

## § 501(c)(3) Charities: Intersection of Federal and State Law and Regulation

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The United States has more charitable organizations than does any other country in the world; not only have the number of American charities increased, with registered public charities growing 66% in ten years, and over 5% from 2007 to 2008 alone,<sup>1</sup> but nonprofits' revenues doubled in twenty years to constitute a significant percentage of this nation's income.<sup>2</sup> At the same time, the American public has been subjected to heightened media publicity about abuse and fraud by charities and their fiduciaries, resulting in greater demand for public accountability by charities.<sup>3</sup> The recent national, and indeed global, economic

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<sup>1</sup> At last count by the IRS, there were about 1.2 million charities, and tax-exempt organizations had over 3.4 trillion dollars in assets, and employed 9.4 million workers. Letter from Lois G. Lerner, Internal Revenue Service ("IRS") Director, Exempt Organizations (Nov. 2008), at [http://www.irs.ustreas.gov/pub/irs-tege/finalannualrptworkplan11\\_25\\_08.pdf](http://www.irs.ustreas.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf) (last visited Dec. 1, 2008)(on file with author); see Grant Williams, *IRS Says Number of Charities and Foundations Hit 1.2 Million*, THE CHRONICLE OF PHILANTHROPY, March 24, 2009, <http://philanthropy.com/news/updates/7536/irs-says-number-of-charities-and-foundations-hit-12-million> (last visited Oct. 6, 2009). According to Marcus Owens, former Director of the IRS Exempt Organization Division, in 2005, there were **1,709,205** tax-exempt organizations listed in the IRS master file, 1,045,979 of which were exempt under §501(c)(3). Marcus S. Owens, *Charity Oversight: An Alternative Approach*, at 5 (2006), [http://www.ksghauser.harvard.edu/PDF\\_XLA/workingpapers/workingpaper\\_33.4.pdf](http://www.ksghauser.harvard.edu/PDF_XLA/workingpapers/workingpaper_33.4.pdf). According to the Urban Institute, the number of nonprofits registered with the IRS grew by 27.3 percent, and registered public charities grew 66 percent, from 1995 to 2005; in 2005, individuals, foundations, and corporations reported \$260 billion in charitable contributions to nonprofits." Amy Blackwood, Kennard T. Wing & Thomas H. Pollak, *The Nonprofit Sector in Brief: Facts and Figures from the Nonprofit Almanac 2008: Public Charities, Giving and Volunteering*, NONPROFIT ALMANAC 2008 (Urban Institute, Washington, D.C.), May 1, 2008, at 1-2. See MARION R. FREMONT-SMITH, GOVERNING NONPROFIT CORPORATIONS: FEDERAL AND STATE LAW REGULATION 6 (The Belknap Press of Harvard University Press 2004)(stating that in 1977, there were about 276,000 501(c)(3) organizations of an estimated 790,000 nonprofits, while in 1997, there were over 692,000 §501(c)(3) organizations of 1.32 million tax-exempt organizations, and in 2002, there were 1.52 million tax-exempt organizations).

<sup>2</sup> In 2005, the nonprofits required to report to the IRS accounted for about \$1.1 trillion in revenue. Blackwood, *supra* note 1, at 3. By contrast, in 1995, reporting public charities accounted for \$573 billion (a 99.5 % increase by 2005) and in 1996, nonprofit revenue totaled \$621.4 billion, *id.* at 4. See Corwin R. Kruse, *Book Review: Sin, Salvation, and the Law of Charities*, 31 WM. MITCHELL L. REV. 383 (2004)(noting that between 1992 and 2002, charitable giving doubled and the number of private foundations almost doubled, but state and federal funds spent to monitor them were the same or declined); Nina J. Crimm, *Why All is Not Quiet on the "Home Front" For Charitable Organizations*, 29 N.M.L. REV. 1, 24, 29 (1999)(stating that between 1975 and 1999, nonprofits' revenues increased from 5.9% to more than 10% of this nation's income, and exceeded a half-trillion dollars). See Jenny Price, *Center seeks collaboration to develop new leaders; New program focuses on nonprofit research, continuing education*, U. WIS.-MADISON NEWS, Sept. 24, 2008, <http://www.news.wisc.edu/15660>.

<sup>3</sup> Some say that the result of this heightened media attention and demand for public accountability led to increased regulation of charities by the Internal Revenue Service ("I.R.S."); however, in today's economic climate, undoubtedly such regulation has decreased. See Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information Be Utilized Effectively?* 40 NEW ENG. L. REV. 447, 453-5, 474 (2006)(noting recent media attention and press reports of wrongdoings by charitable fiduciaries, and implications of Senate Finance Committee hearings); Dana Brakman Reiser & Evelyn Brody, *Who Guards the Guardians? Monitoring and Enforcement of Charity Governance*, 80 CHI.-KENT L. REV. 543, 544 (2005); Ellen W. McVeigh & Eve R. Borenstein, *Exempt Organization Law: The Changing Accountability Climate and Resulting Demands for Improved "Fiduciary Capacity" Affecting the World of Public Charities*, 31 WM. MITCHELL L. REV. 119, 120 (2004); Crimm, *supra* note 2, at 26 (concluding that increased negative press about charitable scandals such as at United Way, Goodwill, and Adelphi, have inflamed citizens to pressure state attorneys general to scrutinize these organizations, and have subjected the IRS to increased scrutiny).

crisis,<sup>4</sup> however, has resulted in decreased staffing and funding of state and federal regulatory authorities, and accordingly decreased regulation of charities. Thus, in order to enhance the ability of federal and state authorities to regulate charities, Congress should amend the Internal Revenue Code (“I.R.C.” or “Code”)<sup>5</sup> to facilitate complete disclosure, cooperation, and coordination between the I.R.S. and state authorities. Specifically, Congress promptly should amend I.R.C. § 6104<sup>6</sup> and related sections to allow complete exchange of information between state and federal authorities regarding charities.

This paper first considers nonprofit public charities described in I.R.C. § 501(c)(3)<sup>7</sup>, and introduces three related limitations on such charities under the Code: the prohibitions against private benefit, inurement, and excess benefit transactions.<sup>8</sup> The paper analyzes the doctrines through the lens and under the facts of *United Cancer Council* (“UCC”)<sup>9</sup>, in which the Seventh Circuit raises, but does not decide, the ramifications of state fiduciary violations, in the context of revocation of federal charitable tax exemption because of private benefit. The paper considers the intersection of federal tax and state corporate laws, and examines one historic example of state and Internal Revenue Service (“I.R.S.”) regulation of a Hawaii charity known as the Bishop Estate. The paper highlights several viable proposals to enhance charitable regulation, including creation of a new “quasi-public/private” entity to serve as the primary regulator of charities.<sup>10</sup> Finally, the paper advocates for complete exchange of information about charities between state and federal authorities, including by the prompt amendment of § 6104 and related Code sections, to facilitate the ability of state and federal authorities to better coordinate and regulate charities.

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<sup>4</sup> Elizabeth McNichol, “Nonprofits and the Deepening State Fiscal Crisis,” NONPROFIT POL’Y NEWS, Nov. 2008, <http://www.councilofnonprofits.org/?q=policynews/november2008>.

<sup>5</sup> All section references are to the Internal Revenue Code of 1986, as amended (“I.R.C.”), or to Treasury Regulations promulgated thereunder.

<sup>6</sup> I.R.C. § 6104 (West 2009).

<sup>7</sup> I.R.C. § 501(c)(3) (West 2009). Although there are many definitions and legal meanings of a “charity,” this paper analyzes only nonprofit corporations described under I.R.C. § 501(c)(3) that are publicly supported charities, and not unincorporated associations or trusts, or private foundations. For definitions of public charities, see generally FREMONT-SMITH *supra* note 1, at 3-4. This paper does not analyze tax-exempt hospitals; for an excellent analysis of tax issues surrounding the tax exemption for hospitals, see John D. Colombo, *Hospital Property Tax Exemption in Illinois: Exploring the Policy Gaps*, 37 LOY. U. CHI. L.J. 493 (2006).

<sup>8</sup> See John D. Colombo, *Are Associations of Doctors Tax-Exempt? Analyzing Inconsistencies in the Tax Exemption of Health Care Providers*, 9 VA. TAX REV. 469, 474-75 (1990). This paper does not analyze in depth the doctrines of inurement, private benefit, and excess benefit in depth. For a more comprehensive analysis, see Harvey P. Dale, *The Crux of Charity: Inurement, Private Benefit, and Excess Benefit Transactions* (Oct. 28, 2004)(unpublished manuscript, on file with N.Y.Univ. Sch. of Law), [http://www1.law.nyu.edu/ncpl/library/publications/Conf2004\\_Dale\\_DRAFT.pdf](http://www1.law.nyu.edu/ncpl/library/publications/Conf2004_Dale_DRAFT.pdf) (last visited Oct. 5, 2009)

<sup>9</sup> *United Cancer Council v. Comm’r*, 109 T.C. 326 (1997), *rev’d*, 165 F.3d 1173 (7<sup>th</sup> Cir. 1999).

<sup>10</sup> Owens, *supra* note 1, at 3, [http://www.ksghauser.harvard.edu/PDF\\_XLA/workingpapers/workingpaper\\_33.4.pdf](http://www.ksghauser.harvard.edu/PDF_XLA/workingpapers/workingpaper_33.4.pdf).

## § 501(c)(3) Nonprofits

Charitable nonprofits organized under § 501(c)(3) enjoy certain privileges under federal and state law, including exemption from federal income tax and certain state taxes<sup>11</sup>; however, in turn, such charities must “do public good” by furthering charitable purposes,<sup>12</sup> and must comply with a number of requirements under federal and state law.<sup>13</sup> Such nonprofits must meet requirements of the states in which they are created or incorporated. Further, the Code lays out the following basic requirements for tax exemption under I.R.C. § 501(a)<sup>14</sup>: first, the charity must be organized as a corporation, community chest, fund or foundation; second, it must be organized and operated “exclusively” for one of the exempt purposes enumerated in the statute; third, none of the net earnings may inure to the benefit of a private individual or shareholder; fourth, a substantial part of the organization’s activities must not constitute lobbying; and fifth, the organization cannot participate in any political campaigning.<sup>15</sup> The I.R.S. and courts have interpreted “exclusively” to mean “primarily”<sup>16</sup> so that a charity qualifies for tax exemption if its activities primarily further its charitable purposes. In addition, the I.R.S. requires that these exempt activities not be contrary to public policy.<sup>17</sup>

Treasury Regulations further specify two tests for charitable purpose: first, under the organizational test, a nonprofit’s articles of organization must limit the purpose of the organization to one listed in § 501(c)(3), must not empower the organization to engage in activities that do not further one or more of its exempt purposes, and must require that upon the organization’s dissolution its assets are distributed to the government, or another organization with the exempt purposes, and not to members; in determining compliance

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<sup>11</sup> For example, I.R.C. § 501(a) exempts organizations described in § 501(c) from federal income tax. States also may exempt such charities from certain taxes such as property and sales. See Colombo, *supra* note 8 (stating that “virtually all states provide for exemptions from state income, property and other taxes”).

<sup>12</sup> Chester, *supra* note 3, at 448.

<sup>13</sup> FREMONT-SMITH, *supra* note 1, at 130, 238-41; John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063 n.1090 (2006)(stating that unlike other tax law, “tax exemption has no clearly-defined underlying theory” and has been explained “as a government subsidy or government non-interference for organizations that broadly benefit the community, that relieve the government of the necessity of providing certain services directly, that produce goods/services not produced by the private market, or that promote the pluralistic ideal in our society”); Darryll K. Jones, “‘First Bite’ and the Private Benefit Doctrine: A Comment on Temporary and Proposed Regulation 53.4958-4T(a)(3),” 62 U. PITT. L. REV. 715 (2001)(stating that, “to be free of taxation might be the closest that humankind can expect to get to paradise. . . .But as with the Biblical residence in paradise, there is one, and only one, unyielding condition imposed on those who undertake charitable wealth. . . .no part of an organization’s net earnings may inure to the benefit of an insider”).

<sup>14</sup> I.R.C. § 501(a) (West 2009).

<sup>15</sup> I.R.C. § 501(c)(3).

<sup>16</sup> John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM AND MARY L. REV. 487, 496-97 (2002)(stating that the “Code is nothing if not amusing” in that “exclusively” has never meant “exclusively”).

<sup>17</sup> See *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983). Prof. Fremont-Smith views the organizational test as a “restatement of the requirements of section 501(c)(3).” FREMONT-SMITH, *supra* note 1, at 246.

with the organizational test, courts look largely to “the actual objects motivating the organization.”<sup>18</sup> Charitable purposes include religious, scientific, literary, educational, or testing for public safety purposes, or for the prevention of cruelty to children or animals,<sup>19</sup> and “relief of the poor and distressed or of the underprivileged. . . and promotion of social welfare.”<sup>20</sup> The term “charitable” in § 501(c)(3) is used in its “generally accepted legal sense,” and is not necessarily limited to specifically enumerated purposes in that section.<sup>21</sup> “Charitable purposes are found in the earliest cases in the common law and were first codified in the year 1601 Statute of Charitable Uses. . . the current definition of charitable purposes remains strikingly similar to the examples in that formulation.”<sup>22</sup>

Second, Treasury Regulations require under an operational test that the charity’s assets and activities are actually devoted to furthering exempt, charitable purposes.<sup>23</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) states: “An organization is not organized or operated exclusively for one or more purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest.”<sup>24</sup> Regulations thus specify “three conditions which must be satisfied for an organization to meet the operational test. . . First, the organization must be primarily engaged in activities which accomplish one or more of the exempt purposes described in section 501(c)(3). . . Second, the organization’s net earnings must not be distributed in whole or in part to the benefit of private shareholders or individuals. . . Third, the organization must not be an ‘action’ organization.”<sup>25</sup>

The prohibitions against private benefit, inurement, and excess benefit transactions accordingly “police the quintessential characteristic of charities: that they operate for the

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<sup>18</sup> Treas. Reg. § 1.501(c)(3)-1(b), (c), (d) (as amended 2008). Frances Hill and Douglas Mancino identify the following requirements of the organizational test: 1) purposes clause; 2) powers clause; 3) “provision prohibiting private inurement and limiting private benefit”; 4) dissolution clause; 5) provision prohibiting participation in a campaign; 6) provision limiting lobbying. FRANCES R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* § 2-2, ¶ 2.01 (Thomson Reuters 2008).

<sup>19</sup> Treas. Reg. § 1.501(c)(3)-1(d) lists exempt purposes.

<sup>20</sup> Colombo, *supra* note 8, at 476-77 (observing that the IRS long has recognized that organizations providing health care services may be exempt).

<sup>21</sup> Treas. Reg. § 1.501(c)(3)-1(a)(2) (as amended 2008).

<sup>22</sup> Marion R. Fremont-Smith, *Approaching Nonprofit Law: The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 *FORDHAM L. REV.* 609, 616 ((2007)(noting also that the “Restatement (Second) of Trusts, adopted in 1959, summarized the then current law by listing five specific categories of charitable purposes: relief of poverty, advancement of knowledge or education, advancement of religion, promotion of health and governmental or municipal purposes, and ‘other purposes. . . which are beneficial to the community’”).

<sup>23</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1). See *American Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1061, 24 (1989)(finding that *American Campaign Academy* was operated for private benefit of certain Republican entities and candidates, and therefore was not entitled to exemption), quoting *Taxation with Representation v. United States*, 585 F.2d 1219, 1222 (4<sup>th</sup> Cir. 1978).

<sup>24</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

<sup>25</sup> See *American Campaign Acad.*, *supra* note 23, 1065-66; *Vision Service Plan, Inc. v. United States*, 265 F. App’x. 650 (2008), *cert. denied*, 129 S. Ct. 898 (2009).

public benefit and do not permit their assets or activities to profit persons other than their intended beneficiaries.”<sup>26</sup>

### Private Benefit Doctrine

The private benefit limitation prohibits a charity’s distribution to an insider or other private party of a benefit that is quantitatively and qualitatively more than incidental.<sup>27</sup> The private benefit doctrine derives from the common law requirements for charitable trusts, that they serve the public or a broad class of people, rather than limited individuals.<sup>28</sup> Although legal scholars may differ as to the importance of the doctrine,<sup>29</sup> they resoundingly agree that private benefit is difficult to define.<sup>30</sup>

The doctrine is not defined in the Code, but rather in regulations, case law, and I.R.S. rulings<sup>31</sup>; regulations under §501(c)(3) state in pertinent part:

An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator, or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).<sup>32</sup> The private benefit prohibition thus extends to insiders and “disinterested persons” as to the organization.<sup>33</sup> A 1987 General Counsel Memorandum furthered the definition of private benefit:

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<sup>26</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); see Dale, *supra* note 1 (manuscript at 1).

<sup>27</sup> Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?* 76 *FORDHAM L. REV.* 735, 746 (2007).

<sup>28</sup> John D. Colombo, *supra* note 7, at 501.

<sup>29</sup> Although scholars have called for elimination of the doctrine, one of those leading scholars believes that a “properly-defined private benefit doctrine has a place in analyzing how exempt entities interact with for-profit entities,” and considers the private benefit doctrine more important, by far, than the prohibition against inurement. Colombo, *supra* note 13, at 1065-66 (noting that Prof. Colombo previously called for the “demise” of the private benefit doctrine, but now accepts that the doctrine is not going away, that it is unreasonable to ask the IRS to abandon an effective policing tool, and that a properly-defined doctrine has a place in analyzing the interaction between exempt and for-profit entities); compare Colombo, *supra* note 28, at 500 (stating importance of private benefit doctrine); Jones, *supra* note 13, at 718, 727 (calling for elimination of the doctrine, or for literal interpretation of “exclusively” in § 501(c)(3)).

<sup>30</sup> Colombo, *supra* note 13, at 1064. See David A. Brennen, *A Diversity Theory of Charitable Tax Exemptions—Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 *PITT. TAX REV.* 1, 34 (2006) (stating that the private benefit prohibition derives from the wording of § 501(c)(3) requiring tax-exempt charities to be organized and operated “exclusively” for certain charitable purposes); Jones, *supra* note 17, at 724.

<sup>31</sup> Manny, *supra* note 27, at 746.

An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . .private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e. the activity can be accomplished only by benefiting certain private individuals. . . .To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.<sup>34</sup>

In 1989, the Tax Court expanded the definition of private benefit to include “secondary” economic benefit to individuals outside a particular charitable class; in *American Campaign Academy*,<sup>35</sup> the American Campaign Academy (“Academy”) sought tax exempt status under § 501(c)(3) for educational and charitable activities, consisting primarily of operating a school to train individuals to work for political campaigns.<sup>36</sup> The Academy apparently served a large charitable class, and was an educational organization; however, the Academy’s graduates “served on campaigns of candidates who were predominantly affiliated with the Republican party.”<sup>37</sup> In addition, the Academy’s activities were funded exclusively by the National Republican Congressional Trust.<sup>38</sup> Accordingly, the I.R.S. denied the Academy tax exempt status because the organization was “operated for a substantial non-exempt private purpose” in that the Academy benefited “Republican Party entities and candidates more than incidentally” and served their “private interests.”<sup>39</sup> The Tax Court, adopting the I.R.S.’s balancing approach, affirmed denial of tax exemption because the Academy operated for the benefit of the private interests of Republican entities and campaigns, and was not operated “exclusively” for charitable purposes.<sup>40</sup>

Subsequent decisions applied private benefit as a policing tool to proscribe transactions between charities and for-profit organizations, resulting in the present definition of private benefit: charities exempt under § 501(c)(3) are prohibited from providing

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<sup>32</sup> See FREMONT-SMITH, *supra* note 1, at 250, quoting Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

<sup>33</sup> *American Campaign Acad.*, *supra* note 23.

<sup>34</sup> I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987). See Colombo, *supra* note 13, at 1065 (criticizing the 1987 I.R.S. Gen. Couns. Mem. test as “a quintessential balancing test under which the IRS both owns and reads the scale, leaving charities completely at sea regarding the possible ill effects of transactions with for-profit entities. . . the larger problem is that no one even knows what to balance”).

<sup>35</sup> *American Campaign Acad.*, *supra* note 23.

<sup>36</sup> *Id.* at 1055.

<sup>37</sup> *Id.* at 1071.

<sup>38</sup> *Id.* at 1070.

<sup>39</sup> *Id.* at 1063.

<sup>40</sup> *Id.* at 1079.

*substantial* economic benefit to any private individual or entity not part of the charitable class; rather, a § 501(c)(3) organization must serve a public, and not private, interest.<sup>41</sup>

To clarify the definition of private benefit, the I.R.S. in 2005 proposed the following three examples of private benefit<sup>42</sup>: (1) an organization whose purpose is to trace the genealogy of a single family<sup>43</sup>; (2) an art museum that exhibits and sells art by a group of artists, at prices set by the artists that includes a ten percent commission to the museum, with ninety percent of sales prices to the artists<sup>44</sup>; and (3) an educational organization with a single activity of training individuals in a program for a for-profit company that sets tuition rates for the program, with the educational organization licensing the program from the for-profit, contracting for faculty and materials with the for-profit, and agreeing to assign any materials developed by the educational organization to the for-profit.<sup>45</sup> According to Frances Hill and Douglas Mancino, this latter example appears to have been “loosely based on *United Cancer Council, Inc. v. Commissioner*.”<sup>46</sup> Both *UCC* and the third example involve private benefit when a charity transacts with a private company that may be an insider, at less than fair market value.<sup>47</sup> Professor John Colombo also has offered two examples of private benefit to illustrate his paradigm that private benefit is defined by a charity’s failure to conserve assets for the charitable class: (1) a charity transacts with a for-profit entity or individual to provide “core services” to beneficiaries of the charity; and (2) a charity transacts with a for-profit or individual that provides “core services that confers a competitive advantage on the for-profit in its own business activities.”<sup>48</sup> He suggests that authorities allow a charity to rebut an allegation of private benefit by providing “reasonable justification” for a transaction, utilizing a state-law duty of care, or a new federal standard of care.<sup>49</sup>

In an obvious type of private benefit case, an organization has a stated public charitable goal, in comparison to an actual substantial benefit to a for-profit entity and a private interest.<sup>50</sup> *See, e.g. United Cancer Council v. Comm’r*, 165 F.3d 1173 (7<sup>th</sup> Cir. 1999)

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<sup>41</sup> Colombo, *supra* note 16, at 504; Colombo, *supra* note 13, at 1064 (describing private benefit as a doctrine that concerns a charity’s “failure to conserve” assets).

<sup>42</sup> Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or If an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transactions(s), 70 Fed. Reg. 53,599 (Sept. 9, 2005) (to be codified at 26 C.F.R. §§ 1, 53).

<sup>43</sup> Prof. Colombo views this example as a “failure of charitable purpose.” Colombo, *supra* note 13, at 1102.

<sup>44</sup> Professor Colombo views this example as illustrative of his “failure-to-conserve rationale.” *Id.* at 1103.

<sup>45</sup> *Id.* at 1104 (noting that this example also shows the “failure-to-conserve” paradigm).

<sup>46</sup> HILL & MANCINO, *supra* note 18, at §4-4, ¶ 4.02[4].

<sup>47</sup> *Id.*

<sup>48</sup> Colombo, *supra* note 13, at 1066. Ultimately, Professor Colombo’s definition-- negligent failure to conserve charitable assets—along with the caveat that assets were not conserved for a charitable purpose, is a useful view of private benefit. *Id.* at 1088.

<sup>49</sup> *Id.* at 1089.

<sup>50</sup> *See, e.g., Vision Serv. Plan, supra* note 25 (holding that although Vision Service Plan claimed to be a social welfare tax exempt organization, it did not primarily engage in promoting the common good and general welfare of the community, and therefore was not a tax exempt organization); *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179 (7<sup>th</sup> Cir. 1999).

(noting in dicta that a charity that pays excessive compensation<sup>51</sup> to a private entity, and is operated to a significant degree for the private benefit of that entity, might not exist to serve a public interest, in violation of the private benefit doctrine).<sup>52</sup> This type of private benefit is considered in the analysis, *infra*, of *UCC*.

### Prohibition against Inurement

A nonprofit described under § 501(c)(3) also is subject to the prohibition against inurement, “the federal statutory method of requiring that an exempt organization be ‘nonprofit’ in the sense of not distributing earnings to private individuals.”<sup>53</sup> The inurement prohibition thus embodies and mandates the non-distributional constraint as to nonprofits.<sup>54</sup> “The essence of the concept is to ensure that an exempt organization subject to this provision will serve a public interest rather than a private interest”<sup>55</sup> Inurement is not defined specifically in the Code or Regulations,<sup>56</sup> but does derive from the language of statutes.<sup>57</sup>

Prior to the enactment of § 501(c)(3), the 1909 Corporation Tax Law predecessor to that statute provided for exemption from excise tax for a “charitable” organization only if “no part of the profit of which inures to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable, or educational purpose.”<sup>58</sup> § 501(c)(3) currently states that “no part” of a § 501(c)(3) nonprofit’s “net earnings” may “inure[] to the benefit of any private shareholder or

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<sup>51</sup> See *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1200 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970).

<sup>52</sup> United Cancer Council, *supra* note 50. An important non-legal consideration for a § 501(c)(3) Board in setting compensation is the ever-increasing transparency of compensation paid by these nonprofits. First, the public may request a copy of a nonprofit charity’s Form 990. Further, the public is able to access increasingly more information about nonprofits from the Internet. The public may find Form 990 and other financial information about nonprofits with ease through a proliferation of Internet sites such as *Guidestar* and *Charity Navigator*. Finally, and relatedly, the press is able to access and disseminate faster and more widely every day information about nonprofit finances as well as charities’ transgressions. Such transparency, setting aside basic legal considerations, should serve to encourage nonprofit Boards to set compensation that is reasonable from some articulable, objective standard. Nicole Gilkenson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L. J. 842 (2007)(noting that after publicity about the 2001 United Way fraud, donations to United Way of the National Capital Area dropped by more than \$30 million, resulting in a 30% reduction of total revenue from the previous year).

In most states, donors and the public have no standing to sue directors for breach of fiduciary duty; by contrast, shareholders of a for-profit corporation have standing to sue directors for breach of fiduciary duty; some secondary authorities recommend legislation to extend standing to donors on a limited basis. *Id.* at 853; FREMONT-SMITH, *supra* note 1, at 428.

<sup>53</sup> HILL & MANCINO, *supra* note 18, at §4-20, 21, ¶ 4.03[2]; see Colombo, *supra* note 8, at 498-99. Tax-exempt entities may not distribute profits to their owners. . . . , directors and other persons possessing ownership-like authority with respect to the entity and are colloquially referred to as ‘insiders.’ Darryll K. Jones, “*The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefits*,” 19 VA. TAX REV. 575, 577-78 (2000).

<sup>54</sup> Manny, *supra* note 27, at 745.

<sup>55</sup> *Id.* at 744-45.

<sup>56</sup> *Id.* at 744.

<sup>57</sup> *Id.*

<sup>58</sup> 444 CONG. REC. 4157 (1909), *quoted in* Dale, *supra* note 1 (manuscript at 5); Colombo, *supra* note 13, at 1067.

individual,”<sup>59</sup> now defined as an “insider” in a position to control the nonprofit<sup>60</sup> such as a founder, Board member, controlling member, senior executive, or their families.<sup>61</sup> The test of whether one is an “insider” is functional, based on whether one actually controls a charity, as opposed to one’s title or position in the charity.<sup>62</sup>

The inurement “provision is designed to prevent *any* distribution of charitable receipts to insiders of the charity,”<sup>63</sup> and thus has been described as “absolute”<sup>64</sup> and subject to a “hair trigger,”<sup>65</sup> so that “even if a ‘scintilla’ of charitable profits go to insiders, the charitable exemption is lost.”<sup>66</sup> This prohibition “is of such significance that it underlies all but one of the emerging theoretical justifications for tax-exemption. . . . [and is] the most enduring and significant rule with respect to the grant of tax-exempt status.”<sup>67</sup> “A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is the equivalent of an owner or manager.” *UCC*, 165 F.3d at 1176. Professor Colombo, acknowledging that inurement is “usually far from subtle,” provides two classic examples: (1) a charity pays greater than fair market value for services provided, or property owned, by an insider; and (2) a charity charges and receives “less than fair market value” for property or services provided by the charity to an insider.<sup>68</sup>

For example, utilizing the facts of *UCC*, as analyzed *infra*, if the Board of a nonprofit described under § 501(c)(3) pays excessive compensation to a fundraiser that has become an insider due to its control of the nonprofit, then the charity has violated the prohibition against inurement, and may result in revocation of exempt status.<sup>69</sup> A charity’s payment of such

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<sup>59</sup> § 501(c)(3).

<sup>60</sup> See Treas. Reg. § 1.501(c)(3)-1(a)(1); I.R.S. Gen. Couns. Mem. 39562 (Oct. 8, 1986); *Church of Scientology v. Comm’r*, 823 F.2d 1310, 1316-19 (9<sup>th</sup> Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988), *cited in* *United Cancer Council*, 165 F.3d at 1176.

<sup>61</sup> HILL & MANCINO, *supra* note 18, §4-23-26, ¶ 4.03[4].

<sup>62</sup> *United Cancer Council*, 165 F.3d at 1176.

<sup>63</sup> *Id.* at 1176 (emphasis added); see Darryl K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 576 (2000)(contending that neither Congress, nor courts, nor the IRS has stated the defining principles of inurement).

<sup>64</sup> Brennen, *supra* note 30, at 32.

<sup>65</sup> Manny, *supra* note 27, at 745; see Jones, *supra* note 63, at 589(stating that because the definition of inurement is elusive, rather than an articulated standard, the inurement prohibition should be eliminated).

<sup>66</sup> Brennen, *supra* note 30, at 32.

<sup>67</sup> Jones, *supra* note 63, at 580-81(stating, “there is one, and only one, unyielding condition imposed on those who undertake charitable activities. Those who stand in the relationship of “owner” vis-à-vis the charity may never share in the charity’s surplus wealth. To state the matter in the Tax Code’s . . . jargon, no part of an organization’s net earnings may inure to the benefit of an insider. A violation of that commandment, *no matter how small*, justifies immediate revocation of tax exemption.”)

<sup>68</sup> Colombo, *supra* note 13, at 1067-68.

<sup>69</sup> Jones identifies three categories, and examples of less obvious cases, of inurement: “strict accounting” in which an insider realizes accession to wealth greater than the value provided to the nonprofit (the example given); “incorporated pocketbook,” in which an insider receives value from a transaction with “little, if any, positive effect on an exempt organization’s ostensible beneficiaries,” usually involving looting of the entity; and “joint venture” private inurement, in which the “operations of the tax-exempt entity and an insider-controlled taxable entity are so closely related that the insider, by virtue of his interest in the taxable entity, financially benefits.” Jones, *supra* note 63, at 580-81, 595, 610-11, 620.

excessive compensation<sup>70</sup> represents a classic case of inurement.<sup>71</sup> Whether compensation is excessive or reasonable is a question of fact<sup>72</sup>; reasonable compensation has been described as an amount that ordinarily would be “paid for like services by like enterprises. . .under like circumstances.”<sup>73</sup>

Although there is some redundancy and intersection between the prohibition against inurement and private benefit doctrine,<sup>74</sup> the two proscriptions are distinct. For example, private benefit is not defined in the Code, whereas the prohibition against inurement derives from the language of § 501(c)(3) itself. Further, private benefit must be quantitatively more than incidental such that the nonprofit serves a private, rather than public, benefit; on the other hand, *any* prohibited inurement, regardless of infringement upon a charity’s assets,<sup>75</sup> subjects a § 501(c)(3) to loss of exempt status.<sup>76</sup> As a final example, private benefit can apply to any economic benefit to people beyond insiders, whereas the prohibition against inurement applies only to insiders.<sup>77</sup> Although the private inurement prohibition arguably may be subsumed within the private benefit prohibition, the reverse is not true, so that when courts determine that there is no prohibited inurement, courts nevertheless must determine whether there is prohibited private benefit.<sup>78</sup>

### Excess Benefit Transactions and Sanctions

I.R.C. § 4958<sup>79</sup>, enacted in 1996 and retroactive to September 14, 1995, imposes excise taxes on organization managers and “disqualified persons” for excess benefit transactions between these disqualified persons and applicable tax-exempt organizations, including public charities.<sup>80</sup> Section 4958 penalizes individuals, and not organizations, for violations that also may constitute inurement, thus exposing an organization to revocation of tax exempt status.<sup>81</sup> The section protects charities from the results of the “hair trigger” of

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<sup>70</sup> As noted *infra*, whether compensation is excessive is question of fact. However, it seems that a determination of excessiveness cannot be made without a market-based approach.

<sup>71</sup> Church of Scientology, *supra* note 60, at 1316.

<sup>72</sup> Manny, *supra* note 27, at 738; HILL & MANCINO, *supra* note 18, at §4-34, ¶ 4.03[6][b], *citing* World Family Corp. v. Comm’r, 81 T.C. 958, 969 (1983).

<sup>73</sup> Treas. Reg. § 53.4958-4(b)(1)(ii)(A) (2002), *quoted in* HILL & MANCINO, *supra* note 18, §4-53, ¶ 4.03[6][b].

<sup>74</sup> American Campaign Acad., 92 T.C. at 1068.

<sup>75</sup> Jones, *supra* note 63, at 594.

<sup>76</sup> Manny, *supra* note 27, at 746.

<sup>77</sup> *Id.*; Jones, *supra* note 63, at 583.

<sup>78</sup> American Campaign Acad., 92 T.C. at 1068-69. I.R.S. Gen. Couns. Mem. 39,598 points to the following differences between private benefit and inurement: (1) private benefit requires “balancing public versus private benefit in making case-by-case determinations” as opposed to the rule that any private inurement may result in loss of exemption; and (2) private benefit applies beyond “insiders” and to those outside a charitable class.

<sup>79</sup> I.R.C. § 4958 (West 2009).

<sup>80</sup> Section 4958 applies to § 501(c)(3) public charities, but does not apply to private foundations.

<sup>81</sup> Congress enacted § 4958 specifically to provide an alternative to the “ultimate” sanction of revocation, considered seldom-used and unfair result to the beneficiaries of charities from the transgressions of those responsible for the inurement. A.L. Spitzer, *Symposium: Health Care and Tax Exemption: The Push and Pull of Tax Exemption Law on the Organization and Delivery of*

inurement --revocation of exempt status<sup>82</sup>-- instead punishing just the disqualified persons receiving excessive payments, along with those responsible for facilitating these excessive payments by charities.<sup>83</sup> For this reason, the I.R.S., practitioners, and scholars refer to § 4958 as an “intermediate” sanction, as distinct from the “ultimate” sanction of revocation for prohibited inurement.<sup>84</sup>

Prior to the 1960s, the I.R.S.’s charitable regulatory authority focused solely on revocation of tax exemption; revocation of exempt status has been termed the “ultimate” sanction, that the I.R.S. , states, and court were loathe to impose. After the Tax Reform Act of 1969<sup>85</sup>, the I.R.S. began levying excise taxes on “misgoverned” private foundations.<sup>86</sup> The I.R.S. then began policing foundation board governance, including loans to disqualified persons, excessive compensation, and other fiduciary violations.<sup>87</sup> Some viewed this authority by the I.R.S. to supplant state regulation of foundations,<sup>88</sup> while others felt that states retained the unique “ability to invoke the jurisdiction of an equity court.”<sup>89</sup> However, in the 1960s, the I.R.S. could not thus regulate charities that were not foundations.

In 1996, Congress provided the I.R.S. with the ability to police charities in a manner other than revocation of exemption, by passing § 4958.

Indeed, the legislative history of Section 4958 indicates that revoking the exemption of an organization would be appropriate only when the benefits “rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization.” The legislative history also adds that “[i]n practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would only occur when the organization no longer operates as a charitable organization. Presumably this was the lawmakers’ way of saying that it was their intent that as an excess benefit transaction, regardless of size, would always be subject to the penalty excise taxes of Section

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*Health Care Services: Executive Compensation in Nonprofit Health Care Organizations: Who’s in Charge?* 15 HEALTH MATRIX 67, 71 (2005).

<sup>82</sup> Manny, *supra* note 27, at 751.

<sup>83</sup> *Id.*

<sup>84</sup> HILL & MANCINO, *supra* note 18, at §4-44, ¶4.04[2]. For an in-depth discussion of why § 4958 should not apply to private benefit, non-inurement situations, see Manny, *supra*, note 27.

<sup>85</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat 487 (1970)(codified as amended in scattered sections of 26 U.S.C.)

<sup>86</sup> Norman I. Silber, *Who Guards the Guardians?: Monitoring and Enforcement of Charity Governance: Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613, 624 (2005).

<sup>87</sup> *Id.*

<sup>88</sup> Silber, *supra* note 86, at 625, quoting Crimm, *supra* note 2, at 6.

<sup>89</sup> Silber, *supra* note 61, at 626.

4958, but that exemption revocation would occur only if the organization's participation in one or more such transactions indicated that it has a substantial nonexempt purpose.<sup>90</sup>

Section 4958 thus, in purpose if not in fact, imposes "intermediate sanctions" on disqualified persons and organization managers for certain self-dealing transactions between tax-exempt charities, including those described under § 501(c)(3).<sup>91</sup> The statute is intended, in part, to "ensure[s] that executive salaries in the nonprofit sector reflect market rates."<sup>92</sup> Further, the statute penalizes transactions between a charity and a disqualified person that unduly favors the disqualified person.<sup>93</sup>

Section 4958(c)(1)(A) defines an "excess benefit transaction" as a transaction between an applicable tax-exempt organization, including an organization described in § 501(c)(3), and a "disqualified person," where the value of the economic benefit provided to the disqualified person exceeds the value of any consideration received. Further, § 4958(f)(1) defines a disqualified person as any individual who, during the preceding five years, was "in a position to exercise substantial influence over the affairs of the organization" as well as certain family members and controlled entities of such individual.<sup>94</sup> For example, voting members of a charity's governing body such as directors, trustees, presidents, chief executive officers, chief operating officers, treasurers and chief financial officers typically are disqualified persons for purposes of § 4958.<sup>95</sup> Disqualified persons also may include family members of disqualified persons, entities controlled by disqualified persons, and donors and their advisors.<sup>96</sup> Ultimately, whether an individual is a disqualified person depends upon the facts and circumstances surrounding the individual's influence over a charity, and not solely on title.<sup>97</sup> Professor Colombo has opined that § 4958 largely supplants the inurement prohibition as to disqualified persons.<sup>98</sup>

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<sup>90</sup> HILL & MANCINO, *supra* note 18, at §4-44, ¶ 4.04[2]. For an in-depth discussion of policies surrounding enactment of §4958, see Manny, *supra* note 27, at 750-53.

<sup>91</sup> I.R.C. § 4958. See Manny, *supra* note 27, at 736 (positing that the "4958 or some similar process and sanctions should be compelled in private benefit, non-inurement, situations where the compensated individual does not have substantial influence over the affairs of the organization").

<sup>92</sup> Manny, *supra* note 27, at 737 (noting, however, that 4958 may not ensure reasonable compensation, and that the current "knowing," "willful" standard permits extensive escape routes for those charged with setting and reviewing salaries).

<sup>93</sup> *Id.* at 747.

<sup>94</sup> See I.R.C. § 4958(f)(1)(A); Treas. Reg. §53.4958-3(a)(1), b; Carraci v. Comm'r, 118 T.C. 379 (2002), *rev'd o.g.* 456 F.3d 444 (5th Cir. 2006).

<sup>95</sup> I.R.C. § 4958(f)(1)(A); the Pension Protection Act of 2006 amended § 4958 to include donors and their advisors, including investment advisors, in the definition of "disqualified persons." Pension Protection Act of 2006, Pub. L. No. 109-280, § 1232, 120 Stat. 780 (2006)(codified in scattered sections of 29 U.S.C.)(("Pension Protection Act"). See Marcus S. Owens, *Recent Developments in Intermediate Sanctions*, TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 266 (Practicing L. Inst. 2003).

<sup>96</sup> I.R.C. § 4958(f)(1)(A); see Owens, *supra* note 95.

<sup>97</sup> § 53.4958-3 provides examples of facts and circumstances showing that an individual is a "disqualified person."

<sup>98</sup> Colombo, *supra* note 13, at 1068.

Section 4958 provides for an initial tax on a disqualified person equivalent to 25 % of the excess benefit total made by a charity to disqualified persons; the section specifies for additional tax 200% of the excess benefit for a disqualified person's failure to correct the excess benefit within a certain period of time. § 4958(b). At the same time, § 4958 imposes a separate tax equal to 10% of the excess benefit, up to \$20,000 with respect to any one excess benefit transaction, on the organization managers who participated in excess benefit transactions, unless participation was not willful and was due to reasonable cause. § 4958(a)(2), (d)(2). Section 4958(f)(2) defines "organization managers" as any officer, director, or trustee, or individual having such powers or responsibilities.<sup>99</sup> Organization managers would be jointly and severally liable for this tax. § 4958(d)(1). Finally, § 4958 applies lookback rules to apply to any entity that was an applicable tax-exempt organization for a period of five years before the excess benefit transaction.<sup>100</sup>

Treas. Reg. § 53.4958-6 provides a rebuttable presumption of reasonableness "safe harbor" process for such tax-exempt organizations in setting reasonable<sup>101</sup> compensation for disqualified persons.<sup>102</sup> This "safe harbor" process requires: first, compensation must be approved by a Board, or a Committee authorized by the Board, composed of individuals unrelated to, and not subject to, the control of the disqualified person; second, Board or Committee approval for compensation is obtained and relied upon based on appropriate comparability data; and, finally, there must be adequate documentation for the basis of determination.<sup>103</sup> If a Board follows this "safe harbor" process, then its compensation agreement is presumed not to be an excess benefit transaction, and the burden of proof shifts to the I.R.S.<sup>104</sup>

Treas. Reg. § 53.4958-4 furthermore sets forth an "initial contract exception" to § 4958, where § 4958 does not apply to any initial fixed payment contract, made between a nonprofit § 501(c)(3) and an individual who was not a disqualified person before the initial contract.<sup>105</sup> Thus, a § 501(c)(3) Board may have one "free" or "first" bite<sup>106</sup> under § 4958 in

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<sup>99</sup> See Treas. Reg. § 53.4958-1(d)(2)(i) (2002).

<sup>100</sup> See Treas. Reg. § 53.4958-2(a) (2008).

<sup>101</sup> Neither the Code nor Regulations "specify an objective test for determining reasonable compensation" under § 4958; rather, Congress intended that the reasonableness standard for § 162 would apply. Manny, *supra* note 27, at 739, 741. Rather, the Regulations suggest a facts and circumstances test for whether compensation is reasonable. *Id.* at 738. For a thorough analysis of § 4958 and reasonableness of compensation, see Manny, *supra* note 27.

<sup>102</sup> Treas. Reg. § 53.4958-6 (2002).

<sup>103</sup> Manny, *supra* note 27, at 742. Although the "safe harbor" process may ensure reasonableness under § 4958, it may not ensure reasonableness under other standards. Manny, *supra* note 27, at 743.

<sup>104</sup> Treas. Reg. § 53.4958-6(a) (2002).

<sup>105</sup> Treas. Reg. § 53.4958-4(a)(3).

<sup>106</sup> Although *UCC* was not explicitly about the first bite rule, under Judge Posner's reasoning in *UCC*, a person cannot become an "insider" until a charity hires that person, and thus is entitled to a "first bite" at the charity's profits, without risking tax

setting compensation for a new employee.<sup>107</sup> Inurement and private benefit rules, however, still apply to these initial contract transactions.

*Caracci v. Commissioner* was the first case to be decided under § 4958.<sup>108</sup> In *Caracci*, the Tax Court determined that organizations exempt from tax under § 501(c)(3) engaged in excess benefit transactions by selling their assets to disqualified persons for prices less than fair market value. The Court found that the excess value of sales in *Caracci* exceeded \$5 million, and that the transactions also constituted inurement; however, the Court declined to impose revocation of exemption<sup>109</sup> on the basis of prohibited inurement.

Although the imposition of section 4958 excise taxes as a result of an excess benefit transaction does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case.<sup>110</sup>

In 2006, the Fifth Circuit reversed the Tax Court, and found that the Tax Court made clearly erroneous findings of fact, erred as a matter of law as to the valuation method, and erred as a matter of law in affirming the Commissioner's decision after the I.R.S. failed to meet its burden of proof.<sup>111</sup> However, subsequent cases have applied the Tax Court's interpretation of § 4958.

### The Current Dual System of Charitable Regulation

One distinguishing aspect of charity regulation in this country "is that it is a dual system, with state and federal rules and enforcement programs that parallel each other to a large degree."<sup>112</sup> On one hand, the I.R.S. traditionally has enforced federal tax laws governing charitable nonprofits in federal courts; thus, the I.R.S. alone has been responsible for enforcing the Code prohibitions against private benefit and inurement in federal courts.<sup>113</sup>

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exemption. See Jones, *supra* note 13, at 717, 719, 724 (criticizing the "first bite" rule of § 4958 and the private benefit doctrine, as presently defined, because it allows a "loophole" through which charities may distribute profits to private interests).

<sup>107</sup> Although Judge Posner's decision in *UCC* did not consider § 4958, it essentially established a "first bite" rule where those who are not directors, managers or otherwise controlling authorities in a charity, hired for the first time, could not be "insiders" for purposes of inurement, and thus charities could pay excessive compensation to any such newly-hired employee. See Jones, *supra* note 13, at 716-17.

<sup>108</sup> *Caracci v. Comm'r*, *supra* note 94.

<sup>109</sup> Of course, in the "rare case," a charity may be subject to both intermediate sanctions as well as revocation. *Caracci*, 118 T.C. at 417.

<sup>110</sup> *Id.* at 417.

<sup>111</sup> *Caracci*, 456 F.3d 444 (5<sup>th</sup> Cir. 2006).

<sup>112</sup> FREMONT-SMITH, *supra* note 1, at 428.

<sup>113</sup> The Justice Department handles civil litigation arising under revenue laws, and prosecutes criminal tax cases. Several federal agencies also help regulate charities. These include the Federal Bureau of Investigation and the Federal Trade Commission..

On the other hand, states traditionally have had primary responsibility for regulation of charitable wrongdoings and for protection of charitable assets.<sup>114</sup> States typically license charitable corporations, trusts, and associations, and state statutes typically govern their formation, operation, and dissolution.<sup>115</sup> Authorities have recognized the inherent tension between the I.R.S. authority derived from the Code and states' authority derived from common law and equity.<sup>116</sup> Recently, statutory and case law developments have created "considerable overlapping enforcement responsibility" of state and federal charitable regulators, e.g. state attorneys general and the I.R.S.<sup>117</sup>

Initially, this country's strong tradition of federalism ensures the continuation of the present dual mode of regulation of charities. Indeed, the history of charitable regulation in this country demonstrates a trend of increasing cooperation between state and federal authorities. Beginning in the 1960s, the federal government increased cooperation with states in regulating charities.<sup>118</sup> For example, the Tax Reform Act of 1969 expanded federal and state roles, and established a more coordinated "dual regulatory system" by the I.R.S. and states in policing nonprofits.<sup>119</sup>

The 1970s brought increased state involvement.<sup>120</sup> Later, in the 1990s, Congress investigated allegations of taxpayer abuse by the I.R.S., and ultimately passed legislation to address this abuse.<sup>121</sup> Further, although the "Sarbanes-Oxley" Act, applied only to publicly-traded American companies, that Act influenced nonprofits to consider voluntarily adopting the governance best practices set forth in the Act, and called into question the "allocation and coordination of power between the I.R.S. and state law for nonprofit governance."<sup>122</sup> In 2004, the Senate Finance Committee drafted proposals to grant additional enforcement power to the I.R.S. with regard to nonprofit fiduciaries and to the states with regard to federal tax law violations, and to allow the I.R.S. to share income tax information with

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<sup>114</sup> FREMONT-SMITH, *supra* note 1, at 377; Silber, *supra* note 86, at 620.

<sup>115</sup> Silber, *supra* note 86, at 620.

<sup>116</sup> Marcus S. Owens, *Charities and Governance: Is the IRS Subject to Challenge?* (2008),

[http://www.capdale.com/files/Publication/c3941121-3ce4-412a-8ed0-](http://www.capdale.com/files/Publication/c3941121-3ce4-412a-8ed0-0c170665ed50/Presentation/PublicationAttachment/bf33a906-9a00-44b4-847d-106b4e3a8863/Governance%20article.pdf)

[0c170665ed50/Presentation/PublicationAttachment/bf33a906-9a00-44b4-847d-106b4e3a8863/Governance%20article.pdf](http://www.capdale.com/files/Publication/c3941121-3ce4-412a-8ed0-0c170665ed50/Presentation/PublicationAttachment/bf33a906-9a00-44b4-847d-106b4e3a8863/Governance%20article.pdf).

<sup>117</sup> Silber, *supra* note 86, at 618 (observing that over the past thirty-five years, "legislative and case law developments have obliterated many of these distinctions" between the focus and enforcement responsibilities of the IRS and state attorneys general, and criticizing greater coordination and concurrent jurisdiction between the IRS and state attorneys general).

<sup>118</sup> Crimm, *supra* note 2, at 6.

<sup>119</sup> FREMONT-SMITH, *supra* note 1, at 54 (noting one measure in Act was a provision allowing IRS to disclose information about charities to state charity officials).

<sup>120</sup> Crimm, *supra* note 2, at 8.

<sup>121</sup> Crimm, *supra* note 2, at 27-28.

<sup>122</sup> Ellen P. Aprill, *Nonprofit Law, Economic Challenges, and the Future of Charities: The Increasing Resemblance of Nonprofit and Business Organizations Law: What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 *FORDHAM L. REV.* 765, 768 (2007). See American Competitiveness and Corporate Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) ("Sarbanes-Oxley Act").

states.<sup>123</sup> Of course, the latter proposal was in fact enacted in the Pension Protection Act of 2006 (“Act” or “Pension Protection Act”)<sup>124</sup>; the Act expanded the I.R.S.’s ability to exchange information with state regulators about charities violating the Code,<sup>125</sup> amending § 6104 to allow the I.R.S. , under certain narrow circumstances, to disclose to state officials information regarding proposed and potential actions relating to charities.

Despite this increasing “interjurisdictional overlapping enforcement responsibility,” however, jurisdiction is hardly coextensive, and in some scholars’ view, the overlap is detrimental to charitable regulation.<sup>126</sup> Nevertheless, considering the history of strong federalism and legislation authorizing disclosure by the I.R.S. to state authorities, the dual system of charitable regulation likely will continue.

### History of State Regulation of Charities

State regulation of charities in state courts derives from the fact that such charities are “creatures of state corporate law and state fiduciary standards.”<sup>127</sup> State courts accordingly have exercised broad power over charities and their fiduciaries, ranging from dissolution to transfer of property, from removal of directors to restitution, from transfer of property to enjoinder, and from disclosure of information to accountings.<sup>128</sup>

State laws governing charitable nonprofits “are found in the state statutes enabling creation of charitable corporations and trusts.”<sup>129</sup> State statutes typically: “define accepted charitable purposes,”<sup>130</sup> including noninurement and nondistributional constraints,<sup>131</sup> so that charities are operated for a public, and not private, benefit; “describe the powers, duties, and liabilities of fiduciaries in regard to the administration of these entities; and govern the

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<sup>123</sup> Silber, *supra* note 86, at 628-29.

<sup>124</sup> See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1224, 120 Stat. 780, 1091-93 (2006) (hereinafter “Pension Protection Act”). See legislative history of Pension Protection Act, e.g. *Overview of the Tax-Exempt Sector: Hearing Before the Committee on Ways and Means, U.S. House of Representatives*, 109<sup>th</sup> Cong. 1 (2005).

<sup>125</sup> See generally Marion R. Fremont-Smith, *supra* note 22 (noting, however, that the 2006 Act did not include a number of other recommendations from the Senate Finance Committee staff, such as increased funding to the IRS and states for enforcement; jurisdictional changes granting Tax Courts equity powers to enforce the Code, giving the IRS—in addition to states--power to remove fiduciaries and employees for self-dealing, giving the IRS—in addition to states--power to regulate solicitation of charitable donations and conversion of nonprofits to for-profits, and giving standing to the public to sue to enforce Code provisions; reevaluation of exemption every five years; increased disclosure; best practices and certification requirements; among a number of substantive recommendations aimed at reducing and detecting nonprofits’ lack of compliance with the Code); see Pension Protection Act.

<sup>126</sup> See generally Silber, *supra* note 86.

<sup>127</sup> James J. Fishman, *Symposium: Nonprofit Law, Economic Challenges, and the Future of Charities: Panel I: Approaching Nonprofit Law: Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 *FORDHAM L. REV.* 567, 578 (2007).

<sup>128</sup> FREMONT-SMITH, *supra* note 1, at 309-11.

<sup>129</sup> Fremont-Smith, *supra* note 22, at 610.

<sup>130</sup> *Id.*

<sup>131</sup> Silber, *supra* note 86, at 622.

dissolution or merger of charitable organizations.”<sup>132</sup> Every state has legislation defining fiduciary responsibilities for trustees, and most states have statutes that impose a fiduciary duty<sup>133</sup> on directors and officers of nonprofits,<sup>134</sup> including the duties of care and loyalty, along with obedience.<sup>135</sup> “The duty of care is traditionally characterized by a three-part test inquiring into whether directors acted ‘in good faith,’ with that level of care that an ordinarily prudent person would exercise in like circumstances and in a manner they reasonably believe to be in the best interests of the corporation.”<sup>136</sup> The duty of loyalty<sup>137</sup> generally requires directors to consider “the best interests of their organization. . . rather than personal interests.”<sup>138</sup> The duty of obedience requires directors to “observe and advance the mission of the charitable corporation by adhering to its purposes, usually as set forth in the entity’s articles of incorporation or bylaws.”<sup>139</sup> The 2008 Model Nonprofit Corporation Act proposes for state adoption the fiduciary duties of care for charitable directors; directors must act in good faith, in the best interests of the nonprofit, exercising the standard of care of an ordinary person in the same position.<sup>140</sup>

State attorneys general (“AGs”) may bring a wide variety of claims as to charities, including fiduciary; indeed, state authorities may bring any claim except for federal tax law violation, whether statutory, common law, contract, tort, parens patriae, trust, property tax—including claims for conduct that also violates the Code.<sup>141</sup>

The ability to invoke the jurisdiction of an equity court, with its broad and adaptable powers, is uniquely the province of the states. Only in certain limited circumstances can the Service take all

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<sup>132</sup> Fremont-Smith, *supra* note 22, at 610.

<sup>133</sup> See MODEL NONPROFIT CORP. ACT (2003), adopted in substance by some states.

<sup>134</sup> FREMONT-SMITH, *supra* note 1, at 207; Silber, *supra* note 86, at 621.

<sup>135</sup> Chester, *supra* note 3, at 455. New York imposes on directors and officers the duties of care, loyalty and obedience. The common law duty of care requires that directors and officers of charitable organizations be attentive to the charity’s activities and finances, and actively oversee the way in which its assets are managed; New York requires them to “discharge the duties of their respective positions in good faith and with the degree of diligence, care and skill which ordinarily prudent [people] would exercise under similar circumstances in like positions.” N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (Consol. 2009). The common law duty of loyalty requires directors and officers to pursue the interests and mission of the charity with undivided allegiance by, among other things, acting in good faith and not self-dealing. See *id.* § 715, 716, 717. The common law duty of obedience requires directors and officers to act within the organization’s purposes and mission. See, e.g., *id.* § 201, 202, 402, 701, 713.

<sup>136</sup> Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Nonprofit Health Care Enterprise*, 5 YALE J. HEALTH POL’Y L. & ETHICS 1, 40-41 (2005)(noting that courts rarely impose sanctions on directors for breaching the duty of care).

<sup>137</sup> CURTIS C. SPROUL, *Directors and Officers: Standards of Conduct for Directors, in Advising California Nonprofit Corporations* § 8.103 (J. Patrick Whaley ed., 2d ed. 2006).

<sup>138</sup> SPROUL, *supra* note 137, at § 8.105.

<sup>139</sup> Greaney & Boozang, *supra* note 136, at 44 (adding that courts have also included in this duty the responsibility to assure compliance with the law).

<sup>140</sup> MODEL NONPROFIT CORP. ACT § 8.30 (2003).

<sup>141</sup> Silber, *supra* note 86, at 621-24, 630-34 (listing types of violative conduct by charities); FREMONT-SMITH, *supra* note 1, at 301 (noting, however, that “the effectiveness of state regulation of charities depends primarily on the manner in which the state attorneys general carry out their enforcement duties”).

of the steps necessary fully to protect the public. . .the state's role . . .where correction remains outstanding, is to bring about "correction." The state alone can do this through the exercise of state equity powers.<sup>142</sup>

AGs of most states are responsible for protecting charitable assets, prosecuting nonprofit wrongdoing, and enforcing nonprofit directors' fiduciary duties.<sup>143</sup> Most AGs may "stand in the shoes of injured parties" and "sue on their behalf when doing so is in the public interest."<sup>144</sup> AGs furthermore may dissolve a charity for inurement or private benefit.<sup>145</sup> "Except for federal tax law violations, few types of nonprofit wrongdoing have escaped the purview of an Attorney General's authority to investigate, and, if warranted, to prosecute miscreants."<sup>146</sup>

States, led by New York and California, have increasingly and aggressively exercised their powers over the nonprofit sector; observers have noted this increasing state activism, related to this country's strong history of federalism.<sup>147</sup> Thus, for example, New York's Attorney General's power over charities derives statutorily from the New York Not-For-Profit Corporation Law ("N-PCL"), Estates, Powers and Trusts Law ("EPTL"), Executive Law, Penal Law, among other statutes. In addition, New York's "Attorney General's supervisory authority over charities is rooted in the common law of charitable trusts and corporations, as well as the *parens patriae* power of the state to protect the interest of the public in assets pledged to public purposes."<sup>148</sup> The Attorney General has broad powers, including regulation of nonprofit activities, registration, filings, assets, and corporate changes; removal of directors and officers; enforcement of charitable gifts; prosecution and defense of legal actions involving nonprofits; and dissolution.<sup>149</sup> New York's Attorney General, for example, has intervened aggressively and publicly in numerous cases of nonprofit malfeasance, pursuing civil and criminal claims against trustees and officers, and publicly warning nonprofit boards to comply with their fiduciary duties.<sup>150</sup> The Attorney

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<sup>142</sup> Silber, *supra* note 86, at 626-27, quoting Crimm, *supra* note 2, at 7.

<sup>143</sup> FREMONT-SMITH, *supra* note 1, at 305-11; Silber, *supra* note 86, at 620.

<sup>144</sup> Silber, *supra* note 86, at 620

<sup>145</sup> FREMONT-SMITH, *supra* note 1, at 476-95.

<sup>146</sup> Silber, *supra* note 86, at 621; Greaney & Boozang, *supra* note 136, at 2.

<sup>147</sup> Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 MICH L. REV. 1312, 1319, 1331 (2002); Crimm, *supra* note 2, at 2. However, it has been noted that only a "handful of cases address the duties of care and loyalty; mention of the duty of obedience is even rarer." Greaney & Boozang, *supra* note 136, at 37.

<sup>148</sup> Robert Pigott, *The Regulatory Role of the Attorney General's Charities Bureau*, in ADVISING NONPROFIT ORGANIZATIONS 14851 (Practicing L. Inst., 2008); Sidel, *supra* note 147, at 1319 n. 22.

<sup>149</sup> FREMONT-SMITH, *supra* note 1, at 309, 476-95. For a comprehensive summary of the powers of New York's Attorney General over charities, see generally Pigott, *supra* note 148.

<sup>150</sup> Sidel, *supra* note 147 at 1319-33 (discussing the New York Attorney General's aggressive intervention in various cases involving charities, including the United Way, Adelphi, Wallace-Reader's Digest, Hale House, and Holy Land Foundation matters).

General also has threatened litigation to force charities to abide by state and federal requirements.<sup>151</sup> Following the New York Attorney General’s investigation and successful prosecution of nonprofit criminal activity, including fraudulent or improper use of charitable assets, a court may order restitution.

Many legal scholars have espoused the view that states are better suited than the I.R.S. to police nonprofits<sup>152</sup> and therefore state officials should have broader standing and powers than does the I.R.S. to patrol nonprofits.<sup>153</sup> The I.R.S., these scholars say, is focused on enforcement of laws to collect taxes, as opposed to state authorities’ focus on preservation of charitable assets for public good.<sup>154</sup> One commentator has attributed increased “public activism and awareness by attorneys general” to the public’s responses to widely publicized media reports about nonprofit abuses and about the I.R.S.’s alleged mishandling of matters.<sup>155</sup> Accordingly, these scholars have advocated for increased jurisdiction and access to information for state authorities in policing charities. Indeed, several AGs, including those in New York and California, have introduced bills to increase state regulation of charitable nonprofits.<sup>156</sup> Nevertheless, it not inconceivable for the states’ regulatory role to decrease upon enactment of proposals such as those to create a new federal regulatory entity for charities.<sup>157</sup>

## History of Federal Regulation of Charities

The I.R.S. is responsible for enforcing the Code and collecting tax revenues as to charities; the I.R.S. is said to have become by default the primary regulator of charities.<sup>158</sup> As stated *infra*, some experts have advocated in favor of increasing the I.R.S.’s role in policing nonprofits on the basis that “state enforcement of fiduciary duties of officers and

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<sup>151</sup> See FREMONT-SMITH, *supra* note 1, at 446 (criticizing AGs’ threats of litigation to force charities into settlements that are more restrictive than required by law or likely to be imposed by courts).

<sup>152</sup> See, e.g. Fishman, *supra* note 127 (proposing local volunteer charity commissions serving under state attorneys general).

<sup>153</sup> Dale, *supra* note 8, at 1 n. 7; see generally FREMONT-SMITH, *supra* note 1; Sidel, *supra* note 147.

<sup>154</sup> Fremont-Smith, *supra* note 22, at 644. The IRS has been said to be “limited in its ability to nonprofit fraud and mismanagement” for the following reasons: 1) the IRS’s primary function is to collect revenue and not to uncover fraud; 2) the IRS has limited resources to police nonprofits, and is said to be “inadequately staffed and insufficiently powerful” (citation omitted); 3) the IRS has limited ability to share information, thus making it unlikely that the IRS would refer suspected cases of nonprofit fraud to state AGs; 4) “the IRS is subject to political influence and may lack the impartiality necessary for uniform enforcement,” and the IRS Commissioner is a political appointee. Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 1035 (2004)(criticizing the IRS as well as state attorneys general as “inadequately staffed and usually not-very-interested”).

<sup>155</sup> Crimm, *supra* note 2, at 27.

<sup>156</sup> California passed a bill regarding regulation of charitable nonprofits, imposing requirements on nonprofits that were similar to those imposed on for-profits by the 2002 Sarbanes-Oxley Act. For example, the 2004 California act contains an audit requirement for charities with gross receipts of over \$2 million. See Fremont-Smith, *supra* note 22, at 613 (noting that New York’s attorney general submitted bills in 2004 regarding the scope of his ability to enforce and prevent fraud in not-for-profit corporations).

<sup>157</sup> *Id.* at 641, 644.

<sup>158</sup> *Id.* at 642 (noting that the vast majority of regulation of charities “has fallen by default to the IRS”).

directors” is “lax and demands significant attention and augmentation.”<sup>159</sup> State attorneys general are said to be spread thin from enforcement of a variety and vast number of civil and criminal state laws.<sup>160</sup> Further, these experts argue that state AGs offices are not typically staffed with experts in charity law, whereas the federal government does employ such experts.<sup>161</sup> State AGs also are said to be politically influenced, and that “suing the directors of a charity is not always politically expedient.”<sup>162</sup> Indeed, state AGs may be politically influenced, whether appointed or not.<sup>163</sup>

The I.R.S. itself in recent years intentionally has expanded its oversight of charity governance. At the 2007 meeting of the Philanthropy Roundtable, Steven T. Miller, the Director of the I.R.S. Tax Exempt and Government Entities Division, stated that the I.R.S. was concerned whether charities were making effective use of charitable assets, and that the I.R.S. might need to take action to encourage and enforce charitable effectiveness and efficiency.<sup>164</sup> Accordingly, in 2007, the I.R.S. publicized a proposed revised Form 990 to be used beginning in 2008, in which charities were required to provide information regarding governance. In 2008, the I.R.S. released the final amended Form 990 with a new “Governance, Management and Disclosure” section and questions.<sup>165</sup> The I.R.S. thereafter released draft instructions on this Form 990:

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<sup>159</sup> Manny, *supra* note 27, at 758.

<sup>160</sup> *See id.* (noting the “perception that there are more significant issues for attorneys general to police”); Greaney, *supra* note 136, at 5, 37 (stating it “questionable whether attorneys general have the resources or expertise to engage in the detailed assessments of the business and health policy issues surrounding the appropriate deployment of charitable assets that such decisions implicate. . . . presented in a politically charged atmosphere, these enforcement decisions may reflect policy judgments and preferences that go beyond the attorney generals’ competence or mandate”); Crimm, *supra* note 2, at 24-25 (attributing failure by state attorneys general to guard the welfare of charitable organizations potentially to “personnel constraints, the stress of more important duties, the lack of full information about nonprofit organizations within [their] jurisdiction[s], political pressures that attach to the position as a political officer and the infrequency of public complaints about particular nonprofit organizations”).

<sup>161</sup> FREMONT-SMITH, *supra* note 1, at xiii; *see* Manny, *supra* note 27, at 758 (observing that attorneys general, unlike the IRS, are “understaffed in the charities area” and “where attorneys general do take action, the focus seems to be on issues of fund-raising and charitable solicitation rather than on breaches of board fiduciary duties”).

<sup>162</sup> Manny, *supra* note 27, at 758. *See* FREMONT-SMITH, *supra* note 1, at 353; Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U.L. REV. 701, 703 (2008); Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?* 21 HAWAII L. REV. 537, 539 (1999) (noting that the Hawaii Senate refused to reconfirm the state attorney general to a second term because of her role in the Bishop Estate investigation). *See generally* FREMONT-SMITH, *supra* note 22; Silber, *supra* note 86, at 622.

<sup>163</sup> *See* FREMONT-SMITH, *supra* note 1, at 446 (criticizing the “politicization” of AGs and pointed to their use of power to replace board members with AG-selected appointees); Silber, *supra* note 86, at 634. For example, the Illinois Attorney General was accused in the media of a “go lightly” approach to the Citizenship Education Fund nonprofit corporation, led by Reverend Jesse Jackson, when the nonprofit failed to disclose on its Form 990 the salary of one of its five highest paid employees: an employee who had received a generous severance package after having given birth to Reverend Jackson’s child. Silber, *supra* note 86. The state attorney general, who at the time was seeking the Illinois governorship, allowed the nonprofit to file an amended state charities report, then closed the investigation, and defended his actions by stating he was adhering to normal practices of his office. *Id.*

<sup>164</sup> Ben Gose, *IRS Official Says Tax Agency May Step Up Efforts to Identify Ineffective Charities*, THE CHRONICLE OF PHILANTHROPY (Nov. 12, 2007) at <http://philanthropy.com/news/updates/index.php?id=3441>.

<sup>165</sup> Among the new questions that charities must answer are: the number of governing board members that are independent; whether the organization has a process to determine compensation for chief personnel; and whether the organization has a written

Even though certain governance, management, and disclosure policies and procedures may not be required under the Internal Revenue Code, the I.R.S. considers such policies and procedures to generally improve tax compliance.<sup>166</sup>

During a speech on November 10, 2007, Mr. Miller explicitly stated the I.R.S.'s interest in promoting "good governance, management and accountability."<sup>167</sup> Marcus S. Owens, former chief of the I.R.S.'s tax-exempt division from 1990 to 2000, initially objected to I.R.S. regulation of charitable governance: "I would urge the I.R.S., as it begins to contemplate the concepts of efficiency and effectiveness, and of good governance, to keep in mind that some of those words are not found in the Internal Revenue Code."<sup>168</sup> Further, Mr. Owens said, "State prosecutors have far greater powers to tackle issues related to governance and effectiveness than does the I.R.S."<sup>169</sup> Mr. Owens recently urged the I.R.S. to publish specific standards for charitable governance, considering that the Code does not set forth such specific governance standards.<sup>170</sup>

### United Cancer Council and the Intersection of State and Federal Charitable Regulation

*United Cancer Council* presents a fascinating case of possible private benefit under the Code, resulting from an arguable breach of state fiduciary duty in a charity board's overpayment for fundraising services. In *UCC*, the I.R.S. alleged and the Tax Court found that excessive payment to the for-profit fundraiser constituted inurement.<sup>171</sup> The Tax Court revoked United Cancer Council's exemption on the basis that its fundraiser so controlled the nonprofit as to qualify as an insider, thus, violating the prohibition against inurement.<sup>172</sup> The Seventh Circuit subsequently reversed the Tax Court's revocation of charitable exemption.

United Cancer Council ("UCC"), a "splinter" from the American Cancer Society, was granted exempt status under § 501(c)(3) for the charitable purpose of encouraging

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conflict of interest, document retention and destruction, and whistleblower policy. *Return of Organization Exempt from Income Tax*, available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> 2008.

<sup>166</sup> Owens, *supra* note 116.

<sup>167</sup> *Id.*

<sup>168</sup> Gose, *supra* note 164.

<sup>169</sup> *Id.*

<sup>170</sup> Grant Williams, *Nonprofit Tax Expert Urges IRS to Clarify Stance on Governance Practices*, THE CHRONICLE OF PHILANTHROPY (Jan. 14, 2009), <http://philanthropy.com/news/government/6795/nonprofit-tax-expert-urges-irs-to-clarify-stance-on-governance-practices>.

<sup>171</sup> Professor Colombo views the case from the perspective of a board's failure to "diligently conserve" the charity's assets "for use on the charitable class." Colombo, *supra* note 13, at 1100. He posits that, because "a variety of charities have far lower fundraising costs" than 90% of gross funds raised, UCC could have conserved more assets either by performing its own fundraising or by contracting with another outside fundraiser. *Id.*

<sup>172</sup> *United Cancer Council*, 165 F.3d at 1174.

“preventive and ameliorative approaches to cancer, as distinct from searching for a cure,” a goal of the American Cancer Society.<sup>173</sup> UCC was on the verge of bankruptcy in 1984 when it entered into an arms-length transaction with a for-profit fundraiser, Watson & Hughey Company (“W&H”) for five years, in which W&H would conduct a direct-mail fundraising campaign for UCC, and would “front” all fundraising expenses for UCC.<sup>174</sup> W&H also agreed to advance funds to UCC so that it could operate until any fundraising campaign generated income to support UCC.<sup>175</sup> In return, UCC agreed to retain W&H as its exclusive fundraiser for the five years, for fees considered at the “high end” for such fundraising contracts, and gave W&H co-ownership and unrestricted use of UCC’s mailing list; UCC, however, could neither sell nor lease the list, although it was free to use it.<sup>176</sup>

Ultimately, as a result of W&H’s fundraising in 1989, including 79.6 million solicitation letters, it raised \$28.8 million in contributions to UCC; \$26.5 million were costs incurred by W&H and reimbursed by UCC to W&H, thus netting UCC a little over \$2.2 million (less than 10% of the gross) and W&H over \$4 million in fees.<sup>177</sup> UCC did not renew the fundraising contract with W&H, but rather contracted with another fundraiser in 1989.<sup>178</sup> In 1990, UCC declared bankruptcy, and shortly thereafter, the I.R.S. revoked UCC’s tax exemption retroactively to the 1984 date of UCC’s fundraising contract with W&H.<sup>179</sup> The Attorneys General of several states also initiated action against UCC.<sup>180</sup>

The I.R.S. argued two grounds for revocation before the Tax Court: private benefit and inurement. The I.R.S. did not contend that UCC’s contract with the fundraiser was anything but arm’s length, but, rather, that the contract was so advantageous to the fundraiser and disadvantageous to UCC as to classify W&H as an insider in control of UCC, thus violating the prohibition against inurement.<sup>181</sup> The Tax Court found that UCC violated the prohibition against inurement because W&H was an insider to UCC, and UCC’s net earnings inured to W&H’s benefit; W&H was “analogous to that of a founder and major contributor to a new organization,” and exercised extensive control over UCC’s fundraising and substantial control over UCC’s finances.<sup>182</sup> The Court did not reach the issue of private

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<sup>173</sup> *Id.*

<sup>174</sup> *Id.* at 1175.

<sup>175</sup> *United Cancer Council*, 109 T.C. at 347.

<sup>176</sup> *Id.* at 1175; 109 T.C. 326, 343, 393; *see generally* Daniel M. Ford, *Insiders & Inurement: The Seventh Circuit’s Reversal of the Tax Court in United Cancer Council v. Commissioner*, 50 CASE W. RES. L. REV. 909, 913 (2000).

<sup>177</sup> *United Cancer Council v. Comm’r*, 109 T.C. at 331-333; 165 F. 3d at 1174; *see Jones, supra* note 13, at 719.

<sup>178</sup> 165 F.3d at 1175.

<sup>179</sup> *Id.* at 1176.

<sup>180</sup> David Cay Johnston, *Court Rules Against I.R.S. in Charity Case*, N.Y. TIMES, Feb. 12, 1999,

<http://www.nytimes.com/1999/02/12/business/court-rules-against-irs-in-charity-case.html> (last visited Oct. 5, 2009).

<sup>181</sup> 165 F.3d at 1174, 1176.

<sup>182</sup> 109 T.C. at 387-88 (noting that because W&H provided UCC funds to continue operating, W&H was like a founder of UCC, and as a result of the five-year agreement, W&H had exclusive control of UCC’s fundraising and substantial control over UCC’s

benefit.<sup>183</sup> Section 4858 was not applicable to *UCC* because that Code section had not been enacted until 1996. Thus, the only issue before Judge Posner in the Seventh Circuit on appeal was inurement.

Judge Posner rejected the Tax Court's finding of inurement. The Seventh Circuit, while acknowledging that the test of an insider was a functional one, found nothing in the record to support a finding that W&H so controlled *UCC* as to be an insider, so as to constitute inurement.<sup>184</sup> Judge Posner rejected, "singly and together," the Tax Court's reasons for finding that W&H was an insider:

There was no diversion of charitable revenues to an insider here, nothing that smacks of self-dealing, disloyalty, breach of fiduciary obligation or other misconduct of the type aimed at by a provision of law that forbids a charity to divert its earnings to members of the board or other insiders.<sup>185</sup>

Judge Posner, however, did not rule out the possibility that W&H might have become an insider for purposes of inurement if there were a second contract between *UCC* and W&H.<sup>186</sup>

Although neither the Seventh Circuit nor the Tax Court reached the issue of private benefit, Judge Posner remanded to enable the Tax Court to consider private benefit. In so doing, Judge Posner intimated that the facts supported a finding of private benefit resulting from the board's violation of state fiduciary duty:

Remember the I.R.S.'s alternative basis for yanking *UCC*'s exemption? It is that as a result of the contract's terms, *UCC* was not really operated exclusively for charitable purposes, but rather for the private benefit of W&H as well. Suppose that *UCC* was so irresponsibly managed that it paid W&H twice as much for fundraising services as W&H would have been happy to accept for those services, so that of *UCC*'s \$26 million in fundraising expense \$13 million was the equivalent of a gift to the fundraiser. Then it could be argued that *UCC* was in fact being operated to a significant degree for the private benefit of W&H, though not because it was the latter's creature. . . . That in fact is the I.R.S.'s alternative ground for revoking the exemption, the one the Tax Court gave a bye to.<sup>187</sup>

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finances in that W&H controlled the parties' joint escrow account and mailing list, and *UCC* was liable to W&H on a recourse basis for any "draw" from funds generated by W&H's fundraising campaign).

<sup>183</sup> 165 F.3d at 1175.

<sup>184</sup> *Id.* at 1178.

<sup>185</sup> *Id.* at 1176, 1179.

<sup>186</sup> *Id.*

Although Judge Posner stated that the Court would not “prejudge” the Tax Court on remand, and that the facts did not make out the usual private benefit case in which a charity “has dual public and private goals,” the Court noted, in dicta, that UCC’s charitable exemption also might have been jeopardized due to private benefit by the UCC’s Board imprudent and “lax” failure to negotiate the contract, resulting in dissipation of charitable assets, and constituting a violation of a duty of care.<sup>188</sup> Judge Posner’s alternative view of potential private benefit departed from the I.R.S.’s traditional application of the doctrine. This view also would expand the private benefit doctrine arising from the Code and traditionally policed by the I.R.S. , to include state statutory and common law breaches of fiduciary duty, traditionally regulated by state charity authorities and AGs.

Judge Posner ended the opinion with the observation that a charitable board’s violation of a duty of care might “support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity [and] [t]his, for all we know, may be such a case.”<sup>189</sup> Following Judge Posner’s decision, and prior to consideration by the Tax Court on remand, UCC settled with the I.R.S. and the charity dissolved.<sup>190</sup>

Had UCC proceeded to remand, the Court likely would have revoked UCC’s exemption. Legal commentators agree that Judge Posner or the Tax Court, following reconsideration on remand, would have revoked UCC’s federal tax-exempt status under the private benefit doctrine<sup>191</sup> and probably for breach of state fiduciary duty. Nevertheless, even without any decision on remand, Judge Posner’s opinion in *UCC* specifically and firmly links the federal Code violation of private benefit with state law violations of fiduciary duty; this link points to the present need for complete concurrent and cooperative enforcement of charities by federal and state authorities, and the passage of legislation to facilitate cooperative enforcement.

## Intersection of State and Federal Charitable Regulation and the Bishop Estate

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<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> *Id.*

<sup>190</sup> In February 2000, UCC and the IRS agreed that the exemption would be revoked from 1986 to 1990, and that it would stop public fundraising. Jones, *supra* note 13, at 723 n.34.

<sup>191</sup> Ford, *supra* note 176, at 930; Dale, *supra* note 8, at 16; see Jones, *supra* note 13, at 717-18, 720, 727 (stating that “the opinion most clearly indicates that another doctrine—the prohibition against private benefit—should be used to address profit distributions when made to a person who is an outsider. . . [and suggests] punishment should be had under the theory of private benefit,” and observing that the more difficult question for cases less “extreme” than *UCC* is the threshold for when a distribution becomes private benefit) .

In another important example of inurement and private benefit resulting from breach of fiduciary duty, Hawaii's state attorney general, master, and courts ultimately cooperated with the I.R.S. to remove trustees and establish a management plan for the Kamehameha Schools Bernice Pauahi Bishop Estate ("Bishop Estate"). The Bishop Estate was established in 1884 upon the death of Hawaiian princess Bernice Pauhi Bishop, the great-granddaughter of King Kamehameha, who unified and ruled the Hawaiian islands prior to their acquisition as a territory of the United States.<sup>192</sup> At the time, in Hawaii, testamentary trusts were known as "estates," and thus the trust became known as the Bishop Estate.<sup>193</sup>

Bernice Pauahi Bishop's will left the bulk of her estate in trust "to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls, to be known as, and called the Kamehameha Schools."<sup>194</sup> The will specifically appointed five trustees and directed that the trustees could invest the estate at their discretion and use the annual income to operate the schools.<sup>195</sup> Further, she directed that the Hawaii Supreme Court appoint replacement trustees, that they be Protestant, and that teachers be Protestant.<sup>196</sup> Finally, the trust provisions specified "preference to Hawaiians of pure or part aboriginal blood."<sup>197</sup> The schools opened in 1887 and operate to this day.<sup>198</sup>

When the trust started in 1884, it owned land valued at \$470,000. Subsequently, Bernice Puahi Bishop's widower added to the trust,<sup>199</sup> ultimately making the Bishop Estate the largest private landowner in Hawaii.<sup>200</sup> During this century, Bishop Estate trustees breached fiduciary duty by, among other things: accepting excessive compensation; approving reimbursement of trustees' and employees' excessive expenditures, including expenditures that were personal and not related to the Bishop Estate; hiring and payment of attorneys "for work that appeared to benefit individual trustees"; involvement in campaigns; failing to diversify.<sup>201</sup> For example, Bishop Estate trustee Marion Mae Lokelani Maples Lindsey used trust funds for numerous first-class trips to Asia and the mainland, including sixteen trips to Las Vegas, all without any demonstrable tie to the Bishop Estate; Lindsey also ordered Bishop Estate staffer to perform personal errands for herself and her grandchildren.<sup>202</sup> As another example, during the 1990s, trustees approved a bonus equaling an Kamehameha school employee's debt plus any taxes for the bonus, so that the employee

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<sup>192</sup> SAMUEL P. KING & RANDALL W. ROTH, *BROKEN TRUST: GREED, MISMANAGEMENT, & POLITICAL MANIPULATION AT AMERICA'S LARGEST CHARITABLE TRUST* 12-13, 28, 31-32 (Univ. of Haw. Press 2006).

<sup>193</sup> *Id.* at 31-32.

<sup>194</sup> *Id.* at 301.

<sup>195</sup> *Id.* at 31.

<sup>196</sup> *Id.* at 301-02.

<sup>197</sup> *Id.* at 301.

<sup>198</sup> *Id.* at 32; see <http://www.ksbe.edu>.

<sup>199</sup> KING & ROTH, *supra* note 192, at 32.

<sup>200</sup> *Id.*, see [http://en.wikipedia.org/wiki/kamehameha\\_schools](http://en.wikipedia.org/wiki/kamehameha_schools).

<sup>201</sup> KING & ROTH, *supra* note 192, at 195, 231.

<sup>202</sup> *Id.* at 110.

could reimburse Bishop Estate for using a school credit card for “hostess bars” and other personal entertainment.<sup>203</sup> Trustees were paid \$800,000 to \$900,000 annual commissions in 1997.<sup>204</sup>

As the investigations mounted, it became abundantly clear that Bishop Estate trustees, over time, had violated numerous fiduciary duties, perhaps even criminal laws. As the I.R.S. eventually put it, they were treating Princess Pauhi’s legacy like “a personal investment club,” theirs to do with as they pleased, with shockingly little apparent concern about the trust’s charitable mission.<sup>205</sup>

It comes as no surprise that the Bishop Estate was one of the few charities to lobby against enactment of the intermediate sanctions bill that ultimately was enacted in 1996 as § 4958, thereafter exposing Bishop Estate trustees to sanctions. At the same time, public criticism of the trustees was mounting. The I.R.S. began auditing the Bishop Estate in 1995, the same year that the *Wall Street Journal* publicized possible transgressions within the trust. On August 19, 1997, a group that included a federal judge and University of Hawaii professor published a report entitled “Broken Trust” that called for investigation.<sup>206</sup> The next week, the Attorney General began a multi-year investigation that ultimately resulted in numerous court removal proceedings.<sup>207</sup> On December 31, 1998, the I.R.S. issued a Form 5701 alleging that breaches and abuse, or “just about every applicable rule in the Internal Revenue Code,” that would require revocation of the Bishop Estate’s tax-exempt status.<sup>208</sup> Specifically, the Form 5701 said that the Bishop Estate had ceased to serve primarily a charitable function, in part because it paid excessive fees, performed excessive lobbying, accumulated income in violation of the will provisions, and “made improper payments to friends, relatives, business associates, and elected officials.”<sup>209</sup> The I.R.S. accused the trustees of taking “grossly excessive” fees.<sup>210</sup> Ultimately, in 1999, in consideration of the I.R.S. demands and the state’s allegations, Hawaii state courts removed Lindsey and other trustees, and put into place a new trust management procedure.<sup>211</sup>

State courts took action, however, only after the I.R.S. joined the Hawaii Attorney General in issuing demands; when the Hawaii Attorney General brought charges, there

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<sup>203</sup> *Id.* at 220.

<sup>204</sup> *See id.* at 224-25; *see* [http://en.wikipedia.org/wiki/kamehameha\\_schools](http://en.wikipedia.org/wiki/kamehameha_schools).

<sup>205</sup> KING & ROTH, *supra* note 192, at 195.

<sup>206</sup> *Id.* at 1.

<sup>207</sup> *Id.* at 169, 247-53.

<sup>208</sup> *Id.* at 253, 277.

<sup>209</sup> *Id.* at 255-56.

<sup>210</sup> *Id.* at 256.

<sup>211</sup> *Id.* at 168-69, 253-60.

were numerous trials for removal, without much result, until the I.R.S. filed Form 5701.<sup>212</sup> Judge Kevin S.C. Chang’s May 7, 1999 Order removing trustees began and ended by referencing the I.R.S. findings and demands, and ultimately concluded that removal was warranted and in the best interests of the Bishop Estate because, otherwise, the I.R.S. would revoke the trust’s tax-exempt status, resulting in “significant injury and harm” to the Bishop Estate.<sup>213</sup> Had the I.R.S. been required to provide state authorities with information at the beginning of the I.R.S. investigation and audit of the Bishop Estate, then the state courts most likely would have removed trustees earlier, and estate assets would have been preserved.

### Proposals to Enhance State and Federal Charitable Regulation: Increased Transparency and a New Federal Regulatory Entity

Legal scholars long have criticized the inability of state and federal authorities to coordinate in any productive, meaningful way to regulate charities<sup>214</sup> and state and federal oversight as to the non-distribution constraint has been called “lax and inadequate.”<sup>215</sup> Nevertheless, this country’s dual system of state and federal charitable regulation is here to stay for the foreseeable future. Thus, viable proposals to enhance charitable regulation must function within the framework of this dual system of regulation.

Scholars largely posit that additional funding to the I.R.S. and states would result in better charitable regulation<sup>216</sup>; however, in this time of national and, indeed global, economic crisis, additional funding is unlikely.<sup>217</sup> The inability of the I.R.S. and states,

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<sup>212</sup> *Id.* at 253. In fact, the Attorney General was hesitant to act prior to the “Broken Trust” article; Trustee Stender had requested action against other Trustees in 1992 and 1995, but the Attorney General did not act. *Id.* at 264. At the time, Hawaii Supreme Court justices appeared to have appointed trustees based on political affiliation, as opposed to qualifications, and dozens of lawyers in Hawaii who represented the Bishop Estate violated ethics rules by serving the interests of the trustees, as opposed to the trust. *Id.* at 213-14.

<sup>213</sup> *In re Estate of Bernice P. Bishop*, Equity No. 2048 (Cir. Ct. Haw. May 7, 1999) (removing trustees, including that “[o]ne of the nonnegotiable conditions for settlement stated by the IRS involves . . . that the five Incumbent Trustees must resign or be removed, to resolve IRS concerns).

<sup>214</sup> Fremont-Smith, *supra* note 22, at 644; see Silber, *supra* note 86, at 638-39 (suggesting that increasing overlap of state and federal regulation of charities would result in less enforcement and potentially duplicative actions, and advocating against certain provisions of the Pension Protection Act of 2006, and in favor of “formal assignments of primary enforcement responsibilities” to the IRS, and to states, in policing nonprofits). For example, between 1995 and 2002, “charity officials stole or misused over \$1.28 billion from 152 nonprofit organizations. . . , but the organizations recovered less than half that amount while many perpetrators received minor punishments.” Corwin R. Kruse, *Book Review: Sin, Salvation, and the Law of Charities*, 31 WM. MITCHELL L. REV. 383, 284 (2004). Some scholars have recommended as a solution that the IRS or states have primary enforcement authority, while others recommend increase in nonprofit self-regulation, via strengthening of the roles and capacities of boards, internal regulatory standards, accreditation of nonprofits, regulatory efforts of non-governmental “watchdog” organizations, and organizational disclosure and transparency. Sidel, *supra* note 147, at 1333-34. Some scholars recommend independent state charity boards. See FREMONT-SMITH, *supra* note 1, at 375.

<sup>215</sup> Manny, *supra* note 27, at 758.

<sup>216</sup> *Id.* at 757, 761.

<sup>217</sup> *Id.* at 757-58.

separately or together, to police charities properly furthermore is said to result from structural interferences, and not merely from underfunding.<sup>218</sup> Marcus Owens, former director of the I.R.S. Exempt Organization Division, feels that the I.R.S. is “structurally ill suited” to provide “vigorous oversight” to this nation’s nonprofits.<sup>219</sup> If additional funding, even if available, would not necessarily improve federal and state regulation of charities, then one must look to other solutions for proper scrutiny of, and enforcement over, charities.

Undoubtedly, there is no model to ensure complete compliance by all charities:

In a free society, no amount of governmental regulation and oversight, even coupled with vibrant and vigorous self-regulatory initiatives, will prevent all nonprofit fraud, misfeasance, or ineffectiveness.<sup>220</sup>

However, without question, increased transparency certainly would enhance charitable regulation, without any discernable downside. Increased transparency through Internet and other forms of publication of charities’ Forms 990 and financial data recently has enhanced charitable regulation and self-regulation. Professor Jill Manny has suggested, as a possible solution to the discrete problem of excessive compensation, further increasing transparency through additional disclosure by nonprofits, including amendment of §170(f) to require that charities submit in their written acknowledgment of donations a copy of their Forms 990 and/or a list of amounts paid by the charities to highly-compensated persons.<sup>221</sup> Inasmuch as charities now frequently provide such donation receipts via electronic mail, there is no undue burden on charities in including a Form 990 and list of salaries of highly-compensated persons.

Further, of the various proposals to enhance charitable regulation, one proposal by Marcus Owens seems most viable, particularly given the climate of the current administration. Mr. Owens forcefully argues in favor of creation of a new “quasi-public/private entity” federal entity to oversee nonprofits.<sup>222</sup> The climate seems right to propose this new federal entity for nonprofit regulation; President Obama currently is urging the creation of a new Consumer Financial Protection Agency (“CFPA”) to oversee

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<sup>218</sup> Owens, *supra* note 1, at 5-9.

<sup>219</sup> *Id.* at 2.

<sup>220</sup> Fishman, *supra* note 127, at 593, *quoting* Harvey P. Dale & Jill S. Manny, Draft Study on Models of Self-Regulation in the Non-Profit Sector (2005)(unpublished manuscript, on file with Nat’l Ctr. on Philanthropy & the Law at New York Univ. Sch. of Law). See Silber, *supra* note 86, at 633, 636-38 (stating that greater “coextensive” regulation may result in “inadequate attention to poor performance” and rather than state and federal officials being able to “pass the ball,” that “the ball may be dropped”).

<sup>221</sup> Manny, *supra* note 27, at 761.

<sup>222</sup> Owens, *supra* note 1, at 2..

and police financial institutions,<sup>223</sup> and therefore the creation of an analogous, new “quasi-public/private entity” to oversee charities is not a far leap.

In his 2006 paper, Mr. Owens generally notes concerns about the inefficiencies and lack of “adequacy and sophistication of oversight of the tax-exempt sector, and charities in particular.”<sup>224</sup> He specifically identifies challenges to I.R.S. oversight, including: inadequate funding, with the number of nonprofits growing and I.R.S. staffing and resources falling or remaining stagnant; civil service constraints limiting salaries for senior personnel; institutional constraints of the I.R.S.’s primary functional role of tax collection; and I.R.S. reliance on the Code for authority to regulate.<sup>225</sup> Because of the breadth of these limitations, any increased funding to the I.R.S. would not produce the type of holistic oversight necessary.<sup>226</sup>

Thus, Mr. Owens strongly urges a new federal quasi-public/private entity that would work alongside the I.R.S.<sup>227</sup> He envisions this new federal entity to be similar in structure and function to the National Association of Securities Dealers (“NASD”), or FINRA, in that the new entity would assist the I.R.S., much as FINRA assists the Securities and Exchange Commission agency, in regulating and enforcing member charitable organizations.<sup>228</sup> Congress could charter the organization as a nonprofit, to ensure exemption from income tax and deductibility of contributions; could give the nonprofit rule-making and enforcement powers; and could provide for an independent governing body.<sup>229</sup> The new entity, as envisioned by Mr. Owens, could be funded in part by nonprofits’ membership fees<sup>230</sup>; user fees; application fees<sup>231</sup> if the new entity were authorized to process

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<sup>223</sup> The funding mechanism for the CFPA has been widely applauded; the CFPA would be funded by financial institutions that it would oversee, and perhaps other Wall Street firms. Luke Mullins, *How Obama’s Consumer Protection Agency is Rattling Bankers*, US NEWS & WORLD REPORT, June 18, 2009, <http://www.usnews.com/blogs/the-home-front/2009/06/18/how-obamas-consumer-protection-agency-is-rattling-bankers.html> (last visited Oct. 7, 2009).

<sup>224</sup> Owens, *supra* note 1, at 3, 15..

<sup>225</sup> *Id.* at 5-9.

<sup>226</sup> *Id.* at 10.

<sup>227</sup> *Id.* at 3.

<sup>228</sup> *Id.* at 11-13 (noting that this new entity would be chartered by Congress under section 501(c)(1), and Congress would amend the Code to facilitate funding by member charities, and to increase disclosure between the IRS and the entity; the new entity further would be governed by an independent body appointed by the IRS and National Association of Attorneys General). Prof. Joel Fleishman also supports this concept of a new quasi-public nonprofit organization, as opposed to his former proposal of a new agency, to regulate charities. There are academics that are skeptical as to the efficacy of a new organization to regulate charities; for example, Prof. Fishman is doubtful that the IRS, with its other responsibilities, would be able to oversee such a new organization, as opposed to the SEC’s ability to oversee FINRA. Instead, Prof. Fishman recommends creation of volunteer state advisory charity commissions, supervised by state AGs. This notion of volunteer citizen charity commissions being supervised by AGs, however, seems unrealistic given the vast number of states lacking any charity officials and the dearth of personnel and expertise in the states, perhaps with the exception of California and New York, to regulate charities. Fishman, *supra* note 127, at 591-94.

<sup>229</sup> Owens, *supra* note 1, at 11-13..

<sup>230</sup> Assuming only 1.7 million tax-exempt organizations as of 2010, with mandatory annual membership fees on a sliding scale from \$100, \$300, \$500, \$750, and \$1000 (averaging \$300), \$500 million in mandatory fees easily could be charged per year. By

applications; private deductible donations; and private sector funding through amendment of § 4940 to permit credit against the excise tax on net investment income for payments made to the entity.<sup>232</sup>

In addition to Marcus Owens, other practitioners, scholars, associations, and charities themselves have voiced the need for a new entity to regulate charities.<sup>233</sup> Most scholars and practitioners have suggested creation of a new agency to regulate charities. For example, in the 1970s, “the Filer Commission report contained proposals for alternative regulatory schemes.”<sup>234</sup> In 2004, the National Council of Nonprofit Associations suggested a “Small Business Administration-like agency for nonprofits.”<sup>235</sup> In a 2006 speech before the Nonprofit Congress, Mark Lloyd, senior fellow with the Center for American Progress in Washington, expressed surprise that “an economic sector as large as nonprofits” was not regulated by a federal entity with expertise in that sector, and advocated in favor of “one agency that understood what charitable organizations and civic organizations do and to oversee intelligent rulemaking of the sector.”<sup>236</sup> A new federal agency or part of an existing agency, however, might be plagued by the same institutional, civil service, structural and funding challenges now faced by the I.R.S.<sup>237</sup> and the states. Therefore, Mr. Owens’

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comparison, the NASD regulated “trading in equities, corporate bonds, securities futures, and options, with authority over the activities of more than 5,100 brokerage firms, approximately 173,000 branch offices, and more than 676,000 registered securities representatives. “ The NASD had a staff of nearly 3,000 and an annual budget of more than **\$500 million**, “funded primarily by assessments of member firms’ registered representatives and applicants, annual fees paid by members, and by fines.” The SEC’s budget for 2008 was \$906 million. [http://www.sec.gov/2008annual/SEC\\_2008annual\\_financial.htm](http://www.sec.gov/2008annual/SEC_2008annual_financial.htm) (last visited Oct. 6, 2009). By comparison, the NASD regulated “trading in equities, corporate bonds, securities futures, and options, with authority over the activities of more than 5,100 brokerage firms, approximately 173,000 branch offices, and more than 676,000 registered securities representatives. “ The NASD had a staff of nearly 3,000 and an annual budget of more than **\$500 million**, “funded primarily by assessments of member firms’ registered representatives and applicants, annual fees paid by members, and by fines.” The SEC’s budget for 2008 was \$906 million. [http://www.sec.gov/2008annual/SEC\\_2008annual\\_financial.htm](http://www.sec.gov/2008annual/SEC_2008annual_financial.htm) (last visited Oct. 6, 2009).

<sup>231</sup> As to the increase in I.R.S. filing fees in 2010, see <http://www.irs.gov/charities/article/0,,id=212562,00.html> (last visited Oct. 5, 2009).

<sup>232</sup> Owens, *supra* note 1, at 2, 11-14.

<sup>233</sup> See, e.g. Jonathan Click & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey’s Kiss-Off*, 108 COLUM. L. REV. 749, 818 (2008)(suggesting a nonprofit organization); Fishman, *supra* note 127, at 567, 590 (noting that over forty-five years earlier, Prof. Kenneth Karst suggested state boards of charities; Prof. Fleishman “urged the creation of a new federal regulatory agency for policing the nonprofit sector”); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593 (1999), citing Mary G. Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993)(discussing creation of federal or state commission for charitable oversight); Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 482 (1996)(suggesting permanent national supervisory agency). In addition, some think that a single trial tax court and a single appellate tax court would eliminate the unfairness and inefficiency of multiple tax fora. See, e.g. LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE 296 (LexisNexis 2002).

<sup>234</sup> Fremont-Smith, *supra* note 122, at 641.

<sup>235</sup> M. Z. Hemingway, *Nonprofit Leaders Propose a New Agency*, Nov. 24, 2006, <http://federaltimes.com/index.php?S=2376194>; see <http://philanthropy.com/news/philanthropytoday/1585/nonprofit-leaders-push-for-a-new-federal-agency>.

<sup>236</sup> Hemingway, *supra* note 235.

<sup>237</sup> Owens, *supra* note 1, at 2.

proposed structure of a quasi-public private entity seems more likely to succeed in better regulating charities, especially in the current economic climate.<sup>238</sup>

### Increased Cooperation between Federal and State Authorities

Consistent with these proposals and the present dual system of nonprofit regulation, many scholars and experts support increased cooperation between state and federal charity authorities to enhance charitable regulation. Professor Fremont-Smith<sup>239</sup> and Marcus Owens<sup>240</sup> both have suggested that the Code be amended to facilitate increased communication and cooperation between the I.R.S. and state authorities.<sup>241</sup> Prior to enactment of the 2006 Pension Protection Act, the Panel on the Nonprofit Sector recommended increasing exchange of information between the I.R.S. and state regulators.<sup>242</sup> For example, §6103 “effectively precludes” information sharing and close cooperation between state charity authorities and the I.R.S.,<sup>243</sup> and thus, as Professor Jill Manny notes, “state charities officials suffer from lack of information.”<sup>244</sup> Section 6104(c) currently states a narrow exception to this rule in §6103, and authorizes the I.R.S. to provide information about proposed actions against charities under a narrow set of circumstances.<sup>245</sup>

In addition to cooperation between the I.R.S. and state charity authorities, Professor Manny urges a “unified standard and compliance regime” for charitable oversight.<sup>246</sup> To

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<sup>238</sup> Some argue against a new entity. Prof. Fremont-Smith, for example, has argued in favor of maintaining regulation with the IRS on the basis that the IRS has become more responsive to needs of nonprofits, and its “record . . . in resisting political pressures, despite challenges to the contrary, has been unusually unblemished.” Prof. Fremont-Smith also pointed to the lack of “guarantee” that a new agency would be able to maintain this degree of independence, “an advantage that should not be lost.” FREMONT-SMITH, *supra* note 1, at 465-66. Prof. Silber has expressed concerns regarding lack of charitable supervision resulting from overlapping state and federal jurisdiction, Silber, *supra* note 86, at 638.

<sup>239</sup> Prof. Fremont-Smith has advocated for “the ability of federal and state regulators to communicate freely on pending matters so that their efforts are complementary.” FREMONT-SMITH, *supra* note 1, at xiv (noting, however, that greater information sharing with states is effective only insofar as the states actively regulate); Fremont-Smith, *supra* note 22 at 638 (concluding that the “need for greater understanding and cooperation between state attorneys general and the IRS was highlighted in U.S. Trust Co. v. Attorney General,” a 2006 Massachusetts Supreme Judicial Court case where the Court misunderstood federal and state laws applicable to a trust).

<sup>240</sup> Owens, *supra* note 1, at 12-13.

<sup>241</sup> Prof. Fremont-Smith also advocates for greater funding to regulatory authorities, and removal of protection accorded fiduciaries, points with which this paper does not disagree. See FREMONT-SMITH, *supra* note 1, at 471.

<sup>242</sup> See Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* at 39-48 (2005), [http://www.nonprofitpanel.org/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf).

<sup>243</sup> Owens, *supra* note 1, at 8, 13..

<sup>244</sup> Manny, *supra* note 27, at 758.

<sup>245</sup> Silber, *supra* note 86, at 630; Carter G. Bishop, *supra* note 162, at 704, 710 (stating that the “combination of state law duty and federal liability and detection appears to be the most efficient and best model” for enforcement of fiduciary duty). See Brody, *supra* note 162 (noting that, following the IRS’s “non-negotiable” threat that unless all five trustees resigned or were removed, the IRS would move for revocation, one trustee resigned and four were removed and advocating for IRS sharing of information with state attorneys general, as recommended by a 2000 study by the staff of the Joint Committee on Taxation).

<sup>246</sup> Manny, *supra* note 27, at 758.

accomplish this, states should enact legislation to facilitate cooperation with the I.R.S.; Professor Manny suggests, for example, that states enact legislation paralleling § 4958.<sup>247</sup>

### Amendment of § 6104

Section 6103 “effectively shields information regarding a tax-exempt organization’s behavior from public scrutiny until the behavior is so violative of federal tax rules that exempt status is revoked,”<sup>248</sup> and prohibits the I.R.S. generally from sharing tax returns and related information with state officials. See §6103(a), (b). Section 6104(c) carves a narrow exception by generally allowing the I.R.S. to notify states of its refusal to grant or its revocation of a nonprofit’s exemption and, under certain circumstances, of proposed actions relating to charities.<sup>249</sup>

Specifically, § 6104(c)(1) directs the I.R.S. , “at such times and in such manner as [the Secretary] may by regulations prescribe” to (A) “notify the appropriate State officer of a refusal to recognize” an organization’s 501(c)(3) status, “or of the operation of such organization in a manner which does not meet, or no longer meets, the requirements of its exemption”; (B) “notify the appropriate State officer of the mailing of a notice of deficiency”; and (C) “*at the request of* such appropriate State officer, make available. . . filed statements, records, reports, and other information relating to a determination under subparagraph (A) or (B) as are relevant to any determination under State law.” § 6104(c)(1)(emphasis added).

Furthermore, if § 6104(c)(1) applies, then only “upon written request by an appropriate State officer,” § 6104(c)(2)(A) allows, but does not require, the I.R.S. to “disclose to the appropriate State officer” (i) “a notice of proposed refusal to recognize” an organization as described under § 501(c)(3), “or a notice of proposed revocation of” exempt status; (ii) “issuance of a letter of proposed” tax deficiency; (iii) “the names, addresses, and taxpayer identification numbers of organizations which have applied for recognition as organizations described in section 501(c)(3).” § 6104(c)(2)(C). Along with any of this information, and again only “upon written request of an appropriate State officer,” § 6104(c)(2)(C), the I.R.S. is allowed, but not required, to provide to the appropriate State officer the returns and return information of such organizations. § 6104(c)(2)(B).

Section 6104(c)(2) similarly authorizes, but does not require, the I.R.S. to disclose to an appropriate State officer (i) a “notice of proposed refusal to recognize” an organization under § 501(c)(3) or “a notice of proposed revocation of such organization’s recognition” as

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<sup>247</sup> *Id.*

<sup>248</sup> Owens, *supra* note 1, at 12-13.

<sup>249</sup> I.R.C. § 6104(c)(1), (2); see Crimm, *supra* note 2, at 6.

exempt; (ii) “the issuance of a letter of proposed deficiency”; and (iii) “names, addresses, and taxpayer identification numbers of organizations which have applied for recognition” under § 501(c)(3). § 6104(c)(2)(A). “Returns and return information” of these organizations may be made available to State officers. §6104(c)(2)(B). As to all of these documents and information, the I.R.S. may be disclosed “*only (i) upon written request by an appropriate State officer, and (ii) for the purpose of, and only to the extent necessary in, the administration of State laws regulating such organizations.*” §6104(c)(2)(C)(emphasis added).

Otherwise, if there is no request, the I.R.S. may make available or disclose returns and return information to a State officer if the I.R.S. “determines that such returns or return information may constitute evidence of noncompliance under” state laws. §6104(c)(2)(D). Section 6104(c)(3)(A) exempts from disclosure §501(c)(3) organizations contributors. Thus, while §6104(c) authorizes the I.R.S. to share information about charities with state authorities,<sup>250</sup> the I.R.S. is not required under the statute to disclose any information or documents regarding a charity unless it does not qualify for exempt status and, even if so, the ability of the I.R.S. to disclose such information or documents is circumscribed.

The Pension Protection Act amendments to §6104 and related sections took a significant step in the direction of complete coordination between federal and state charity authorities; the 2006 amendments essentially made precatory, but not mandatory, I.R.S. disclosure to appropriate State officers of “proposed actions regarding charities.”<sup>251</sup> Section 6104, prior to the 2006 amendments, included the general rule for publication to state officials regarding an organization’s failure to meet the requirements for exemption.<sup>252</sup> The Act added the present §6104(c)(2) through (6), including provisions regarding the I.R.S.’s proposed position that an organization is not exempt, and including stringent provisions regarding requests by state officers, and disclosure by the I.R.S.

An efficient and immediate solution to better charitable regulation, however, is to provide for complete exchange of information about charities between federal and states authorities, thus enhancing cooperation between them so that they can better regulate

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<sup>250</sup> Then-Assistant Commissioner of the I.R.S. For Employee Plans and Exempt Organizations, Alvin D. Lurie, stated at the time in support of § 6104(c):

[W]e see our regulatory powers as inextricably entwined with those of the states. The Internal Revenue Service makes tax exemption determinations, and monitors compliance with them. However, when a violation is discovered, the ability to invoke the jurisdiction of an equity court, with its broad and adaptable powers, is uniquely the province of the states.

Crimm, *supra* note 2, at 6.

<sup>251</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, § 1224, 120 Stat. 780, 1091-92 (2006)(codified in 26 U.S.C. § 6104)

<sup>252</sup> § 6104(c)(2); *see* 26 U.S.C.A. § 6104(c)(1), (2) (West 2005).

charities. In this regard, Congress should amend §§ 6104(c) and 6103 to require, rather than simply allow, the I.R.S. to provide state officers with any and all information about potential revocation of exemption and notices of deficiency, or about potential noncompliance with state or federal laws. Section 6104(c)(2) should be amended to eliminate any requirement that a state officer request information. There should be no proscription on the type of information exchanged between the I.R.S. and state authorities.<sup>253</sup> Finally, as to the proposal by Marcus Owens to create a new federal charitable regulatory entity, the Code could be amended to allow complete sharing of information about charities between the I.R.S. , this new federal entity, and states.<sup>254</sup>

Even if any sharing of information between federal and state officials were to result in disclosure to parties other than those regulating charities, any impact on charities and entities applying for exempt status would be *de minimus*; increasingly, charities' financial information is disclosed, disseminated and publicized through Internet sites and otherwise. The current amended version of Form 990 reflects this trend of increasing disclosure of information about charities. This transparency is only increasing. Indeed, for these reasons, state and federal officials, along with charities themselves, have called for greater information sharing between the I.R.S. and states.<sup>255</sup> Thus, the Code should be amended to provide for complete disclosure of information between federal and state charity officials, in order to achieve enhanced charitable regulation.

## Conclusion

This nation's system of dual federal and state charitable regulation, although criticized as insufficient and ineffective, will continue for some time. The most economic, efficient, and logical way to enhance regulation of charities, particularly during this time of economic crisis<sup>256</sup> and budgetary constraints, is to facilitate complete coordination and exchange of information between federal and state authorities. Accordingly, Congress should act as soon as practicable to amend § 6104 and related sections to require the I.R.S. to share with state authorities any information about charities and applicants for exempt status under §

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<sup>253</sup> The I.R.S. has spent much time and energy devising guidelines for, and explanations of, requests by state officers, and disclosure by I.R.S. officials, and then stating these guidelines through publications, including training manuals, and regulations such as Treas. Reg. § 301.6104(c)-1.

<sup>254</sup> Amendment of the Code, so that federal and state authorities could thus share information about charities, would not be adverse to the privacy concerns that gave rise to § 6103, that apply with greater force to individuals and their income tax return information, than to charities, and entities applying for exempt status. See Silber, *supra* note 86, at 630.

<sup>255</sup> See *e.g. id.*, citing the CARE Act, S. 1780 (2005) ("containing provisions that would amend the Internal Revenue Code of 1986, as amended, to authorize disclosure by the Internal Revenue Service to state charity regulators of information about organizations that have applied for, received, or been denied exemption from federal income tax or which have been the subject of adverse action by the Internal Revenue Service"); STAFF OF S. COMM. ON FIN., 108<sup>TH</sup> CONG., STAFF DISCUSSION DRAFT, at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

<sup>256</sup> During these economic times, it is unlikely that legislatures will fund new agencies, and it is unlikely that citizens will volunteer for commissions, to regulate charities.

501(c)(3). Likewise, states should be obligated to share any information about charities with the I.R.S. and should enact legislation paralleling federal Code provisions to ensure a uniform standard for charity compliance and regulation.<sup>257</sup>

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<sup>257</sup> Manny, *supra* note 27, at 758.