

Under the Microscope

Public scrutiny of tax-exempt institutions affects orchestras by definition.

by Heather Noonan

Having endured a series of high-profile corporate fraud cases and nonprofit gaffes of late, America is casting a reformist eye toward her institutions. The collapse of Enron set off a chain of investigations and indictments of corporate leaders whose trials are still playing out. With the adoption of the Sarbanes-Oxley Act in 2002, Congress set forth strict guidelines on corporate accountability practices. Nonprofits, as we have discussed before in SYMPHONY ["Are We OK?" November-December 2004*], have shared in the scrutiny, as have philanthropic foundations. Congress, the Internal Revenue Service, and the American public continue to turn a critical eye towards all institutions, including those in the nonprofit sector.

Whether through new laws squeezed out in an election year by an increasingly divisive Congress, or through tougher regulations handed down by the Internal Revenue Service, or through a second look before an individual commits to a donation, there is no doubt that the current call for reforms will have a lasting impact on how the nonprofit sector does business. Hoping to boost public confidence, the nonprofit sector is swiftly upping its own standards of accountability.

By virtue of their 501(c)(3) status, orchestras reap the full benefits of being a part of the charitable community. Tax-exempt status reduces the cost of presenting orchestral music and provides a financial incentive for corporations and private

citizens to further offset that cost through tax-deductible contributions. And tax-exempt status bestows another significant advantage to orchestras: We are part of a cherished charitable sector that is recognized for its contributions to the public good. As the entire sector's business practices and contributions to the public good come under the microscope, so do those of orchestras.

It's worth noting that the American

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Symphony Orchestra League's orchestra membership took its current shape in response to a challenging tax policy. In 1950, America's largest orchestras—which, at the time, were not part of the League—joined efforts with the League's smaller orchestras to repeal a World War II-era tax on ticket sales. Then, as now, orchestras must keep a vigilant eye on how tax-related policies will affect their day-to-day activities, and continue to emphasize the role orchestras serve in the charitable sector.

What Kind of Scrutiny?

Having established tight accountability requirements for the corporate sector through the 2002 Sarbanes-Oxley Act, key Congressional committees turned their attention to the business practices of the entire nonprofit sector. Late in 2004, the

Senate Finance Committee released a discussion paper outlining 41 areas of potential reform. Next came a January 2005 statement from the Joint Committee on Taxation, describing potential areas to be targeted by Congress and including proposals to curb abuse by donors and the managers of nonprofits.

Meanwhile, the IRS announced it would step up efforts to enforce existing requirements in an attempt to reclaim lost revenue. In testimony before the Senate Finance Committee, IRS Commissioner Mark W. Everson said, "The twin cancers of technical manipulation and outright abuses are spreading." The IRS named four key reasons for concern. First, the size of the nonprofit sector has increased dramatically to nearly 3 million entities, and its complexity has grown in proportion to its size. At the same time, IRS enforcement resources have declined. Lax attitudes toward governance in the corporate sector seem to have spilled over into the nonprofit arena, and abusive tax avoidance is on

the rise. The IRS points specifically to instances in which charitable gifts of property—conservation easements, in particular—were overvalued by donors; and to the existence of outright sham nonprofit companies, such as certain credit-counseling organizations, serving no legitimate charitable purpose.

In the wake of these concerns, the Senate tapped Independent Sector—a national coalition of nonprofit organizations, foundations, and corporate philanthropy programs—to develop recommendations for nonprofit reform. In June, 2005, IS's Panel on the Nonprofit Sector submitted a report to Congress titled, "Strengthening Transparency, Governance, Accountability of Charitable Organizations." More than 100 pages long, the report responds to Congressional proposals with recommended "approaches that maintain the crucial balance between legitimate oversight and protecting the independence that charitable organizations need to remain innovative and effective." The report suggests ways to beef up enforcement through new laws, but also

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points to opportunities for the nonprofit sector to be strengthened through self-regulation. Several tax proposals currently in play on Capitol Hill present an opportunity for legislators to hand down new laws regarding nonprofit reform.

It often goes unnoticed that those calling for nonprofit reform—whether policymakers on the Hill, the press, or donors to individual charities and cultural groups—consistently recognize the unique and valuable contributions of the nonprofit sector. In the ideal outcome—hoped for by many reformers as well as nonprofits themselves—increased accountability requirements would be paired with new incentives for charitable giving, creating a boost to both the integrity and capacity of America's charities. The Senate version of the Tax Relief Act of 2005 currently includes both nonprofit reforms and new giving incentives, while the House version omits such measures.

Whether or not Congress passes new legislation, the IRS is stepping up its enforcement efforts. A combination of Hill and IRS activity focuses on several areas of relevance to orchestras.

Governance. Limits on the size, composition, and structure of nonprofit boards have been suggested by the Administration and on the Hill. In 2004, Senate staff proposed a minimum of three and no more than fifteen board members, sparking an as-yet unresolved debate. A board that is too small may lack a sufficient diversity of skills and the checks and balances needed for good oversight. A bloated board may diffuse responsibility to a point where individuals do not fully participate, particularly in their fiduciary responsibilities.

A one-size-fits-all approach would be a significant change. A 2005 Grant Thornton survey of nonprofit board governance found that 39 percent of respondents have a board of six to fifteen members, while 41 percent have fifteen to thirty board members. According to the League's research, in 2003 the average size of an orchestra board was 32 members. The average board sizes for orchestras correspond to budget size, with the largest-budget orchestras averaging 65 members and the smallest-budget orchestras averaging 13.

The Panel on the Nonprofit Sector maintains that the size and expertise of a nonprofit board is best determined by individuals in a community, and not by a fixed standard. Still, critics point out that having a vote on a nonprofit board does not mean that an individual has a voice, and conversely, that in order to weigh in on a nonprofit's activities, one need not be a trustee. Regardless of size, Congress, the IRS, and the nonprofit sector all agree that more can be done to ensure that governing boards exercise improved oversight, and that all board members are fully aware of their responsibilities.

Executive Compensation. Officials at the IRS and in Congress express concern that nonprofit boards are not taking enough responsibility for setting executive-compensation levels, and that current statutes and IRS enforcement need to be beefed up to thwart excessive and inappropriate nonprofit pay arrangements. Since mid-2004, the IRS has increased enforcement in the area of executive compensation and is currently analyzing the results of nearly 1,200 compliance inquiries issued to nonprofits. So far, the IRS has identified two specific areas of concern—loans made by nonprofits to executives and excessive compensation to relatives—but is hoping that their efforts also raise overall awareness and compliance.

Senate Finance Committee Chairman Charles Grassley (R-IA) has said that current statutes do not give the IRS enough power to crack down in this area, that nonprofit boards lean too much on outside consultants in determining pay levels, and that individuals have too much say in setting their own compensation. Sen. Grassley warns that legislation imposing stricter requirements for setting and documenting executive compensation levels may be proposed before the end of 2006. "We're going to put more of a burden on the judgment of directors," he has said, "so they don't have a crutch of somebody advising extraordinary salaries."

Current law requires nonprofits to document that executive compensation is comparable to what would ordinarily be paid for "like services by like enterprises under like circumstances." When public

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attention is turned to the topic of executive compensation, orchestras often make it into the headlines—not due to any documented impropriety, but rather to the scale of what falls well within the IRS standard for executive pay. Executive directors' salaries are rarely in the spotlight; but in any case the public and the press tend to focus on music directors, often the highest-paid employees at their orchestras. The going rates for America's top artistic directors have been charted in *The New York Times*, *The Chronicle of Philanthropy*, and *The Wall Street Journal*. The League encourages orchestras to participate in and consult the League's annual Administrative Staff Salary and Benefits Survey, and all orchestras are advised to thoroughly document how pay levels are set and report compensation levels on the IRS's Form 990, the public report of a nonprofit's activities.

Increased Accountability. Who completes the Form 990, and how, is being re-examined. Current law requires nonprofits to provide a copy of their Form 990 to any individual requesting it. The GuideStar

web site (www.guidestar.org) serves as a popular clearinghouse for finding Form 990 information, and a number of nonprofits are moving towards increased transparency by posting their forms directly on their web sites.

Some proposals seek to ensure the accuracy of the reported information by raising the stakes and penalties for chief executive officers and chief financial officers signing the Form 990. In the for-profit world, this approach has resulted in more costly reviews of the forms for accuracy. Meanwhile, new auditing requirements are also being discussed, aiming to increase the accuracy of the Form 990 without placing an undue burden or expense on nonprofits. The Panel on the Nonprofit Sector recommends a requirement that nonprofits with \$1 million or more in annual revenues attach an audit to their Form 990, and make both publicly available. Some policy makers have recommended requiring nonprofits to change auditors every five years—a notion that may produce a hardship for nonprofits serving smaller communities.

The Senate version of the Tax Relief Act includes a reporting requirement that has sparked direct opposition from the nonprofit community. When filing the Form 990, charitable organizations with gross revenues of \$10 million or more would be

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required to submit a certification by an independent auditor attesting that the organization's unrelated business income tax (UBIT) filings are accurate; and the form on which UBIT is reported would be required to be made publicly available. The nonprofit community says that this added auditing requirement would be burdensome and expensive.

The challenge in crafting accountability-related policy will be to improve the transparency of nonprofit activities without adding burdens that could interfere with an organization's ability to carry out its core activities.

Accountability Resources Online

The best way to stay on top of accountability requirements and best practices is to bookmark a few key links in your browser:

National Council of Nonprofit Associations. Get connected to your state nonprofit association and stay on top of new and emerging state-level requirements for nonprofit accountability. www.ncna.org

"The Charitable Impulse." Read Public Agenda's complete report on what's needed to keep the public trust. www.publicagenda.org/research/pdfs/charitable_impulse.pdf

American Symphony Orchestra League Government Affairs Update on Tax Policy. Visit the League's web site regularly to find out whether Congress has passed new nonprofit accountability requirements. www.symphony.org/govaff/what/index.shtml

GuideStar. Join the 5 million people per year logging on to GuideStar to look up information about nonprofit organizations. www.guidestar.org

In Tune with the Public Trust: The Orchestra's Guide to Ethics and Accountability. Find out what steps your orchestra can take to stay a step ahead of accountability requirements. www.symphony.org/book/all/ethicsaccount.shtml

Panel on Nonprofit Reform. Read the Independent Sector panel's response to congressional proposals. www.independentsector.org/programs/gr/npreform.html

—H.N.

The Charitable Impulse

As policymakers and nonprofit leaders ponder reform, what do donors think? Public Agenda recently conducted research to discover what motivates people to give, and what the current level of trust might be between contributors and those who run nonprofit organizations. The results were announced in October 2005, in a report titled "The Charitable Impulse."

According to Public Agenda, most respondents to the survey could be classified as "salt of the earth" or "heart and soul" donors. These middle-class, civically engaged men and women say they give based on trust and instinct, and do little research before making a donation (few, for example, would look up a nonprofit on GuideStar). They are suspicious of nonprofits that use too businesslike an approach to soliciting contributions and carrying out their mission, pointing specif-

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<p>Lei Wang <i>Pianist</i> "...listening... -... piano... the... the... the..."</p>	<p>Gabriel Izzi <i>Pianist</i> "...listening... the... the... the..."</p>	<p>Yvonne Mancini <i>Colla</i> "...performance of... Du... Concerto... one of... the... the... the..."</p>	

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ically to "slick, wasteful, and aggressive" marketing techniques. Once a charity is publicly tainted by scandal their trust in that particular charity is broken forever, they say, but their faith in the sector remains intact; these donors will simply redirect their contributions to charities they view as more effective. Overall, respondents signaled enthusiasm for the work of nonprofits—particularly locally based ones—and little interest in or awareness of potential increased government oversight.

The comprehensive tax-relief bill being considered by Congress is the most likely major vehicle for addressing charitable-giving incentives and nonprofit reforms in 2006. As this article goes to press, House and Senate negotiators are working out the final shape of the bill, but it seems likely that the charitable provisions—both reforms and incentives—will be left out in an effort to streamline and move the bill to passage. Those measures may still be taken up piecemeal, as separate bills, or tacked on to other measures. Or they might stay on hold until a new Congress convenes in 2007. Regardless, IRS enforcement efforts already underway will continue. And many reforms proposed at the federal level are being echoed and implemented in state-level policymaking.

As the reforms and giving incentives take further shape, orchestras should take note: The respondents to the Public Agenda survey overwhelmingly view the "nonprofit community" as largely made up of social-service organizations. As policymakers and the public consider strategies to improve how nonprofits benefit the public good, it is imperative that orchestras be mindful of the transparency of both their operations and their place in the nonprofit sector. ∞

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