

**“The IRS’s Role in an Evolving Charitable Sector”**  
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Thank you and good morning. I am happy to be here.

Let me say, at the outset, that we recognize that tax issues are not, and should not be, at the forefront of your concerns. You have organizations to run, good work to do.

We know – I know – that a vigorous tax-exempt sector is vital to the country, and, increasingly, to the world. Our job at the IRS is not to burden the sector with rules and minutiae – though we certainly have skill and experience in that area. Our job is to operate a program that will promote compliance and protect the integrity of the sector while allowing you to succeed.

So let’s begin. I have been asked to speak on the Service’s role in an evolving charitable sector. “Evolving” seems an apt word to characterize the sector. Just as “unsettled” is an apt word to characterize the current environment. This morning I would like to discuss, from our perspective, where the sector is today and identify some of the factors that I think are driving its evolution. I’ll describe the Service’s role in responding to these factors, now and into the future.

A few years ago we learned that some of the bad practices of the corporate world that led to Sarbanes-Oxley were taking hold in the charitable sector, including the foundation area. And we were jolted by scandals involving charitable organizations and their leaders that surfaced in the press.

It seems to me that the environment may have improved somewhat since then. Still, instances of scandal continue and call for a vigorous response from the Service, the States, and the charitable community.

Nevertheless, I see some positive developments. First, the charitable sector itself has acted in a most impressive way. It is engaged in a forthright program of self-criticism and self-examination.

Second, the Internal Revenue Service also has acted. We have reinvigorated and greatly expanded our compliance efforts in the tax-exempt sector, utilizing new techniques and new staffing.

Whether my sense that the sector is moving in the right direction is correct remains to be seen. The community participating in the elevation of standards by and large influences a very different group from those designing, promoting and participating in abusive schemes. And the world continues to change.

No one should imagine that the sector is static. Powerful forces are reshaping it. Some of the trends are obvious, and some subtle. Let me identify just a few that I believe will impact the IRS relationship with the sector.

The first trend is the constant increase in the number of tax-exempt organizations. Seventy thousand plus a year – this is a gross not a net number, but the sector continues to grow. This growth raises the question whether we now have, or will get to the point where we will have, too many exempt organizations? Over 175 new tax exempt organizations every day – Saturdays, Sundays and holidays included. One exempt organization for every 228 Americans.

Can – or will - the public fund all these organizations? Does the Service, or do the States, have the wherewithal to regulate this many entities? The presence of a very large number of tax-exempt organizations also presents the question whether we Americans are spending too much on duplicative infrastructure.

A second trend is the growth in the economic power of the sector. Its size and economic complexity continue to increase. One driver of this trend is the transfer of wealth. This is happening now – and it will accelerate for the foreseeable future as the World War II generation passes and as Baby Boomers focus on estate planning. Beyond the implications of a richer charitable sector, the presence of large amounts of money is driving the creation and the energetic marketing of a variety of new giving techniques, some very good and some very bad. This will require heightened focus by the Service.

Another aspect of the growth in economic power – and a rather unique one – is the emergence of the very large non-profit organization – what I will call the nation-sized non-profits. These organizations are global in scope and scale. Their command of vast resources gives them the ability to initiate programs, to conduct research, and to influence policy in ways that once were thought to be the exclusive province of national governments. This development has the potential to change how some important issues of public policy are formulated and implemented. This is especially true to the degree these organizations may be able to implement programs with significant impact on their own say-so, without meaningful public debate, continued public support, or the involvement of traditional governmental policy makers.

A third trend – a tidal wave that certainly is not limited to the tax-exempt sector – is the rise of technology and the Internet. It allows supercharged and almost real-time transparency, but it may bring some troubling developments as well.

Web-based fundraising and virtual, stateless charities are possibilities in this category. The Internet has the potential to blur the concept of state and national borders, with consequences for governmental jurisdiction over charities.

Yet another trend is the blurring of the line between the tax-exempt and the commercial sectors. The convergence of these two realms raises the issue of unfair competition and threatens to undermine the good will that you depend on. One can imagine difficult questions: "If charities are making profits, why do they need my support?" And, "If the charity is doing the same thing as a for-profit business, why should the public subsidize it?"

Please understand that I am not saying that no valid differences exist between the non-profit and for-profit sectors. I am asking something more nuanced: to what degree has the non-profit sector drifted toward the commercial sector, and to what extent should it be taxed like the for-profit sector? And even where the exempt sector acknowledges unrelated commercial activity, why are so many organizations declaring losses on these endeavors? It seems as if the IRS needs to police this Drift Line.

The final trend I'll mention this morning is one I already alluded to and that we both should be concerned about, and that is the presence and the perception of abuse in the charitable sector. I mention it here not because I think anyone in this room is taking improper advantage, but because even within the charitable sector there is not a full appreciation of the extent to which abuse has emerged in recent years. It is a threat to the tax-exempt community. More than anything else, it is abuse, actual and perceived, that unsettles the environment of the charitable sector and requires action by the regulators.

All of these trends impact the ability of the Service to effectively regulate the sector. So what should we at the Service do? How do we respond? It is no surprise that we have changed direction toward more enforcement, but do we need to go farther or in a different direction?

Our traditional compliance program for the tax-exempt sector continues to be very relevant. It has three main pillars. One is customer education and outreach. We have a vigorous program of public education, and I would like to strengthen it further.

The second pillar is our determinations program. An organization seeking tax-exempt status submits an application and we review it. This is "up front" compliance, and it is critical.

Our third pillar is examinations. We are back in the enforcement business, but we have more to do here, as well.

But is this traditional program enough? It seems ill-suited to meet some of the important current problems within the sector. Among these are insufficient transparency, lax management and a lack of meaningful ways and metrics to measure an organization's effectiveness. As the charitable sector evolves, we too must evolve.

While being clear that we will never give up our work in service or enforcement, I want to discuss two new pillars for our program that begin to respond to the forces and problems I've been talking about.

The first new pillar is to use the authority and resources of the Service to gather significant and reliable information about the charitable sector – more than we have before – and then make that information broadly available to the public, in a timely and user-friendly fashion. We are already doing much of this, of course: we are encouraging and expanding electronic filing, and redesigning the Form 990. But we will need to do more.

The second new pillar is to promote standards of good governance, management and accountability. I believe that the IRS contributes to a compliant, healthy charitable sector by expecting the tax-exempt community to adhere to commonly accepted standards of good governance. For many tax-exempt organizations, governance is already very good. But in too many instances, we have found governance to be wanting.

While a few continue to argue that governance is outside our jurisdiction, most now support an active IRS that is engaged in this area.

The concept of IRS involvement with good governance is not new. We have been quietly but steadily promoting good governance for a long time. Our determination agents ask governance-related questions. Further, our agents assess an organization's internal controls as the agents decide how to pursue an examination. And recently we took a deliberate step in support of principles of good governance and of an independent board of directors in our discussion draft of the new Form 990.

We are comfortable that we are well within our authority to act in these areas. To encourage transparency is not a stretch at all. We've been doing it for a long time, beginning with work with Guidestar and others to make 990s and 990PFs easily accessible. To more clearly put our weight behind good governance may represent a small step beyond our traditional sphere of influence, but we believe the subject is well within our core responsibilities.

Will these new steps, added to our traditional program, be all that is required to meet the challenges of promoting compliance, suffocating abuse and giving the public a clear line of sight into the operations of charities and private foundations?

I remain somewhat skeptical.

Beyond the trends I have discussed, there are other issues that significantly affect the health of the sector and the goodwill of the public where there has been little discussion or recent federal activity. Let me mention two of them.

The first issue is what to do about inefficient or ineffective organizations.

I am not talking here about questioning your business judgment or decisions – that job belongs to you, your contributors, and to some extent the states.

But efficiency and effectiveness have obvious implications when you consider the enormous tax subsidy that tax-exempt organizations receive. Should the public be able to rely on the IRS and the states to ensure that when they make a contribution to a charity, it is put to good use and is not squandered?

In this area, the IRS has a limited role. Federal tax law does not establish minimum standards of efficiency or effectiveness. Exemption is not limited to “effective and efficient” organizations.

But that is not to say we are uninterested or powerless. We can use the Form 990 to highlight the organization’s efficiency so a potential contributor can make an informed decision about whether to support it.

We also can act where the organization is spending improperly. For example, we will act against an organization that wastes its resources by providing extravagant compensation.

A second issue where the Service may have an interest but has not asserted its authority in recent years involves a comparison between what a charity ought to be able to do, given its resources, and what it actually does. Is providing a peppercorn of public benefit enough? How much saving is too much saving?

Should we insist, on behalf of the public, that a charity provide a public benefit that is commensurate with the charity’s financial resources and the tax subsidy it receives? Should there be, for example, an annual payout or spending rate for charities? You can find an analogy to that idea, inexact though it may be, in your private foundation rules or the coming rules on supporting organizations. And even in the private foundation area – is the 5% rule enough?

The question is pertinent right now as intergenerational wealth is being willed or otherwise transferred to charities. The IRS must be, and is, concerned with transparency here.

The new Form 990 will give all of us more information in this area. And as we move to the 990 PF, the same thing will happen. At the same time, however, it seems to me that we should review existing tools and explore whether we can hold organizations to a standard of commensurate use of assets – at least in the most offensive and egregious cases. And it may be time for us to review what is being spent and counted toward the 5% rule.

Finally, let me identify two issues of concern to the sector that I believe are appropriately outside our current reach and thus will not impact our future role. While these issues are significant, I would not strain to argue that we have authority to regulate here.

The first of these may be pejoratively termed the “dead hand” issue. The issue is whether all 501(c)(3) organizations should be entitled to perpetual existence. To immortality, if you will. Should those alive today be able to secure, in perpetuity, a tax subsidy that generations now unborn will fund forever?

In this regard, is there a useful distinction to be drawn between publicly funded organizations that are constantly renewed and revalidated by new donors and supporters, and organizations that are funded at a single point in time by a single donor?

Should the fact that the corpus of some entities is largely insulated from public accountability create public unease? These questions are valid, but I am not sure how big a problem this is. I say that because, in some cases, it appears that many large private foundations – after being in existence for a while – take on some of the characteristics of public charities. Query whether this is true for the small family foundation? And, I do think that the ability to insulate the charitable corpus from the whims of the public may be desirable in some instances. Philanthropic stability and the ability to finance unpopular causes may depend upon such a system.

Another issue that is important to the charitable sector but that lies beyond the IRS’s jurisdiction concerns the issue of respecting donor intent.

We have little to say in fights between donors and donees. This is primarily a matter of state law. From the federal point of view, the question is, has the money been used for an exempt purpose? If the answer is yes, our inquiry is over.

Does this hands-off approach seem satisfying? I would say yes – no one needs a federal taxing authority deciding the better use between two charitable endeavors.

I should wind up here. The Service needs to be aware of these trends and issues and to find a way to respond to some of them. How we do that is the

question. I have outlined areas where our jurisdiction, our authority, has bounds. In some of these areas, efficiency and effectiveness for example, we will take the path of encouraging transparency, good governance and accountability. In other areas, such as the delivery of a public benefit commensurate with resources, we need to consider whether we should go beyond promoting transparency, and, if so, how.

I haven't really touched today on what you can do. So let me just say that no matter how far we stretch at the Service, no matter how far the states move in these areas, it will not be enough.

It will not be enough to ensure that the sector is insulated from the next scandal and its resulting pressure to push further mandated regulation.

So the sector needs to remain active and attentive. Think about it. Consider whether in these areas you would rather establish widely adhered to best practices, or have Congress or the IRS do it.

Leading organizations and actors within the sector have already made excellent strides toward self-regulation. Do not let those efforts falter.

I've spoken long enough. Thank you for your attention. I will be glad to answer questions after the panel is done.