sometimes as a division of that office, sometimes simply as an individual assigned to supervising charities (frequently an Assistant Attorney General). Often they are placed in other state offices such as the Consumer Affairs Bureau and in at least one case the Agriculture Department. As to the amount of resources devoted to these offices, the first thing to say is that none of them are close to being adequately financed. Some states have no such offices at all and their Attorneys General as a practical matter do virtually nothing in the area of supervising charities. Some devote a very little to this work and most devote only a bit more than a very little. It is estimated that there are only about a dozen states with adequate state charities offices and even these, as suggested, are woefully under-resourced.

¹² For many nonprofits they will be the only government agencies which exercise any jurisdiction over them.

negative accountability system.¹³ Ultimately this system will be no better than its enforcement and it is the conclusion of this paper that the enforcement provided by these two agencies needs strengthening.

These two offices have somewhat different interests. The IRS's interest is largely focused on whether any of an organization's assets are being improperly diverted from charitable uses into private, personal hands. In any such cases there might be money that ought to be taxed or it might be that an organization's exemption should be revoked with the result that either the organization becomes taxable or that money that should have been taxable but was sheltered by the organization's exemption, will now be taxable.¹⁴

State charities offices generally are charged with protecting the public's interest in charities.

Nonprofits receiving government grants or contracts will, of course, be supervised by those government agencies which award the grants or contracts. But even in these cases, for the most part, the government agency awarding the contract will only be interested in how the contract is carried out. General, overall supervision will be left to the EO Division and the state charities office.

¹³ These two nonprofit regulatory agencies will be referred to as the two generic agencies.

¹⁴ This suggests that primary concern for the IRS is to assure that income that ought to be in the tax base is being taxed. Some observers have a broader view's of the IRS's function in the area of charitable organizations. James J. McGovern, former Assistant Commissioner of the Office of Exempt Plans/Exempt Organizations of the Internal Revenue Service, in his testimony before the National Commission on Restructuring the Internal Revenue Service and more recently in an article in *Tax Analysts*, has argued persuasively that when Congress set up the EO/EP Office in 1974 by adding section 7802(b) to the Code as part of the Employee Retirement Income Security Act it so did so that the non-revenue-raising aspects of the IRS's interest in employee plans and exempt organizations would be given a high level of attention. In the recent *Tax Analyst* article that McGovern did with Phil Brand, they cite the following from the legislative history of section 7802(b): "...[I]t must be recognized that the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of the exemption provisions. Similar concern has been expressed in the past over the Service's administration of the provisions of the tax law relating to exempt organizations.

Your committee believes that in the employee benefit plan and tax-exempt organization area it should be easier to emphasize the basic objectives involved if the activities relating to these plans and exempt areas relating to auditing, rulings, etc., whether in the field or in the national office are brought together and if the top direction for these activities also specialized in them. For the reasons outlined, the bill established a separate office in the Internal Revenue Service, headed by an Assistant Commissioner for Employee Plans and Exempt Organizations...." S. Rep. No 383, 93rd Cong., 2d Sess. 107-87 (1974), 1974-3 C.B. 186-7. McGovern & Brand,

Charities do not have owners. They are public entities and their boards govern them as fiduciaries for the public. The sovereign, through its state charities office, is responsible for making sure the public's interest in these organizations is safeguarded. Thus, while state charities offices like the IRS are concerned to make sure that moneys that ought to be used for charitable purposes are not improperly siphoned off for private interests, they arguably have a somewhat broader interest. Using income from restricted funds for purposes other than those for which the funds were given is a concern of state charities offices and very rarely of any interest to the IRS. Similarly state charities offices spend a great deal of their time and energy watching out for charitable solicitation fraud while these matters are only of minor interest to the IRS. Furthermore, governance lapses that may not result in the improper diversion funds could be of concern to a state charities office. Moreover, it is hard to imagine that the IRS would ever sponsor conferences or workshops on what nonprofit board members should do to fulfill their responsibilities and yet this is becoming an important activity for a number of state charities offices.¹⁵ In any event, a preponderance of the abuses that occur involve the improper diversion of funds into private hands, and this is a concern of both agencies.

For a number of years observers of the nonprofit sector have discussed whether the regulation of nonprofits should be largely federalized by either expanding the IRS's jurisdiction or establishing something like England's Charity Commission¹⁶ or whether

EP/EO – 'One of the Most Innovative and Efficient Functions within the IRS', Tax Analysts (August 25, 1997).

¹⁵ Massachusetts, New York and the state charities offices in several other states have conducted such programs.

¹⁶ The Charity Commission has general jurisdiction over charities in England and Wales. Most charities must register with the Charity Commission. It has two divisions: the Charity Support division which provides charities with legal assistance and the Charity Supervision division which deals with matters of accountability and

regulation should be left largely to state charities offices.¹⁷ An argument against leaving it to state charities offices has pointed to how woefully under-funded and consequently understaffed these offices are. More recently severe cut backs to the EO Division¹⁸ have rendered that agency much less able to perform its basic regulatory role and retraction rather than expansion of functions would seem to lie in its immediate future. It is a conclusion of this paper that both generic charitable regulatory agencies are too weak, and thus, a debate as to which ought to primarily be relied upon to assure nonprofit accountability is fatuous. Both ought to be strengthened.¹⁹

If these two agencies are weak it is not because they are poorly run or staffed by ineffective bureaucrats. In fact the EO Division and many state charities offices are very well run and are staffed by superb public servants. No, these offices are weak because society has chosen to allocate so few resources to these agencies and they simply do not have anywhere near the staff or resources to do a fully adequate job.

Today, the Form 990 is the major disclosure form both for the EO Division and for

the protection of charitable property. The Commission has the power to appoint, discharge or remove any trustee, officer or employee of a charity, to vest or transfer charitable property and to institute investigations into charities.

The Federal Trade Commission has some jurisdiction over charitable solicitation and there is debate about whether it should be expanded. See Gerhart, *Regulating Charitable Solicitation as a Form of Consumer Protection*, Paper presented to the NYU Program on Philanthropy and the Law Conference on "Charitable Solicitation: Is There a Problem," October 12-13, 1990.

¹⁷ When a little over a year ago the author of this paper expressed a strong interest in state charities offices, one of its commentators began to refer to him as George Wallace.

¹⁸ On April 24, 1997 at the N.Y.U. Tax Planning for Exempt Organizations Symposium, James McGovern characterized these cuts as "regulatory meltdown."

¹⁹ This conclusion hardly enjoys universal acceptance. There are a number of people for whom it will be an anathema. They regard the sector as being over rather than under regulated. Most of them come from the professional solicitors and multi-state solicitors quarter of the sector who are concerned about the burdensome nature of charitable solicitation rules. There may also be reflected here a contemporary discontent with government. For an expression of these views see almost any issue of the estimable *The Philanthropy Monthly*.

state charities offices. It was not always this way. For many years the Form 990 was of use only to the IRS. In the early 1980s representatives of the Treasury Department and Internal Revenue Service and representatives of the National Association of Attorneys General and the National Association of State Charity Officials (NAAG/NASCO), with the goal of making uniform charitable reporting requirements, agreed on changes to the 990 that made the form acceptable both to the IRS for Federal tax purposes and to the state charity officials for purposes of the annual report that most charitable organizations must file with their local state charities offices. These reports are required by the states both to help them supervise domiciled charities to assure that abuses are not occurring as well as to help them regulate those charities that solicit funds within their borders. Today nearly all states that require annual financial reporting accept the 990. Some require supplements.²⁰

In general terms how might the Form 990 be used as a negative accountability tool?

First, it can be used to detect abuses. Although, as will be frequently repeated below, it is unlikely that any preparer knowing of an abuse will report it specifically on Form 990,²¹ there

²⁰ A general effort continues to persuade other states to adopt the 990. This effort toward uniformity is of critical importance to those charities that solicit for funds in many states. To the extent that different forms are required, the burden of preparing and filing them can be time consuming and costly. Multiple filing requirements has also had the effect of causing friction between that very small portion of the charitable sector that engages in multi-state solicitations and state charity officials. This has hurt efforts by representatives of the nonprofit sector and state charities offices to cooperate together in working to address accountability abuses. Today an endeavor to promote uniformity in state reporting forms that supplement the 990 is being energetically undertaken by a coalition of representatives from state charities offices and multi-state filers in an effort called the “Multi-State Filer Project.” A NAAG/NASCO resolution has in effect sanctioned this project to pursue collaborations between state officials and representatives from the nonprofit sector to further the aim of uniformity of reporting requirements. To begin their effort they have been promoting the acceptance of a registration form (the NAAG/NASCO Standardized Registration Form) that over the past few years or so has been created by representatives of the nonprofit community and state charity officials. So far some 20 states have agreed to accept this form. Thus progress has been made toward achieving uniformity of reporting: the NAAG/NASCO Standardized Registration Form for the initial registration form and the 990 for the annual report.

²¹ It will be suggested below that the Form 990 has evolved to such an extent that if an organization has perpetrated one of the abuses that are the warp and woof of negative accountability concerns, e.g., self-dealing or

may be somewhat general indications that all is not right with an organization -- aggregated expense payments that are inconsistent with payments to individuals or incomplete lines -- that call for further investigation. Second, if it is found out from sources other than the Form 990 -- a whistle blower -- that an abuse has occurred and the abuse is not reported on the form, enforcement agencies can add to their quivers the arrows of intentional misrepresentation of material facts.

Implicit in what has just been said is the suggestion that the Form 990 as a negative accountability tool is primarily for the enforcement agencies, the IRS and state charities offices. And it is certainly so that this is one of its major functions. It was surely the intent of the developers of Form 990 that it would be used primarily by enforcement agencies.

Do the two generic enforcement agencies use the Form 990 effectively as a negative accountability tool? As mentioned, every year most 501(c)(3) nonprofits are required to file the form both with the IRS²² and with their state charities office.²³ The author of this paper has spent a fair amount of the last three years learning about these agencies²⁴ and it is clear that neither the EO Division nor any state charities office have sufficient staff to adequately review these filings. The information elicited by a small number of the lines on each Form 990 filed are key punched into a data base by the IRS and computer checks are run to see if anything untoward shows up. But given the complexities of some of the transactions by

improper payments to key employees, and if the preparer knows about the abuse, it is nearly impossible to complete the return and not report the abuse without making a material misrepresentation.

²² Generally, five and half months after the close of their fiscal year.

²³ Requirements for filing with state charities offices vary widely from state to state. Moreover, in most states there are other forms that need to be filed in addition to the Form 990.

²⁴ He has been aided in these efforts by Harriet Bograd, a superlative researcher and wonderful colleague, to

which abuses are perpetrated and the carefulness with which the Form 990 needs to be examined to begin to see these problems, it is hard to believe that these computer checks are terribly effective. On the state side, there appear to be very few states that carefully examine all the Form 990s filed with them.²⁵ One state runs a computer check similar to the IRS. For the rest, little is known, but it does not appear that in many cases the forms are scrupulously reviewed and in a few cases the claim that the forms sit around in boxes collecting dust may be true. Furthermore, numerous attempts at trying to find out how personnel use the forms to detect abuses have suggested that the science has not been overly developed.²⁶ That so few cases appear to be have been brought for intentionally misfiling the Form 990,²⁷ in view of the fact that over 650,000 forms for 501(c)(3) organizations are filed each year, further suggests that these forms are not are fully reviewed.²⁸ Finally, also suggesting that the Form 990 has not been used effectively to detect abuses, it appears that a large number of the cases of abuse that these agencies investigate and prosecute are originally brought to their attention from outside sources, particularly by stories appearing in the newspapers and other media. In these cases the second use of the 990 noted above comes into play. Thus, when it is found

whom he is endlessly grateful.

²⁵ Most of these states have relatively few nonprofits in their jurisdiction so the task is manageable. Several of them use the information that is elicited by the 990 for purposes of supplying information about charities within their borders to the public. See Note 33 in Appendix B.

²⁶ Representatives from the generic offices have tended to be very cautious in what they say about their operations. This is understandable. Some of the information sought is in the nature of a trade secret. (If it was widely known what lines regulators particularly looked at or what ratios they used to find evidence of abuses, returns prepared by abusers would be perhaps be tailored to avoid these checks.)

²⁷ Appendix A at the end of this paper briefly describes the various penalties authorized in the code for misfiling. Similar penalties exist at the state level.

²⁸ It also points to the fact that these agencies are woefully under staffed and do not have adequate resources to bring these cases.

out from sources that an abuse has occurred and the abuse is not reported on the 990, enforcement agencies can add to their quivers the arrows of intentional misrepresentation of material facts.

If these assertions about the difficulties that the generic agencies have in giving the Form 990 the kind of review that would be necessary to fully realize its potential as a tool for dealing with negative accountability are true, it is, to recall an earlier point, simply because society has chosen to allocate so few resources to these agencies. At the end of this paper (before the appendices) there is a note that compares the staff and budget sizes of the EO Division, the state charities offices, and the Securities and Exchange Commission.

If society at large has little interest in policing the relatively few incidences of abuse in the nonprofit sector, the sector itself does. As mentioned above, the exposure of cases of abuse and corruption by nonprofit organizations is very likely to have caused an erosion in the public's confidence in the sector. It may then be in the sector's interest to help ferret out these problems.²⁹ One way of doing this would be to increase the ability of individuals to read the Form 990. If a greater number of private individuals were regularly reviewing filed Form 990s knowing what to look for, it is likely that the level of abuses would decrease. The

²⁹ Since the early 1990s, when these abuses first began to receive press exposure, a number of self-reform efforts have begun in the sector. The author with the help of Harriet Bograd engaged in a two-year study sponsored by the Nonprofit Coordinating Committee of New York to see how the nonprofit accountability system might be strengthened. Other efforts include the Independent Sector's development and promotion of the new Intermediate Sanctions legislation which was enacted into law last summer, (The Intermediate Sanctions law is discussed below in Part I.), the Maryland Association of Nonprofit Organizations' "Ethics and Accountability in the Nonprofit Sector Initiative," and the Colorado Association of Nonprofit Associations' "Accountability Project." The Maryland initiative, supported with major foundation funding, aims at developing a sector-wide code of conduct or standards, a system of self-regulation to promote compliance with the code of conduct and educational programs which will encourage board and staff members of nonprofits to comply with all existing laws and regulations. Colorado has been reviewing their local watchdog group, the Better Business Bureau's Philanthropic Advisory Service, to see how effectively it promotes nonprofit accountability and is encouraging nonprofits to subscribe to and comply with the BBB's standards.

reasons for this are elaborated upon below. This paper then is part of a wider effort aimed at engaging private citizens with the negative accountability problems of the nonprofit sector.

Of critical importance in making filed Form 990s easily available to private individuals will be the placing of all Form 990s on the Internet so that anyone with access to the Internet can have transmitted to her a copy of any 990 that has been filed virtually immediately after it has been filed. Many refer to such a system as cyber-accountability. There will be a number of technical problems in implementing this system, but those who work on these matters are well on the way toward solving them and we believe that it will only be a few years before this system is in place.³⁰ This will allow any individual with access to the Internet³¹ to examine any or all of the 990s filed by an organization for the past three years. And, importantly, s/he will be able to do this without anyone in the organization knowing s/he is doing so. While anyone can now travel to a nonprofit's office and ask to see its 990s, or will soon be able to ask that the organization mail a copy of the 990s to them, in these instances they will have made their identity known and this may deter some (say an employee) from asking to see the documents. On the other hand, with cyber-accountability, as just mentioned, people will be able to snoop without anyone knowing they are snooping. Furthermore, those who run organizations that file 990s will be aware that anyone in the world will be able to examine their 990 without these managers knowing they are doing so. This may move those who complete 990s to be more careful. Quality reporting will be

³⁰ See Note 3.

³¹ We believe that the number of people who will have computers, modems, etc., and can afford the \$20 or so per month for unlimited access to the Internet is growing exponentially. If someone does not have the equipment herself, she will be able to use that of a friend, colleague, or the machine at the office. That is to say, access will not be a big difficulty.

enhanced.³²

Here is one way that cyber-accountability might work:

1. The EO Division of the IRS would maintain a 990 web site (“990 Web Site” or “Web Site”). The 990 Web Site would be available to anyone with access to the Internet.³³ By going to the Web Site a user could call-up a 990 form for completion. It would appear on the user’s screen and would be similar to the paper-copy Form 990. S/he could then complete the 990 by key-punching in the data elicited.³⁴ When the 990 was completed, the user could electronically transmit it to the IRS.
2. The 990 Web Site would receive and store in a database each 990 filed.
3. By accessing the 990 Web Site anyone could call-up any 990 almost immediately after it was filed. This could be done by entering the organization’s name or Employer Identification Number (E.I.N.).³⁵ Seconds later the organization’s 990 would appear on her screen. She would be able to download it and print it out. At the end of this process she would have in effect a hard-copy of the organization’s 990. This could be done for one organization or for many, say, for example all the day care centers located in three or

³² This would be a very constructive incidental benefit of cyber-accountability. It is widely recognized that many groups do not complete the 990 accurately. This comes about mostly as a result of lack of attention and rather than as a result of intentional omissions or errors. As more and more 990 preparers become aware that their work is subject to being viewed at any time by anyone, they may take more care. This will be a boon for positive accountability purposes.

³³ The web site address of the 990 Web Page would be widely publicized and the Web Page would be accessible by following a link from the existing IRS Web site.

³⁴ After working on the form, a user would have the option of saving her work prior to submitting it to the IRS. If s/he saves her work, s/he would be able to return to it later and continue to work on it until s/he is satisfied with the entries. After the form is submitted to the IRS, however, s/he will not be able to make further changes to the document.

³⁵ If there were multiple entries with the same name or E.I.N.

four contiguous zip codes.³⁶ The data on the 990 Web Site could be easily copied from the Web Site to a file using standard database format and then sent anywhere. Thus, the EO Division could use this file to transfer data to their own system. State charities offices could use the method.

A demonstration project is now underway that will in effect produce this cyber-accountability system.³⁷ As of this writing, the pages of the 990 have been encoded into the language of the Web (html). The next step will be to write programs that store and retrieve submitted information. If requested, the complete system, loaded into a computer, could be made available to the IRS for less than \$25,000 requiring nothing more than plugging into a power outlet and connecting to the Internet via a phone line. Several states have expressed an interest in the system, and it is likely that New Hampshire will install it next spring.

In assessing the potential for cyber-accountability, let us assume for a moment that rogues are intent on committing all sorts of negative accountability abuses. If the 990 has been developed to such an extent that it is nearly impossible to commit such abuses and honestly fill out a 990 in a way that the abuses will not be exposed, then the only way to avoid in a sense self-confessing would be to have the 990 intentionally filled out in a misleading way. This would put the signer, preparer and others who participated in the fraud in jeopardy of all sorts of penalties including criminal sanctions. See Appendix A, which describes the various penalties for misfiling 990s. It is conceivable therefore that cyber-

³⁶ As organizations file at different times, in getting access to all day care centers in the zip codes requested, the searcher may be presented with 990s for different years.

³⁷ The demonstration project is being conducted by the Multi-State Filer Project (a consortium of nonprofits who file in many states) under the direction of Cliff Landesman and Bill Levis. It is estimated that the system will be complete by the end of the year.

accountability will cause rogues to think twice before they stray. They might reflect about the difficulty of completing the 990 in such a way that would not be misleading and would not reveal their abuses. They might then think about all the people who will be able to access to their 990 without their knowing and that it might just happen that one of these snoopers aware, for example, that an abuse has taken place, might conclude that the 990 had been intentionally misfiled. A fear may then arise that the snooper will inform some authority about his suspicions. Potential penalties would swim before their eyes and at this point, just conceivably, they might change their behavior.³⁸

It may be expected that the increased level of attention to the 990 that is likely to be

³⁸ Morals and ethics address the questions of what man ought to do and ought not to do. Thou shalt not take the life of another (except in cases of self-defense), thou shalt not steal and thou shalt so act as to treat humanity, whether in your own person or in that of any other, always at the same time as an end, and never merely as a means (Kant's supreme practical principle). Positive law covers much of the same ground as ethics. Murder and stealing are crimes. But in many cases, because the likelihood of being caught by those who enforce positive law may be remote, we rely on a person's moral behavior to help assure a civilized society. We expect that people will act morally because they believe they ought to act so. It is said that they are guided by their conscience. But while what is wrong and what is right may be clear, there are an unfortunate number of people who are not moved by a sense of ought. However, while such people may not feel the pangs of conscience, they may decide that it is prudent to act morally, because if they do not do so and it is found out, they may suffer loss. In traditional terms, we are describing two different moralities: the morality of obedience and the morality of prudence. As the words suggest, the morality of obedience expects people to follow moral maxims because they feel they ought to. On the other hand the morality of prudence supposes that people behave ethically because they believe it is prudent to do so.

Let us see how this distinction applies to our problem. Assume a rogue executive director of a nonprofit organization contemplates having funds transferred to him in circumstances where the transfer would clearly constitute prohibited inurement. He knows this. As part of his scheme he also intends to have the organization's 990 filled out in such a way that the inurement will not be disclosed, that is, he expects to have intentional misstatements made in the 990. Our rogue is impervious to any morality of obedience and is sophisticated enough to realize that, given the number of filing nonprofits and the size of the staff of the IRS, it is wildly unlikely that his malefactions would ever be discovered. Now we introduce cyber-accountability and suppose that our rogue becomes aware that any one of his staff (some of whom he believes detest him) may examine the 990. He may think that some of them might find out about the transfer and be sufficiently sophisticated about reading 990s to notice, in the event he decided to have the 990 misstated, that the organization's 990 did not seem to report the transfer. Finally, he may fear that one of his staff as a result of snooping around the 990 may report the fact that it is likely that the 990 was not filled out correctly and may contain intentional misstatements. Now, however immoral he might be, being a prudent fellow, he decides not to have the transfer made. In sum, the introduction of cyber-accountability may produce a heightened morality of prudence that will be effective in changing behavior for the good.

brought about by the advent of cyber-accountability will include the board of directors of nonprofit groups. As the boards of nonprofits are the primary guardians of nonprofit accountability, it will surely be a positive result if they begin to devote more time to reviewing their organizations' 990s. Today it is widely understood that only a very few board members ever look at their organizations' 990s and in many cases they are merely signed by one board member who gives the document only the most cursory of glances. As board members begin to realize that any one in the world may be looking at their 990, this deplorable situation may change. Board members themselves may discover problems that they would not otherwise have know about and take steps to stop developments that might ripen into abuses.

All of this, however, assumes that the 990 can be used to detect abuses and this is a proposition that hardly enjoys universal acceptance. Many believe that the 990 is impenetrable and is of little use to anyone. They wonder even if regulators can really use it to detect abuses. And it is at just this point that we get to the crux of this paper. Is the 990 useful for those who might characterize themselves as sleaze-busters? Most of the remainder of this paper, goes through the 990, more or less on a line by line basis, to see where it is that abuses that give rise to negative accountability might be detected. Not every line of course. Given both the Form 990 proper and Schedule A, there may be as many as 300 lines. This paper only deals with a fairly small number of the whole. There are some lines where it is hard to see how if an abuse has taken place these lines can be filled out in a non-misleading way. There are other lines which, even assuming an abuse of some sort, can be filled out in such a way that reflects what actually happens, that is honestly filled out, without self-confessing so-to-speak. But they may give rise to suspicion. That is to say fire may rise from some lines while others will only produce smoke. But there are many lines where it would be

virtually impossible to find evidence of a negative accountability abuse. These lines are not discussed.

Perhaps I am overly optimistic about the use of the 990 as a tool for sleaze-busting. One way then of approaching this paper is to think of it as an exercise aimed at testing how adequate the 990 is for flushing out the kinds of abuses that negative accountability is worried about. To the extent it is adequate, then what is explained here should be useful to those intent on examining a 990 to find out whether any such abuses have occurred. On the other hand, to the extent the 990 is inadequate for such purposes perhaps this exercise will suggest ways of strengthening it.³⁹ This would surely be a good thing since, as pointed out, the 990 is the primary disclosure tool for the two generic government regulatory bodies -- the IRS and the state charities offices.

Some may be offended by the somewhat police detective nature of much of what follows. There may even be a suggestion of perverse glee as we unearth another line that has been astutely written to catch malefactors. An understandable reaction may be that this is awfully negative, perhaps even paranoid, in its assumption that there are people out there intent on abusing the system. But, of course, the goal of the paper is to show how the 990 can be used for finding abuses and, given that goal, it is perhaps inevitable that the tone of the cop creeps in from time to time.⁴⁰

³⁹ In this connection, the author would very much like to hear any reactions to the paper and ideas about ways people might think the 990 could be improved. There follows various ways of reaching me: By mail: Peter Swords, NPCC, 121 Avenue of the Americas, New York, NY 10013. By phone: 212-925-5340. By fax: 212-925-5675. By e-mail: pds @ pipeline.com.

⁴⁰ Worse. Some of the things said below about excess compensation and excessive fringe benefits may suggest a latter-day Savonarola. But here a note of caution. Some of the salaries and perks that well-off nonprofits pay may not be considered troubling by those who work for them or by their lawyers and accountants who are retained by them and like-situated organizations. However, the ordinary American citizen takes a somewhat

As suggested, there are some lines and parts of the 990 that are more likely to reveal negative accountability abuses than others. As the major abuses involve improper payments to individuals, those lines and parts where such payments are listed are the places where it is most likely that abuses may be found. On the other hand, those lines that call for the listing of aggregate payments are less likely to suggest problems. Between these two types of requests for information are such questions as “Is the organization related ... to any other exempt or nonexempt organization?” or “During the year, has the organization attempted to influence ... legislation?” Part I of this paper will deal with those lines which show payments to individuals and are believed to be the places on the 990 which might bear the most fruit, albeit sour fruit, for those looking for trouble. Part II identifies those places that might intimate some cause for concern but are unlikely to show clear evidence of abuse. For the most part they will be lines which show aggregate amounts. One might say that Part I looks at places on the 990 where a smoking gun may be found whereas Part II merely notes spots where smoke, and sometimes only slight wisps of smoke, may be found. This paper concentrates most of its attention on financial abuses and gives somewhat less attention to those parts of the return which ask questions about political activity.

In sum, this paper advances the following syllogism. First, that it is important to improve nonprofit accountability and particularly what the paper calls negative accountability.⁴¹ Second, that the two generic enforcement agencies, because the public has

different view of these payments and those who work for regulatory agencies may be exposed to these more populist views to a greater extent than those who inhabit the high-end of the nonprofit sector.

⁴¹ This is important at any time; with recent assaults on the sector, a fair number of which have been stimulated by publicity given to abuses, jacking up negative nonprofit accountability has become particularly important. While the paper recognizes that positive accountability, assuring that groups are being run efficiently and accomplishing worthwhile goals, is as important as negative accountability and, indeed, may be more so, since it

not seen fit to adequately support them, are not fully up to the task and that therefore those who care about the health of the sector, who for the most part are people who work in and for the sector, should take up the cudgel and become more involved in helping police abuses. It suggests that this can be done in part by learning how to read the Form 990. Thus, the essential purpose of this paper is to examine how ordinary individuals can use the Form 990 to help eradicate or at least lessen negative accountability abuses. Parts I and II constitute in effect a how-to manual.⁴² As noted, many believe that because of its complexities the Form 990 is a poor accountability tool⁴³ and will never be used to any significant effect by private individuals. This paper rejects this conclusion and will try to show that it can be a very useful instrument for challenging negative accountability abuses.

Part I

There are four principal places on the 990 asking for the listing of amounts paid to individuals which are prime sites for looking for abuses. They are (1) Part V of the 990

limits its attention to a text-based reporting form and is at best agnostic about the usefulness of such a form for positive accountability, it largely limits itself to negative accountability.

⁴² This paper is obviously too dry and technical for such use. A next step will be to simplify it and make it reader-friendly.

⁴³ I believe that this criticism emanates for the most part from those who would use the Form 990 for positive accountability purposes. This seems a fair criticism. As noted, other than Part III of the Form 990 proper, there is hardly anything on the form that tells you what an organization does. Furthermore, Form 990 is long and it is complex and is likely to turn away all but the most intrepid unless they have available to them some assistance on how to read it. Even with such assistance, however, which is precisely what this paper will try to provide for negative accountability purposes, it remains the conclusion of this paper that the form is not overly useful for positive accountability purposes.

proper asking for compensation information on directors, key employees, etc.,⁴⁴ (2) Part I of Schedule A of the 990⁴⁵ asking for compensation information on the five highest paid employees other than directors, etc., who receive compensation in excess of \$50,000, (3) Part II of the Schedule A asking for compensation information on the five highest paid independent contractors who receive compensation in excess of \$50,000, and (4) Question 2 of Part III of Schedule A, the “Great Self-Dealing Question.”⁴⁶

A major type of improper payments to individuals involves either excessive compensation or some sort of non-compensation payment to an organization “insider” that violates the rule against private inurement.⁴⁷ Who is an insider can be a thorny question and much debate is now taking place about this issue in connection with the implementation of the new Intermediate Sanctions law,⁴⁸ but for our more simple purposes, in nearly all cases it

⁴⁴ Including the all-important Question 75, discussed in detail below, asking about payments from related organizations.

⁴⁵ For the rest of this paper Schedule A of the 990 will be referred to as “Schedule A.”

⁴⁶ There are also several other lines in the 990 proper where payments to individuals are listed. They are discussed at the end of Part I.

⁴⁷ Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (Code) provides in part that an organization will be exempt if it pursues a charitable purpose and does not engage in proscribed political activity so long as “no part of the net earnings of which inures to the benefit of any private shareholder or individual...” Very generally, inurement occurs when an exempt organization transfers income or assets of the organization to an insider of the organization that are worth more than what the organization received from the insider for the transfer. Here is what an important Ninth Circuit Court of Appeals case dealing with the Church of Scientology says: “The heart of section 501(c)(3) tax exempt status is the phrase ‘inures to the benefit.’ Payment of reasonable salaries to church officials does not constitute inurement. However, payment of excessive salaries will result in a finding of inurement. Inurement can also result from distributions other than the payment of excessive salaries. Unaccounted for diversions of a charitable organization’s resources by one who has complete and unfettered control can constitute inurement.” Church of Scientology of California v. Commissioner, 823 F.2d 1310, [](1987). The Internal Revenue Service has developed a companion “private benefit” doctrine that puts a 501(c)(3)’s tax exemption in jeopardy if it provides a substantial economic benefit to individuals who do not exercise control over the organization. See Note 80. The new Intermediate Sanctions law discussed below covers much of the same ground.

⁴⁸ The new law, found at section 4958 of the Code, calls such insiders “disqualified persons” and defines the term “disqualified person” in part as “any person who was ... in a position to exercise substantial influence over the

is clear that key employees, officers and directors will be insiders and to begin with these are the individuals we will focus on.

To start our more detailed analysis of the provisions of the 990, we assert that virtually any payment⁴⁹ to an officer, director, key employee or highly paid employee by an exempt organization must be listed at either Part V of the 990, Part I of Schedule A, or in the attached detailed statement explaining the self-dealing transactions noted at Question 2 of Part II of Schedule A. Thus, assuming an improper payment, there are three possibilities: first, that the payment is there for everyone to see; second, that it is there but not disclosed in such a way as to be obvious; and third, that it was intentionally omitted from the return. As we go through the 990 provisions in question, we will suggest how these three possibilities might play out.

We start with Part V of the 990 proper and Part I of Schedule A. They are set out immediately below.

affairs of the organization.” Section 4958(f)(1)(A). Who such a person might be is hardly self-defining.

⁴⁹ Or the transfer of income or assets of the filing organization.

“key employee” is defined in the Instructions to the 990 as follows: “A ‘key employee’ is any person having responsibilities or powers similar to those of officers, directors, or trustees. The term includes the chief management and administrative officials of an organization (such as an executive director or chancellor) but does not include the heads of separate departments or smaller units of an organization.”⁵⁰ The Instructions to Schedule A make clear that key employees are not to be included in Part I, they having been listed at Part V of the 990 proper.⁵¹ Thus the net is cast wide: all key employees (which includes pretty much all those at the top with organization-wide authority) and in addition the five highest paid employees (who receive over \$50,000 a year), plus directors and officers. One might suppose that if compensation payments are going to be made that raise questions, they would be made to individuals included in this group.

Next it should be noted that the compensation net is a wide one. Column (C) Compensation picks up salary, fees, bonuses and severance payments; Column (D) all forms of deferred compensation;⁵² and Column (E) fringe benefits.⁵³ It is all there. If there are

⁵⁰ See 1996 Instructions of Form 990 and Form 990-EZ, page 18. The Instructions read: “A chief financial officer and the officer in charge of administration or program operations are both key employees if they have the authority to control the organization’s activities, finances, or both. The ‘heads of separate departments’ reference applies to persons such as the head of the radiology department or coronary unit of a hospital or the head of the chemistry or history or English department at a college. These persons are managers within their specific areas but not for the organization as a whole and, therefore, are not key employees.”

⁵¹ The 1996 Instructions of Schedule A (Form 990) at page one states: “**Do not** include employees listed in Part V of Form 990 or in Part IV of Form 990-EZ (list of Officers, Directors, Trustees and Key Employees).”

⁵² The Instructions for Column (D) read in part: “Include in this column all forms of deferred compensation and future severance payments (whether funded or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under section 401(a)). Include also payments to welfare benefit plans on behalf of officers, etc. Such plans provide benefits such as medical, dental, life insurance, severance pay, disability, etc.”

⁵³ The Instructions for Column (E) state in part: “Enter both taxable and nontaxable fringe benefits (other than

questions about a person being paid excessive compensation, it is hard to see how all the amounts paid will not be picked up by Parts V and I. So, assuming the form is filled out correctly, the data as to the compensation payments to that individual will be known.⁵⁴ This will provide a good start for those who want to raise questions about salary levels however difficult it maybe to establish that actual salary levels are improperly high.⁵⁵ In some cases the information required by Column (D), deferred compensation, or by Column (E), fringe benefits, may be omitted. This may reflect a mere oversight in completing the return or it may have been done intentionally to obscure the level of total compensation. In any event such an omission may raise a flag.

On the topic of excessive compensation, a word needs to be said about the new Intermediate Sanctions law and excessive compensation.⁵⁶ In brief, this law imposes on any disqualified person⁵⁷ who receives an excess benefit as part of an excess benefit transaction a tax equal to 25 percent of the excess benefit.⁵⁸ Here is how the new law defines “excess

de minimis fringe benefits described in section 132(e)). Include expense allowances and reimbursements that the recipients must report as income on their separate income tax returns. Examples include amounts for which the recipient did not account to the organization or allowances that were more than the payee spent on serving the organization. Include payments made under indemnification arrangements, the value of the personal use of housing, automobiles, or other assets owned or leased by the organization (or provided for the organization’s use without charge), as well as any other taxable and nontaxable fringe benefits.”

⁵⁴ Of course, whether others in comparable positions are being paid comparable amounts, a factual matter of decisive importance for determining whether excessive compensation has been paid, will not be revealed by the particular 990 being examined. See discussion in the text below on the new Intermediate Sanctions law.

⁵⁵ There may well be others in comparable positions who are being paid similar amounts or at least amounts close enough in size as to make it difficult to assert that the salary in question is excessive.

⁵⁶ The new Intermediate Sanctions Law also pertains to self-dealing by disqualified persons.

⁵⁷ See Note 48.

⁵⁸ Section 4958(a)(1) of the Code. A tax of 10% of the excess benefit is also imposed on the organization manager who participated in the excess benefit transaction that gave rise to the excess benefit, knowing that it is such a transaction, unless such participation is not willful and is due to reasonable cause. Section

benefit transaction” and “excess benefit”:

“(A) IN GENERAL. -- The term ‘excess benefit transaction’ means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

(B) EXCESS BENEFIT. – The term ‘excess benefit’ means the excess referred to in subparagraph (A).”⁵⁹

Thus, excessive compensation would be compensation paid to an employee which was in excess of the value of the services that the organization received for such compensation. The House Report on the new law suggests that a rebuttable presumption shall be raised in favor of a compensation package. That is, a rebuttable presumption that it is reasonable and not excessive, if the arrangement was approved by the board of directors (or a committee thereof) that: “(1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement; (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the

4958(a)(2). Perhaps of even more significance is the fact that a disqualified person must repay the entire excess benefit to the tax-exempt organization to avoid a 200% tax on the amount involved. Section 4958(b). “Excess benefit” is defined in the text.

⁵⁹ Section 4958(a)(c)(1)(A) & (B).

location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).”⁶⁰ Most of what the House Report says about the rebuttable presumption is almost surely to be included in the Treasury Regulations to be promulgated under the new law. For our purposes we should note that if an employee's compensation package gets anywhere near close to what might be considered excessive, the board of the organization that is paying her will likely feel constrained to carry out the three procedural steps needed to raise the presumption. Thus, if from reading a 990 a question is raised about excessive compensation, one might ask to see the documentation that was prepared by the board of the filing organization to show its basis for awarding the compensation.

It should be kept in mind that persons listed at Part I of Schedule A may not be disqualified persons under the new Intermediate Sanctions law because they do not exercise substantial control over the affairs of the filing organization. Therefore the provision of an extremely high compensation package to such individuals might not constitute inurement or an excess benefit transaction taxable under section 4958 of the Code. Such payments may nonetheless raise eyebrows and suggest that the filing organization is not being managed

⁶⁰ House Report at 57. It goes on to say: “If these three criteria are satisfied, penalty excise taxes could be imposed under the proposal only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction...” *ibid.*

optimally.⁶¹

While it may be difficult to establish that a salary arrangement is excessive, because certain perks may be easy to keep from being disclosed, their impropriety may be even more difficult to reach. Such perks would include the payment of club dues and expenses and extravagant entertainment expenses, the use of expensive limousines, first class travel to exotic places, the provision of million dollar plus homes in which to live, in a word being set up in a lifestyle exceeding the level of comfort and convenience which most people would accept for the leaders of charitable organizations.

As a preliminary to our discussion of perks, a word needs to be said about expense allowances. Generally, expense allowances are provided for employees who incur expenses to advance the business purposes of their employers. Expense allowances include payments made by an employer to an employee before the employee incurs the expenses (advances) and reimbursements to an employee by an employer for expenses s/he has incurred after s/he has incurred them.⁶² They might also include payments made by an employer on behalf of its employee as in the case of payment of annual membership dues in a social club. Sometimes a part of an expense allowance will be used by an employee for his or her personal use.⁶³ So we need to distinguish between that part of an expense allowance that is used to advance the employer's business purpose and that part which is used to advance the personal interests of

⁶¹ In extreme cases, the payments might constitute the advancement of a private interest and jeopardize the filing organization's tax exemption under the rule that provides that an exempt organization cannot pursue a substantial non-exempt purpose. See Note 80.

⁶² They also include expenses charged by an employee to an employer with credit cards.

⁶³ For example, an employee may use his club partly to entertain clients on behalf of his employer and partly for his own personal use (e.g., taking his family to dinner on Saturday night).

the employee. Generally, the value of the personal use component is includable in the employee's gross income and reportable at Column (E) of Part V of the 990 proper and Part I of Schedule A. On the other hand, that part of the expense allowance which is used solely to advance the employer's business purpose will most likely constitute working condition fringe under section 132(a)(3) of the Code and will not be includable in the employee's gross income and therefore need not be listed as compensation to him on his employer's 990. For our purposes, we may define working condition fringe as a payment provided to an employee (e.g., cash advance or reimbursement) for an expense the employee will or has incurred on behalf of her employer which, if the employee had himself incurred, would have been deductible under section 162 of the Code⁶⁴ as an ordinary and necessary business expense incurred in connection with the performance of services as an employee.⁶⁵ The Regulations provide that a benefit will qualify as working condition fringe only if certain conditions are met, one being that the employee substantiates the proper use of the payment to the employer.⁶⁶

⁶⁴ Section 162 of the Code allows a deduction of all ordinary and necessary expenses paid or incurred in carrying on any trade or business.

⁶⁵ More specifically, section 132(d) of the Code defines working condition fringe as: "...any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167."

⁶⁶ The Regulations under section 132 provide that "If, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or 167 to be allowable, then those substantiation requirements apply when determining whether a property or service is excludable as a working condition fringe." Treas. Reg. section 1.132-5(a)(1)(ii). The Regulations also state that: "A cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to -- (A) Use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under section 162 or 167, (B) Verify that the payment is actually used for such expenses, and (C) Return any part of the payment not so used." Treas. Reg. section 1.132-5(a)(1)(v).

Finally, Treas. Reg. Section 1-132-5(c) states: "(1)The value of property or services provided to an employee may not be excluded from the employee's gross income as working condition fringe, by either the employer or the

Appendix C analyzes the payments by a nonprofit employer of employees' membership dues in a social club, expenses incurred at the club by the employee (including, more generally entertainment expenses) and certain travel expenses and shows how they can all be characterized as working condition fringe and thus are not required to be reported on the 990.

The significance of working condition fringe for purposes of negative accountability, is that if a nonprofit wants to pick up a lot of entertainment-type expenses for one of its key employees (expenses for items that many today would regard as extravagant and inappropriate), and the organization and the employee in question follow the right procedures, none of these payments need be disclosed on the 990 except as part of some aggregate functional expense line. In considering an employer's payment of these expenses that many may regard as extravagant, there is always the possibility that some part of them were used to confer personal benefits to the employee. In this case that portion of the payment that was used for the personal benefit of the employee should be reported in the 990 as compensation to the employee. To fail to do so may be improper.⁶⁷ But if a nonprofit

employee, unless the applicable substantiation requirements of either section 274(d) or section 162 (whichever is applicable) and the regulations thereunder are satisfied. The substantiation requirements of section 274(d) apply to an employee even if the requirements of section 274 do not apply to the employee's employer for deduction purposes (such as when the employer is a tax-exempt organization or a governmental unit). (2) The substantiation requirements of section 274(d) are satisfied by 'adequate records or sufficient evidence corroborating the [employee's] own statement.' Therefore, such records or evidence provided by the employee and relied upon by the employer to the extent permitted by the regulations promulgated under section 274(d), will be sufficient to substantiate a working condition fringe exclusion."

⁶⁷ If such payments are used for personal use and were treated as compensation, they would have to be added to what the employee received as "regular" compensation in determining whether her total compensation package was reasonable. If they were not treated as compensation and the employee was an "insider" for inurement purposes or a disqualified person for Intermediate Sanctions purposes, such a diversion of charitable resources would almost certainly constitute proscribed inurement and be a taxable excess benefit

organization receives a substantiation report from its employee suggesting that all expenses incurred were in connection with carrying out the exempt purposes of the nonprofit, it is likely that the nonprofit organization would have no way of knowing about the personal use. It is also likely that no one else would know about the personal use, so that even assuming a thorough examination of the organization's 990, the questionable use would never turn up. There would be no smoke. But even if all the expenses were incurred in pursuing an organization's exempt purposes (e.g., taking wealthy contributors to dinner) and there was no element of personal use, many might believe that payments at this level ought to be disclosed to help people fully assess the nature of the organization. However, as noted, this would not be possible since these payments will not appear as being made to any individual but will only appear on some line for aggregate functional expenses.

Would the new Intermediate Sanctions law cause any restraint to be exercised with respect to payments characterized as working condition fringe? Probably not. Only if these payments by the nonprofit employer were to be considered the transfer of an economic benefit to the key employee (disqualified person) under section 4958 of the Code would an Intermediate Sanctions issue be raised. But it is unlikely that section 4958 would be so interpreted, since by hypothesis the payments were not for the employee's personal use but only for the benefit of her organization.

One perk that has received recent attention is provision by a nonprofit employer to a key employee of an expensive home to live in while serving as an employee of the

transaction under the Intermediate Sanctions law. Note, if the payments were not treated as compensation and the employee who received them was an officer or key employee, they would also have to be listed at question 2 of Part III of Schedule A. See text below beginning at Note 85. Of course, as suggested in the text it is not likely that such payments for personal use would be listed anywhere.

organization.⁶⁸ This perk may be more difficult to hide. It is only under quite limited circumstances that furnishing a home to an employee will not be considered compensation⁶⁹ and thus the annual value of the home would have to be listed as compensation to the key employee on the employer's 990.⁷⁰ Here as well the new Intermediate Sanctions law may have some bite. If there is a question about the key employee's compensation being reasonable and not excessive, the board may well feel constrained to follow the procedures called for in the House Report to establish a rebuttable presumption of reasonableness. Doing so may cause them to see the key employee's home in a new light.⁷¹

Payments by a nonprofit employer of the personal expenses of a key employee (e.g., his children's college tuition or satisfaction of personal creditors of the employee) are egregious perks and could not be considered to be working condition fringe. They would therefore have to be considered compensation or as non-compensatory payment for which the employer organization received nothing in return and in the latter case would almost surely be prohibited inurement and subject to the new Intermediate Sanctions law.⁷² Of course, if the payments were considered compensation, they would have to be included as

⁶⁸ Some reports suggest homes with purchase values in the \$1,000,000 range.

⁶⁹ Section 119 of the Code controls. Excluded from an employee's gross income is the value of lodging furnished to him, his spouse and any of his dependents by his employer if "the employee is required to accept such lodging on the business premises of his employer as a condition of employment." Section 119(a). Section 119(d) provides special rules for educational institutions.

⁷⁰ And included in the key employee's gross income. If it was not treated as compensation it would almost certainly constitute proscribed inurement and be a taxable excess benefit transaction under the Intermediate Sanctions law. See Note 57.

⁷¹ It is unclear at this point whether in considering the reasonableness of an employee's compensation by comparing it to what others similarly situated are being paid, whether the comparison need only be of the aggregate amount of compensation or whether perk-type payments should be evaluated independently, e.g., how many employees in similar nonprofits are furnished homes of such opulence, etc.

compensation to the employee at Part V of the 990. As with the housing example discussed above, the new Intermediate Sanctions law may have some bite. If there is a question about the key employee's compensation being reasonable and not excessive, the board may well feel constrained to follow the procedures called for in the House Report to establish a rebuttable presumption of reasonableness. Doing so may cause them to see in a new light the payments for tuition of the children of the key employee or those in satisfaction of the key employee's creditors.⁷³ If such payments were considered non-compensatory, they would have to be listed at Question 2 of Part III of Schedule A discussed below.⁷⁴

We next address the all-important Question 75, which appears at the bottom of Part V. For the sake of convenience, it is set out again immediately below.

75 Did any officer, director, trustee, or key employee receive aggregate compensation of more than \$100,000 from your organization and all related organizations, of which more than \$10,000 was provided by the related organizations? Yes No
If "Yes," attach schedule—see Specific Instructions on page 18.

Prior to the introduction of this question, if, for example, a key employee's compensation was generously supplemented with payments from related organizations which the filing organization influenced or controlled, the existence of such an arrangement would be wholly undisclosed on the filing organization's 990.⁷⁵ Indeed, what was reported on the 990 might suggest that the key employee was being compensated at a modest level which may not have

⁷² Theoretically in this case the payments should be listed at Schedule A, Part III, Question 2e.

⁷³ As mentioned above, it is unclear at this point whether in considering the reasonableness of an employee's compensation by comparing it to what others similarly situated are being paid, whether the comparison need only be of the aggregate amount of compensation or whether perk-type payments should be evaluated independently, e.g., how many employees in similar nonprofits have their children's college tuition paid for, etc.

⁷⁴ See text at Note 85.

⁷⁵ This question was derived from a similar question that Massachusetts developed for one of its reporting forms. Massachusetts apparently was faced with some nonprofit managers who believed as a matter of principle that salaries should be kept confidential and used related organizations as a way of keeping their total compensation unknown.

been the case if compensation from related organizations⁷⁶ had been taken into account. With Question 75 the possibility of such an arrangement would now be suggested. If the question is answered “Yes,” a schedule must be attached listing the names of each officer, key employee, etc., receiving such compensation, the name of each related organization that provided the compensation and the amount each provided (using the same format as required by Columns (C) through (E) of Part V of the 990 proper). Such a disclosure will provide no indication of whether the key employee was receiving compensation from related organizations essentially for the services he was providing to the filing organization or for services he furnished the related organizations that were unrelated to those performed for the filing organization. Consequently, more information would have to be known about all these payments before it could be said that anything improper had occurred. But the mere

⁷⁶ The Instructions are quite specific about the definition of a “related organization.” “A ‘related organization’ is any entity (whether tax-exempt or taxable) that the filing organization directly or indirectly owns or controls, or that directly or indirectly owns or controls the filing organization. For example, if Organization A owns 90% of B, and B owns 80% of C, then A would directly own 90% of B and indirectly own 72% (90% of 80%) of C.

‘Owns’ means holding (directly or indirectly) 50% or more of the voting membership rights, voting stock, profits, interest, or beneficial interest.

‘Control’ means that:

1. Fifty percent (50%) or more of the filing organization’s officers, directors, trustees, or key employees are also officers, directors, trustees, or key employees of the second organization being tested for control;
2. The filing organization appoints 50% or more of the officers, directors, trustees, or key employees of the second organization being tested; or
3. Fifty percent (50%) or more of the filing organization’s officers, directors, or key employees are appointed by the second organization.”

Control exists if the 50% test is met by any one group of persons even if collectively the 50% test is not met. Whether or not any elements of ownership or control are present, a related organization also includes:

- A supporting organization operated in connection with the filing organization where one of the purposes of the supporting organization is to benefit or further the purposes of the filing organization; and
- A supported organization operated in connection with the filing organization where one of the purposes of the filing organization is to benefit or further the purposes of the supported organization.

for amounts paid by the fundraiser to others for printing, paper, envelopes, postage, mailing lists, etc. Part II is intended for the fee portion of payments to contractors, not for expense reimbursements.”⁷⁸

Large fees paid to lawyers or accountants may give some pause. Are the recipients of such fees closely connected to anyone in the organization? Were they incurred because the organization is in trouble? Large fees paid to a fundraiser may also give pause. While such payments may not suggest a United Cancer Council case,⁷⁹ unexpectedly high payments may locate a problem in the gray area between negative and positive accountability. Indeed, large payments made to an outside consultant might indicate that the filing organization is pursuing a substantial non-exempt purpose.⁸⁰ Finally, one might look for consistency between how this question is answered and how Lines 30, 31 and 32 at Part II of the 990 proper are answered. These lines call for that aggregate of payments made for professional fundraising fees (Line 30), accounting fees (Line 31) and legal fees (Line 32).⁸¹ For example if Line 30

organizations to find additional compensation, assuming s/he could identify all the related organizations.

⁷⁸ 1996 Instructions for Schedule A (Form 990).

⁷⁹ The United Cancer Council case involves a challenge by the IRS to the tax exemption of the United Cancer Council which under a contract with the professional fundraiser Watson & Hughie raised more than \$18,000,000 over a period of time, less than \$300,000 of which ever got to the charity. Baldly stated the case raises the issue of whether a charity's exemption should be revoked for becoming in effect a fundraiser's vehicle to green pastures. The case has been before the Tax Court for over two years and the exempt organizations bar eagerly awaits a decision.

⁸⁰ A 501(c)(3) is liable to have its exemption revoked if it pursues a substantial non-exempt purpose, regardless of how many truly exempt purposes it otherwise pursues. Better Business Bureau v. United States, 326 U.S. 279 (1945). Paying large amounts to an outside consultant may suggest a purpose to advance a private interest (viz., the consultant's interest) and this might be a substantial non-exempt purpose under the Better Business Bureau test. Note, the private interest limitation is different than the inurement prohibition. To run a cropper of the private interest rule, the amounts involved need be substantial. For inurement purposes the smallest amounts will justify a revocation of exemption.

⁸¹ These questions are covered below in Part II.

showed large expenses for professional fundraising and Part II of Schedule A showed no or only small payments to fundraising fees, there might be a problem.⁸²

One might also find payments here to board members or key employees for providing services as independent contractors outside of their usual services for which they receive compensation.⁸³ This may suggest improper amounts of an organization's money are being funneled to disqualified persons.⁸⁴

Next we consider the fourth and last principal place where payments to individuals are listed,⁸⁵ namely, Schedule A, Part III, Line 2 – the great self-dealing question. It is set out immediately below.

⁸² Of course, all of the organization's fundraising may be done in-house.

⁸³ As discussed below, it is also likely that these payments should be listed at Line 2 of Part III of Schedule A.

⁸⁴ Such payments could also be reported at Part V of the 990 proper as such amounts constitute compensation, although the preparer of the 990 might believe that Part V is only for regular compensation and not for occasional fees for work as an independent contractor. If the amounts are reported at Part II of Schedule A, they should be combined with the amounts shown at Part V for the same individual in determining whether his or her compensation is reasonable, taking into account, of course, that s/he performed additional tasks as an independent consultant.

⁸⁵ As is pointed out in the next note, there may be a question as to whether one is required to list the names of any of the persons who were involved with the transactions covered by this Line 2.

Part III Statements About Activities		Yes	No
1	During the year, has the organization attempted to influence national, state, or local legislation, including any attempt to influence public opinion on a legislative matter or referendum? If "Yes," enter the total expenses paid or incurred in connection with the lobbying activities = \$ _____ Organizations that made an election under section 501(h) by filing Form 5768 must complete Part VI-A. Other organizations checking "Yes," must complete Part VI-B AND attach a statement giving a detailed description of the lobbying activities.		
2	During the year, has the organization, either directly or indirectly, engaged in any of the following acts with any of its trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary:		
a	Sale, exchange, or leasing of property?	2a	
b	Lending of money or other extension of credit?	2b	
c	Furnishing of goods, services, or facilities?	2c	
d	Payment of compensation (or payment or reimbursement of expenses if more than \$1,000)?	2d	
e	Transfer of any part of its income or assets? If the answer to any question is "Yes," attach a detailed statement explaining the transactions.	2e	
3	Does the organization make grants for scholarships, fellowships, student loans, etc.?	3	
4	Attach a statement to explain how the organization determines that individuals or organizations receiving grants or loans from it in furtherance of its charitable programs qualify to receive payments. [See instructions on page 2.]		

On the face of it, this would be the place for the deepest searching for evidence of negative accountability, self-dealing being perhaps the paradigmatic instance of negative accountability abuses. This question appears to pick up all transfers of value to key employees, etc., including such things as sales of property to the organization by a board member, loans to board members or key employees and the like. If the answer to any of the questions is “Yes,” the question calls for the attachment of a detailed statement explaining the transactions.⁸⁶

Of course, if there were any self-dealing transactions during the year covered, it is not very likely that the preparer of the form would answer any part of Line 2 “Yes” and then attach a detailed statement explaining the transactions. To do so would be in effect to confess to such things as prohibited inurement or excess benefit transactions under the new Intermediate Sanctions law. Therefore, the answers to these questions may very likely be

⁸⁶ Neither the form itself nor the instructions to Line 2 call for the listing of names. It may be that to furnish an attachment providing a “detailed statement explaining the transactions” without naming the parties would be to file an incomplete return. (It would seem to be a good idea, however, for the instructions to make clear that the names be listed of those who were parties to the transactions being asked about.)

“No,” and this will frustrate any intensive search for wrong-doing. However, there is always the possibility that someone examining the 990 will know of some act of self-dealing that occurred during the period covered and will then know that Line 2 was improperly filled out and that it is likely that this was done so intentionally. This would give rise to the possibility of further action.⁸⁷

For the rest, we shall offer brief comments on the various sub-lines of Line 2:

a Sale exchange, or leasing of property? -- If the property was sold, for example, to the filing organization by a key employee or board member for an amount materially above its fair market value, it would very likely constitute an excess benefit transaction under the Intermediate Sanctions law. If sold at fair market value or below, there would be no excess benefit transaction, but the transaction would still have to be identified here.

b Lending of money or other extension of credit? -- Lending money to board members or key employees will give pause.⁸⁸ If the loan is below market, the foregone interest

⁸⁷ And, in addition, one should keep in mind the corollary point that those who are in control of preparing the 990 will know that someone may examine it knowing about an act of self-dealing (and without those in control of preparing the 990 knowing that it is being examined) and this knowledge may deter some improper behavior.

⁸⁸ An article in a recent CPE Textbook has this to say about loans to key employees: “A loan between an EO and another person associated with the EO invites close scrutiny by the Service, particularly if the terms of the loan by an EO to an employee/independent contractor are more favorable than terms available from unrelated lenders (e.g., lower interest rate, less security). Even if the loan terms are similar to those available from unrelated lenders, the mere existence of a ‘private’ source of loan credit available to executives or highly compensated employees/independent contractors which is not available to rank-and-file employees or other members of the general public may be viewed as a form of inurement. See Founding Church of Scientology [v. United States], 412 F2d 1197, (CT.Cl. 1969), cert. denied, 397 U.S. 1009 (1970)], John Marshall

may well give rise to income to the borrower under section 7872 of the Code and be treated as a compensation-related fringe benefit which would require that it be listed as part of the key employee's compensation on the organization's 990 (Column (E) of Part V). Such amounts would have to be taken into account in determining whether the total compensation paid to the key employee was reasonable and not excessive for Intermediate Sanctions purposes.

c Furnishing of goods, services, or facilities? -- Any payments to or on behalf of key employees for their personal use would be listed here. These might include payments of their children's tuition or club dues and expenses in circumstances where the club was not used by the key employee to advance the exempt organization's exempt purposes or the furnishing of a home to live in, the value of which would not be excluded from the key employee's gross income under section 119 of the Code. Also listed here would be a variety of self-dealing transactions that were not included as compensation earlier in the return, including, for example, giving the chairwoman of a board the contract to place all the liability insurance for a university and similar contracts. Of course, if any of these payments or transactions were "innocent," it is likely that they would be fully explained in the attached detailed statement explaining them. If they were not "innocent," it is likely the question would be answered "No,"

Law School [v. United States, 48 A.F.T.R. 2d 81-5340, 228 Ct. Cl. 902 (Ct. Cl. 1981)], supra; 333.3(10) of the EO Examination Guidelines Handbook." Thomas and Bloom, Reporting Compensation on Form 990, 1995 (for FY 1996) Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook, 195 at 206.

but as suggested above, this might trigger further examination.⁸⁹ If the transaction in question involved a board member furnishing a service to her organization for which she received a fee as an independent contractor and the fee was for more than \$50,000 and she was one of the five highest paid independent contractors, she would be listed in Part II. It would seem that she also ought to be listed here. The Instructions for subsection d, covering compensation, provide that if the compensation is already listed in Part V of the 990 proper, it need not be listed at 2d. No such instruction is given for payments to independent contractors.⁹⁰ If the payment for the same service was to a taxable organization of which the board member was an officer and it was in excess of \$50,000, it should also be listed in Part II although no indication need be given in Part II of her interest in the taxable organization.

d Payment of compensation (or payment of expenses if more than \$1,000)? -- The Instructions make clear that: “If the only compensation ... relates to amounts reported in Part V of Form 990, check “Yes” and write “See Part V, Form 990 ... on the dotted line to the left of the entry space.” Here is where an organization would list compensation in excess of \$1,000 paid to members of the families of officers, directors, key employees, etc. Such payments may give pause.

e Transfer of any part of its income of assets? -- Any transfer to or on behalf of a key

⁸⁹ Returning to our example of the chairwoman and liability insurance brokerage services, if the payment was made to the chairwoman’s firm and not to her personally, and the firm was a taxable organization of which she is an officer, etc., it would also be required to be listed here.

⁹⁰ It seems likely, however, that if the payment was listed in Part II and omitted at question 2c, that no pen-

employee of an organization's income or assets not listed in Part V or at sub-questions 2 a-d above would be listed here. 2e, then, is the great catch-all. Gifts,⁹¹ transfers of income or other assets not treated as compensation (flat-out inurement) would be listed here. It is barely conceivable that this question would be answered "Yes," but again if someone knew of such transfers and had access to the 990 that answered the question "No," further action might be suggested.

Note, the question asks whether "the organization, either directly or indirectly, engaged in any of the following acts..." The word "indirectly" covers the situation where the sale or loan, etc., was made to or by an affiliate of the filing organization, although the Instructions do not make this clear and there is no indication of how "related" the second organization needs be to have the transaction listed here.⁹²

Before completing Part I, there are a few other lines on the 990 where transfers to individuals must be listed. They will now be briefly mentioned.

Line 22 Grants and allocations (attach schedule) -- On an attached schedule must be shown

alties would be assessed for misfiling the return.

⁹¹ Actually under section 102(c) of the Code a gift to an employee is not excluded from gross income and therefore should be reported as taxable compensation to the employee unless it is de minimis.

⁹² Because the preamble to Line 2 ends with the phrase "or with any taxable organization with which such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary...", it may suggest that only transactions between key employees and taxable organizations need to be listed here and that transactions between key employees and affiliated 501(c)(3)s need not be listed. This would surely be an incorrect reading, but perhaps the instructions under Line 2 ought to be expanded to eliminate the possibility of such a reading.

the name of each donee that received a grant or award and the relationship (if related by blood, marriage, adoption, or employment (including employees' children)) of the donee to an insider. This picks up grants or awards to an employee or her family, such as scholarships for children, although these payments might be reported as compensation.

Line 50 Receivable due from officers, directors, trustees, and key employees (attach schedule)

-- On an attached schedule for each loan or advance etc., there must be shown: 1. the names of any officer, etc., who received a loan or advance etc., from the organization, 2. the original amount of the loan, etc., 3. the balance due, 4. the date of the note, 5. the maturity date of the note, 6. the repayment terms, 7. the interest rate, 8. the security provided by the borrower, 9. the purpose of the loan, and 10. a description and fair market value of the consideration furnished by the lender (e.g., cash - \$1,000, etc.). This covers the same ground as Line 2b to Part III of Schedule A discussed above. See the discussion there.

Line 63 Loans from officers, directors, trustees, and key employees (attach schedule) -- Here

also names must be named, etc. There might be a problem if the loans were made at an above-market interest rate. It might also suggest weakness in the organization's overall financial stability -- a positive accountability concern.

In this part we list all the lines on the 990 and its Schedule A where aggregate payments are listed that might suggest negative accountability problems, self-dealing, etc. As suggested in the Introduction, I believe these parts of the 990 are much less likely to harbor such information.⁹³ There may be information that suggests the organization is not being run in the best manner (too much money being spent on management and general administration and not enough being spent on programs), but rarely will such information point to a negative accountability abuse. To recur to a point made in the Introduction, this should not suggest that the 990 cannot be used constructively for making important determinations as to whether the organization is being run effectively and is, for example, worthy of support. These matters are what I have called positive accountability and are dealt with in Appendix B. Of course, as also noted in the Introduction, the line between negative and positive accountability is not clear but for the most part we believe this distinction is useful. Brief mention will be made of those parts of the 990 where the line between negative and positive accountability is blurred.

In this part, I list the lines that I believe may suggest some problems in the order in which they come up on the 990 and Schedule A. Many lines are not discussed. First, however, I want to make a few general observations about using these parts of the 990 to detect problems. To begin with, if the 990 is completed in such a way that large amounts of information are simply omitted or do not make sense, this may give grounds for suspicion.

⁹³ That is to say, finding smoke arising from lines where aggregate payments are listed strikes me as a much more problematical undertaking than looking for trouble in lines showing payments to individuals.

For example, pause may be taken if Part III, **Statement of Program Service**

Accomplishments, gives little idea of what the organization does or suggests that it is doing something that is not a charitable activity. State charity officials report that there are some organizations parading as 501(c)(3) which solicit funds from the general public that in fact do nothing and are only vehicles to which unsuspecting people contribute funds which are used exclusively to enrich a few individuals that operate the sham entity. Perhaps an overall examination of such an organization's 990 might suggest such a problem. Connected with this, if the return suggests that the organization does not take its filing responsibilities particularly seriously it may send off adverse signals. Finally, there may be some information that doesn't jibe with common sense that might be troubling. For example, a flag may be raised if large amounts are reported for fundraising expenses and the organization does not seem to have a program that would require a fundraising effort at this level.

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Part I Statement of Revenue, Expenses, and Changes in Net Assets or Fund Balances

Lines 1 - 12 Revenue -- While it is hard to see how any of these entries might point to negative accountability abuses, there is one abuse that could be suggested by a large non-cash dollar figure listed under Line 1d. There have been cases of nonprofits receiving contributions of large amounts of such things as out-of-date vegetable seed, rags, useless textbooks, or powdered milk provided by the U.S. Department of Agriculture and then sending this material to a depressed country. (The material is not actually given to the nonprofit, but it claims it as a contribution.) The useless or nearly useless, but substantially

overvalued, merchandise is often received and re-donated to another nonprofit the same day with none of the nonprofits, except the last one (sometimes) actually taking physical possession the merchandise. The shipment of the material to the foreign recipients has the financial effect of inflating the organization's program expenses and making its ratio of program expenses as a percent of expenses look better. While Line 1d obviously does not indicate the kinds of material contributed, if a suspicion is raised, it may be further fueled by looking at the noncash section of Line 22 (Grants and allocation) in Part II that does require that a schedule be attached. Lines 1-12 may be used in other ratios that point to problems.⁹⁴

Lines 13 - 17 Expenses -- Here there are some potential ratios that might give rise to questions, namely, Management and general (Line 14)/ Total expenses (Line 17), or Fundraising (line 15)/Total expenses (Line 17). While these ratios are more likely to raise questions of positive accountability (is the organization being effective, etc.) than those of negative accountability, if they are extreme enough, they may provide some indication of more severe problems.⁹⁵

Line 16 Payments to affiliates (attach schedule) -- While this seems innocent enough -- dues paid by the local charity to its affiliated state or national (parent) organization -- it could be a place to hide payments to related organizations that in turn use the payments to pay for key employees, family members or friends, etc. Thus, unexpectedly high payments listed here may be smoke. (See discussion of related organizations below.)

⁹⁴ The use of ratio analysis is explained in Appendix B.

⁹⁵ Ratio analysis for positive accountability purposes is covered in Appendix B.

Lines 18 - 21 Net Assets -- While this balance sheet-type summary may be quite useful for positive accountability, it is unlikely to give rise to negative accountability suspicions. While a huge decrease in net assets may suggest someone has taken the money and run, it might also suggest poor management or government cutbacks, etc.⁹⁶

Part II Statement of Functional Expenses

Line 23 Specific assistance to individuals (attach schedule) -- This line calls for the aggregate of payments to clients or patients, i.e., payments made to directly advance the organization's exempt purpose. It is hard to see any smoke rising from this line suggesting the fire of an abuse. Since, however, the schedule does not call for the names of individual recipients, might it be a good place to hide payments to family members and friends? Thus, if the amounts are surprisingly large, a problem might be suggested. If a significant amount is reported on line 23, it should set off some bells if it is not fully reflected in Part III.

Lines 25 - 29 Compensation of officers - Payroll taxes -- While some thin wisps of smoke might rise from these lines, it is much more likely that blacker patches would lift off Part V (compensation of officers, directors, trustees, and key employees) and Schedule A Part I (compensation of the five highest paid employees other than officers, etc.). If, however, you knew what the total size of the organization's staff was and you had the totals from Part V

⁹⁶ A large decrease in net assets may also represent a correction of one or more prior year returns that presented the filing organization in a more favorable light than was appropriate. This could mean that a new CPA firm is refusing to follow past practices with respect to certain types of income or expenditures. It may also represent an uninsured theft loss discovered during the year for which the return is filed. Or it may be the financial effect of litigation that the 990 filer lost. It could be a host of other things, but should always

and Part I (Schedule A) and the numbers seemed very high here, that might suggest a problem.

Line 30 Professional fundraising fees -- Big numbers here surely give rise to positive accountability questions and if you think, as I do, that Watson & Hughie/United Cancer Council⁹⁷-type situations involve negative accountability questions, here is a place to look for sleaze. As with Line 29, there may be an inconsistency between amounts shown here and amounts shown elsewhere on the return. For example, as suggested above in our examination of Part II of Schedule A, if large amounts are listed here but little is shown at Part II, some pause may be taken.⁹⁸ It should also be noted that better information on potential problems having to do with professional fundraisers may be found on reports filed with state charities offices, many of which require that contracts with professional fundraisers (PFRs) be filed.⁹⁹

Line 31 Accounting fees -- Here big numbers may be suspicious suggesting friends being paid, or cover up work requiring high fees, etc.

Line 32 Legal fees -- As with accounting fees, here big numbers may be suspicious suggesting

be required reading for anyone carefully inspecting a 990.

⁹⁷ See note 79.

⁹⁸ Of course, if all fundraising is done in-house and outside fundraising independent contractors are not used, that could explain the discrepancy,

⁹⁹ Some states require supplemental information designed to give a much clearer picture of fundraising abuses than the 990 provides. For example, some require a breakdown of each solicitation campaign show-

friends being paid, or cover up work requiring high fees, etc.

Lines 39 and 40 Travel and Conferences, conventions and meetings -- High travel and conference expenses might be cause for alarm. As suggested in Part I, here is where an organization would list the aggregate of payments to individuals for extravagant and lavish expense account advances and reimbursements.

Line 43 Other expenses (itemize) -- Here is where you list investment counseling and other professional fees. Big numbers may be suspicious: friends being paid, etc. Here is where penalties, fines and judgments are listed which may be grist for the snooper's mill.

Part IV Balance Sheets

Lines 60 and 53 are discussed above in Part I. See Appendix B for a discussion of the use of Part IV for positive accountability.

Part V List of Officers, Directors, Trustees, and Key Employees

See Part I above

Part VI Other Information

Line 80 Is your organization related to any other exempt or nonexempt organization? -- See section on related organizations below.

Line 81 Enter the amount of political expenditures -- This line deals with expenditures

ing gross proceeds, outside fundraiser fees, other expenses, and net proceeds to the exempt organization.

intended to influence the selection, nomination, election or appointment of anyone to political office. For those who believe that an organization is violating the flat proscription against electioneering, looking here and finding that the organization answered the question “No,” might suggest some possibilities of further action.

Line 83 Did the organization comply with the public inspection requirements for returns and exemption applications? -- This line relates to the requirement that 501(c)(3) organizations must show their 990s for the past three years and their 1023 to anyone who comes to their office and asks to see them. It is hard to imagine that an organization would answer this question “No.” Thus if someone knew that the organization in fact did not comply with the inspection requirements, which would include anyone who asked to see an organization’s 990 and was rebuffed,¹⁰⁰ possibilities for further action might be suggested.

Line 88 At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership? -- See section on related organizations below.

Part IX Information Regarding Taxable Subsidiaries -- See section on related organizations below.

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¹⁰⁰ There is evidence that this happens alarmingly often. Soon exempt organizations will have to mail copies of their returns to those who request them.

Part I Compensation of the Five Highest Paid Employees Other Than Officers, Directors, and Trustees & Part II Compensation of the Five Highest Paid Independent Contractors for Professional Services

See Part I above.

Part III Statements About Activities

Line 1 During the year, has the organization attempted to influence legislation? -- This line deals with expenditures intended to influence legislation. For those who believe that an organization is going beyond the limitations imposed on lobbying, looking here and finding that the organization answered the question “No,” might suggest some possibilities of further action.

Line 3 Does the organization make grants for scholarships, fellowships, student loans, etc.? -- This line covers the same ground as Line 22 of the 990 proper, except that Line 22 asks for specific individual names. Perhaps inconsistent answers might suggest a problem.

Part IV Reason for Non-Private Foundation Status & Part Private School Questionnaire

There could be little of interest in these parts.

Part VII Information Regarding Transfers To and Transactions and Relationships With

Noncharitable Exempt Organizations -- See section on related organizations immediately below.

Transactions With Related Organizations

An important frontier for potential abuse is the use of related organizations to make improper transfers to private individuals of income or assets of a 501(c)(3) organization that should otherwise have been spent to advance the transferor organization's exempt purpose. This problem was very well illustrated in the recent United Way of America (UWA) case which, among other things, involved UWA setting up spin-off corporations to which loans were made in which UWA officers had an interest. This was followed by making loans to spin-off corporations which then took actions that benefited William Aramony, the Chief Executive Officer of United Way of America, and his family and friends.

The relevant sections of the 990 for this problem are Lines 75, 80, 88 of the 990 proper and Part IX, Line 2 of Part III of Schedule A and Part VII of Schedule A.

Form 990

Part V Question 75 Did any officer, director, trustee, or key employee receive aggregate compensation of more than \$100,000 from your organization and all related organizations, of which more than \$10,000 was provided by the related organizations? If "Yes," attach schedule. — This question has been discussed above in Part I. While the definition in the Instructions covering the meaning of "related" is very good, this question (restricting itself as

it does to “compensation”) would seem to leave out the following transfers to officers, etc., of the filing organization by a related organization:

1. Loans to officers, etc.
2. Payments that would not be compensation to officers, etc.
3. Providing to officers, etc., the use of assets (residences, cars, etc.) that are not compensation.
4. All manner of non-compensatory payments and transfers to family members and friends of officers, etc.

These items should be picked up by Schedule A’s self-dealing question (Part III Question 2).

But, as suggested in the discussion above on that question, since it may not be clear to all the preparers of the 990 that the word “indirectly”¹⁰¹ includes sales and loans, etc., from related organizations, and since the clause “with any taxable organization” may suggest that only sales or loans, etc., from taxable organizations should be listed here, such transactions with affiliated 501(c)(3) organizations might not be included. Thus, non-compensation transfers to key employees by related organizations would be left out of the 990.

Line 80 Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers etc., to any other exempt or nonexempt organization? -- All the filing organization has to do is answer “Yes” or “No” and if “Yes,” indicate whether the related organization is exempt or

¹⁰¹ Question 2 reads as follows: “During the year has the organization, either directly or *indirectly*, engaged in any of the following acts with any of its trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary: a Sale, exchange, or leasing of property? b Lending of money or other extension of credit?” etc.

nonexempt. There need be no disclosure of any use of the related organization, nefarious or otherwise. One may suppose that where there is a related organization and some suspicion that the filing organization may be inclined to use the second organization for improper purposes, that the mere disclosure of a related organization will give a determined sleuth something to go after, but this seems pretty slim.

Line 88 At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership? If “Yes,” complete Part IX / Part IX Information Regarding Taxable Subsidiaries -- All Part IX asks for is the name, address and employer identification number of the corporation or partnership; the percentage of ownership interest; the nature of the business activities; total income and end-of-year assets. The 1996 instructions contain nothing on this part. Like Line 80, there appears to be no need to disclose any particular uses of the related organization.

Schedule A

Schedule A, Part III Statements About Activities, Line 2. During the year, has the organization, either directly or indirectly, engaged in any of the following acts with any of its trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary: a sale, exchange, or leasing of property etc.? -- This question is discussed above.

Schedule A, Part VII Information Regarding Transfers To and Transactions and Relationships With Noncharitable Exempt Organizations -- This part aims primarily at efforts to get around limitations on political activity by using related organizations. There should be included here such things as transfers from a 501(c)(3) to a 501(c)(4) where the assets transferred are used to do things that 501(c)(3)s are not permitted to do, e.g., engage in direct political activity. Generally, here would be a place to look for potential abuses of the limitations on political activity or the misfiling of returns to hide such abuses.

Note on Budget and Staff Sizes of the EO Division, State Charities' Offices and the Securities and Exchange Commission.

This section offers a preliminary sketch of some of the government regulatory agencies that oversee the United States securities markets and the nonprofit sector, comparing their sizes and the amount of resources allocated to regulate them. Some estimates will be sheer guesses. This, however is all that is possible given the available information. It is hoped that the comparisons will suggest orders of magnitude that approximate actuality and shed some light on our inquiry. The term “securities market” is meant to roughly include those persons and entities regulated by the Securities and Exchange Commission. The term “nonprofit sector” refers to those organizations described under sections 501(c)(3) and (c)(4) of the Code, i.e., what the Independent Sector calls the “independent sector” in its Nonprofit Almanac 1997/1998 (“Nonprofit Almanac”).¹⁰² The securities market has been chosen for comparison, in part because, like the nonprofit sector, it is regulated to protect the public interest -- both individual investors and the public’s general interest -- by ensuring that the securities markets are fair and honest¹⁰³ and, in part because many consider the Securities and Exchange Commission to set the standard for well-conducted government regulatory agencies. What is left out of the comparison is all of the state agencies that regulate the securities market.¹⁰⁴

¹⁰² Hodgkinson & Weitzman, Nonprofit Almanac 1996-1997, Dimensions of the Independent Sector, Independent Sector (1996).

¹⁰³ Similarly, the two nonprofit regulatory agencies protect individual contributors and the public’s general interest in ensuring that the nonprofit sector is well run and not being abused for personal gain.

¹⁰⁴ There has not been time to develop this information. A fuller treatment of the subject would, of course,

Some effort was spent trying to figure out how to compare the size and significance of the securities markets to the nonprofit sector, but the difficulty of finding relevant and comparable data ended this quest, at least temporarily, empty handed. The Independent Sector's Nonprofit Almanac 1996-1997 shows that the independent sector for 1994 totaled 6.5% of national income,¹⁰⁵ but no comparable data about the securities market was found. Indeed, even if data were readily available, it is not clear what should be compared: portions' of national income, gross domestic product, work force, etc.

An aggregate comparison will now be made of staffs and resources devoted to the Securities and Exchange Commission, the Exempt Organization Division of the Internal Revenue Service and the various state charities offices. For fiscal 1996 the SEC had 3,039 positions allocated to it and a budget of \$300,921,000.¹⁰⁶ (The U.S. Securities and Exchange Commission Budget Estimate Fiscal 1998 shows a position allocation figure of 3,039¹⁰⁷ and a total funding figure of \$369,354,339.) For fiscal 1996 the EO Division had 957¹⁰⁸ positions

include it. It would also provide a nicer balance showing the two federal agencies with nationwide jurisdiction, namely the Securities and Exchange Commission and the EO Division and the several state agencies that generally have statewide jurisdiction over securities markets and the state charities offices.

¹⁰⁵ See Nonprofit Almanac, Table I shows that the business sector took up 77% of national income and the government 15 1/2%. The residue consisted of that part of the nonprofit sector which is not made up of the independent sector.

¹⁰⁶ 1996 Annual Report, United States Securities and Exchange Commission, Table 25.

¹⁰⁷ Of the total of 3,039 positions, 1,913 were assigned to the Washington Headquarters office (63%) and 1,126 to regional offices (37%). See Budget Estimate 1998 table entitled "Position and Cost Data for 1996-1998."

¹⁰⁸ Of the total of 957, 118 were assigned to the Washington Headquarters office (12%) and 839 to regional offices (88%).

allocated to it and a budget of \$58,100,000.¹⁰⁹

There is very little information about the size of state charities offices. Every year the National Association of Attorneys General (NAAG) publishes a book of statistics on the office of the attorney general.¹¹⁰ The most recent book shows that nation-wide there are about 85 full-time equivalent attorney positions assigned to “Charities.”¹¹¹ New York’s Charities Bureau is shown as having 18 FTE attorneys; and a total full-time staff of 51¹¹² -- about two and one-half times the number of its attorneys. If one assumes that on average states had charities offices with staff sizes double their number of attorneys,¹¹³ this would bring the total person power assigned to these offices nation-wide to about 170. However, these statistics only cover those cases where the state charities office is located in the office of the attorney general. Twenty-two states have no state charities office located in the office of the attorney general. According to a report done in 1996 by NAAG, nine states do nothing in the field of charities while 13 exercise some jurisdiction.¹¹⁴ If we assume that these 13 states assign 25 persons to charity, this would bring the total staff of all state charities offices up to 195.¹¹⁵

¹⁰⁹ These figures were supplied by Marcus Owens, Director of the EO Division.

¹¹⁰ See NAAG Management Series, Statistics on the Office of Attorney General March 1997. [Hereinafter AG Statistics.]

¹¹¹ See AG Statistics, Table III-B.

¹¹² This information was supplied by Karin K. Goldman, Assistant Attorney General, Charities Bureau, New York State.

¹¹³ Sheer guess department.

¹¹⁴ See Report on NAGG/NASCO Charities Survey 1996, National Association of Attorneys General (1996).

¹¹⁵ Sheer guess department -- 170 plus 25 = 195.

AG Statistics indicate that as of January 1997 there were 9,671 full-time equivalent attorney positions assigned to the offices of attorney general throughout the country.¹¹⁶ If we assume that the estimated 13 state charities offices that assign some personnel to charities employ the equivalent of 8 full-time attorneys, this brings our total figure for attorneys assigned to state charities offices to 93, or about 1 percent of the total ($93/9,671 = 1\%$). AG Statistics show that the total 1996-1997 attorneys general budgets stood at \$1,970,908,018.¹¹⁷ If we assume that the total state charities offices budget as a portion of the total attorneys general offices budget is the same as the portion of the total number of state charities offices attorneys to the total number of attorneys general, namely 1%,¹¹⁸ then we can grossly estimate a total 1996-1997 state charities offices budget of \$19,709,080.

Thus, remembering the shaky nature of our AG estimates, we can conclude from these figures that the SEC's staff is over three times the size of the EO Division,¹¹⁹ and over fifteen times the size of the aggregate staff of all state charities offices.¹²⁰ Further we can conclude that the SEC's budget is over five and one-half times as large as the EO Division's budget¹²¹ and 17

¹¹⁶ See AG Statistics. Table III-A. AG Statistics includes information for American Samoa, the District of Columbia, North Mariana Islands and Puerto Rico. Data from these regions is not included in the text.

¹¹⁷ See AG Statistics, Table II.

¹¹⁸ Sheer guess department verging on the tipsy perhaps.

¹¹⁹ 3,039 divided by 957.

¹²⁰ 3,039 divided by 195

¹²¹ \$330,000,000 divided by \$58,100,000.

times that of the aggregate of the budgets of all state charities offices.¹²² Finally, we can conclude that the staff of the EO Division is about five times larger than the aggregate staff of all state charities offices¹²³ and that its budget is about three times as large as the aggregate of the budgets

¹²² \$58,100,000 divided by \$19,700,000.

¹²³ 957 divided by 195.

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SECTION

B

SECTION

C

Appendix A

Penalties for Misfiling the Form 990

There follows a rough paraphrase of the principal sections of the Internal Revenue Code that prescribe penalties for late filing or misfiling of the Form 990.

Section 6652(c)(1)(A): In the case of -- (i) a failure to file a return required under section 6033 on the date and in the manner prescribed therefor, or (ii) a failure to include any of the information required to be shown on a return filed under section 6033 or to show correct information, there shall be paid by the exempt organization \$20 for each day during which such failure continues with a maximum penalty of the lesser of \$10,000 or 5% of the gross receipts of the organization for the year. In the case of an organization with over \$1,000,000 in gross receipts for any year, the fine is increased to \$100 a day with a maximum penalty of \$50,000.

Section 6652(c)(1)(B): Provides that if an organization has been late in filing its 990 and the IRS has made a written demand specifying a date by which such return must be filed (or the information furnished), that the person who fails to timely comply with such demand shall pay \$10 for each day up to a maximum of \$5,000.

Section 6701: Any person who aids in the preparation of any portion of a return who knows that such portion (if used) would result in the understatement of the liability for tax of another person shall pay a penalty of \$1,000 with respect to each such document. [Prior to the introduction of Intermediate Sanction provisions under section 4958, it is very unlikely that this provision would apply to the preparation of a Form 990.]

Section 7203: Any person required ... to ... make a return ... or supply any information ... who willfully fails to ... make such a return ... or supply such information ... shall ... be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than \$25,000 (\$100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of the prosecution.

Section 7206: Any person who -

- 1) willfully makes or subscribes any return ... which contains or is verified by a written declaration that is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

2) willfully aids ... in ... the preparation ... of a return ... which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized .. to present such return

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation) or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Section 7207: Any person who willfully delivers ... to the Secretary any ... return ... known by him to be fraudulent or to be false as to any material matter, shall be fined not more than \$10,000 (\$50,000 in the case of a corporation) or imprisoned not more than 1 year, or both.

Note: for the lawyers, the relevant statute of limitation provisions are found in section 6501.

SECTION

D

Appendix B

This Appendix looks at the Form 990 as positive accountability tool. For these purposes the 990 can be divided into three sections. First, there are those parts which are essentially financial disclosure sections, namely, Parts I, II, IV, IV-A, IV-B, and V of the 990 proper and Parts I & II of Schedule A. These parts make up somewhat less than half of the Form 990. Second, there are those parts which are essentially tax information sections,¹⁴⁷ namely, Parts VI, VII, VIII and IX of the 990 proper and Parts III, IV, IV-A, V, VI-A, VI-B and VII of Schedule A. These parts also make up somewhat less than half of Form 990. Third, there is Part III (**Statement of Program Service Accomplishments**) which elicits direct program information and is designed to elicit the kinds of information that positive accountability is most interested in. Part III makes up less than 10% of the 990.¹⁴⁸

To make this analysis manageable, we eliminate those parts of the 990 eliciting tax information which might only be of marginal interest. Thus, a few questions from Part VI (**Other Information**) of the 990 proper may be omitted. These are questions which do not relate to 501(c)(3) nonprofits, namely questions 85, 86 and 87. Parts VII and VIII of the 990 proper relating to unrelated business income may be of only marginal interest¹⁴⁹ and therefore

¹⁴⁷ These parts elicit information that the IRS needs to administer the tax laws. For example, Part IV of Schedule A elicits information by which an organization establishes whether it is a private foundation or public charity (i.e., other than a private foundation)

¹⁴⁸ In figuring these proportions, Part V of Schedule A (Private School Questionnaire) was omitted because it involves an infinitesimal portion of the whole 501(c)(3) sector. The distinction made in the text between “financial disclosure” and “tax information” is quite arbitrary. Some parts are useful for both purposes, e.g., Part V (List of Officers, Directors, Trustees, and Key Employees).

¹⁴⁹ In the huge majority of cases, 501(c)(3) nonprofits do not engage in unrelated businesses. If, however, an organization does do a fair or large amount of unrelated business, this might be of interest to an information

could be omitted. Turning to Schedule A, Parts IV and IV-A, regarding an organization's private foundation status, are of only of marginal interest and so might be omitted from our consideration.¹⁵⁰ If we also assume that we are not concerned about an organization's political activity, we can also omit Parts VI-A, VI-B and VII. This leaves us with Parts I, II, IV, IV-A, V, VI (several lines), and IX of the 990 proper and Parts I, II, III of Schedule A to look at.

Part III (**Statement of Program Service Accomplishments**), which asks the filing organization to state its primary exempt purpose and then to describe its exempt purpose achievements for each of its program services,¹⁵¹ appears to aim at the bull's eye of positive accountability.¹⁵² For each program service listed, the filer must enter such service's total

seeker as it may suggest that the organization has been spending too much of its time and efforts pursuing such activities to the detriment of seeking to achieve its exempt purposes.

¹⁵⁰ Of course, if a 501(c)(3) nonprofit has not achieved other-than-private-foundation status, this may mean it has not been able to garner a wide level of public support and this might well be of interest.

¹⁵¹ More precisely, the Instructions ask for information regarding "...the organization's four largest program services (as measured by total expenses incurred) or for each program service if the organization engaged in four or fewer such activities." A "program service" is defined as "... a major (usually ongoing) objective of an organization, such as adoptions, recreation for the elderly, rehabilitation, or the publication of journals or newsletters."

¹⁵² Eliciting information about program service accomplishments began with Line 67 of the 1979 Form 990, which merely asked the filer to "Describe each significant program service activity and indicate the total expenses paid or incurred in connection with each." Line 67 provided much less space for describing each program service activity than the current Part III does nor did it require disclosure of the dollar amount of grants and allocations included in the expense total for each activity. The 1979 form was a major revision of the 1978 form. It incorporated the reporting format recommend by the Filer Commission, which was essentially the New York State Form 497. Before adopting the 1979 form, the IRS held meetings with the National Association of College and University Business Officers, NAAG/NASCO, and other outside groups. Line 67 became Part III in the 1981 version of Form 990. This was one of the changes the IRS agreed to in order to induce the states to adopt Form 990 as their basic reporting form. In addition, NAAG/NASCO, the National Health Council, United Way of America and AICPA promoted the change. The IRS agreed to the change in recognition that it had misunderstood the significance of Part III information and its value to regulators and the general public. The information contained in this footnote was supplied to the author by Robert W. Gardiner, Senior Program Analyst, EO Division, Internal Revenue Service.

expense.¹⁵³ Furthermore, it is asked to state “the number of clients served, publications issued, etc.” and to “[d]iscuss achievements that are not measurable.”¹⁵⁴ If any effort is taken in answering this part, the reader of the 990 may derive a fair sense of what the filing organization does and the volume of its efforts. Given that the volume of each program service is linked to the total expenses incurred for such service, perhaps some inferences could be made about efficiency. But such efficiency may not tell you much. Knowing that an organization had 4,080 counseling contacts does not tell you anything about whether they were useful contacts. These kinds of evaluations are very difficult to make and to turn them into objective assessments is even more difficult. Assuming this can be done, to reduce these objective assessments to text entries seems highly problematical.¹⁵⁵ For one thing, given the large subjective component of such evaluations, it is hard to imagine that most filers’ strong biases for presenting a favorable picture of their organizations would not skew their assessments. What has just been said relates mostly to “tangible” outputs. For the more “intangible” outputs the problems of reporting

¹⁵³ Three lines are provided on the form for each program service and in parentheses at the at the bottom of these three lines the amount of grants and allocations made with respect to such an activity is elicited. The instructions provide: “If part of the total expenses of any program service consists of grants and allocations reported on line 22, show the amount of the grants and allocations in the provided space.”

¹⁵⁴ The Instructions elaborate as follows: “Specify the service outputs, products, or other measures of a program service, such as clients served, days of care, therapy sessions, or publications issued. Indicate the number of outputs or products rendered, such as 4,800 counseling contacts. If the quantity of output is intangible, such as in a research activity, describe the objective of the activity for this time period as well as the overall longer-term goal. Give reasonable estimates for the statistical information (number of clients, patients, etc.) asked for in Part III if exact figures are not readily available from the organization’s records. Indicate that the information provided is an estimate.”

¹⁵⁵ What would a preparer say? “We had 4,080 counseling contacts and all were good” or “... and the clients expressed satisfaction with 85% of the contacts” or “... and in most cases the clients went on to lead productive lives.”

useful information seem even more difficult.

In fact, Part III does not seek information about ultimate outcomes.¹⁵⁶ Essentially it limits its request for data to units of service delivered. While in many cases such inputs can be measured and data may be developed showing an organization's ability to serve more inputs over time (input efficiency),¹⁵⁷ Part III would seem to reflect an understanding that, in the nature of things, most of the outcomes that are sought to be accomplished by nonprofits simply cannot be measured.¹⁵⁸

So having looked at that part of the Form 990 which was expressly designed to elicit positive accountability information and having found it of somewhat limited use, are there other parts of the 990 that might illuminate the search for information on positive accountability? As suggested above most of those parts where we might find some help are financial disclosure sections. Financial disclosure provisions are, of course, designed to give information about financial performance. Such provisions are useful for those seeking positive accountability-type information about for-profit companies as financial performance is usually exactly what is being assessed. In contrast, nonprofit financial performance, while

¹⁵⁶ For example, it does not ask whether the community has been improved as a result of a nonprofit organization's efforts.

¹⁵⁷ It might happen, however, that a reporting form's emphasis on such inputs will ultimately be counterproductive for an organization's outcomes.

¹⁵⁸ While it is very likely that we will never be able to know "scientifically" what the final outcome of a program service (e.g., a counseling service) may be, this is not to say that it is impossible to gain some fair idea of how successful it has been, and on this basis to make decisions about whether the program service is worthy of support. This may be done, for example, by making on-site visits to the nonprofits being evaluated and interviewing those who have been served. Rather, the contention here is that these kinds of judgments cannot be very well made from examining text entries.

important, is not the ultimate concern. For purposes of positive accountability, financial performance will be of interest only in so far as it sheds light upon an organization's actual performance: on what it does and how well it is able to do it. Knowledge about the latter is the final end for those seeking positive accountability information about nonprofits and financial performance is only an intermediate means to reaching the final end.¹⁵⁹

Before examining these parts in some detail, a few introductory comments about the relevance of financial disclosure information for purposes of nonprofit positive accountability are in order. Such information may suggest whether an organization is being well managed. This information is of obvious importance, but it does not shed much light on how well an organization is doing in terms of ultimate outcomes. Financial performance can also indicate how widely an organization is supported, and given the fact of external support inferences might be drawn as to what others believe about the value of what the organization is doing. Information about who controls a nonprofit organization might also suggest conclusions about its likely performance.¹⁶⁰ Perhaps as important as anything, financial performance indicators may show that an organization is in financial trouble and that its future financial viability is not secure. These points are elaborated upon below.

In some of what follows it may seem that the lines between negative and positive accountability are being blurred. This is because in many cases a particular piece of information has relevance for both kinds of accountability. A key employee's salary, for

¹⁵⁹ For those seeking information about for-profits, financial performance for the most part is the final end.

¹⁶⁰ For example, if the board of directors of a nonprofit is small and if all its members appear to have the same last name (or perhaps to be in-laws), a question may be raised as to whether the organization has been set up primarily to benefit the family (a negative accountability issue) or whether the organization is driven with missionary zeal by a relatively narrow ideological view (perhaps, a positive accountability issue). See the following paragraph in the text on the difficulty of clearly separating positive and negative accountability

example, may raise questions about excessive compensation or it may be of relevance in suggesting the experience level of the personnel employed by an organization. Of course, evidence of a negative accountability abuse itself may suggest something about how well an organization is being managed. Keep in mind, however, that questions of positive accountability will be the principal thrust of the analysis that follows. We are now ready to continue with a part-by-part analysis.

Part I (Statement of Revenue, Expenses and Changes in Net Assets or Fund Balances) -- Most of Part I elicits information about revenues. Expenses are summarized and a summary indication of net balances for the beginning and end of the year are requested. From examining this part an information seeker can tell the level and the kinds of support the organization received during the year and whether it ran at a surplus or deficit. By looking at the organization's 990 for the prior two years¹⁶¹ a seeker can garner a fair idea of how constant an organization's level of support has been, whether it has been running in balance or near balance or whether it has been regularly generating surpluses or running at deficits and, if the later, s/he can learn how serious those deficits have been. That is, s/he can develop some idea of how financially viable the organization has been. This is not insignificant information. From the fact that an organization has enjoyed financial health for a number of years, a fair inference may be drawn that it is well managed. Indeed, a potential contributor,

issues.

¹⁶¹ An organization must, during the three year period beginning with the due date, make its 990 available to the public on request. Consequently, an information seeker can get access to an organization's current 990 and those for the prior two years. (As of this writing an organization need only show the 990s to those who visit their offices and ask to see them. Soon they will have to be mailed out upon request and before too long it is hoped all filed 990s will be accessible on the Internet. See Note 3 in the main article.)

for example, might feel assured that she was not about to contribute to a failing organization, but this is hardly a reason for contributing to a charity.

Perhaps more useful conclusions can be drawn from looking at the types of revenues an organization has received. If the group received a large amount of support from the general public (Line 1a) this could mean that a good number of people think well of it.¹⁶² Of course, most of its contributions might have come from a direct mail or telemarketing campaign raising the possibility that most individual contributors knew relatively little about the organization.¹⁶³ Light might be shed on this possibility by seeing how much money was expended on fundraising (Line 15).¹⁶⁴ The receipt of government grants (Line 1c) or government contracts (Line 2)¹⁶⁵ might also be reassuring.¹⁶⁶ In like manner, the receipt of substantial amounts of program service revenues (Line 2)¹⁶⁷ might be reassuring. If people are willing to pay for the service provided by the organization and have done so for a few years, it may well be concluded that the organization is worthy. On the other hand if virtually all of

¹⁶² It could, of course, have received a large number of contributions from only a very few sources. Knowing this might remove whatever assurance an information seeker might gain from believing that the organization was widely supported. These questions might be resolved by looking at those sections of the 990 where an organization establishes its status as other-than-a-private-foundation, namely Part IV and IV-A of Schedule A.

¹⁶³ I have in mind situations similar to the United Cancer Council case. See Note 79 in the main article.

¹⁶⁴ And, in turn, a careful inspection of Part II (**Statement of Functional Expenses**) of the 990 proper.

¹⁶⁵ An information seeker would have to turn to line 93 of Part VII (**Analysis of Income-Producing Activities**) to sort out government contract(s) from other kinds of program service revenues (e.g., tuition or fees for services, etc.)

¹⁶⁶ One might presume that experienced government officials have awarded these grants or contracts only after concluding that the organization was providing an important public service efficiently.

¹⁶⁷ An information seeker would have to turn to line 93 of Part VII (**Analysis of Income-Producing Activities**) to sort out the various kinds of program service revenues (e.g., tuition or government contracts, etc.).

its income comes from program service revenue and virtually none from contributions or government support, a question may be raised as to whether the organization is truly a charitable entity.¹⁶⁸ Questions may also be raised if most of an organization's revenue was derived from passive income sources, namely, interest income, dividends, rents, sale of assets, etc., (Lines 4, 5, 6, 7 and 8). By like token, doubts about an organization may be raised if most of its revenue was derived from special events (Line 9) or the sale of inventory (Line 10). Finally, if a large part of an organization's revenue was reported as "other revenue" (Line 11), this would surely bear some further inquiry.

Part II (**Statement of Functional Expenses**) -- Perhaps some useful conclusions may be drawn from inspecting this area. Large amounts spent on professional fundraising fees (Line 30) might suggest that the organization's success in generating individual contributions is derived more from the professional fundraiser's skills than by the intrinsic worth of what the organization does. Or worse it might suggest that the organization has effectively been taken over by a fundraising firm and is being used as a vehicle by which the fundraising concern can produce funds for itself.¹⁶⁹ Perhaps the expenditure of large sums on accounting and legal fees (Lines 31 and 32) may raise questions about whether the organization is struggling with some sort of adverse circumstances. Also, large amounts spent on travel, conferences, conventions and meetings (Lines 39 and 40) may suggest a laxness in controlling expenses.¹⁷⁰

More generally, large amounts spent on fundraising which would be reflected on Line

¹⁶⁸ There are a good number of people who abuse the charitable form by organizing what is essentially a small business as a charity. See *Lorain Avenue Clinic v. Commissioner*, 31 T.C. 141 (1958).

¹⁶⁹ Again I have in mind the *United Cancer Council* case. See Note 79 in the main article.

44, Column D may raise questions similar to those suggested above on whether the support for an organization is due more to the skills of the fundraising efforts rather than to the intrinsic worth of what the organization does.¹⁷¹ At the bottom of Part I there is an unnumbered question asking whether the organization reported as program service expenditures (in Column B) any joint costs from a combined educational campaign and fundraising solicitation. Since there have been a number of instances where groups have spent large amounts of money on fundraising while claiming that its fundraising communications were educational in circumstances (and where reasonable people might differ as to the value of the educational material), if this question is answered “yes,” an information seeker might want to explore this aspect of the organization’s functioning before reaching any decision as to its worth. Finally, if Part II discloses that large amounts were spent on Management and General (Column C), some questions about the effectiveness of an organization’s program may be raised.¹⁷²

Part IV (**Balance sheets**) – This area will shed considerable light on an organization’s financial performance and viability. Right off the bat it suggests how much an organization has in reserves to weather the storms of year-to-year travail (Line 67 (unrestricted net assets) less

¹⁷⁰ This, of course, would not be so if travel or holding of conferences were intrinsic to what the organization did.

¹⁷¹ This statement would appall most of my friends who work as fundraisers or work for fundraisers. (I have met many of them over the past few years and they strike me as being very good people.) But despite what my friends might feel, it would seem to be a perfectly legitimate line of exploration for someone trying to size up the worth of an organization.

¹⁷² This brief statement covers a mountain of debate as to dividing expenses between program services and management and general and whether those not familiar with the nonprofit world really understand how much must be spent on management and services to successfully run a nonprofit. This debate is way beyond the scope of this paper.

Lines 55 and 58 (the fixed/non-current asset portion of net assets)). If the 990s for several years are available, one, by examining changes in net assets, can see whether the organization is failing financially or is proceeding on a financially even keel.

Many believe that the ratio of available net assets to total expenses (Line 67 less Lines 55 and 58/Line 44A) is the most significant information that can be gleaned from the balance sheet. Nonprofits with less than three months of their expense budgets in available reserves (i.e., an available net asset ratio of less than 25%) may, for example, be determined to have moderate financial viability problems.¹⁷³

More particularly, accounts receivable (Line 47) can suggest that a seemingly weak balance sheet is not all that weak as significant receivables may be expected to strengthen the organization's financial position.¹⁷⁴ Line 50 (Receivables from officers, directors, trustees, and key employees) may raise some questions about the actual financial strength of the organization.¹⁷⁵ On the other hand, Line 60 (Accounts payable and accrued expenses) may suggest significant problems. Since neither Line 47 nor Line 60 requires schedules,¹⁷⁶ important interpretative information will be missing. This would include information about how likely the receivables are to be received and when they can be expected. It could also

¹⁷³ Nonprofits with six months of their expense budgets in available reserves (i.e., an available net asset ratio of 50%) may be determined to have mildly problematical problems, where as a net asset ratio of 10% may be considered quite serious. On the other hand, some believe that the net asset ratio should not exceed 200% (i.e., that available net assets are double the size of total annual expense). This is the position of the National Charities Information Bureau. Many donors of unrestricted gifts do not expect their money to be used to build up unreasonable reserves.

¹⁷⁴ Line 51 (Other notes and loans receivable) may also suggest additional strength.

¹⁷⁵ It may also suggest some negative accountability problems. See main article at page 45.

¹⁷⁶ In contrast, lines 50 and 51 both require schedules. This is likely to be the case as these lines could show negative accountability-type information which is important for the government regulators.

show whether the accounts payable include, for example, significant salary amounts (which would suggest that the organization is in severe trouble) or whether they only include a number of small bills to vendors (which would suggest no cause for serious alarm).

Before leaving Parts I, II and IV a few words should be said about ratio analysis. Ratio analysis is a method by which ratios whose numerators and denominators are taken from line entries¹⁷⁷ and are developed for monitoring the financial position and health of nonprofits. It has been said that, “[f]inancial ratios can help board members and managers understand financial statements, compare an organization’s financial picture with past years and see how it ranks compared to similar organizations.”¹⁷⁸ Attached to this Appendix is a set of performance-indicator ratios derived from the Form 990 developed in the early 1980s by a group of state charity officials with the assistance of representatives from the nonprofit sector. They have been circulated by the National Charities Information Bureau and the Nonprofit Management Group at Baruch College for the past fifteen years or so.¹⁷⁹ If ratio analysis becomes widely used by those assessing nonprofit groups it may be legitimately wondered whether these groups will feel pressure to develop their underlying figures in a way that will produce favorable ratios. Here we touch upon a more general problem with financial

¹⁷⁷ For example, Fundraising expenses (Line 15)/Total contributions (Line 1d); Program services expenses (Line 13)/Total revenue (Line 12); Program service expenses (Line 13)/Total functional expenses (Line 44A), Management & general expenses (Line 14)/Total functional expenses (Line 44A); Officers compensation (Line 25A)/Total functional expenses (Line 44A) or Total compensation (Lines 25-29)/Total functional expenses (Line 44A).

¹⁷⁸ See, Bograd, Alerting Nonprofit Boards to Financial Trouble; Variations on a Theme. PONPO (Yale university) Working Paper 226 (1995) at page 3. This fine paper provides a useful description and history of ratio analysis as it has been used in the nonprofit world.

¹⁷⁹ These ratios have been used by a number of state charities offices (Connecticut, Maryland, New Hampshire, New Jersey and some others) to prepare report cards for the public on charities that file reports with them. (My understanding is that several states have stopped issuing such report cards.) California has developed a set of 100 ratios for these purposes as well as for its own efforts at overseeing nonprofits.

disclosure statements, namely, the degree of absolute accuracy with which figures are reported. How one figures their time is allocated, say, between program and fundraising, is usually not done with minute by minute care (nor should it be) and will very likely be influenced by what it is understood that people expect.¹⁸⁰

Part V (**List of Officers, Directors, Trustees, and Key Employees**) -- may provide useful material for an information seeker. To begin with, the number and identity of the directors can be revealing. If there are few directors and they appear to be related, questions may be raised.¹⁸¹ High levels of compensation paid to directors might also raise questions. Finally, the levels of compensation paid to officers and key employees might also affect decisions about whether an organization is worthy of support. Some people, for example, may not want to contribute a part of their hard earned income to organizations that pay their top staff compensation far in excess of what they are making or what they think is appropriate for a charitable organization to pay. On the other hand, if the compensation levels for officers and key employees are low, this information may also appear significant. Finally, Question 75 at the bottom of Part V, which asks whether any officer, key employee, etc., who received aggregate compensation in excess of \$100,000 from the filing organization and all related organizations of which more than \$10,000 was provided by the related organizations, may suggest further inquiry. Part V, of course, is a fruitful source of information for those seeking information about possible negative accountability problems, e.g., excessive compensation.

¹⁸⁰ It is submitted that entries made reflecting these kinds of judgment calls are vastly different than those entries that deliberately cover-up self-dealing or other improper payments that are known to be improper, that is, the stuff of negative accountability.

See main article at page 27. While what has been said above may suggest a negative accountability inquiry, the focus has been in fact on positive accountability concerns. Key employees may be being paid levels of compensation that do not constitute inurement or are otherwise excessive and yet, as suggested above, may suggest an operation that is not one that a potential supporter would be happy with. Similarly, as also mentioned above, an organization controlled and run by what appears to be all members of the same family may very well not be abusing the charitable form but may nevertheless raise questions for a potential supporter. Again, the lines between negative and positive accountability can be blurry.

Part VI (**Other Information**) -- For the most part, this part is not a financial disclosure section but rather one that collects tax information. Nevertheless, a fair amount of positive accountability-type information can be gleaned from it.

Line 76 asks whether the filing organization engaged in any activity not previously reported to the IRS and, if it did, asks for a detailed description of each activity. If this question is answered “Yes,” the description of any new activity might be of obvious interest in developing a sense of what the organization does.

Line 77 asks whether any changes have been made in the organizing or governing documents and, if so, asks that a copy of the changes be attached. Here also the provisions of a new by-law section or of an amended certificate of incorporation, for example, would be of obvious interest to a careful analyst.

¹⁸¹ See Note 14.

Line 79 asks whether a liquidation, dissolution, termination or substantial contraction took place during the year covered by the return and, if so, requires that a statement be attached describing the changes. This too is of obvious importance.

Line 80 asks whether the organization is related through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization and asks for the names of the organizations to which the filing organization is related. While this is a key question for negative accountability concerns (see main article at page 55), it might also raise some positive accountability concerns.

Line 88 asks whether at any time during the year the organization owned a 50% or greater interest in a taxable corporation or partnership and, if so, directs the filer to complete Part IX. Again, of perhaps more interest to those concerned about negative accountability (see main article at page 56), but such information could also justify further inquiry by those trying to gain a picture of what the organization does.

Line 90 asks for a list of states with which a copy of the 990 is filed. If a fair or large number of states are listed, this might suggest that the organization engages in multi-state solicitations, either through direct mail or telemarketing campaigns, and this would raise all the questions mentioned above about organizations that rely heavily on

direct mail campaigns and the like.¹⁸²

Schedule A can be dealt with in a fairly summary fashion since much of the financial disclosure information it collects is of interest to those seeking positive accountability data and is very similar to that elicited by the 990 proper about which comment has already been made. For example, Part I (**Compensation of the Highest Paid Employees Other Than Officers, Directors and Trustees**) elicits data identical to Part V of the 990 proper for the five highest employees who make more than \$50,000 a year other than those listed in Part V. All the concerns mentioned in discussing Part V would apply here. What can be inferred from the level of salaries that high-level employees are being paid? Does it reflect on their experience and competence or does it reflect perhaps an organization overly comfortable in terms of what the seeker of information thinks is appropriate for a charitable organization?

Part II (**Compensation of the Five Highest Paid Independent Contractors for Professional Services**) may be of more interest. Here would be listed independent fundraising concerns, law and accounting firms. Levels of payment may suggest all the concerns mentioned above about the use of professional fundraisers or, for example, the need for a high level of legal service may reflect a struggle that bears looking into.

Part III (**Statement About Activities**) comprises what the text refers to as the great self-dealing question. (It also includes a question about political activity.) The great self-dealing question is perhaps the ne plus ultra of negative accountability question (see main article at page 39), but it may also raise some positive accountability concerns. Significant dealings

¹⁸² See Note 17.

between an organization and its insiders may suggest management concerns or otherwise trigger a wish for further information.

SECTION

E

Appendix C

This Appendix examines three employee perks that might be considered working condition fringe.¹⁸³ We begin with the payment of the annual membership dues in a social club by a nonprofit employer on behalf of one of its key employees.¹⁸⁴ The Regulations specifically provide that such a payment will be considered a working condition fringe benefit if the amount would qualify for a deduction by the employee under section 162 of the Code,¹⁸⁵ the employee properly substantiates his use of the club¹⁸⁶ (including showing that he used the club exclusively to advance the organization's exempt purpose and not for any personal use), and the employer does not treat the payment as compensation. Treas. Reg. 1.132-5(s). Thus, the employer-provided membership in the club would not be includable in the key employee's gross income and would not have to be shown as compensation to the key employee on the organization's 990. It would merely have to be included in one of the aggregate functional expense lines of Part I of the 990, very likely Line 40 (Conferences, conventions and meetings).

A similar analysis would apply to payment by the nonprofit employer of expenses incurred at the social club by the key employee. If the proper procedures are followed,¹⁸⁷

¹⁸³ Working condition fringe is defined in the main article at page 31.

¹⁸⁴ When the terms "key employee" or "key employees" are used in what follows, they should be understood to include officer(s), director(s) and trustee(s).

¹⁸⁵ That is, if the employee had paid for the dues himself instead of his employer, he would be entitled to a deduction under section 162 of the Code.

¹⁸⁶ The Regulations in this case call for substantiation under section 274(d) of the Code.

¹⁸⁷ The employee provided his employer a full substantiation for the expenses, etc.

such payments would also be considered working condition fringes and excludable from the key employee's gross income and reportable on the employer's 990 only on an aggregate functional expense line. And likewise, if a key employee is reimbursed pursuant to a reimbursement or other expense allowance system for expenses incurred "with respect to an activity which is of a type generally considered to constitute 'entertainment, amusement or recreation'"¹⁸⁸ and the proper procedures are followed, such payments will be treated as working condition fringe and will not be included in the key employee's gross income or need to be listed as compensation to the employee on the organization's 990. It need hardly be pointed out that the terms "entertainment, amusement and recreation" are capable of covering much that those who view the nonprofit sector with a somewhat puritan cast of eye might find objectionable. Finally, the provision of a car to a key employee by his nonprofit employer, including chauffeur services, may be treated as working condition fringe.

When travel becomes excessive, some may regard it as a perk. If the travel is domestic travel there are no limits, so long as each trip is made solely to pursue the organization's exempt purposes and proper substantiation is made.¹⁸⁹ Such travel payments or reimbursements would be considered working condition fringe. There are limits, however, on foreign travel. Payment or reimbursement for such travel would not be considered working condition fringe unless such travel did not exceed one week or the portion of time outside the United States not attributable to the pursuit of the organization's exempt purposes

¹⁸⁸ Under section 274(n)(1) of the Code, from which the above phrase is quoted, a taxable employer's business expense deduction would be limited to 50% of the amount of each such payment. This suggests that the U.S. Congress takes a somewhat jaundiced view of lavish entertainment expenses when it comes to for-profit groups. (This provision was no doubt enacted as much to collect additional revenue as to express moral opprobrium for lavish entertainment expenses.) It would seem to follow a fortiori that such expenses are not appropriate for the nonprofit sector.

is less than 25 percent of the total time of such travel.¹⁹⁰ Finally, even if an employee's spouse, dependent or companion accompanies him or her on the trip, payment or reimbursement of the travel expenses will be considered working condition fringe if it can be adequately shown that the spouse, etc., accompanying the employee has a bona fide business purpose and if the employee properly substantiates the travel.¹⁹¹

¹⁸⁹ In this case the substantiation would be made under the section 274(d) rules.

¹⁹⁰ See section 274(c) of the Code.

¹⁹¹ Treas. Reg. section 1.132-5(t). Note, if the employer was a taxable entity, it would be allowed a deduction for spousal travel only if the spouse, etc., was an employee of the employer. See section 274(m) of the Code.