

**TESTIMONY IS EMBARGOED UNTIL
APRIL 1, 2011 AT 9:00 AM**

Statement of William Josephson
Before
Health Subcommittee
Committee on Ways and Means
House of Representatives
Washington, D.C.
April 1, 2011

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear before you to talk about the Investigative Report about AARP's Organizational Structure and Finances.

1. Introduction. I am a retired partner in the law firm of Fried, Frank, Harris, Shriver & Jacobson, LLP and a member of the bars of the District of Columbia, State of New York, Tax Court and the Supreme Court of the United States, among other courts.

While a partner at Fried, Frank, part of my practice consisted of advising on corporate, trust and tax issues involving federal income tax exempt organizations.

Moreover, from April 1999 until August 2004, I served as the Assistant New York Attorney General-in-Charge of the Charities Bureau of the New York State Law Department during Attorney General Eliot Spitzer's first term.

I have also served as an expert witness and adviser to the Attorneys General of the States of New Jersey and Tennessee with respect to exempt organization enforcement issues, as well as an expert in private civil litigation with respect to those issues.

I was a member of the Independent Sector's Expert Legal Advisory Panel with respect to IS's responses to various 2004 proposals of a committee of the other body about which proposals I have also testified before it.

I have published with respect to tax exempt organization issues. A copy of my resumé is attached to my statement. It lists those publications.

I have had too brief an opportunity to review the Investigative Report which is the subject of this hearing, and I have not had any opportunity to review any of the extensive documentation underlying that Report. Therefore, I hope the Subcommittee will understand that my comments will be at a level of generality.

2. AARP's Complex Organizational Structure. The complexity of the AARP organizational structure in 2010 as set forth in the Report, and in particular in Chart 1 on page nine of the Report, is unprecedented in my experience. It is not uncommon for an Internal Revenue Code section 501(c)(4) tax exempt organization like AARP, Inc. to have a for-profit subsidiary and/or to have a related Code section 501(c)(3) tax exempt organization. But it is uncommon for such a tax exempt organization to have eight affiliates, some for profit and some tax exempt.

The legal and accounting issues thus raised would require an extraordinary amount of further study by me before I could express an opinion about them. However, I can express the opinion that further investigation is warranted by (a) the Committee, (b) the Internal Revenue Service which has in the past had concerns about AARP as set forth in the Investigative Report and (c) the General Accountability Office. Much more AARP document production about itself and each of the affiliated organizations and their relationships is required. I would be particularly interested in whether or not the AARP Foundation and the AARP Institute, both of

which are section 501(c)(3) tax exempt organizations, meet the organizational and operational charity tests under the Treasury Department's regulations. I would also want better to understand the AARP Insurance Plan which is described in the Report as a grantor trust. In particular, the IRS should consider withholding prior approval for AARP filing a consolidated 2010 990, so that investigators should not have to separate the finances of AARP and of each of its affiliates.

3. Code Section 501(c)(4) Issues. As the Committee knows, the Treasury Department's regulations under Code section 501(c)(4) are meager, to put it mildly. They deserve, in my opinion, considerably more tax policy and legislative attention to the adequacy of the laws and regulations governing section 501(c)(4) organizations.¹

According to the Internal Revenue Service's tax exempt organizations work plan for 2011, it is starting a new project that will examine the activities of section 501(c)(4) organizations, but over the next several years.

But I will return to the question of the adequacy of the IRS's exempt organization resources at the end of this statement.

4. AARP Governance. Another issue that, in my opinion, requires further investigation by the Committee is the qualifications and independence not only of the AARP, Inc. Board of Directors, as set forth in Chart 2 of the Investigative Report, but of any Board subcommittees membership. Good governance issues also include how frequently the Board and any subcommittees meet, the quality of attendance at those meetings. Equally important is the governance structure of each of the eight AARP Inc. affiliates described in Chart 1.

¹ In this respect, the inadequacies of the law and regulations affecting section 501(c)(4) organizations reminds me of the inadequacies of the law and regulations under section 4944 of the Internal Revenue Code. As I recently testified before a committee of the other body in connection with the Madoff ponzi scheme scandal, they also require review by both the Internal Revenue Service and the Congress.

5. Royalty. Another important area for further Committee investigation, in my opinion, is AARP's treatment of income from its insurance business as unrelated business income (UBI) tax exempt royalty income under section 512(b)(2) of the Code. "Royalty" is not a defined term anywhere in the Code or regulations.² The dictionary definitions of royalty for these purposes is "a share of the product or profit reserved by the grantor."³ The examples given are an oil or a mining lease and what is paid to an author, composer or inventor. The Treasury Department's section 1.512(b)-1(b) regulations are consistent in referring to, for example, "overriding royalties," and "mineral royalties . . . whether measured by production or by gross or taxable income." In my 55 years of law practice, royalties usually entail percentages of gross or net income.

While further investigation is required, the impression I have from reading the Investigative Report is that the income AARP receives from its insurance business, which it treats as UBI tax exempt royalties, is not necessarily measured by production or by gross or taxable income, but is, in fact, more like flat fee commissions paid on each insurance policy sold. If so, there would be a substantial issue as to whether or not such commission income is properly excluded from UBI tax as a royalty under the Sierra Club line of decisions or more properly included as income under the Texas Farm Bureau line of decisions.

In this connection, I have examined summaries of the rulings that the Internal Revenue Service has issued with respect to royalty income under Code section 512(b)(2) and its regulations. It is difficult for me to see a consistent basis for IRS rulings that a particular transaction is or is not a royalty. This lack of coherency is, in my opinion, another reason for

² See Texas Farm Bureau v. United States, 53 F.3d 120, 123 (5th Cir. 1995) (Wisdom, J.); Sierra Club Inc. v. Commissioner, 86 F.3d 1526, 1531 (9th Cir. 1996).

³ Sierra Club at 1531-32.

further exercise of the Congress's legislative and the IRS rulemaking jurisdiction with respect to these issues.

Another UBI issue is the treatment under Code section 512(b)(13) of the amounts AARP receives from its controlled entities.

6. AARP Compensation and Benefits. Another issue raised by the Investigative Report that, in my opinion, is worthy of further legislative and regulatory attention is the compensation and benefits paid by AARP and its affiliates to their directors, trustees, officers, key employees and foundation managers. Questions with respect to compensation and benefits have received increasing attention in recent years from both the Congress, the IRS and the state charity regulators. In that connection, the IRS has made significant changes in its Form 990. For example, page 14 of the 2010 instructions for Form 990 contains the following:

An **excess benefit transaction** can have serious implications for the **disqualified person** that entered into the transaction with the organization, any **organization managers** that knowingly approved of the transaction, and the organization itself. A section 501(c)(3) or section 501(c)(4) organization that becomes aware that it may have engaged in an **excess benefit transaction** should obtain competent advice regarding section 4958, consider pursuing correction of any excess benefit, and take other appropriate steps to protect its interests with regard to such transaction and the potential impact it could have on the organization's continued exempt status. See Appendix G, Section 4958 Excess Benefit Transactions, for a discussion of section 4958, and Schedule L (Form 990 or 990-EZ), Part I, regarding reporting of **excess benefit transactions**.

I particularly want to mention that the Form 990 reporting instructions under Part VII at page 24 state:

Organizations must report compensation for both current and former officers, directors, trustees, key employees, and highest compensated employees. The distinction between current and former such persons is

discussed below. The determination of “former” uses a 5-year look-back period.

Organizations must report compensation from themselves and from related organizations, which generally consist of parents, subsidiaries, brother/sister organizations, supporting organizations, and supported organizations. See the instructions for Schedule R (Form 990) for a fuller discussion of related organizations.

(emphasis added)

7. Inurement. Another area appropriate for further legislative and regulatory oversight concerns the section 501(c)(3) organizational and operational test, “no part of net earnings of which [exempt organization] inures to the benefit of any private shareholder or individual.” Code section 501(c)(4)(B) contains a similar requirement applicable to section 501(c)(4) organizations like AARP Inc.

Again unfortunately, the law and regulations with respect to what constitutes private inurement is meager. That phrase is too succinctly defined in Treasury Department regulation section 1.501(a)-1(c), “persons having a personal and private interest in the activities of the organization.” Treasury Department regulation section 1.501(c)(3)-1(f)(2)(ii) contain what we call a facts and circumstances test with respect to this issue. Those regulations also link to the excess compensation and benefits provisions of Code section 4958 and the regulations thereto.

While the above-quoted Form 990 instructions link both section 501(c)(3) and section 501(c)(4) exempt organizations to the excess compensation and benefits Code section 4958 and regulations, as does the Committee’s report, neither Code section 501(c)(4) nor the regulations thereunder contain such an explicit link. However, Code section 4958(e) does provide the link to section 501(c)(4) organizations.

8. IRS Resources. As a former state charities regulator, I have been concerned for many years with the absence in most states, and in this respect I include the District of Columbia and Delaware where I understand most of the AARP entities have been created, of effective state charities regulation. Except for all but a few states, in default the IRS has become the most effective charities regulator. Unfortunately, the IRS is unable to devote to tax exempt organizations the necessary resources as General Accountability Office and other studies have shown.

The Committee, I am sure, is aware that the excise tax on private foundation income in section 4940 of the Code was originally intended in 1969 to be allocated to the IRS, without appropriation, for exempt organization oversight and enforcement. That, unfortunately, has never happened.

I have been around Washington long enough to know how difficult it is to earmark funds for government activities that are not subject to appropriation. But there are precedents, and perhaps someday, hopefully soon, due to the Committee's renewed interest in the tax exempt organization area, the IRS will finally get the resources it needs as the primary tax exempt organization regulator.

I would be pleased to answer any questions you may have.