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Point of View

What We Really Need

Eight reforms to make nonprofits more accountable and effective

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Eight reforms to make nonprofits more accountable and effective

This summer, the Senate Finance Committee is deliberating on a bill that would do for the nonprofit sector what the Sarbanes-Oxley Act did for the private sector: establish stricter financial reporting requirements for organizations operating in the United States. Several groups have presented recommendations to the committee, including Independent Sector, which is a coalition of nonprofits, foundations, and corporations.

In a few short months, Independent Sector appointed a 24-member Panel on the Nonprofit Sector, as well as the panel's 121 advisers. The panel presented its first set of recommendations to the Finance Committee on April 6. As this issue was going to press, the panel was rushing to complete a second set of recommendations before the Senate committee concludes its inquiry.

We take our hats off to Independent Sector and other groups that have crafted and presented recommendations to the Senate Finance Committee on how to make nonprofits more accountable. However, our organization's experiences in consulting, education, and advocacy with community-based organizations suggest a different set of reforms. Unlike Independent Sector, we are not constrained by concerns of what is politically achievable. We therefore propose the following eight reforms that, in our opinion, would best strengthen both the *external* accountability of the nonprofit sector and its *internal* ability to effect social change.

Increase accountability for the entire nonprofit sector, not just 65 percent of it.

Churches, temples, and other religious institutions receive all of the benefits of tax-exempt status – including 35 percent of all charitable donations in the United States – yet do not file Form 990 or have the other reporting and accountability requirements imposed on the rest of the nonprofit sector. In addition to more than $80 billion in annual tax-deductible donations, faith-based organizations received $2 billion in federal grant money in 2004 to provide social services.[1] Yet the public cannot find out the executive compensation and overhead costs of the Unification Church, the Crystal Cathedral, or the thousands of other religious institutions that use both direct and indirect tax dollars to do public work. In contrast, the public can get these facts about, say, the local barn theatre. The Senate should hold religious organizations to the same standards of accountability as it does the rest of the nonprofit sector.

Classify foundations and nonprofits separately.

There are currently more than 20 501(c) designations, including 501(c)(5) for labor unions and 501(c)(6) for chambers of commerce. Yet nonprofits and foundations, which are both classified as 501(c)(3)s, are just as distinct from each other as each is from unions or chambers of commerce. Lumping nonprofits and foundations together is confusing to the public and complicates efforts at regulation like the one currently under way. From a regulatory perspective, foundations present different issues than nonprofits – from payout rates to donor-advised funds – and distinguishing between foundations and nonprofits would enhance the clarity and focus of regulations for each. Moreover, such a distinction would give nonprofits more representation and meaningful influence *within* the sector, such as within the Panel on the Nonprofit Sector and other bodies.

Classify community-based nonprofits separately.

While we're distinguishing between nonprofits and foundations, let's also distinguish between community-based nonprofits and large institutions like hospitals and universities. The latter hold many of the sector's assets but are not what most of the public understands by the label "nonprofit." By aggregating a mishmash of organizations' assets and employees, we end up with an impressive-sounding but distorted story about the sector as a whole: gigantic numbers that put

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lawmakers on alert but that are in fact a wild mixture of apples, oranges, squid, and mutton. Separating community-based nonprofits from hospitals, universities, and other unlike organizations would make data on the nonprofit sector more useful – something everyone from academics to investigative journalists would welcome. Just as we need to understand family farms as distinct from agribusiness, we need to understand community-based nonprofits as a distinct group within this sector.

Stop paying trustees and board members.

Does the public get better performance from foundations that pay their trustees $50,000 to attend four meetings a year than it gets from those that only reimburse trustees' travel expenses? It seems clear that the answer is "no." Moreover, compensation turns board members into "insiders," a status that weakens their ability to act on behalf of the public and, when necessary, to dissent. To ensure that board members and trustees are truly working in the public's interest, take compensation out of the picture. (If foundations or nonprofits want to have the expertise and perspective of people who would not be involved without compensation, they can still pay those people as advisers and have them attend board meetings, but not give them voting seats.)

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Ensure independent boards.

Boards of directors in the nonprofit sector are there in large part to hold the organization accountable to the public. They can't do that if they are paid staff members or are relatives of paid staff. As is already law in some states, a minimum of 51 percent of nonprofit and foundation board members should be independent parties with no relationship to paid staff.

Redefine foundation payout.

Scrutiny of nonprofit overhead rates serves as a market incentive – albeit an imperfect one – for nonprofits to be efficient. Unfortunately, there is no equivalent incentive for efficiency in foundations. Instead, both internal expenses and granted funds are currently allowed to count toward foundations' mandatory payout. As a result, foundation members may not be motivated to choose more modest accommodations over luxury accommodations, for example, or to give more money to grantees over more money to trustees. If we limit the costs that can be counted toward payout only to grantmaking – or costs that directly inform and support grantmaking – foundations may devote more of their assets to their public purposes.

Call donor-advised funds and Type III supporting organizations what they are.

It is time to treat donor-advised funds and Type III supporting organizations for what they are – private foundations. Tax them at the same rates as private foundations rather than give them the same tax benefits as public, nonprofit charities. There are currently more than 100,000 donor-advised funds – with assets totaling more than $3 billion – in investment funds and community foundations. Right now, if an individual makes, say, a $5 million contribution to a donor-advised fund at Fidelity, Schwab, or a community foundation, he or she gets the full $5 million tax deduction. And yet, for all practical purposes, that individual retains complete control over the funds in perpetuity. To get around the tax rules governing private foundations, holders of donor-advised funds have elaborate documents that say that the assets fully belong to them. But the gentleman's understanding – and the business premise – is that the donor directs the funds.

Specify continuing education requirements for nonprofit auditors.

Attorneys and physicians are required to have minimum continuing legal education in their fields of practice. Since nonprofit auditing is a distinct competence and a key factor in sector accountability, the American Institute of Certified Public Accountants (AICPA) and other state CPA associations should set clear standards for training and continuing education specific to the nonprofit arena.

Just as Congress rightfully sees its role not only as regulating American businesses, but also as promoting and supporting them, it should also play a role in regulating, promoting, and supporting American nonprofits. Our suggested reforms focus on these larger areas of nonprofit integrity and viability. We urge their adoption.

1 Grants to Faith-Based Organizations FY 2004, White House Faith-Based and Community Initiatives at http://www.whitehouse.gov/government/fbci/.