

Maintaining Public Trust in Charities During the Economic Downturn

**Remarks of Lois Lerner
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Good morning and thank you for inviting me to be here. Steve Miller has asked me to send his regrets at not being here — he thinks highly of this forum and is sorry to miss the program this year.

Over the next day or two, as you discuss representing and managing tax-exempt organizations, I'm guessing the biggest concern facing many of them today is the same challenge facing the for-profit sector — the economy. It seems we can't read a newspaper, watch television, or go online without some discouraging news about the economic downturn. We watch as the banking system is revamped, a major overhaul of investment practices is considered, and previous cornerstones of the economy confront possible bankruptcy. We're all facing uncertainty as much of what we have come to take for granted is changing.

In addition, the economic downturn has sent shock waves throughout the tax-exempt sector. Endowment values have fallen. Charitable contributions to many organizations have dropped significantly. Income is down and operating budgets are being cut. Reports of cutbacks in charitable services, layoffs, wage reductions, and delays of long planned capital projects are sadly becoming the norm.

And all of this is happening to the sector just when its goods and services are needed most. In difficult times, tax-exempt organizations serve as a safety net for our communities. They provide shelter for those who have lost their homes, meals for those who are no longer able to feed their families, and social services for the elderly who have watched their retirement nest eggs diminish.

We have a long tradition of support for charitable institutions in our country — and not simply through the tax code. More than any other culture, our strong national belief in the values of "community" and "private initiative" have fostered a wide variety of charitable institutions that offer new and innovative ways to meet community needs, in addition to the traditional methods of providing charity. And the number of those organizations continues to grow — increasing by more than 5% in each of the past two years. That trend is continuing so far this year, as the

IRS has received more applications from new organizations than we had predicted.

There is a great deal of public trust in these organizations, and it is that trust that must be preserved as we confront the challenges brought on by the economic downturn.

I believe the greatest challenge facing many tax-exempt organizations is the downturn's impact on their financial support. We are seeing frequent reports about the difficulty that charities are having with fundraising. Individual and corporate donors are tightening their belts as they assess the impact of the downturn. Private foundations have seen the value of their assets decrease substantially and, while a few have reacted to the economic situation by promising to award more grants, the Chronicle of Philanthropy reports that 40% of foundations expect that their giving will be reduced in 2009. Many are providing assistance only to charities they have supported in the past. Even charities that get money from fee-for-service operations are concerned about possible drops in revenues.

In the healthcare sector, we have seen reports of individuals postponing medical care to avoid the co-pay or because they have lost their insurance. We have heard that private colleges have been admitting more students than in the past because they worry that a larger number of students will not be able to afford the tuition and will end up declining admission. The arts sector is reporting that it is hard hit. Right here locally, the Baltimore Opera Company went bankrupt and has announced that it was unable to restructure under Chapter 11, and so is liquidating after 58 years. For social service organizations, even where they can maintain their level of support, the demands for their services are increasing. States and municipalities are facing budget shortfalls and cutting services, and many are counting on the tax-exempt sector to be there to pick up the slack.

All of this means there are more charities chasing fewer dollars. The Chronicle of Philanthropy reported:

Only 46% of nonprofit organizations raised more money last year than they had the previous year

1/3 of fundraisers expect to raise less money this year than last year

During this very difficult time, I want you to know that we at the IRS are sensitive to all these conditions, and we are anxious not to worsen them inadvertently as the result of unconsidered habit or through needless inflexibility.

We want to be helpful, and will be, but there is another consideration to keep in mind as we go forward. Experience has shown us that in times of economic peril, we must be watchful. During hard times, there is often a rise in questionable or fraudulent activity, in overly aggressive or inappropriate

fundraising, and in tax avoidance accommodation schemes of less than sterling character.

Unfortunately, those few organizations that engage in improper, inappropriate or illegal behavior are generally more newsworthy than the many that are faithfully fulfilling their mission. Because public trust is so important to the sector, none of us wants the actions of the bad apples to overshadow all the good work that most tax-exempt organizations are doing.

So, what can you and I do about it? From the IRS side, we are trying to stay ahead of the curve to curtail predatory abuse of tax-exempt organizations. For example, we are seeing a number of applications from organizations offering mortgage foreclosure counseling and assistance. Based on our experience with abusive credit-counseling organizations, we are concerned that some of these applicants may be using the guise of an exempt organization to profit from individuals who have been harmed by financial upheaval. Consequently, we are looking very closely at applications from new organizations, and at activity being conducted by established organizations.

We also will be on the lookout for aggressive fundraising tactics and the valuation manipulation that often accompanies them. On the “good news” side, we believe the information about non-cash contributions required on the redesigned Form 990, coupled with the PPA automatic loss of exemption for organizations that fail to file for 3 years, leave little room for organizations to hide and will help us detect and combat this type of abuse.

As cash-strapped tax-exempt organizations attempt to cope with the economic downturn, some may fail to pay over withheld employment taxes to the IRS. The trust fund provisions impose personal liability on those responsible for reporting and depositing the amounts withheld from employees to for-profit and non-profit employers alike. Just recently, the Fifth Circuit affirmed a decision holding the chairman of the board of a non-profit hospital personally liable for unpaid payroll withholding taxes. We recently included a warning about this in our EO Update, but it bears repeating – don’t let that happen to you or someone you represent.

We also may see a rise in unrelated business activity as exempt organizations seek new sources of revenue. While not necessarily a bad thing, public disclosure of Forms 990-T filed by charities will certainly lead to more public scrutiny of those activities. We are already looking at unrelated business income activities to better understand why a high percentage of organizations that are conducting business activities continually report losses on their Forms 990-T.

As money becomes tighter, donors will be looking to see that their contribution dollars are well spent. We have begun looking at this in our “Charitable Spending Initiative” -- a long-range study that we started earlier this year. It is designed to learn about the sources of funds in the charitable sector, and how

the funds are used. The first phase focuses on organizations with unusual fundraising levels, and organizations reporting high levels of unrelated trade or business activity and relatively low levels of program service expenditures.

Those are several areas where I think the IRS can help to protect the trust and confidence in the sector. Now I would like to mention a few areas where I think organizations and their advisors have an opportunity to build on that trust.

One is through better transparency. A primary tool in that area is the Form 990. The 990 is not just about reporting financial information to the IRS. Because it is publicly disclosed, tax-exempt organizations should also look at it as a public relations tool. Make sure the form accurately reflects the good work that your organizations are doing. This is your chance to tell your story. Potential donors will look to the form when making their decisions about where to lend their support — and they are not the only ones looking at the form. Reporters and watchdog groups also review and report on the 990's filed by tax-exempt organizations. You need to make the Form 990 work for you; you don't want it to be used against you.

Another area organizations can focus on to enhance public trust is governance. While the tax laws do not explicitly set governance standards for EOs, we believe good governance and compliance go hand-in-hand, and that an active and independent board is the best defense against the misuse of charitable assets, as well as against bad press.

So, look at your governance practices — have the conversation and determine what works best for your organization. And think about making your governance documents and policies public, another public relations opportunity to instill confidence and trust in the organization and set you apart in donors' minds.

Organizations should take a close look at their executive compensation packages and practices. While the furor over the AIG bonuses and the response to the \$500,000 executive salary cap for bailout recipients were on the for-profit side, we already are seeing news reports that people are looking equally closely at executive compensation in the tax-exempt community.

And just as people will be looking at those compensation amounts more critically, it will be easier for them to do so because the redesigned Form 990 provides much more comprehensive compensation reporting. So, everybody, not just the IRS, will be scrutinizing non-profit executive compensation numbers.

Being an eternal optimist, I try to think about what good can come from this crisis. The world is changing around us — and the tax-exempt sector is changing as well. We do not know today what the sector will look like in a few years — but I believe it will be stronger for having weathered this storm.

Some organizations, whether newly formed or long-established, may not make it. Those that are not able to benefit from economies of scale may have a more difficult time surviving, both in the for-profit and non-profit sector. For that reason, we are hearing more about tax-exempt organizations considering mergers and acquisitions involving other exempt organizations. Some think this is a positive development — others do not like the idea of fewer exempt organizations. At the IRS, our role is not to decide how many tax-exempt organizations there should be. Rather our concern is whether the organizations that are out there continue to meet the requirements for tax-exemption and comply with all federal tax laws.

Traditionally there has not been widespread merger and restructuring work in the tax-exempt area. It involves a number of legal issues, many of which fall under state laws, and a number of which can be thorny. The involved organizations must consider whether a change in the use of the assets is consistent with donors' intentions and charitable trust principles, for example. As you work through these transactions, I ask that you make us aware of the issues you are seeing and tell us how we can help in this area. If you think we need to issue guidance; we would love to see a draft of how you would approach the issues; provide us with a draft that gives us a good starting point. This is just one area where we can work with you to provide needed outreach and education to the sector during this time of change.

As an alternative to merging, some tax-exempt organizations are partnering with other exempt organizations, through cost-sharing arrangements and other contractual means, to take advantage of economies of scale. Others are developing innovative fundraising mechanisms – some of which might result in UBIT – which organizations may view as an acceptable cost of obtaining the additional funds. Necessity is the mother of invention, and as tax-exempt organizations develop new ideas, I expect there will be some not-so-successful efforts, as well as come creative gems that really shine.

My final observation about our economic circumstances is addressed to you as leaders. Perhaps the best measure of success of leaders, whether they be in business, government, or the independent non-profit sector, is how they respond to the challenges imposed in the most difficult times. The sector has made great strides in the past few years. I hope the gains in good governance and best practices – the general upgrading of the standards of the tax-exempt sector – are not lost as staff cuts fall upon those whose work insures good compliance and adherence to high standards. As leaders in the sector, I appeal to all of you to help individual organizations and the broader sector to maintain those standards.

On my end, I believe we are well positioned to address these challenges. And I have some good news – we will be hiring additional staff, for both the EO examination function and for Rulings & Agreements, which will better enable us to hold up our part of the bargain.

Looking ahead, I believe the continued vitality and financial stability of the sector depends most on one thing – public trust. The IRS can help instill and maintain this trust by promoting compliance and transparency. Organizations and practitioners can build and maintain this trust by doing the right thing – operating consistently with their long-held beliefs and mission, promoting transparency and accountability to the public, and resisting the temptation to sacrifice principles for short-lived and perhaps ill-gotten gains.

In closing, I thank you for all that you and the sector do for this country. The IRS wants to, and will, work closely with you to confront and resolve the challenges that are sure to arise in the wake of what we all hope will be a short-lived crisis. In short, we want to help you weather the storm.

Thank you for your attention, and I would be happy to answer questions or hear any response you may care to make to what I have said.