Government Regulation of Nonprofit Fiduciaries

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The subject of this book is the methods society has adopted to hold trustees and directors of nonprofit organizations accountable, how the rules that govern their behavior evolved, their effectiveness and how they might be improved.

Chapter 1. The Charitable Sector Today

This chapter contains a description of the current status of the charitable sector, including statistics about its size, composition and relative place in the United States economy. It describes efforts to achieve self-regulation. It also includes a survey of seven years of newspaper accounts of "scandals" in the sector, compiled in an attempt to assess the degree of wrong-doing and thus the need for changes in the regulatory scheme.

Chapter 2. History of the Law of Charity

Charity had a role in the earliest of recorded societies and the historic data is summarized in a brief introduction that includes a section on Islamic foundations. The concept of privately operated institutions "lessening the burdens of government", which was the rationale used during the middle ages in England for encouraging the creation of charitable trusts, was unique to that country and provided the precedents for our support and regulation of the sector. The early formulations of the laws applicable to charitable trusts and the role of the attorney general in supervising their operations are summarized, together with a brief summary of current regulation in Great Britain.

The chapter then describes developments in the United States where individual states diverged in their treatment of charitable trusts and corporations; the enactment of the first federal tax laws with their exemption for charities, and the subsequent attention of Congress to their organization and operation.

The latter part of the chapter describes the major changes in charity law and regulation since the middle of the 20th century at the state and federal levels, including accounts of the major Congressional investigations of charities and changes in the laws that followed, from the private foundation provision of 1969, the debate over granting exemption to private segregated schools and competition with small businesses, to the recently enacted Victims of Terrorism Tax Relief Act of 2001.

Chapter 3. Legal Forms for Charities: Administrative Duties and Powers of Fiduciaries

This chapter starts with a description of the purposes considered under the common law to be "charitable" in the broad sense of that word. These purposes still form the basis for the definition of "charity" under state and federal tax and substantive laws. They are described in the light of contemporary public policy considerations, particularly prohibitions against discrimination.

The second section of this chapter describes the rules governing the creation and administration of charitable trusts, the original form of organization, but one that has given way in large part to that of the nonprofit corporation. The trust rules are included to assist in understanding of the development of the rules applicable to corporations. The remainder of this section describes state law requirements for creating corporations, methods for amending charters, merging organizations, and a description of the administrative duties and powers of directors and officers.

The final section of the chapter describes the rules under which changes in purposes are permitted under the legal doctrines of cy pres and deviation together with critiques of their present formulations.

Chapter 4. Holding Charities Accountable: Fiduciary Standards under State Laws

Trustees and directors of charitable organizations are subject to two substantive duties designed to assure their accountability: a duty of loyalty and a duty of care. In the last fifty years there has been a reformulation of these duties as applied to directors of charitable corporations. Where once the same rules applied to charities regardless of their legal form, the rules applicable to directors have been markedly relaxed, a change that tracked changes in the laws applicable to business corporations. Today, the rules for directors of charities in the majority of the states are the same as those applicable to their for-profit counterparts and, in some states, directors of charities have been provided almost total relief from liability. This has been a largely unremarked development, and the study includes summaries and comparisons of the new requirement in each of the various states.

Another recent development described in detail is the adoption in all but a handful of states of a "Modern Prudent Investor Rule" governing investment of assets. It requires fiduciaries to apply modern portfolio theory to their investment policies, a major change in the laws governing the management of their assets.

Chapter 5. Holding Charities Accountable: Fiduciary Standards in the Internal Revenue Code

The importance of the provisions in the Internal Revenue Code governing the behavior of fiduciaries of tax-exempt charitable organizations cannot be overemphasized, as it is these rules that are, effectively, the only ones enforced in all but a handful of states. The chapter contains descriptions of the federal standards, found in the first instance in the description of organizations eligible for both tax-exemption and receipt of contributions deductible by their donors that appears in section 501(c)(3) of the Internal Revenue Code. These requirement as expanded in the Regulations and court cases include prohibitions against private inurement and private benefit, prohibitions not dissimilar to the state law duties of loyalty and care.

The federal requirements were further tightened for private foundations in 1969 in the form of amendments to the Code penalizing certain foundation managers and donors for entering into certain self-dealing transactions. In 1996, the Code was again amended to extend the prohibitions against self-dealing to the remaining universe of tax-exempt charities. These provisions are set forth in detail.

Chapter 6. Agencies for State Supervision

This chapter contains descriptions of the various agencies of state government that form the regulatory scheme for charities. It starts with the courts, which have broad equity powers to correct abuses of fiduciary duties, and describes the special role of the attorney general who, in each state, is given nearly exclusive power to bring suits against fiduciaries. Included is a description of the rules of "standing" which in effect prohibit members of the general public from enforcing fiduciary behavior. The exceptions to the rule under which certain limited groups of individuals, such as co-fiduciaries, may exercise enforcement powers is described, together with a summary of scholarly criticism of the doctrine of exclusive standing.

A brief description of other state agencies with enforcement powers, such as state tax officials, is included, but the major focus is on the attorney general. Efforts to enhance the power of that office, initiated primarily in the 1960's and described in detail in my earlier work, Foundations and Government, are summarized, with emphasis on programs in the few states that currently are have active enforcement programs. The chapter concludes with a critique of state efforts.

Chapter 7. Agencies for Federal Supervision

The Internal Revenue Service, in contrast to the state's attorneys general, has broad regulatory powers over tax-exempt

charities, and this chapter contains a description of the manner in which the Service is organized to exercise these powers. It includes changes made in the 1980's to improve the operations of the Exempt Organization branch of the Service, changes that were further revised in the late 1990's. Included are the process by which regulations and rulings are issued, efforts by the Service to educate exempt organizations and their attorneys and accountants, and programs designed to improve reporting procedures. The use of "settlements" to resolve cases as an alternative to lengthy court trials is described, as are the methods by which the Service is implementing the 1996 Excess Benefits limitations.

Chapter 8. Achieving Accountability: Options and Recommendations

This Chapter starts with a summary of the current status of the law, and the shortcomings described in the preceding chapters. It reviews suggestions in the literature to improve both the substantive laws and enforcement procedures. Included are descriptions and critiques of proposals to move the power of the Internal Revenue Service to a separate federal agency, and suggestions for merging state and federal enforcement. It concludes with an assessment of the likelihood that changes will be adopted, noting particularly the reluctance of state legislatures and the Congress to impinge significantly on the freedom of operation accorded to charities.

Appendix.

Included are three tables summarizing data from each state and the District of Columbia. The first contains statutory and case references to the laws that set forth the duties of charitable fiduciaries and the administrative rules under which they operate. The second contains citations to the sources of regulatory powers in each state and the registration and reporting requirements for charitable organizations in those states. The third contains information on the cy pres doctrine in each state. The remaining portion of the Appendix will contain references, cases and statutes.

DRAFT 12/9/02

EXCERPT FROM

GOVERNMENT REGULATION OF NONPROFIT FIDUCIARIES

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CHAPTER 2

HISTORY OF THE LAW OF CHARITIES

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CONGRESSIONAL ACTIVITY AFTER TRA 1969

No issues relating to exempt organizations have received the same degree of interest and attention from Congress as that generated by the Patman investigations. Nor has any lasted as long or produced as much printed information. Of the issues that have been the subject of Congressional investigations and hearings in the years between 1970 and 2002, private foundations remained on the agenda, joined by consideration of political and lobbying activities, competition with small business, audit of churches, and discrimination by private schools.

Private Foundations

The impact of the Tax Reform Act of 1969 on private foundations was the subject of extensive hearings before the Subcommittee on Foundations of the Senate Finance Committee in

1974 and 1976,[1] and led to the amendment of section 4940 to reduce the excise tax on foundation income from 4% to 2%[2] as well as to change the payout rate for foundations to a fixed 5% of asset value.[3] The House of Representatives also reviewed the effect of the Tax Reform Act of 1969 on private foundations in 1983, but no additional legislative enactments ensued.[4] No investigations have been conducted as to their activities and it was generally believed that the provisions of the 1969 Act had corrected the abuses perceived by Congress at the time.

Lobbying by Public Charities

Political activities and lobbying received Congressional attention in the mid 1970's. The limitations on lobbying were the subject of hearings in the House in 1972 and 1976[5] and in the Senate in 1976.[6] At issue was the imprecision of the Code provision prohibiting public charities from engaging in

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[1] Private Foundations: Hearings Before the Subcommittee on Foundations of the Senate Committee on Finance, 93d Cong., 2d Sess. (1974); Impact of Current Economic Crisis on Foundations and Recipients of Foundation Money: Hearings Before the Subcommittee on Foundations of the Senate Committee on Finance, 93d Cong., 2d Sess (1974); Tax Reform Act of 1975, Part 5: Hearings Before the Senate Committee on Finance, 94th Cong., 2d Sess. (1976).

[2] Revenue Act of 1978, Pub. L. No. 95-600, §520(a), 92 Stat. 2763, 2884 (1978).

[3] Tax Reform Act of 1976, Pub. L. No. 94-455, §1303, 90 Stat. 1520, 1715 (1976).

[4] Tax Rules Governing Private Foundations, Part 1: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 98-32, 98th Cong., 1st Sess. (1983); Tax Rules Governing Private Foundations, Part 2: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 98-33, 98th Cong., 1st Sess. (1983).

[5] Legislative Activity By Certain Types of Exempt Organizations: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, 92d Cong., 2d Sess. (1972); Influencing Legislation By Public Charities: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, 94th Cong., 2d Sess. (1976).

[6] Tax Reform Act of 1975, Part 7: Hearings Before the Senate Committee on Finance, 94th Cong., 2d Sess. (1976).

substantial lobbying. The outcome was the enactment of section 501(h) which permits public charities other than churches to elect to have an expenditure test apply to determine compliance with the "substantial" test.[7] The act also attempted to close a perceived loophole by prohibiting an organization that lost its exemption under section 501(c)(3) from obtaining exemption under section 501(c)(4).[8]

In 1987, the Senate Subcommittee on Oversight reconsidered the effectiveness of the limitation on lobbying by public charities and the provisions of section 501(h).[9] This led to a consensus within Congress that they were ineffective in curbing these activities by certain organizations and that the sanction of revocation of exemption for an isolated political campaign activity was in some instances too harsh, while for some organization it was meaningless in that they would disband in all events after the campaign they were formed to support or oppose was concluded. The outcome was enactment of section 4912, which imposed excise taxes on organizations and their managers for the year in which the organization lost its exemption by reason of having conducted substantial lobbying.[10]

Unfair Competition with Small Businesses

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[7] Tax Reform Act of 1976, Pub. L. No. 94-455, §1307(a), 90 Stat. 1520, 1720-1721 (1976).
[8] Tax Reform Act of 1976, Pub. L. No. 94-455, §1307(a)(2), 90 Stat. 1520, 1721-1722 (1976), I.R.C. §504.
[9] Lobbying and Political Activities of Tax-Exempt Organizations: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 100-15, 100 Cong., 1st Sess., (1987).
[10] Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §10714(a), 101 Stat. 1330, 1330-470 to -472 (1987); I.R.C. §4912.

Allegations of unfair competition between charities and small businesses received the attention of Congress during the 1980's. This interest was generated by reports from the Small Business Administration to the effect that charities were benefiting unduly at the expense of small businesses. In September of 1986, the Chairman of the Ways and Means Committee requested Congressman J.J. Pickle, Chairman of the Subcommittee on Oversight to conduct a comprehensive review of the tax treatment of commercial and other income producing activities of tax exempt organizations. The subcommittee issued a set of 16 questions which it termed its framework for review and it commissioned the GAO to provide information on the competition issue.

The results of the GAO study appeared in a Briefing Report that was made public in February of 1987.[11] It served as a resource during hearings held by the Subcommittee on Oversight over five days in June of 1987.[12] Nearly a year later, on March 31, 1988, the subcommittee released a set of preliminary discussion options relating to the unrelated business income tax and requested public comments.[13] They included substitution of a "directly related" test for the current "substantially related"

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[11] General Accounting Office, *Competition Between Taxable Businesses and Tax-Exempt Organizations* (GAO/GGD-87-40BR) (February 1987).
[12] The Unrelated Business Income Tax, Parts 1-3: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 100-26, 100-27, 100-28, 100th Cong., 1st Sess. (1987).
[13] Subcommittee on Oversight, House Committee on Ways and Means, Press Release #16 (March 31, 1988); see also Subcommittee on Oversight, House Committee on Ways and Means, *Report on Recommendations on the Unrelated Business Income Tax (UBIT)*, 100th Cong., 2d Sess. (1988).

one, determining whether each income producing activity standing alone was tax exempt, or retaining the current test but imposing tax on 12 specific activities "whose nature and scope are inherently commercial, rather than charitable." Each of the 12 had been the target of a segment of the business community. Ten options were suggested that dealt with other aspects of the UBIT provisions, and the report concluded with recommendations to meet the need for increased reporting and improved IRS administration. The Subcommittee reported receiving over 400 comments which were subsequently made public.[14]

The final report of the Pickle subcommittee contained a detailed review of the current law, summarized testimony from the hearings and public comments, giving particular attention to the Treasury's recommendation that the existing form of the tax be retained, while increasing IRS oversight and making technical changes to the law in connection with the allocation of expenses, the definition of a controlled subsidiary, exclusions from income for research activities and from partnerships.[15]

The report concluded that the "substantially related" test to determine which business activities would not be subject to income tax should be retained and that additional studies based on better reporting and meaningful data were needed before there was a major overhaul of the law, but that in the meantime certain areas could be clarified and strengthened. Among the activities

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[14] Subcommittee on Oversight, *Report on Recommendations on the Unrelated Business Income Tax (UBIT)*.
[15] Id.

that were targeted as needing attention were gift shops, bookstores, catalog and mail order activities, activities related to sale of medical equipment and devices, drugs and laboratory testing, fitness activities, travel and tour services, ancillary food sales, veterinary activities, hotel facility activities, sales of condominiums and time-sharing units, affinity credit cards and similar merchandise, and theme or amusement park activities. In addition, the subcommittee recommended repeal of the convenience exception, modification of the royalty exclusion and expansion of the definition of control for purposes of taxing income of a subsidiary. Other changes related to the allocation of expenses and the computation of advertising income. Improved regulation by the IRS, increased and improved reporting provisions, and more accurate disclosure of nondeductibility of return benefit payments by donors were also supported.[16]

Despite the amount of attention to the issue of competition and the effectiveness of the UBIT provisions, Congress took no immediate action in response to the recommendations of the subcommittee. During the ensuing years, legislation was passed to modify the rules relating to corporate sponsorships and sales and exchange of mailing lists. It was not until 1997, however, that the standard for determining control of a taxable subsidiary was changed as recommended by the Pickle subcommittee.[17] During the

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[16] Id.

[17] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1041(a), 111 Stat. 788, 938-939 (1997); I.R.C. §512(b)(13)(D).

interim, as described below, the IRS did respond to almost all of the other issues raised by the subcommittee.

Corporate Sponsorships: The issue of whether payments by business to charities in exchange for public acknowledgment of the payment came to public attention during the 1980's after the Service held that payments for the right to sponsor certain college athletic events, including the Mobil Cotton Bowl and the John Hancock Bowl were for advertising rights subject to the tax on unrelated business and not charitable contributions as the donors claimed.[18] Affected companies and charities turned to Congress to obtain legislation exempting these payments from tax, but a provision to this effect enacted in 1992 was vetoed. The Service then issued proposed guidelines designed to clarify the circumstances under which sponsorship payments would be taxable and followed this with a Proposed Regulation 1.513-4 that followed the guide lines in most respects. Before the regulation was made final, Congress enacted a new section 513(i) that contained more lenient standards for determining exemption from tax.[19] New proposed regulations reflecting the amendment changes were issued on January 22, 1993, but again were subjected to severe criticism.[20] Final regulations, which were not issued until

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[18] Priv. Ltr. Rul. 91-47-007 (August 16, 1991); Priv. Ltr. Rul. 92-31-001 (October 22, 1991).
[19] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §965, 111 Stat. 788, 893-894 (effective after December 31, 1997); I.R.C. §513(i).
[20] 58 Fed. Reg. 5,687 (1993).

April of 2002, were responsive to the protests from the affected organizations.[21]

Royalties: Another issue which garnered Congressional attention and was resolved only after passage of legislation was the taxation of mailing list rentals and exchanges. As with sponsorship payments, the Service took the position that receipts from these sources were not in the nature of royalties that were exempt from UBIT, but rather were payments for services. In response to protests from affected charities, in 1986, Congress reversed the Service's position in regard to exchanges and rentals among charities and veterans' organizations of lists of their own members and donors.[22] The Service continued to attempt to tax exchanges and rentals involving charities and other organizations until, after a series of defeats in the courts, in December, 2002, it announced that it would no longer pursue the matter and directed its agents to settle outstanding cases.[23] However, the definition of royalties and thus the scope of the exemption continued to be a difficult issue for the Service, affecting the treatment of payments from affinity credit cards.

Commercial Insurance: In 1996, Congress enacted section 501(m) of the Code which denied exemption to organizations that provide commercial-type insurance as a substantial part of their

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[21] 67 Fed. Reg. 20,433 (2002) (T.D. 8991) (effective April 25, 2002 for payments solicited or received after December 31, 1997).
[22] Tax Reform Act of 1986, Pub. L. No. 99-514, §1601(a), 100 Stat. 2085, 2766-2767 (1986); I.R.C. §513(h)(1)(B).
[23] cross reference to ch. 5; Memorandum from Director, Exempt Organizations Division, to Acting EO Area Managers (December 16, 1999).

activities.[24] Aimed primarily at Blue Cross Blue Shield and similar health insurance providers, the revocation of exemption resulted in a number of these organizations being treated as charities under state law while being fully taxable business corporations for federal tax purposes, one of the rare instances in which this anomaly affected a large part of the charitable sector.

Standards for Exemption of Hospitals

The Internal Revenue Service has had difficulty establishing the requirements under which a hospital would qualify for exemption, particularly after the enactment of Medicare and Medicaid which transformed the base of hospital revenues from reliance on contributions from the public, government grants, and fees for services from those able to pay to almost total reliance on payments from third parties. In an early ruling, exemption was conditioned on a hospitals providing free care to those unable to pay.[25] In 1969, the Service adopted a community benefit standard which could be met even though free care was not provided if the hospital operated an emergency room available to all.[26] This position was modified in 1983 to permit a hospital to demonstrate that operation of an emergency room would duplicate other emergency services available in the community.[27] In July of 1991 the Ways and Means Committee held hearings to

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[24] Tax Reform Act of 1986, Pub. L. No. 99-514, §1012(a), (b), 100 Stat. 2085, 2390-2394 (1986); I.R.C. §501(m), §833.
[25] Rev. Rul. 56-185, 1956-1 C.B. 202.
[26] Rev. Rul. 69-545, 1969-2 C.B. 117.
[27] Rev. Rul. 83-157, 1983-2 C.B. 94.

review the basis for exemption of hospitals,[28] and to consider the provisions of two bills that would have codified additional requirements for exemption and imposed new sanctions for noncompliance.[29] Treasury representatives testified that community benefit was a more appropriate standard for determining exemption than one based on the amount of charity care being provided or other more specific requirements. It also voiced objections to the proposed sanctions which were based on mechanical tests tied to the value on a hospital's tax exemption, or would provide for a temporary loss of exemption along with certain intermediate sanctions. The Treasury suggested that intermediate sanctions similar to those imposed on private foundations would be more appropriate and far easier to administer.[30] Neither of the bills were passed and the issue was not revisited by Congress in succeeding years. However, in the following year the Service published new audit guidelines for hospitals which indicated that

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[28] Tax-Exempt Status of Hospitals, and Establishment of Charity Care Standards: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 102-73, 102d Cong., 1st Sess. (1992). Prior to the hearing the GAO had conducted a survey of the provision of health care in five states and concluded that the criteria for exemption would need revision if Congress wished to encourage hospitals to provide charity care and other community services. General Accounting Office, *Nonprofit Hospitals: Better Standards Needed for Tax Exemption* (GAO/HRD-90-84) (May 1990).

[29] Charity Care and Hospital Tax-Exempt Status Reform Act of 1991, H.R. 790, 102d Cong., 1st Sess. (1991); H.R. 1374, 102d Cong., 1st Sess (1991).

[30] Tax-Exempt Status of Hospitals, and Establishment of Charity Care Standards: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 102-73, 102d Cong., 1st Sess. (1992).

it would be increasing its attention to the issues that were addressed in the proposed legislation.[31]

Regulation of Church Activities

Church Audits: Regulation of churches and church affiliated organizations has been a particularly difficult are for the Congress as well as the Internal Revenue Service, as much because of the constitutional considerations as the sensitivity of Congress in regard to matters of religion and the rules applicable to them are far more lenient than those for all other charities. For example, the determination of exemption for churches is essentially automatic in that they are under no obligation to file an application for exemption and receive a determination of eligibility. Furthermore, they are exempt from filing annual information returns and, until 1969 were exempt from the tax on unrelated business income. In 1969 Congress enacted section 7605(c) which was designed to protect churches from unnecessary audits.[32] Then, in 1983, as a result of protests that the Service was being overly intrusive in its examining churches, the Senate Subcommittee on Oversight conducted an examination of IRS audit procedures for religious organizations[33] that led to the enactment of section 7611 which contained parts

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[31] Audit Guidelines for Hospitals, Ann. 92-83, 1992-22 I.R.B. 59.
[32] Tax Reform Act of 1969, Pub L. 91-172, §121(f), 83 Stat. 487, 548 (1969); adding I.R.C. §7605(c).
[33] Church Audit Procedures Act: Hearing Before the Subcommittee on Oversight of the Senate Finance Committee, S. Hrg. 98-481, 98th Cong., 1st Sess. (1983).

of section 7605(c) with new limits on the ability of the Service to conduct audits of churches.[34]

Television Ministries: The Subcommittee on Oversight of the House Ways and Means Committee held a hearing in October of 1987 on the effectiveness of the federal tax rules applicable to a category of religious organizations that were engaged in television ministries.[35] The press had called general attention to the activities of certain "televangelists" with large followings who were reported to be receiving large amounts of contributions which were not in all circumstances being applied for their charitable purposes. The press had focused on the activities of the PTL Ministry and its leaders, Jim and Tammy Fay Bakker who were offering partnerships in a vacation park and retreat the PTL was building in South Carolina.[36]

The Hearings focused on the effectiveness of self-regulation by ministries, especially in preventing diversion of funds to ministry insiders, the Service's difficulty in monitoring the tax compliance of ministries given the limits on church audits and IRS reporting requirements for church, and ongoing investigations of ministries by the Service. At the close, the Internal Revenue Service agreed to provide the Subcommittee with quarterly status reports on its audit

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[34] Deficit Reduction Act of 1984, Pub. L. No. 98-369, §1033(a), 98 Stat. 494, 1034-1039 (1984).

[35] Federal Tax Rules Applicable to Tax-Exempt Organizations Involving Television Ministries: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 100-43, 100th Cong., 1st Sess. (1988).

[36] See, for example, William E. Schmidt, TV Minister Calls His Resort 'Bait' For Christianity," *New York Times*, December 24, 1985, at A8.

activities in connection with the televangelists. The first report, submitted in February of 1988, covered the 4th quarter of 1987.[37] Congressman Pickle on November 2, 1988 requested a summary for the prior year which was submitted by the IRS on December 5, 1988.[38] It covered the period between October 1987 and October 1988. The results of the report, released by the Congressman, indicated that the Service had conducted six examinations of prominent televangelists, with two of them involving criminal inquiries. In most cases they involved diversion of funds from the organization to insiders who failed to report the payments as income. The case involving the Bakkers was not identified in the reports, but Jim Bakker was convicted of mail and wire fraud in October 1989, fined $500,000 and sentenced to 45 years in prison, a sentence that was subsequently reduced to 8 years. He was released in 1994.[39]

In June of 1988 the IRS revised the Internal Revenue Manual to reflect procedures for collecting information for the quarterly reports to the Oversight Committee.[40] No public reports were published after one that covered the 4th Quarter of 1988.[41] The reporting requirement was discontinued in 1994.

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[37] "Service Recommends Prosecution of Television Evangelists," 88 TNT 51-1 (March 7, 1988).
[38] "Pickle Releases IRS Televangelist Report," 88 TNT 245-8 (December 7, 1988).
[39] Ronald Smothers, "Ex-Television Evangelist Bakker Ends Prison Sentence for Fraud," *New York Times*, December 2, 1994, at A18.
[40] "Quarterly Activity Reports on Evangelist-Related Cases," MS CR 7(10)G-56, Manual Transmittal 7(10)00-148 (June 1, 1988); see also "Reporting Guidelines on Evangelist-Related Cases Provided," 91 TNT 109-62 (May 17, 1991).
[41] "Pickle Releases IRS Report on Tax-Evading Televangelists," 89 TNT 59-16 (March 15, 1989).

Church Support of Candidate for Public Office: Controversy over the prohibition against participation in political campaigns came to the fore in late 1995 when the IRS revoked the exemption of a church which had placed a full-page advertisement in USA Today and the Washington Times four days before the 1992 election urging the public not to vote for Clinton, and noting that it would accept tax-deductible donations to pay for the advertisement. The church appealed the revocation, but it was upheld in the district court and, subsequently, in the court of appeals in a unanimous decision.[42]

In reaction several bills were introduced in the Congress in 2001 and 2002 that would have permitted churches to participate in political campaigns on behalf of or in opposition to any candidate for public office, so long as the participation was not a substantial part of their activities.[43] Although strongly supported by a number of conservative organizations, it was reported that a large number of clergy were opposed. The bill failed of passage in the House of Representatives in the fall of 2002.[44]

Relief for Victims of the Terrorist Attacks of September 2001

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[42] Branch Ministries, Inc. v. Rossotti, 40 F. Supp. 2d 15 (D.D.C. 1999), aff'd, 211 F.3d 137 (D.C. Cir. 2000).
[43] Houses of Worship Political Speech Protection Act, H.R. 2357, 107th Cong., 1st Sess. (2001); Bright-Line Act of 2001, H.R. 2931, 107th Cong., 2d Sess. (2001).
[44] Houses of Worship Political Speech Protection Act, H.R. 2357, 107th Cong., 1st Sess. (2001).

The scope of exempt purposes became a subject of public and Congressional concern in the aftermath of the terrorist attacks on September 11, 2001. Contributions to aid the victims came in at an unprecedented rate and charities were faced immediately with the questions of to whom and under what circumstances they could disburse the contributions. Rulings issued by the Internal Revenue Service in connection with aid to the victims of the Oklahoma City bombing in 1995 had held that the Code required that beneficiaries be part of an "indefinite" class and that relief of the "distressed" could only be provided upon demonstration of financial need.[45] These guidelines were restated and expanded in the Service's 1999 CPE Text.[46]

Critics of these guidelines noted that the Service apparently relied on the definition of needy found in the regulations under section 170 of the Code which limits the deductibility of contributions by businesses of inventory and other equipment to qualified charities that provide care of the ill, needy or infants. Korman called attention to the inappropriateness of this application and the mistaken confluence of charitable class with "need".[47]

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[45] *IRS Guidance Letter for Relief Efforts in Oklahoma City*, Internal Revenue Service (August 25, 1995).
[46] Ruth Rivera Huetter and Marvin Friedlander, "Disaster Relief and Emergency Hardship Programs," in *1999 IRS Continuing Professional Education Text*, 219-242.
[47] Rochelle Korman, "Charitable Class and Need: Whom Should Charities Benefit?," in *Conference: Defining Charity: A View from the 21st Century* (New York University School of Law, National Center on Philanthropy and the Law, 2002).

Immediately following the attacks the Service issued an announcement summarizing the existing rulings and the establishment of expedited procedures for handling requests for exemption from new organizations formed to provide disaster relief. On November 8, the Ways and Means Oversight Committee convened hearings to investigate responses to the disaster.[48] The Director of the IRS Exempt Organizations Division reiterated existing standards, in particular that payments to victims and their families must be based on need and that distributions pro rata were inappropriate.[49] This statement generated wide criticism from the media, as well as from several relief organizations that had already made pro rata distributions among beneficiaries.[50] Then on December 10, the Commissioner of Internal Revenue announced what amounted to a new set of guidelines to the effect that they would be proper if made in good faith based on reasonable objectives.[51]

The Victims of Terrorism Tax Relief Act of 2001 was enacted in January 2002.[52] It provided in section 104 a one time exception to the existing rules by permitting charities to make payments to victims of the attacks or of anthrax "if made in good faith using

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[48] Response by Charitable Organizations to the Recent Terrorist Attacks: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 107-47, 1007th Cong., 1st Sess. (2001).
[49] Id. (testimony of Steven T. Miller, Director, Exempt Organizations, Tax Exempt/Government Entities Division).
[50] See, for example, Diana B. Henriques and David Barstow, "A Nation Challenged: Charity; Victims' Funds May Violate U.S. Tax Laws," *New York Times*, November 12, 2001, at B1.
[51] Notice 2001-78, 2001-50 I.R.B. 576.
[52] Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, §104(a)(1), 115 Stat. 2427, 2431 (2002).

a reasonable and objective formula which is consistently applied." The explanation provided by the Joint Committee on Taxation stated more specifically that in making payments under this provision, charities would not be required to make a specific assessment of need so long as the good faith requirements were met and that victims and their families are deemed to be a charitable class to whom lump sum pro rata distributions could be made without taking specific financial needs into account.[53] The Act also addressed the ability of private foundations to make payments to their employees who were victims of the attacks, another issue that had needed clarification.[54]

Public controversy over the disbursement of relief funds did not abate, centering around the propriety of pro rata payments, coordination of lists of victims among the charities, and the question of whether donations were to be distributed immediately or a portion reserved to meet their future needs or future disasters.[55]

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[53] Joint Committee on Taxation, *Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001" as Passed by the House and Senate on December 20, 2001* (JCX-93-01) (December 21, 2001).
[54] Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, §104(a)(2), 115 Stat. 2427, 2431 (2002).
[55] Victoria B. Bjorklund, "Reflections on September 11 Legal Developments," in *September 11: Perspectives from the Field of Philanthropy*, 11 (The Foundation Center, 2002); Rochelle Korman, "Charitable Class and Need: Whom Should Charities Benefit?," in *Conference: Defining Charity: A View from the 21st Century* (New York University School of Law, National Center on Philanthropy and the Law, 2002); Susan Rosegrant, "Giving in the Wake of Terror: The Charitable Response to the Attacks of September 11," (Case Study, Practice of Philanthropy and Nonprofit Leadership, John F. Kennedy School of Government, Harvard University, 2002).

As part of these investigation, the Ranking Minority Member of the Senate Committee on Finance requested the General Accounting Office to investigate and report on the response of charities to the attacks. The GAO released an interim report in September 2002.[56] It found that 34 of the larger charities reported raising an estimated $2.4 billion since the date of the attacks, noting however that with more than 300 charities involved in collecting funds, it was difficult to obtain a more precise set of figures. It also found that two-thirds of the amount reported to have been collected by the large charities had been distributed for aid to the families of those killed or injured, for those more indirectly affected through loss of jobs or homes and for disaster relief workers. In the vast majority of instances, direct uniform payments were made to identified victims, with the Red Cross reporting average payments of $54,000 per family.

Although several measures were in place at the federal, state, and local levels to help address fraud, and relatively few cases had been reported, the GAO concluded that it was too soon to determine the full extent to which fraud occurred. The investigators also found that although initially there was little coordination among the relief agencies a degree of coordination had been achieved. The Report concluded by identifying two issues that required attention for the future: (1) obtaining information as to the amount of charitable funds that were collected and

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[56] General Accounting Office, *September 11: Interim Report on the Response of Charities* (GAO-02-1037) (September 3, 2002).

distributed, to whom and for what purposes; and (2) better coordination of the relief efforts, including consideration of the role the federal government might play in the effort and what trade-offs might be involved such as loss of flexibility in, and independence of, the charitable sector.

The response of charities to the terrorist attacks was the subject of another Congressional investigation, this time in connection with allegations that they had financed terrorist organizations. The Subcommittee on International Trade and Finance of the Senate Banking, Housing, and Urban Affairs Committee held hearings in both 2001 and 2002.[57] In the fall of 2002 three bills were introduced in the Senate and the House that would have suspended the tax exemption of and denied any deductions for contributions to any organization designated as terrorist or terrorist related by an Executive order or under the authority of the Immigration and Nationality Act, the International Emergency Economic Powers Act or the United Nations Participation Act.[58] The bills also provided that no groups could use any judicial proceeding to challenge a terrorist designation, suspension from tax-exempt status or the denial of a deduction.

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[57] The Role of Charities and NGOs in the Financing of Terrorist Activities: Hearings Before the Subcommittee on International Trade and Finance of the Senate Committee on Banking, Housing, and Urban Affairs, 107th Cong., 2d Sess. (2002); Hawala and Underground Terrorist Financing Mechanisms: Hearings Before the Subcommittee on International Trade and Finance of the Senate Committee on Banking, Housing, and Urban Affairs, 107th Cong., 1st Sess. (2001).

[58] H.R. 5603, 107th Cong., 2d Sess. (2002); S. 3081, 107th Cong., 2d Sess. (2002); S. 3082, 107th Cong., 2d Sess. (2002).

One of these bills was passed by unanimous consent in the House on October 16, 2002 and sent to the Senate for consideration.[59]

The Effectiveness of the IRS as Regulator

The effectiveness of the IRS as the regulator of exempt organizations has been a separate subject of Congressional interest, particularly in connection with the reform and restructuring of the IRS that was enacted in 1998, although it also received Congressional attention in 1974 when a new Office of Employee Plans and Exempt Organizations, headed by an Assistant Commissioner, was established as part of the Employee Retirement Income Security Act of that year. This marked a major change in the regulation of charities, removing it from administration by personnel versed in tax collection to those interested in maintaining the integrity of the tax exempt sector.[60]

During Congressional consideration of the reform and restructuring of the Service between 1995 and 1997, there was concern that the separate administration of the exempt organization rules would be dismantled. However, this was not to be the case and, as more fully described in Chapter 7, the office of Assistant Commissioner, Tax Exempt and Government Entities, was created, to administer a separate, dedicated division

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[59] H.R. 5603, 107th Cong., 2d Sess. (2002).
[60] David Ginsburg et al., "Federal Oversight of Private Philanthropy," in Department of Treasury, Commission on Private Philanthropy and Public Needs, *Research Papers*, vol. V, pt. 1, 2575, 2621 (1977). cross reference to Chapter 7.

regulating exempt organization and employee plan activity. Chapter 7 contains a description of its composition and activities in relation to charities.

Congress has also addressed allegations of political influence in the regulation of exempt organizations. In the 1970's, there were three investigations of attempted misuse of the Service for political and ideological purposes. A summary of these investigations reported in a study prepared for the Filer Commission in 1975, concluded as follows:

> The Service has not been totally immune to improper political or partisan influences, but that on the whole its resistance to such influences - even from the White House - seems to be unusually strong. Perfection cannot realistically be expected of any government agency in the face of powerful congressional or White House pressures. However, apart from the aberrations of the early Cold War era which affected the Service equally with the rest of the nation, the instances in which the Service may fairly be regarded as having succumbed to partisan or ideological bias appear to be few. Moreover, the Service's pride in the public evidence from the Watergate-related investigations that successive Commissioners adhered to the tradition of nonpartisan objectivity despite strong contrary pressures, can only have reinforced the institutional strength of that tradition.[61]

Most recently a Joint Committee study of undue influence on the Service,[62] required by the Restructuring and Reform Act of 1998, that was released in 2002, found no credible evidence (1) that the IRS delayed or accelerated issuance of determination letters to tax-exempt organizations based on the nature of the organizations' perceived views; (2) that the forwarding of

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[61] Ginsburg, "Federal Oversight of Private Philanthropy," 2618.
[62] Joint Committee on Taxation, *Report of Investigation of Allegations Relating to Internal Revenue Service Handling of Tax-Exempt Organization Matters* (JCS-3-00) (March 2000).

certain applications to the national office was the result of a deliberate effort by IRS employees to subject organizations with views that opposed the Clinton Administration to more intense scrutiny; (3) that tax-exempt organizations were selected for examination or that the IRS altered the manner in which it conducted examinations based on the views of the organizations; (4) or that the Clinton administration officials intervened in the selection of or failure to select certain exempt organizations for examination; or (5) that the IRS systematically used information items such as press reports, letters from members of Congress or taxpayers to identify for examination exempt organizations that espoused views opposed to the political views of the Clinton Administration.

The Joint Committee had also been charged with investigating allegations of employee misconduct with respect to exempt organizations. It identified eight instances of alleged IRS employee misconduct, but found no substantial evidence of undue influence. The Report contains a valuable description of IRS procedures for handling determinations and audits, as well as the functioning of its internal controls and Appendix B contains a detailed description of the laws limiting political campaign activities and lobbying.

INTERMEDIATE SANCTIONS FOR EXCESS BENEFIT TRANSACTIONS

In 1996 Congress enacted limitations on the financial benefits that fiduciaries may receive from the organizations they

serve.[63] These limitations represented the most far-reaching provisions regulating the operation of charities adopted since exemption was granted in the first income tax laws. Although the private foundation provisions enacted in 1969 had a profound effect of the administration of this group of charities, private foundations comprise only 6.5% of the charitable sector. In contrast, intermediate sanctions apply to all other organizations exempt under section 501(c)(3), a universe that was estimated in 1998 by the IRS to consist of 920,000 organizations. Just as the private foundation provisions forced major changes in the way this group of organizations were operated, it is anticipated that prohibition against excess benefit transactions will force trustees and directors of public charities to revise their operating procedures and pay heightened attention to any transaction that entails self-dealing. It is because of this impact and because of their easy acceptance in the Congress that they are described here in a separate section.

These new provisions are commonly referred to as "intermediate sanctions", a phrase that connotes the nature of the penalties that may be imposed for certain transactions. They are more appropriately described as "excess benefit transactions", the transactions that the legislation is designed to curtail. An excess benefit transaction is one in which a disqualified person receives from the charity an amount or money or other property which is greater than its fair market value.

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[63] Taxpayer Bill of Rights Act 2, Pub. L. No. 104-168, 110 Stat. 1475 (1996), adding I.R.C. §4958.

The rules apply to sales and exchanges between a charity and a disqualified person and to payment of compensation to a disqualified person. Disqualified persons include all fiduciaries and other persons in a position to exercise substantial influence over the organization in question. The sanctions are similar to those applicable in the case of private foundation self-dealing, namely excise tax on the disqualified person and in certain circumstances on the managers of the charity. The sanction is denominated "intermediate" to signify that it lies between no action and the "ultimate" sanction of revocation of exemption.

The impetus for the enactment of the excess benefit transactions provisions came from the Internal Revenue Service itself, specifically from recommendations of a Penalty Task Force established by the Service in November of 1987, that suggested the Service seek legislation providing sanctions similar to those in Chapter 42 governing private foundations to permit correction without revocation of exemption.[64] In 1993, the Commissioner of Internal Revenue recommended enactment of provisions of this nature to Congress during hearings of the Subcommittee on Oversight of the Committee on Ways and Means.[65] Legislation drafted by the Treasury to effect this change was submitted to the Congress in 1996 and, with the support of many leaders of the charitable sector, the bill was enacted as part of the Taxpayers

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[64] Executive Task Force, Commissioner's Penalty Study, Internal Revenue Service, *Report on Civil Tax Penalties*, ch. 9, sec. III (1989).
[65] Tax Administration of Public Charities Exempt Under Section 501(c)(3): Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 103-39, 103d Cong., 1st Sess. (1993).

Bill of Rights 2 of 1996.[66] The substance of the provisions and greater detail as to the legislative history are described in Chapter 5.

The legislative process that led to enactment of the excess benefit provisions was unique in the near absence of opposition by the public and within Congress. Although the IRS issued both temporary and proposed regulations before adopting them in final form, public comments on their content focused on technical aspects.[67] Thus, the history of the enactment of the Excess Benefit Transactions stands as the exception to the more usual atmosphere of confrontation that has been present during other periods when amendment of the provisions affecting charities has been the subject of Congressional and administrative activity.

OTHER CHANGES IN SUBSTANTIVE LAW AFFECTING CHARITIES AFTER 1970

The foregoing sections describe changes in the laws affecting charities that came about directly from Congressional investigations and subsequent enactments. However, federal tax law is also created through the promulgation of administrative rulings and in court decisions. This section describes the development of federal tax law affecting charities that was formulated in the cases, Treasury regulations and Internal

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[66] Taxpayer Bill of Rights 2, Pub. L. No. §1311, 110 Stat. 1452, 1475-1479 (1996).

[67] 63 Fed. Reg. 41,486 (August 4, 1998) (proposed regulations); 66 Fed. Reg. 2,144 (January 1, 2001) (temporary regulations); 67 Fed. Reg. 3,076 (January 23, 2002) (final regulations).

Revenue Service rulings rather than through amendments of the Internal Revenue Code.

Changing Parameters of the Definition of Charitable Purposes

The definition of charitable purposes and the parameters of the requirements for exemption that define a charity pose problems for the Service that are at times difficult to resolve. Included in the definition are the requirements that the beneficiaries of a charity form an indefinite class and that a purpose cannot be charitable if it is illegal or against public policy. Determination of exemption is further complicated by the fact that the prohibition against intervention in campaigns for public office and the limitations on lobbying were engrafted onto the basic common law rules.

The parameters of the definition of exempt purposes were established in 1959 in the regulations under section 501(c)(3) which adopted what was described specifically as the common law definition of charity for determining the meaning of each of the purposes recited in that section.[68] Most important, they incorporated the concept that the meaning of charity was not static, but was meant to evolve over time to reflect changing circumstances and changing views of public benefit. In addition to adopting the common law definition of charity, the 1959 regulations actually expanded the scope of charitable activity by permitting exemption to be granted to groups engaging in various

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[68] Treas. Reg. §1.501(c)(3)-1(d)(2) (T.D. 6391) (1959).

forms of social activism under the heading "promotion of social welfare by organizations designed to accomplish any of the traditional purposes or by lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights secured by law or combating community deterioration and juvenile delinquency."[69] Under this formulation exemptions had been granted prior to 1969 to a voter registration group and to an organization formed to make program related investments. In the years after 1969, the scope of charitable purposes was broadened in connection with the requirements for exemption of hospitals, for environmental groups, legal aid and public interest law firms, human and civil rights organizations and for a wide range of arts organizations.[70] This sensitivity to change on the part of the Internal Revenue Service is in marked contrast to that of the English Charity Commission which has resisted broadening the concept of charity to such a degree that in 2002 it had generated wide-spread support for adding new specific purposes to the general categories in the definition of charity in order to make it relevant.[71]

Application of the Public Policy Doctrine to Definitions of Charitable Purposes

Undoubtedly the most important development in the definition of charity since 1970 was the application of the

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[69] Id.
[70] cross reference to chapter 5.
[71] Strategy Unit Report, Cabinet Office, *Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector* (September 2002), 36-43, available at <http://www.strategy-unit.gov.uk>.

common law rule that a charitable purpose is not valid if it is against public policy to deny exemption to private schools that discriminate on the basis of race, a decision that led to great public debate and was only resolved after a 1983 decision of the Supreme Court.[72]

The dispute first arose in 1967 during the turmoil over desegregation with an announcement by the Service that tax exemption would be denied to any racially discriminatory private schools that received state aid.[73] In response, parents of black public school students in Mississippi sued to enjoin the Service from granting exemptions or allowing charitable contributions to any discriminatory school within the state, regardless of whether it received state aid.[74] While the litigation was pending the Service announced that it was extending the prohibition to church-related schools.[75] The Service's position was upheld in the case of Green v. Connally,[76] in which a three-judge district court enjoined the IRS from recognizing the exempt status of any private school in Mississippi that had a policy of racial discrimination on the basis that exemption was not available for organizations that conducted activities that were illegal or against public policy.

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[72] Bob Jones University v. United States, 461 U.S. 574 (1983).
[73] IRS News Release (August 2, 1967).
[74] Green v. Kennedy, 309 F. Supp. 1127 (D.D.C.), appeal dismissed sub nom. Cannon v. Green, 398 U.S. 956 (1970).
[75] Rev. Rul. 75-231, 1975-1 C.B. 159.
[76] 330 F. Supp. 1150 (D.D.C.), aff'd sub nom. Coit v. Green, 404 U.S. 997 (1971).

The Service announced its compliance with the court decision in a news release,[77] and soon thereafter published a revenue ruling in which it reiterated its new position based on the rationale of the court.[78] In 1975 this ruling was expanded to include discrimination on the basis of color and national origin within the scope of the prohibition.[79]

In 1978 the Service announced a proposed revenue ruling that provided a stricter standard for tax exemption under which exemption would be denied not only to schools with discriminatory policies but also to those with an insignificant number of minority students that were formed or expanded at or about the time of desegregation of the public schools in the community.[80] Congress responded to this proposal by passing legislation denying funds under the 1980 appropriations act for the formulation or enforcement of the proposed rule.[81] This measure effectively prevented the Service from implementing the procedures in the proposed ruling and the matter seemed to be in a stalemate.[82]

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[77] IRS News Release (July 7, 1970).
[78] Rev. Rul. 71-447, 1971-2 C.B. 230; see also Rev. Rul. 75-231, 1975-1 C.B. 158.
[79] Rev. Rul. 75-50, 1975-2 C.B. 587.
[80] 43 Fed. Reg. 37,296 (1978).
[81] Treasury Appropriations Act of 1980, Pub. L. No. 96-74, 93 Stat. 559 (1979). The Dornan amendment provided that "[n]one of the funds available under [the] Act may be used to carry out [the IRS proposals]." Pub. L. No. 96-74, §615, 93 Stat. 559, 577 (1979). The Ashbrook amendment provided that funds may not be used "to formulate or carry out any rule, policy, procedure, guideline, regulation, standard, or measure which would cause the loss of tax-exempt status to private, religious, or church-operated schools." Pub. L. No. 96-74, §103, 93 Stat. 559, 562 (1979).
[82] Thomas McCoy and Neal E. Devins, "Standing and Adverseness in Challenges of Tax Exemptions for Discriminatory Private Schools," 52

During this same period, the courts were adjudicating cases involving the revocation of the tax exemption of two educational organizations, Bob Jones University and Goldsboro Christian Schools, Inc., on the grounds that they discriminated on the basis of race. In 1981 the Court of Appeals for the Fourth Circuit upheld the Service's revocation of the exemptions[83] and the Supreme Court consolidated the two cases and granted certiorari.[84] In 1982, before the case was argued, the Reagan administration which had just taken office, announced that the Service would no longer revoke or deny tax-exempt status for segregated schools without Congressional authorization.[85] Contemporaneously, the Justice Department withdrew its brief in the Bob Jones case and asked the court to vacate it as moot.[86] In the face of strong public protest to these actions, the administration thereupon submitted the matter for resolution to the Congress, proposing legislation that would have given the Service authority to carry out its announced policy.[87] This was done with the expectation that the measure would not be adopted, which was the case.[88]

Following the Justice Department's withdrawal from the Bob Jones case, the Court of Appeals enjoined the Service from

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Fordham Law Review 441, 461-462 (1984).

[83] Bob Jones University v. United States, 639 F.2d 147 (4th Cir. 1980).

[84] 454 U.S. 892 (1981).

[85] IRS News Release (January 8, 1982).

[86] Bob Jones University v. United States, 461 U.S. 574, 585 (1983).

[87] Letter from President Ronald Reagan to the President of the Senate and the Speaker of the House Transmitting Proposed Legislation, 18 Weekly Comp. Pres. Doc. 37 (Jan. 18, 1982).

[88] See 128 Cong. Rec. S111 (daily ed. Jan. 28, 1982) (remarks of Senator Bradley); id. at S108 (remarks of Senator Hart).

restoring exempt status to any racially discriminatory school and appointed independent counsel to support the original position of the Service in the court proceedings.

The decision of the Supreme Court was rendered on May 24, 1983. It reaffirmed the Service's reliance on common law definitions of charity to hold that schools that discriminated on the basis of race, whether or not church-related, were not entitled to tax exemption. It found that the term charitable encompassed education and required that a charity serve a public purpose, thereby precluding it from actions that violated public policy. This decision laid the matter to rest as far as the Congress was concerned, although the success of the tax regulators in prohibiting segregation was open to question.[89]

The Service and the courts have also been called upon to rule as to another aspect of discrimination, namely the validity of measures designed to support disadvantaged minorities. The Service has ruled that granting preferences to Native Americans would not be grounds for denial of exemption, although it also stated that this position should not be interpreted as an endorsement of an affirmative action rationale.[90] In line with this position, the Service also ruled that, although publicly supported educational organizations were prohibited from administering scholarship programs that discriminated on the basis of race, independent trusts or foundations with those

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[89] Frances R. Hill and Douglas M. Mancino, *Taxation of Exempt Organizations*, §7.02 (New York: Warren, Gorham & Lamont, 2002).
[90] Gen. Couns. Mem. 36,363 (August 7, 1975).

purposes were not necessarily prevented from obtaining exemption.[91] It had also ruled that a trust that limited benefits to students of the Caucasian race was not entitled to exemption.[92] However, it retreated from this position in 1983, rejecting use of a per se rule and adopting instead a facts and circumstances test to determining whether any specific trust or fund violated public policy.[93]

As of 2002, the law remained unclear as to whether public policy prohibits discrimination on bases other than that of race or national origin. The question of gender discrimination is also unresolved. Hill and Mancino suggested that the future course of the law on this question may well be shaped by the Supreme Court's 1996 decision in United States v. Virginia in which the court held that the exclusion of women from admission to Virginia Military Academy constituted a violation of the equal protection clause.[94] In this case, however, the school was a state university so that the state action doctrine came into play along with the public policy doctrine. This limitation is described below.

State Action Limitations on Charitable Purposes: The Subsidy Theory

In addition to the limitations on charitable purposes imposed by virtue of the public policy doctrine, a denial of exemption may under certain circumstances involve an

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[91] Gen. Couns. Mem. 39,117 (January 13, 1984).
[92] Gen. Couns. Mem. 37,462 (March 17, 1978).
[93] Gen. Couns. Mem. 39,082 (December 1, 1983); see also Gen. Couns. Mem. 39,117 (January 13, 1984).
[94] Hill & Mancino, *Taxation of Exempt Organizations*, §7.05[3] (discussing United States v. Virginia, 518 U.S. 515 (1996)).

unconstitutional deprivation of the first amendment rights of free speech and freedom to petition, and the equal protection of the laws inherent in the due process clause of the fifth Amendment. These constitutional prohibitions, however, extend only to actions by the state so that it is necessary in the first instance to determine whether a claim that these rights were violated, one must first demonstrate that the state in involved in the action being challenged. State action is obvious in the case mentioned above of a state university, namely Virginia Military Academy.

However, state action can also be present in less direct ways, one of which is through the provision of subsidies to non-governmental entities. Examples would be grants to charities or contracts with them to provide certain products. The question of whether the grant of tax-exemption itself, and the corollary allowance of deductions for contributions to some organizations, were government subsidies has been the subject of extensive debate by legal and economic scholars, but not with consensus. However, the issue was resolved at least in regard to the power of Congress to regulate tax exempt organizations with a 1983 decision of the Supreme Court in the case of Regan v. Taxation with Representation of Washington.[95] The question before the court was whether the limitation on lobbying in section 501(c)(3) was a violation of an organization's constitutional right to free

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[95] 461 U.S. 540.

speech. In holding that the limitation was valid, the court found that:

> Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income. Deductible contributions are similar to cash grants of the amount of a portion of the individual's contributions. The system Congress has enacted provides this kind of subsidy to non profit civic welfare organizations generally, and an additional subsidy to those charitable organizations that do not engage in substantial lobbying. In short, Congress chose not to subsidize lobbying as extensively as it chose to subsidize other activities that non profit organizations undertake to promote the public welfare.[96]

The court noted that TWR was not denied the ability to exercise its right of free speech in that it could divide its activities between two organizations, one to conduct educational activities that would be exempt under section 501(c)(3) and eligible to receive tax deductible contributions and the other exempt under section 501(c)(4) that could conduct unlimited lobbying activities.

TWR had also claimed that the lobbying limitation violated the equal protection clause in that taxpayers are permitted to deduct contributions to exempt veterans' organization that are permitted to lobby without limit, but not to organizations exempt under section 501(c)(4). In rejecting this contention, the court held that Congress' decision not to subsidize the exercise of a fundamental right does not infringe the right. "The issue in this case is not whether TWR must be permitted to lobby, but whether

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[96] Id. at 544.

Congress is required to provide it with public money with which to lobby."[97]

Lobbying

The limitations on lobbying have also caused controversy outside of the Congress. Section 501(h) was enacted in 1976, but it was not until November 5, 1986 that Treasury published proposed regulations.[98] The delay was attributed to a flood of major tax legislation requiring more immediate attention than the lobbying regulations.[99] In all events, the proposed draft quickly attracted severe criticism, particularly its definitions of grass roots lobbying and the rules for allocating expenses between those for activities that were permitted as educational and those that were subject to the statutory limits. McGovern noted that approximately 200 organizations signed a position statement submitted by Independent Sector requesting that the proposed regulations be immediately withdrawn. Similar requests were made by a number of other national organizations and the Service received more than 5000 individual comments.[100]

Soon after the proposed regulations were published, Congressman Pickle began another investigation of lobbying and political activities, holding hearings in March of 1987 which concluded with a Subcommittee report that the restrictions in the

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[97] Id. at 551.
[98] 51 Fed. Reg. 40,211 (November 5, 1986).
[99] James J. McGovern et al., "The Revised Lobbying Regulations - A Difficult Balance," 41 *Tax Notes* 1425, 1427 (1988).
[100] Id.

Code reflected sound tax policy but that the regulations were too complex and at times too inexact. Other Congressmen questioned the rules, including the Chairman of the House Ways and Means Committee who asked that they be withdrawn and that the Service consult with representatives of the public and private sector regarding revisions.[101]

In response to Rostenkowski's suggestion, a Commissioner's Exempt Organizations Advisory Group was established in June of 1987. The group met in September of 1987 and February of 1988 and, although it discussed a wide range of matters affecting the exempt organization community, the principal focus was on the lobbying regulations. New proposed regulations were published on December 23, 1988, containing revisions consonant with many of the most serious objections raised to the first set.[102] These were ultimately published in final form in August of 1990.[103] Despite the long delay, the outcome reflected well on the Service and the exempt sector and provided an example of cooperation that was hoped to be replicated in 2000 with the establishment of a new Advisory Committee in conjunction with the restructuring and reform of the IRS.[104]

UBIT and Commercial Activities

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[101] Lobbying and Political Activities of Tax-Exempt Organizations: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 100-15, 100 Cong., 1st Sess. (1987).
[102] 53 Fed. Reg. 51,826 (December 23, 1988).
[103] 55 Fed. Reg. 35,579 (August 31, 1990) (T.D. 8308).
[104] see chapter 7

Despite the failure of Congress to act immediately on its recommendations, the 1988 report of the Subcommittee of the Ways and Means Committee (the "Pickle Committee") clearly had an impact on the administration of the UBIT provisions by the IRS for. In the years following its release, the IRS directed its audit activity toward all of the areas in which the subcommittee had recommended a tightening of the rules. This was the case particularly in regard to museum shops, college book stores, travel tours, and royalty agreements.

Of even wider import, however, has been the Service's response to the problems generated by increased business activities of exempt organizations. These were noted by the Pickle Committee, but have increased rapidly in the years following its deliberations.[105]

The health care field, which accounted for 49% of the total gross receipts of the charitable sector in 1997,[106] was the first area in which the traditional range of services was broadened to encompass what came to be characterized as "commercial" activities, some of which were related to exempt purposes but others were either subject to UBIT, were conducted by tax-exempt subsidiary organization or, increasingly during the 1990's, conducted by for-profit subsidiaries. These developments posed no problems for the regulators: (1) whether the nature of the

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[105] See generally Burton A. Weisbrod, ed., *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector* (Cambridge: Cambridge University Press, 1998).

[106] Independent Sector, *The New Nonprofit Almanac and Desk Reference*, 125, Table 4.2 (New York: Jossey-Bass, 2002).

arrangements between an exempt organization and its co-venturers imposed obligations on the charity that were inconsistent with the requirement that it operate exclusively for public benefit or resulted in impermissible private inurement or private benefit; and (2) whether there was a limit to the amount of business activity, related or unrelated, that if exceeded constituted grounds for loss of exemption on the basis that the organization was no longer operated primarily for exempt purposes.

The first problem for the tax regulators arose in the 1980's when exempt organizations, looking for ways to increase revenue in the face of cutbacks in government support, turned to arrangements private investors to provide capital with which they could expand their activities. This occurred at a time when a large number of hospitals were reorganizing their corporate structures to create a parent organization that controlled a number of subsidiary corporations and partnerships, some tax exempt and others not, with private investors as shareholders or partners in the taxable subsidiaries. Initially, the Service ruled that exemption would be lost if a charity became a general partner in a partnership with for-profit entities or private individuals. This position was abandoned in the early 1980's, but the Service continued to hold that exemption would be lost if a charity entered into a joint venture with a for-profit entity unless the activities of the joint venture furthered the charity's exempt purposes and the charity maintained control of the taxable entity. During the mid to late 1990's, the government

litigated the validity of a number of joint ventures arrangements, particularly ones involving hospitals and health care insurers. The outcome was watched closely as much for its impact in the health care field as in the larger exempt sector in which joint ventures had long been used to finance low cost housing, but were increasingly being used by universities, arts organizations as well as by a wide range of charities looking to increase revenue through internet activities.

The second problem facing regulators arose in part by virtue of the fact that the Internal Revenue Code is unclear as to whether there is a limit to the amount of commercial activity, both related and unrelated, beyond which it will result in an organization's no longer bring entitled to tax-exemption. Although commentators and representatives from small businesses continued to criticize the amount of commercial activity conducted by the sector, implying that there was a limit, there is no firm basis in the law for such a position. As of the end of 2002 neither the Congress nor the Service had addressed the question directly, but it was likely that it would receive attention as "commercial activities" continued to increase.

Increased Regulation of Public Companies and Auditing Firms in 2002 and its Potential Effect on Charities

The exposure of wide spread breaches of fiduciary duty - and in some instances criminal conduct - on the part of the directors and officers of public business corporations that came

to light in 2002 had no direct impact on charities, but it was clear that it would influence charity regulators and the sector itself in the years ahead. Congressional response to the disclosures was swift and came in the form of the Sarbanes-Oxley Act, signed on July 30, 2002.[107] The Act imposed new obligations on corporate officers and directors, increased disclosure requirements to the Securities and Exchange Commission, enlarged the agency's powers, imposed new and increased criminal penalties on corporate officials who violated the rules, and established a new structure for oversight of public accounting firms under the general supervision of the SEC. One of the provisions that could be applied to charities in the future, particularly those over a certain size, was that the chief executive officer and the chief financial officer are required to certify with respect to each quarterly and annual report that it does not contain an untrue statement of a material fact or omit to state one, that it is fairly representative of the company's condition, and that the signing officers have designed internal controls to assure that proper information is provided to them. Another set of provisions that a number of large charities had already voluntarily adopted required that only independent directors could serve on audit committees, that these directors were required to establish procedures to assure that they would receive questions from employees relating to the company's behavior, and they were given power to retain independent counsel for the committee.

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[107] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

Finally, the Act established a five member body under the supervision of the SEC to which all audit firms conducting audits for public company clients were required to register. The Board was empowered to establish accounting standards, inspect firms for compliance, and conduct investigations and disciplinary proceedings as required. It was granted power to impose a wide range of sanctions, including temporary suspension or permanent revocation of registration for companies and their officers, temporary or permanent limitations on the activities of subject firms or persons, and imposition of civil fines in amounts between $100,000 and $15,000,000.[108]

One section of the Act as originally approved by the House but deleted in the final version approved by the Conference Committee was directed specifically at relationships with exempt organizations. It would have required corporations and their executive officers to inform the SEC about their relationships with "philanthropic organizations". Disclosure would be required if a director, an executive officer, or any member of their immediate families was a director or officer of a nonprofit organization, and contributions made during the last five years by any of them to the organization in excess of $10,000 as well as any other activity undertaken by them that provided a material benefit to the organization, which included lobbying on its behalf.[109]

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[108] Id.
[109] H.R. 3763, §7(2) (as passed by House of Representatives on April 24, 2002).

Treasury Department Anti-Terrorist Financing Guidelines for U.S.-Based Charities

Following the September 11, 2001 terrorist attacks the shut down three of the five largest international Islamic humanitarian organizations operating in the United States and froze approximately $8 million of their assets. The administration also sought Congressional action to permit it to expand its efforts to stop transfer of money to terrorist organizations. One of these was contained in the Victims of Terrorism Tax Relief Act passed in December of 2001 which amended section 6103 of the Internal Revenue Code to permit disclosure of tax returns and return information available to government law enforcement agencies outside of the Treasury for the purpose of investigating or responding to terrorist incidents, threats, and activities.[110] At the time of its passage, the Treasury announced that it was considering whether it would need more authority to stop the misuse of charities by terrorist organizations. On August 1, 2002 the department announced that it would not ask for more authority, nor would it be making any proposals to modify the Code to block the financing of the activities of terrorists through charities.[111]

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[110] Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-204, §201, 115 Stat. 2427, 2440 (2002).

[111] The Role of Charities and NGOs in the Financing of Terrorist Activities: Hearing Before the Subcommittee on International Trade and Finance of the Senate Committee on Banking, Housing, and Urban Affairs, 107th Cong., 2d Sess. (2002) (statement of Kenneth W. Dam, Deputy Secretary, Department of Treasury).

In November of 2002 the Treasury released a "voluntary set of best practices guidelines for U.S.-based charities to follow to reduce the likelihood that charitable funds will be diverted to finance terrorist activities."[112] It was reported in the press that the guidelines had been developed at the request of Muslim groups concerned about future government action and faced with declining contributions.[113] The guidelines were divided into three major sections dealing with governance, disclosure/transparency in governance and finances, financial practice/accountability and anti-Terrorist financing procedures. The section dealing with governance contained specific provisions to be included in governing instruments dealing with composition of the board (at least three members, meeting at least three times annually with the majority of members attending in person) and conflicts of interest. The guidelines stated that the board should be an independent governing body, and then specified that a charity whose directly and/or indirectly compensated board members constituted more than one-fifth of the board or of the executive committee will not be considered to have an independent governing body.

Under the heading Disclosure/Transparency, charities were directed to make publicly available a list of board members and salaries paid, as well as a list of the five highest paid

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[112] "U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-based Charities" (November 7, 2002).
[113] Alan Cooperman, "In U.S., Muslims Alter Their Giving; Those Observing Islamic Tenet Want to Aid Poor but Fear Prosecution," *Washington Post*, December 7, 2002, at A1.

transformation of in part of the Internal Revenue Service from a tax collecting agency to one with broad power to control fiduciary behavior. By including in the Code standards of behavior for fiduciaries developed under the common law to assure loyalty and prevent recklessness in the handling of charitable assets, it imposed on the Service a set of goals that would never have been considered part of the taxing function as recently as 1950. To a certain degree, this occurred because of the failure on the part of the states to fulfill their traditional role in regulating charities. But in larger part, the tax laws developed in tandem with the growth of the charitable sector, a growth that was attributable in large part to the tax benefits provided to charities and their donors. It was changes adopted in the late 1990's - notably the excess benefit limitations of public charities that completed the transformation of the regulatory function. a transformation that was just beginning to be understood at the start of the new century.

A second important element in this legal history is the overriding role of the Congress in directing the course of charity regulation, an influence that has been far more pervasive than any initiatives made by the executive branch. The same can be said in relation to the power of the courts with the exception, however, of their application of the public policy doctrine to the definition of charitable purposes. In that connection, the actions of the Congress, the courts and the administration in response to the decision of the IRS to withhold

exemption from private schools with racially discriminatory policies is an episode that deserves greater attention from scholars, pitting as it did the three branches against each other and demonstrating the extent to which Congress was willing to go to try to overturn a court decision through its appropriation powers.

Finally, it is instructive to trace the changes in the nature of the charges made against charities over the years. The swings mirror public attitudes, but certain themes do recur - the populist distrust of large amounts of property being dispensed for public purposes without public control, the fear of conservatives that charitable funds are being used to support liberal causes, and the opposing fears expressed by liberals; and the concern of business that charities receive unfair benefits at their expense. The pervasiveness of these views is not to be underestimated as one attempts to evaluate the laws and consider areas in which they may be made more effective.

The business judgment rule provides that, given that it is both the duty and the right of the board of directors to manage the affairs of the corporation, courts will defer to business decisions made by the board of directors, as long as in making those decisions the directors complied with their fiduciary duties of loyalty, due care and good faith.

GOVERNMENT REGULATION OF NONPROFIT FIDUCIARIES

MARION R. FREMONT-SMITH

CHAPTER 8

IMPROVING THE LAW AND REGULATION OF CHARITIES

Despite the breadth of the legal constraints on charitable fiduciaries, the law gives them an extraordinary degree of freedom in which to carry out their organizations' mission. So long as fiduciaries are faithful to the purposes of the organization, the law keeps its hands off. It does not tell them how to operate; it does not set priorities for expenditures; it does not mandate any one method for achieving purposes. Of course, the same constraints placed on all members of society apply to charity fiduciaries. They may not steal nor otherwise transgress the criminal laws. They may not adopt measures that are contrary to public policy such as discriminating on the basis of race or religion. Except with respect to the doctrines of cy pres and deviation, the duties imposed on charitable fiduciaries are negative in nature. They must not benefit personally at the expense of the charity. They must not be reckless in carrying out its purposes. These are minimal obligations and the strength of the charitable sector is attributable in large part to the fact that the restrictions on behavior are sufficiently lenient to encourage a high degree of compliance.

Evaluation of the effectiveness of the laws governing charities requires consideration of the degree to which they impinge on their freedom to operate while at the same time assuring that they will be administered for the benefit of the general public. How difficult will it be to comply with a particular restriction? Will it stifle innovation? Will it encourage support from the public? The preceding chapters have described the laws governing charities and the means by which they are enforced. In this chapter, these laws will be revisited in an attempt to evaluate their effectiveness as well as to suggest improvements.

EFFECT OF A DUAL LEGAL SYSTEM

A distinguishing feature of charity regulation is that it is a dual system, with state and federal rules and enforcement programs that parallel each other to a large degree. Accordingly, we will consider each set of rules separately and then look to where they diverge, where they can be brought together for more effective regulation and, finally, whether a single system would be preferable and if so, where it might be lodged.

exceptions?

Charities are creatures of state laws, established and dissolved under the jurisdiction and thus the laws of a particular state. These laws contain definitions of the purposes for which a charity may be established, as well as set limits on the behavior of its fiduciaries. State courts possess a wide

range of sanctions that they can use to correct wrongdoing and assure future compliance.

State laws are permissive regarding the creation of charities. It is possible for an individual to execute a declaration of trust that recites a charitable purpose, name himself or another as trustee, donate as little as ten dollars to it, and thereby constitute a valid charity. To create a charitable corporation one or more persons submits to a state official a form stating a name, charitable purposes, names of directors and officers, the fact that they have agreed to by-laws, the date for an annual meeting and their choice of a fiscal year together with a filing fee. In some states this can be accomplished over the internet. Upon receipt, the state official will approve articles of organization, thereby establishing a charitable corporation.

However, creating a charity under state law is merely the start. The overriding consideration when creating a new charity is assuring that it will be exempt from federal tax and eligibility to receive tax deductible contributions. Since the criteria for exemption from state income and sales taxes in almost every state is federal exemption, compliance with the federal tax requirements has paramount importance. Even though exemption from local property tax may not follow the federal exemption, it is the rare charity that operates by choice without federal exemption.

Until the 1970's the state and federal regulatory regimes operated with divergent aims and divergent enforcement methods. The state courts held the panoply of sanctions, while the only sanction available to the IRS was revocation of exemption, for many charities a sanction without clout. This shortcoming in the federal system was recognized by the mid-1960's. It was remedied to a limited extent in 1969 with respect to private foundations, a group that comprised 5% of the universe of charities. The Tax Reform Act of that year provided for sanctions for self-dealing that would be imposed on transgressors and on foundation managers who approved the transactions knowing they were prohibited. It also amended the Code to permit the IRS to abate a confiscatory termination tax that became payable in cases of repeated or egregious violation of the new limitations if a state court acted to preserve the foundation's funds - a clear recognition that the equitable remedies available in the states were far superior to the sanction of revocation of exemption which confiscated charitable assets while leaving the wrong-doers in charge with no federal limits on their future behavior.

Almost thirty years later, the value of intermediate sanctions as a regulatory tool for all charities was acknowledged when Congress in 1996 in the Taxpayers Bill of Rights 2 imposed self-dealing limitations on publicly supported charities and on social welfare organizations described in section 501(c)(4). The sanctions for violations of these new rules are similar to those applicable in the case of private foundation self-dealing, namely

excise taxes on insiders who receive excess benefits from dealings with the charity and on those managers of the charity who knowingly and willfully approved the transaction. They represent a major extension of federal regulation, not just because of the nature of the remedies, but because they established what is in effect a universal fiduciary duty of loyalty that parallels their duty under state law, thereby bringing the two systems closer. With their focus on punishing individuals, not the charity, they changed the regulation of tax exempt charities from one designed primarily in terms of protecting the integrity of the tax system, to one that also as its purpose the preservation of charitable funds.

The 1969 Act also contained a provision aimed at improving charity regulation by encouraging cooperation between the IRS and the states. The general prohibition against any disclosure by the IRS of taxpayer information was amended to permit IRS personnel to provide information about specific cases involving charities to state attorneys general as freely as they could to state revenue department officials. However, the amendment did not achieve the intended result; rather, it was interpreted in the regulations to permit exchange of information only after a federal matter had been closed, a limitation that rendered the provision virtually meaningless. This was due to the fact that by the time information could be provided to a state attorney general, the charitable assets would have long since been expended or diverted for private purposes. Legislation to remedy

this limitation was proposed by the Joint Committee on Taxation in a report evaluating disclosure provisions in the Code in 2000, and a measure to further amend section 6104 was part of a bill before the Congress in 2002 but it failed of passage.[1]

STATE LAWS GOVERNING CHARITIES AND THEIR FIDUCIARIES

Enabling Statutes for Charitable Corporations

All but two states have enacted statutes governing the creation, operation and dissolution of nonprofit corporations. They encourage creation of new organizations, providing straightforward, fairly uncomplicated rules. Although at one time in some states the courts or a state administrative official had power to refuse to grant a corporate charter, for example because the purposes were not considered charitable, there is now no jurisdiction in which a charity must obtain what was in effect a license from the state before it can come into being.

The Revised Model Nonprofit Corporation Act, adopted in 1987 by the American Bar Association and in effect in 21 states, contains easily understandable rules governing the operation of charitable corporations. It divides the universe of nonprofit organizations into three distinct categories, public benefit, mutual benefit and religious corporations. Individuals are granted wide freedom to choose the form of governance for a charitable corporation, including the number of directors or trustees, their terms of office, the rules relating to the

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[1] See Chapter 7..

calling of meetings, quorums, voting requirements, removal of officers and directors and the degree to which they may be indemnified.

As of the end of 2002 only three states, California, Maine and New Hampshire, imposed limitations on the composition of the board. California and Maine provide that no more than 49% of the directors can be persons who are being compensated by the corporation or members of their families. The New Hampshire statute requires that there be at least five directors of every corporation who are not of the same immediate family or related by blood or marriage.[2] It is likely that some other states will adopt provisions of this nature, mirroring requirements imposed on publicly traded companies contained in the Sarbanes-Oxley Act passed in 2002 which requires that the audit committees of public corporations be comprised solely of "independent" directors. A rule of this nature may be appropriate for large charities that operate complex enterprises such as hospitals and universities. However, for the vast number of charities it would constitute an unnecessary burden.

The powers granted to officers and directors under nonprofit corporation enabling statutes are designed to encourage independence. They affirm the ability of directors to delegate their duties, to establish committees and to rely on their reports. They permit, but do not require, that there be an executive committee. The same is true in regard to audit

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[2] See Chapter 3.

committees, although, given the tendency of nonprofit fiduciaries to follow the practice of business corporations as closely as possible, it is likely that more of these will be established in the future.

Among the few restrictions on the operation of public benefit corporations are those governing the disposition of charitable assets on termination or substantial contractions. In the case of dissolution, statutes in 16 states require prior notice to the attorney general and in three court approval is necessary. In 36 states notice must be given to the secretary of state or other state official with whom governing instruments are filed upon creation, but unlike the attorney general, this state official has no regulatory powers to assure that the corporation has distributed its remaining funds to another charity so that the provision has no regulatory effect. Sixteen states also require that notice be given to the attorney general of a proposed sale of substantially all of the assets of a charitable corporation.

The importance of statutory restrictions of this nature that are designed to protect charitable assets was belatedly recognized in the 1990's when a large number of hospitals converted to for-profit status, selling assets at prices below fair market value in some instances and in others allowing the proceeds to pass into private hands.[3] Statutes in three states prohibit conversions to for-profit status, while in 10 others

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[3] See below and Chapter 6.

approval from the court or the attorney general is required. These provisions apply to all charitable corporations. In addition there are now 22 states with legislation dealing specifically with conversions of health care organizations.

Duty of Loyalty

With few exceptions, state standards of behavior for officers, directors and trustees are well tailored to prevent them from realizing personal benefit at the expense of the charity and deterring reckless behavior. They have failed, however, to impose meaningful penalties for noncompliance, a failure that has seriously undermined enforcement efforts. The principal shortcomings include (1) permitting self-dealing transactions to be ratified after the fact without a showing of fairness, (2) applying a business judgment rule to excuse all but the extreme gross negligence, and (3) condoning broad indemnification, backed by insurance paid for by the corporation even in some circumstances in which there was bad faith. The rationales for the adoption of each of these measures include the old concept that it not appropriate to ask too much of volunteers, and a more contemporary fear that unless shielded from liability, people will not serve as directors or trustees.

Suggestions for reforming the duty of loyalty have ranged from calls to further loosen the standards to recommendations to prohibit any sort of self-dealing. Among them, the most balanced

and likely to gain acceptance is that put forth by Goldschmid, namely requiring that the transaction be fair to the corporation and that court review of transactions be governed "under loyalty standards [and not the business judgment rule]."[4] In addition, statutes providing that validated self-dealing transactions even if they are unfair to the corporation may not subsequently be voided should be repealed. This rule is counter to the excess benefit transactions limitations in section 4958 and offers no protection to a charity that has been misled by an insider.

Other components of the duty of loyalty, or fair dealing as it is termed under business law, needing clarification are the definitions of "conflicts of interest" and of "independent" parties. The descriptions of "conflicts of interest" in the statutes do not always specify whether the term applies only to financial conflicts or rather extends to situations that involve nonfinancial relationships. A common example is a director who serves on the boards of two charities which are looking for major gifts from a specific donor or are interested in purchasing a specific parcel of real estate. In most instances, conflicts arising from service on the boards of competing charities can be taken care of without legal subvention. It is rare to find the same individual serving on the boards of two hospitals, two art museums or two schools in the same community. Perhaps, the best approach would be to follow the example of many state governments

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[4] Harvey J. Goldschmid, "The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms," 23 *Journal of Corporation Law* 631, 651 (1998).

and some private institutions by adopting a code of ethics or other non-binding statement to cover appearances of conflicts and those without financial ramifications.[5]

The definition of "independent directors" is similarly in need of clarification, particularly as to whether it includes donors, or other persons dealing regularly with the charity such as consultants and professionals. If any of these categories are to be included, the parameters of the relationships will need definition. The analogous provisions in the self-dealing and excess benefit provisions in Chapter 42 of the Internal Revenue Code and the regulations may provide models.

Duty of Care

The duty of care, which in effect protects fiduciaries from liability for ordinary negligence, is a rational standard to which charitable managers and directors should be held. As with the duty of loyalty, the problem is not with the formulation of the standard. Rather, it is the application of the business judgment rule to measure liability for failure to comply. The result has been to discourage enforcement in all but the most egregious circumstances; and modifications that will apply to breaches of the duty of care as well as the duty of loyalty are needed. Furthermore, the business judgment rule as formulated in the American Law Institute Principles of Corporate Governance, section 4.01 protects a fiduciary only when there has been a

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[5] Mass. Gen. Laws. Ann. ch. 268A, §23.

conscious exercise of judgment[6] and then only if the director or officer is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances. Inattentive or uninformed directors are subject to the reasonable care standards of section 4.01(a).

The issue of how much attention should be demanded of directors is a particularly acute one for a large number of charities. It is not uncommon to elect individuals to serve as directors because of certain unique contributions they are able to make by virtue of their having particular expertise, or standing in the community benefit the organization, or because they are looked upon as potential donors. In many instances it is understood that these individuals will not be expected to attend meetings or give the affairs of the charity the degree of attention expected of other board members. Suggestions have been made to redefine the duties of directors to permit what might be considered a special class which would not be held to the standards required of others. A better solution would be to provide these individuals with an honorary title or, if the corporation has members, elect them to that position, rather than diluting the overall standards appropriate for directors.

The duty of care applies to the investment of charitable assets as well as to the administration of the organization. The standards for investing were modified in 1992 with the adoption

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[6] *Principles of Corporate Governance*, §4.01(c)(2) (American Law Institute, 1992).

by the American Law Institute of a Modern Prudent Investor Rule, embodied in *Restatement (Third) of the Law of Trusts* and the *Uniform Prudent Investor Act*.[7] This formulation brought modern investment theory and practice to trust law and by extension to the investment policies of charitable corporations. It freed directors to invest in a wide range of assets and to delegate their powers to professionals. This does not, however, mean that it absolved them from exercising judgment nor from failing to pay attention, failures exemplified in the case of the New Era Foundation when a large number of charitable organizations were drawn into a Ponzi-type scheme that resulted in serious losses and the criminal conviction of the foundation's organizer.[8]

The duty to diversify investments is recited in section 227(b) of the *Restatement* formulation of the Prudent Investor Rule as follows: "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Unfortunately, the commentary does not provide adequate guidance to make this a meaningful standard. There were a sufficient number of instances in the 1990's and early 2000's in which charities experienced severe losses from the failure to diversify to warrant concluding that the rule should be modified or at the least further clarified. Examples that were widely publicized involved Emory University which was reported in 2000

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[7] See Chapter 4.
[8] Joseph Slobodzian, "Bennett Gets 12 For New Era Scam," *National Law Journal*, October 6, 1997, at A8.

to be invested disproportionately in Coca Cola stock;[9] Temple University which in 2000 had more than 50% of its portfolio in bonds;[10] and the Art Institute of Chicago whose board approved an investment of almost $400 million of its $650 million endowment in hedge funds, with one particular investment of $23 million reported in June of 2001 to have nearly vanished and another $20 million to be at risk.[11]

The *Uniform Management of Institutional Funds Act* (UMIFA) was formulated in 1972, twenty years before the *Restatement (Third) of Trusts*. This act was also designed to free fiduciaries to follow modern investment principles, specifically the concept of total return. However, it applies only to endowment funds, with the anomalous result that a charity will be governed by two different rules depending on whether its funds were subject to restrictions as to expenditure of principal or not. With adoption of the Modern Prudent Investor Rule, there is a question as to whether it is appropriate to retain UMIFA in its original form, at least in regard to its formulation of an investment standard. Furthermore, UMIFA does not address the question of whether and in what circumstances endowment funds may be pledged as security for loans. In a number of jurisdictions, approval by the attorney general and in some instances, by the court is required. This

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[9] John Hechinger, "Emory U Gets a Lesson in Subtraction as Coke's Stock Fails to Make the Grade," *Wall Street Journal*, January 28, 2000, at C1.
[10] Holly M. Sanders, "Temple University Shifts Investments to Stocks, *Bloomberg News*, September 29, 2000.
[11] Corfman & Rose, "Art Institute Investment Strategy Raises Questions," at C1.

requirement should be universal, particularly if no change is made in the liability provisions applicable in the case of breach of the duty of care. Finally, the provisions in UMIFA defining the charities to which it is applicable are confusing and have created uncertainty, particularly in regard to trusts as to which the intent of the drafters appears to have been to exempt them from the provisions, even though some trusts operate enterprises and hold restricted funds.

Indemnification, D&O Insurance and Liability Shields

The ability to indemnify directors has been considered necessary in order for charities to obtain the services of knowledgeable volunteers to serve as fiduciaries. In 31 states, corporations are permitted to pay attorneys' fees and costs of its officers and directors in suits charging them with breaches of the duty of care. In a few states indemnification is permitted against judgments and fines, while nearly half permit indemnification for amounts paid in settlement of suits. A concomitant to the power to indemnify is the power of the corporation to purchase insurance to cover judgments against directors and officers and to pay attorney fees incurred in defending them. Except in instances of bad faith, the coverage will typically leave the charity and its fiduciaries harmless and, even in cases involving bad faith, will cover the costs of attorneys fees and other expenses. It is also permissible to advance sums to meet expenses. Brody has noted that attorneys

general appear to be keeping an eye on policy limits in negotiating settlements, citing the settlement with the trustees of the Bishop Estate for $25 million which was the limit of the D&O policy, half of which went to the charity and the remainder to attorneys' fees.[12]

It is possible in some jurisdictions to include in the articles of organization of a business corporation, with approval of the shareholders, a provision placing a cap on liability or waiving it entirely, particularly in connection with breaches of the duty of care. The *Revised Model Nonprofit Corporation Act* contains an optional provision permitting inclusion of such a liability shield in the articles of organization. In cases involving breaches of the duty of care only, Brody suggests that such an approach might be salutary by making the risk low enough to attract directors while high enough to induce fiduciaries to take their tasks more seriously. [13]

According to press reports, in the settlement of the suit between the New York attorney general and the trustees of Adelphi University who where removed from office by the New York Board of Regents, the attorney general prohibited use of the university's D&O policy to pay the $1.23 million fines imposed on the trustees and the $400,000 of legal bills they incurred.[14]

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[12] Evelyn Brody, "The Legal Framework for Nonprofit Organizations," in *The Nonprofit Sector: A Research Handbook*, 19-20 (Walter W. Powell and Richard Steinberg eds., 2d ed. forthcoming).
[13] Brody, "The Legal Framework for Nonprofit Organizations," 21.
[14] David M. Halbfinger, "Lawsuits Over Ouster of Adelphi Chief Are Settled," *New York Times*, November 18, 1998, at B1.

Obviously, a cap would be of no avail if this approach were widely adopted.

The California nonprofit corporation act places special limits on the power of indemnification in enforcement proceedings involving the attorney general. As is the case in other jurisdictions, indemnification is mandatory if the defendant prevails on the merits. It he does not, again following the general rule, the court may permit indemnification for expenses in an amount determined by the court. In the case of a settlement, indemnification is allowed to cover costs and the amount of a settlement only if the attorney general approves and if a court, or a majority of disinterested directors or members determine that the person acted in good faith and in a manner he reasonably believed to be in the best interests of the corporation. A provision of this nature would permit relief in appropriate cases while not affording blank coverage regardless of the extent of the breaches of duty involved.

Changes of Purpose: Deviation; Power to Amend Corporate Charters

The doctrine of cy pres, applicable in 46 states to charitable trusts and to charitable corporations, empowers a court to modify the original purposes of a charity if they become illegal, impossible, impracticable or, in some jurisdictions and in the draft of the *Restatement (Third) of Trusts*, and the Uniform Trust Code, wasteful to fulfill. Under common law, the

new purposes were to be "as close as possible" to the original ones, but that rule has been relaxed so that the standard, as recited in Draft *Restatement (Third) of Trusts*, calls for application to a purpose that "reasonably approximates the designated purpose." Furthermore, the *Restatement* explicitly provides that the doctrine is applicable in the case of gifts to charitable corporations that subsequently are dissolved. Prior law had also required a showing that the settlor/donor had a general charitable intent, a requirement that still obtains in 24 states but has been abolished in the others.

A companion to the cy pres doctrine is the doctrine of deviation, applicable to private and charitable trusts alike. It permits a court to modify an administrative or distributive provision of a trust or permit the trustee to deviate from such a provision if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust. Furthermore, it places the trustee under a duty to petition the court for deviation if he knows or should know of circumstances that justify such action. The two doctrines are often confused, with the court in North Carolina rejecting the doctrine of cy pres but applying deviation to modify purposes.[15]

Although the *Restatement* formulation of the doctrine of deviation incorporates a duty to seek its application, there is no corresponding recited in regard to the cy pres doctrine. However, it is implicit in the duty of loyalty which as

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[15]See Chapter 3.

originally formulated in the case of private trusts is a duty to the beneficiaries, while for a charity it was transposed into a duty to carry out purposes that were for the benefit of an indefinite class of beneficiaries. Thus, in situations where it becomes impossible, impracticable or wasteful to continue to fulfill the original purposes, the trustee cannot fulfill his duty to the public beneficiaries unless he seeks modification under the cy pres doctrine. Statutory clarification in the various states would be helpful. In England, by statute charity trustees are under an affirmative duty to seek cy pres application of their trust assets when it becomes appropriate.

Kurtz has articulated a duty of obedience to the original mission of a charity,[16] which was cited in one decision of a court in New York in which the trustees filed a petition seeking approval of a sale of assets.[17] Interpretation of the traditional duty of loyalty to make explicit that it includes the duty to seek revision of purposes when they can no longer be carried out would assure that charitable funds will be used for purposes beneficial to the public on a contemporaneous basis. It is true that an attorney general can bring a cy pres petition on his own motion if the prerequisites for application of the doctrine are met, but it would be preferable for trustees to understand this

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[16] Daniel Kurtz, *Board Liability: A Guide for Nonprofit Directors*, 84-85 (1988).
[17] Matter of Manhattan Eye, Ear & Throat Hospital, 715 N.Y.S.2d 575 (Sup. Ct. 1999).

as one of their duties rather than let it pass to the state by default.

There has been a question as to whether directors or members may amend the original purposes of a charitable corporation without court approval, thereby in effect avoiding the need to apply to a court for application of the doctrines of cy pres or deviation. The limitations on the power of amendment were set forth in a Massachusetts case in which a corporation created to operate a hospital attempted to amend its purposes to permit it to conduct any activity that promoted the health of the public. The court held that, although the corporation statute made no reference to limitations on the power to amend, it would be a violation of fiduciary duty for directors to apply funds given subject to restrictions as well as unrestricted donations made prior to the amendment to a new purpose. In rejecting the hospital's argument that it had unfettered power to amend its purposes, the court stated, "As the Attorney general, colorfully, but no doubt correctly observes in his reply brief, 'those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists.'"[18]

Rights and Duties of Members

The majority of mutual benefit corporations are constituted with members who have certain rights in connection with the governance of the corporation. There are also uncounted public

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[18] Attorney General v. Hahnemann Hospital, 494 N.E.2d 1011 (Mass. 1986).

benefit corporations with members. In some instances, the members are individuals whom the directors wish to acknowledge for their contributions or other manners of support, but who for any number of reasons are not appropriate persons to serve as directors, among them being a desire to keep the board relatively small. In some instances members are chosen to represent various constituencies of the corporation. State statutes and the case law holds that members have a right to vote for directors, to compel accountings, and to approve amendments to the by-laws. In some states they are also given the power to approve amendments to the articles of organization and changes of purposes. There are a large number of cases dealing with the rights of members to sue the directors for breaches of their duties or to protect the corporation's assets. These are discussed below.

There are no precedents and little commentary about the duties of members. During the 1980's and 1990's the extent of these duties assumed importance in an unanticipated context. During this period many charitable organizations, particularly hospitals, were reorganizing their corporate structures to provide for a central parent corporation controlling a number of subsidiary organizations, some taxable and some exempt. In the for-profit context, control would be exercised by virtue of the parent's ownership of stock in the subsidiary corporation. Following the analogy made between members of a nonprofit corporation and stockholders of a business corporation, a nonprofit parent corporation would be named the sole member of

each of the nonprofit subsidiaries, with the right to elect directors, approve certain measures relating to the management of the subsidiary, and the right to amend its articles and by-laws. Once in operation, conflicts arose in some of these arrangements between the interests of the parent and those of the subsidiary, with no rules prescribing to whom the sole member's duty of loyalty ran. The same question arose in regard to the duty of the directors of a subsidiary who were elected by the sole member parent organization: is it to the parent or to the corporation for which they serve as fiduciaries? As of the end of 2002, the problem was unresolved and the conflicting interests involved made it difficult to craft a solution.

Powers of Donors

Under common law, donors have only the rights they may reserve at the time of their gifts. If none are reserved, once the gift is complete, they have no standing to sue the corporation or the directors to enforce the terms of the gift. As a practical matter, if a donor reserves a right of reverter, the gift will not be considered complete for purposes of the tax laws, so that the donor will not be entitled to a deduction from tax for the contribution. Donors wanting to be assured that the terms of their gifts will be observed, but unwilling to risk loss of tax benefits, may provide in the deed of gift for a transfer of the assets to another charity if the original donee fails to carry out the terms of the gift, thereby making the alternative beneficiary the enforcer of the conditions.

Providing for a gift-over is less common than ongoing involvement in the manner in which a charity expends gifts. Although community foundations have long had "donor-advised funds", signifying funds as to which they will consider the recommendations of a donor or his designee as to the identity of grantees of distributions from that specific fund. Since 1991 a number of investment companies followed this model, establishing donor-advised funds for which they serve as trustee and which, because of their size and the large number of contributors, qualify as public charities. A survey published in May of 2002 estimated that $3.7 billion were held by 16 commercial donor-advised funds, of which $2.6 billion were held by Fidelity Investments Charitable Gift Fund, the originator of the concept.[19] Another 46 community foundations offering donor-advised funds held an estimated $5.4 billion. The Fidelity Charitable Gift Fund in 2001 received $1,055,788,830, second only to the Salvation Army in the amount of private donations received by charities that year as compiled by the Chronicle of Philanthropy, an unprecedented record of growth which signified the popularity of this vehicle for funneling charitable contributions.[20]

During the 1990's, it also became popular for some foundations and individual donors to characterize their grant-making as "venture philanthropy," differentiating it from "old

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[19] Marni D. Larose, "Assets of Donor-Advised Funds Totaled $12.3-Billion Last Year, Survey Finds," *Chronicle of Philanthropy*, May 30, 2002, at 8.

[20] Nicole Lewis and Meg Sommerfeld, "Donations to Big Groups Rose 13% in 2000," *Chronicle of Philanthropy*, November 1, 2001, at 35.

fashioned philanthropy" by the degree of involvement of the grantors who proclaimed that they were applying the approach of venture capitalists which entailed a high degree of involvement in the decisions of the company in which the venture funds were invested, as well as receipt of detailed current financial information as the project went forward. Further evidence of support for expanding donor control was exemplified by the provision in the *Uniform Management of Institutional Funds Act* permitting a donor to release a restriction he had placed on his contributed funds.

Taken together these trends reflected a new attitude toward charitable giving and the disbursement of charitable assets which emphasizes the ongoing importance of donors in a manner contrary to common law. If they continue, the limits on donors' powers that have been a basic component of the charity law are likely to change, a development not without irony in light of the objections voiced by the Treasury Department and the Congress to donor control of foundations in the 1960's.

STATE REGULATION OF CHARITIES

Regulation by the Office of the Attorney General

The duty to regulate charities in the states is imposed on the attorney general, acting as representative of the indefinite beneficiaries of these institutions. However, there are only twelve states in which this power is exercised in a manner that impacts positively on the behavior of charitable fiduciaries. In

1991 Dale characterized state enforcement as follows: "In most states, the Charity Bureau of the Attorney General's office is inactive, ineffective, understaffed, overwhelmed, or some combination of these."[21] Ten years later, this characterization holds, particularly in regard to breaches of the duties of loyalty and care and in efforts to assure dedication of funds to charitable purposes. It is to be noted that this characterization does not apply to the same degree to regulation of solicitations of funds for charitable purposes, a separate aspect of charitable activity regulated under separate laws now in force in 36 of the 50 states and the District of Columbia and enforced by the attorney general or a state charity official, most often as part of the duties of a bureau of consumer protection. This aspect of charitable regulation is far better staffed and managed in most states than the efforts to police fiduciary duties. Furthermore, regulation of solicitation is better publicized and better understood by the general public.

The discussion that follows does not apply to regulation of solicitation except to the extent that there is overlap in the programs and the reporting requirements. Thus, for example, in New York, Illinois, Ohio, Michigan and Massachusetts, the attorney general is responsible for both aspects of charity regulation and his efforts are coordinated in the same office. In

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[21] Harvey P. Dale, "Diversity, Accountability, and Compliance in the Nonprofit Sector," The Norman A. Sugarman Memorial Lecture, Mandel Center for Nonprofit Organizations, Case Western Reserve University (March 20, 1991).

contrast, in Connecticut, Maryland, New Mexico, and Pennsylvania, for example, only certain charities that solicit funds from the general public need register and file annual financial reports with the office of the attorney general. In these states the attorney general has no record of the universe of charities in his jurisdiction and no information on the financial activities of any of them other than private foundations which are required to file duplicates of their federal information returns with the state, and those soliciting charities that are required to register and report. In contrast, in California, registration and financial reporting is required of all charities, as well as of professional fund raisers, while soliciting charities are regulated by the cities and towns. In South Carolina and Rhode Island the registration and reporting requirements apply only to charitable trusts, not corporations, while in Minnesota soliciting charities are subject to detailed reporting requirements and other charities are required to file copies of their federal tax return or, if none, an audited financial report.

Indicative of the low level of state interest in regulation of fiduciary duties is the fact that in 1965 the three New England states with reporting statutes, together with California, Illinois, Michigan, Ohio, and Oregon, required registration and reporting from charities and still do. Iowa and Washington had similar statutory requirements, but they were repealed. Minnesota and South Carolina are the only states to have adopted regulatory

programs since 1965, with the result that the number of states regulating fiduciary duties is the same as it was forty years ago. It is true that the great majority of charities in the country are organized and operating in one of these states so that the statutes effect more organizations than it might otherwise appear. The problem, however, is that the disparity between states with active programs and those without fosters forum-shopping and creates inconsistencies which make regulation exceedingly difficult.

The statutes establishing these state regulatory programs are for the most part adequate for their purposes. There is a *Uniform Supervision of Trustees for Charitable Purposes Act*, adopted by the National Conference of Commissioners on Uniform State Laws in 1954. However, the definition of the charities covered by the act is seriously flawed. It required amendment in Illinois and Michigan to clarify that it applied to charitable corporations as well as charitable trusts, while the California version was changed before enactment for that purpose. The Oregon act adopted the same language used in the California act.[22]

The rationale for these statutes is that it is impossible for an attorney general to regulate charities in his jurisdiction if he has no record of their identity nor information about their operations. In addition to the registration and reporting requirements, the acts provide his office with broad powers to investigate allegations of misappropriation of charitable funds,

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[22] See Chapter 6.

to subpoena witnesses, hold hearings and issue regulations to assist in carrying out his duties. Complementary provisions in other state laws require that the attorney general receive notice of all legal proceedings involving the disposition of charitable funds, and in some instances he is considered a necessary party to those proceedings. The latter is the case with petitions for cy pres or deviation in all but a few states. Finally, statutes in a number of states require either notice to or approval by the attorney general of dissolutions, mergers, and substantial contractions of charitable corporations.

In short, these laws give broad power to the attorney general to regulate charities, yet the few active programs in existence operate with limited staff and inadequate financial resources. The lack of support may reflect the disinterest of a particular attorney general, but that has not been the usual case. Rather, the principal reason is that all of these programs are underfunded. For example, New York has 40,000 charities registered and reporting to the attorney general's Charity Bureau which is staffed with 18 attorneys. In California, the attorney general maintains three offices, staffed by 12 ? attorneys. A separate Registry of Charities is maintained in Sacramento with which all annual reports are filed. As of the end of 2002, there were 85,000 charities registered and filing with the state. These are the best staffed and most active of the offices in the larger states and offices in Illinois, Michigan and Massachusetts operate in a similar manner. In contrast, one attorney is

assigned on a part-time basis to handle trust matters in Rhode Island.

In addition to the twelve states just described, there are 22 others with statutes requiring registration and reporting by certain charities that conduct public solicitations for contributions. Some of these programs are conducted by the attorney general, others are under the jurisdiction of the secretary of state or another state official. In a number of these states, notably, Pennsylvania, Connecticut, Texas and New Mexico, the attorney general has instituted proceedings against individual charities on the basis of information obtained through their activities regulating solicitations, in others from members of the public. The regulators in these states are knowledgeable as to the duties of charitable fiduciaries and willing, in appropriate circumstances to bring actions to preserve charitable funds. However, it is far beyond the resources of any of these state officials to enforce breaches of fiduciary duty on a regular basis.

Suggestions have been made to fund state regulatory programs through filing fees and a number of the states do require annual payments. However, as is the case with the federal excise tax on private foundations that was originally to be earmarked to provide funds for the IRS to audit exempt organizations, the Congress and state legislators routinely resist earmarking funds for specific purposes, preferring to

retain control over their disposition as part of the general appropriations powers.

In assessing the effectiveness of the state programs, two disturbing trends have become apparent in recent years. The first trend is increasing use by attorneys general of the threat of litigation to force charities to agree to settlements of disputes with conditions that are far more restrictive than the law requires or that would be imposed by a court. One widely publicized example was the terms of a settlement between the Massachusetts attorney general and the trustees of Boston University over a controversy relating initially to the investment of a large percent of the University's assets in a start-up venture. Under the terms of the settlement, the trustees agreed to reform the corporation's basic governing structure to require fixed terms for directors and trustees with limits on the number of consecutive terms they could serve, giving alumni and faculty a voice in nominating and electing trustees, and requiring the board to adopt special procedures for approving the salary of the president. None of these limits are required of newly formed charities, nor is there precedent for the courts to impose them permanently.

This does not mean that settlements are per se undesirable. In many instances, they assure reform while avoiding embarrassment to well-intentioned fiduciaries and they save public and charitable funds. However, as Brody has noted, settlements commonly remain secret, making it hard to judge the

level and the effectiveness of regulators in influencing charity behavior as well as determining whether the regulators were motivated by their own or the public's interest.[23]

The second trend is closely related to the first; namely, the politicization by the attorney general of his powers over charities. An early example was the release to the press of the allegations against Boston University made by a Democratic attorney general when the president of the university was running for governor as a Republican. More recently, the attorney general of Pennsylvania, while running for governor in the summer and fall of 2002, generated nation wide publicity when he successfully prevented the trustees of a school from selling their controlling interest worth $1.35 dollars in the stock of a company on the grounds that the trustees had a duty to the community in which the charity was located in addition to their duty to operate the school. As a result of the challenge the trustees abandoned the plan to sell the stock and then resigned to be replaced by a slate approved by the attorney general. Shortly thereafter the state legislature amended its prudent investor rule to require charitable fiduciaries to consider needs of the community in which they were carrying out their charitable purposes - a major departure from common law principles.[24]

A final area in which reforms are needed is one affecting both the states and the Internal Revenue Service, namely, the

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[23] Brody, "The Legal Framework for Nonprofit Organizations," 6.
[24] See Chapter 4.

nature of the information that is required to be filed by the charities. Since the 1980's state attorneys general and state charity officials have cooperated with the IRS and each other in efforts to improve the content of the state and federal forms charities must file, and most states now accept the federal Form 990 with some supplemental information to meet state reporting requirements. In those states which regulate solicitation, 33 accept a uniform reporting form that uses Form 990 as its starting point. This has eased the burden on filers to a certain degree, although it has not obviated the need for charities that conduct interstate solicitations to file separate reports in as many as 36 jurisdictions. The specific shortcomings related to the forms filed with the states, and more particularly the information required to be provided on them are discussed below in connection with the federal report forms which are accepted by all of the states.

The nature of state charity programs is regulatory, but they also have an amelioratory function. It is exemplified in the wording of the Massachusetts statute which imposes a duty on the attorney general to "enforce the due application of funds given or appropriated to public charities...and to prevent breaches in the administration thereof." In a few jurisdictions and during different periods, there have been attorneys general who view their role as that of an adversary and confine their activities to policing and prosecuting charities and their fiduciaries. However, in almost all of the states in which the attorney

general is active in enforcement, he has viewed his role as supporter of the sector, placing upon him a duty to improve administration of charities. When the first regulatory statutes were enacted between 1950 and 1970, efforts were made to identify charities and to educate fiduciaries as to their duties, including the duty to register and file financial reports. During this effort, many small trusts were identified with income that merely covered the fees and expenses of their fiduciaries. The state encouraged and in some instances initiated court actions to consolidate small trusts or apply them under the cy pres doctrine to other purposes. A number of attorneys general undertook campaigns to educate trustees as to their duties and to improve reporting procedures. Attorneys general now regularly issue publications and news letters, hold conferences for fiduciaries and, with the advent of the internet, post information about their activities and aids for compliance on the internet. The Massachusetts Division of Public Charities in 1962 established an advisory committee comprised of leaders in the charitable community, members of the bar and accounting professions, fund raisers, the banks and civic leaders who meet with the attorney general and his staff on a regular basis to discuss matters of concern and formulate measures to improve compliance. Succeeding attorneys general have continued this practice and it has been replicated in a number of other states, most recently in Illinois. One of the most compelling examples of the benefits that can arise from cooperation between the attorney general and

the community is the group that was formed in the fall of 2001 in New York to assist in coordinating the disbursement of donated funds to victims of the disaster and their families.

Standing to Sue

Under the common law, the attorney general was granted what amounted to virtually exclusive standing to sue to enforce charitable assets. Members of the general public, unless they could show a specific beneficial relationship to a charity were not permitted to call charitable fiduciaries to account. The rationale was that if trustees and directors were open to suit by anyone, it would be impossible to find individuals to serve. Furthermore, members of the general public were not permitted to sue the attorney general to force him to take action. This has meant that in states in which the attorney general has no role in charity enforcement, in most instances there is no effective way to apply to the courts to correct abuses. Co-trustees and co-directors do have standing, as do members in a few states. The courts have also relaxed this rule of exclusive standing under some circumstances to permit donors or their heirs, hospital patients, park abutters, students and faculty and alumni to bring suit, but the cases in which standing has been denied outnumber those in which it has been granted. In the majority of the cases allowing private parties to sue, a major factor in the court's decision has been the absence of any state official able or willing to act.

The desirability of expanding standing has received a good deal of attention in the legal literature, with a number of suggestions for expanding standing and a number of commentators concerned that to do so will encourage frivolous suits that will divert fiduciaries and deplete charitable funds in defending their actions.[25] There can be no question that expanded standing will encourage disaffected persons, whether grantees, potential beneficiaries, or disgruntled members of the public to use the courts to attempt to force trustees and directors to take desired courses of action. The best solution is to have an active and interested attorney general who will take action to correct abuses. There is also precedent for allowing him to let individuals to bring suit in his name if he believes there is merit to the action but is disinclined to do so himself.

There is one situation in which relaxation of the rules of the standing would be appropriate. That is in a situation in which the attorney general as part of his constitutional duties is called upon to represent a state agency which is party to a suit in which a charity is on the opposing side. In such a case, the attorney general could agree to represent or defend the charitable interest and arrange for outside counsel to represent the state agency. If he chooses, however, to oppose the charitable interests, the doctrine of limited standing should be relaxed so that the charitable interests may be heard.

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[25] See Chapter 6.

Other State Agencies that Regulate Some Aspect of Charitable Activities

The office of the attorney general is not the only state office that regulates charitable activities and the actions of their fiduciaries, although its powers are broader than other state agencies. The Secretary of State or Corporation Counsel in all jurisdictions issues articles of organization and monitors the existence of corporations through requirements to report active status annually. Boards of educations, or in New York the Regents, have broad supervisory powers over educational organizations. The extent of this power was demonstrated in the 1995 case of Adelphi University in which a class consisting of students, faculty and staff brought suit against the trustees alleging violation of the duties of care and loyalty, the outcome of which was the imposition of fines and removal of all but one of the trustees.[26] State tax departments have the power to grant exemption from state income and sales taxes, while taxation of real and personal property is governed at the local level. In almost every case, state exemption follows the federal determination. However, this is not necessarily the case in regard to property taxes, as the history of attempts to tax hospitals and other health care delivery systems in Pennsylvania and Utah, described in Chapter 3, substantiates. It is likely that local taxation will remain a major issue, not easily

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[26] Jack Sirica, "Suit Filed Against Adelphi President," Newsday (NY), October 20, 1995, at A66; David M. Halbfinger, "Lawsuits Over Ouster of Adelphi Chief Are Settled," *New York Times*, November 18, 1998, at B1.

resolved other than through indirect pressure on institutions to make payments in lieu of taxes.[27]

Regulatory powers are also exercised by state accrediting agencies, anti-trust divisions, bankruptcy courts and consumer protection bureaus. None has power to effect change in the entire sector and should not be looked to for regulation of fiduciary behavior.

FEDERAL LAWS GOVERNING CHARITIES AND THEIR FIDUCIARIES

Internal Revenue Code Provisions

Although state laws govern the creation and dissolution of charities and the duties and powers of their fiduciaries, in actuality, it is the federal government and, specifically, the Internal Revenue Service that regulates this segment of the nonprofit sector today, as it has for the last half century. The importance of the federal regulatory regime cannot be overemphasized. One has only to consider that in two thirds of the states regulation of charities is minimal or non-existent and even in the 12 jurisdictions with active enforcement programs, the federal rules set an important minimum standard for compliance.

Recommendations for Changes in the Code and Regulations

The provisions in the Internal Revenue Code that contain the requirements for exemption from income tax and eligibility for receipt of deductible contributions are described in Chapter

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[27] See Chapter 3.

5, while the manner in which the Service regulates these entities is summarized in Chapter 7. Many of the short-comings in the regulatory scheme and recommendations for revision of the substantive provisions are described in those chapters. Like the state provisions, by and large the Internal Revenue Code limitations are adequate to protect charitable funds, and with some exceptions they do require high standards of fiduciary behavior. This was not the case until passage in 1996 of the Excess Benefit Limitations. Prior to that, only private foundations managers and substantial contributors were prohibited from self-dealing, with penalties appropriately imposed on them and not the foundation itself. Private foundations, however, represented only 5% of the organizations exempt under section 501(c)(3). The fiduciaries of the remaining 95% of organizations described in section 501(c)(3) were subject to poorly articulated prohibitions against private inurement and private benefit, with the only sanction being revocation of exemption of the charity and no sanction on the individuals whose behavior led to the revocation. With the limits on the ability of the IRS to provide information to state attorneys general, there was no effective way in which one could assure that timely action would be brought against those individuals or that the assets of the charity would be protected.

The provisions in the Internal Revenue Code that limit the behavior of charitable fiduciaries are found in the first instance in the definition of organizations eligible for

exemption from taxation and the regulations thereunder which prescribe that a charity must be organizational and operated exclusively for exempt purposes in order to qualify. There is a prohibition in the code itself against inurement of income to private individuals and a similar prohibition against provision of "private benefit" is found in the regulations.

The organizational test in a sense sets the ground rules for operation of a charity, requiring that governing instruments limit the manner in which fiduciaries may carry out the organization's purposes. They do not permit broad exculpatory language and require inclusion of a provision assuring that upon dissolution, the organization's assets will pass to another exempt charity. They also identify provisions which, if included, will disqualify the organization from exemption. Thus, they prohibit inclusion of a provision expressly permitting an organization to engage in activities which in themselves are not in furtherance of one or more exempt purposes unless the activity is an insubstantial part of its operations. The effect of this provision has been to alter the Code requirement that a charity be organized "exclusively" for exempt purposes, to read "substantially". The operational test further expands on this distinction by providing that an organization will be considered to be operated exclusively for exempt purposes if it engages primarily in activities which accomplish exempt purposes and that the test will not be met if more than an insubstantial part of an organization's activities are not in furtherance of an exempt

purpose or if it violates the prohibition against private inurement. The prohibition against private inurement applies to directors, officers and employees and other "insiders", and to payments that are not commensurate with the services provided to the charity. There have been two difficulties in its application: uncertainty as to whom it applies and uncertainty as to the extent to which a benefit gives rise to the prohibition. The problem is compounded for the regulators because the existence of any amount of private inurement is grounds for revocation. This is in contrast to the limit on private benefit which is violated only if the benefit is found to be more than insubstantial. The private benefit prohibition, however, applies to any person, not just insiders, so that the private inurement prohibition is in effect a subset of the private benefit rule.

The enactment of the excess benefit provisions was recognition of the shortcomings in applying these rules to police fiduciary behavior. With its passage, it was anticipated that the private inurement provisions would decrease in importance while the private benefit proscription, applying as it does to a greater universe than the excess benefit provisions will assume more importance. This may not, however, be a satisfactory situation for the regulators in that the parameters of private benefit remain unclear and the sanction remains inappropriate.

In regard to the excess benefit prohibitions themselves, there are two major shortcomings that could not be resolved in the regulations. The first is that in determining whether the

amount of compensation is excessive, the Congressional history made it clear that comparable data from the private sector not just the nonprofit universe was to be considered. This provision effectively removed meaningful limits on the amount of compensation that charities may provide. There is already anecdotal evidence that the Code provisions have raised the level of payments.

The second shortcoming relates to indemnification of disqualified persons, specifically managers. Payment of director and officer liability insurance premiums are not excess benefit transactions nor is the application of insurance proceeds to pay excise taxes imposed for violations of the provisions so long as the payments are treated as compensation to the fiduciary. The distortion that results from these provisions was exemplified in the settlement of the Bishop estate dispute with the IRS under which the amount paid by each trustee was $40,000, while the reported total fines of $14 million of taxes and interest came from the proceeds of insurance that had been owned by the estate.[28] Limitations in state law would be preferable, but it is unlikely that they would be universally adopted. Accordingly it would be appropriate to limit the use of insurance proceeds in cases where the persons subject to tax has not prevailed in a court proceeding or the case has been settled. The California statutory provisions applicable in enforcement proceedings

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[28] Rick Daysog, "Ex-Bishop Trustees Pay IRS In Settling Tax Claims," *Star-Bulletin*, 1 (January 4, 2001).

involving the attorney general described above requires approval by the attorney general and a court, or disinterested directors or members if they determine that there as good faith and a reasonable belief that the actions were in the best interests of the corporation.

In addition to these modifications, guidelines are needed from the Service as to the application of section 4958 to revenue sharing arrangements and the relationship between violation of the excess benefit provisions and revocation of exemption for violation of the private inurement or private benefit prohibitions. The case of Caracci v. Commissioner, decided in 2002,[29] in which the Tax Court did uphold the imposition of excise taxes on the disqualified persons refused to approve revocation of exemption of the charities involved was a signal to the Service that the courts may well be reluctant to use revocation as a sanction, particularly if there is evidence that the situation has been corrected and is unlikely to recur. Such a result would be salutary.

In this case the court also invoked another provision in section 4958 which was precedent setting and may signal a new appreciation of the value of preserving charitable assets. The defendants, family members and three S corporations which had purchased the assets from the nonprofit corporations were given the option of restoring the assets to the tax-exempt corporations within a 90-day correction period, in which case the court

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[29] Caracci v. Commissioner, 118 T.C. No. 25 (2002).

indicated that it would consider abatement of the excise taxes. The IRS appealed the decision, but shortly thereafter the Justice Department filed a motion to withdraw the appeal. There is little doubt that power to abatement the taxes could markedly change the manner in which charitable funds would be treated in the federal courts.

In 2002 the Service requested suggestions from the public for changes in the private foundation provisions in light of the parallel provisions applicable to publicly supported charities that provide excess benefits to insiders. Although it appeared unlikely that Congress would agree to any major changes to Chapter 42 that would allow private foundations to be treated on the same equal basis as publicly supported charities, it was possible that some minor revisions might be considered. Among many suggestions for amendment that have been offered, the definition of supporting organizations that are not private foundations is one of the most convoluted in the Code and the regulations under that section seriously added to the complexity. In addition, there is no reason not to use the same definition for family members for both public charities and private foundations.

Consideration should be given to applying the excise tax penalties for self-dealing to the amount of the excess benefit as is the case in section 4958, not to the entire amount involved. Prior to the economic downturn that started in 2000, a number of suggestions were made to increase the pay out rate, either by

increasing the percentage or by prohibiting administrative expenses from being treated as qualifying distributions for purposes of determining compliance with the rules. Another recommendation has been to repeal section 4944 on the basis that it did not lend itself to enforcement by the IRS and was a limitation best left to the states. In view of the fact that it might be enforced in no more than 14 or 15 states, it was unlikely that such an amendment would or should be adopted. There is pressing need, however, for the regulations to be amended to adopt the modern prudent investor rule as the standard for compliance. In addition, the taxable expenditure provisions should be relaxed to remove the distinction between grants and contracts, and to permit foundations to make grants to other foundations in the same manner as they make grants to publicly supported charities. Finally, the excise tax on foundation investment income should be repealed. It serves only to reduce the amount that is contributed to other charities or for direct public benefit. Alternatively, the tax should be earmarked, as was originally intended, to support IRS regulation of exempt organizations.

The most important revision that could be made to Chapter 42, however, relates not to the details of the prohibitions but to the sanctions applicable to violations of all but the prohibition against self-dealing. In each of these cases the punitive excise taxes are imposed on the foundation, thereby diminishing their grant-making ability. Repeal of these penalties

is desirable, but it needs to be accompanied by adoption of more meaningful sanctions on foundation managers who have caused the foundation to enter into the prohibited transactions. The Code does now provide for imposition of taxes on managers who approve a transaction involving violation of the jeopardy investment and taxable expenditure provisions. However, these excise taxes apply only if the manager knew that the act involved was a violation of the Code prohibitions and his approval was willful and not due to reasonable cause, a heavy burden for the Service to prove. Far more meaningful would be sanctions applicable to managers who knew or should have known that they were approving prohibited transactions. Furthermore there is no reason why similar sanctions should not apply in the case of failure to meet the payout provisions or the limit on business holdings, both of which are in the power of the managers. Finally, provisions permitting abatement of the excise taxes if restitution is made should be included in any revision. Precedent can be found in the the abatement provision in section 4958 described above.

There are other Code provisions affecting charities that need amendment or repeal; although they are not directed at fiduciary behavior, they warrant listing here. One of the most far-reaching would be to remove the limitations on lobbying so that charities may contribute more meaningfully to society. However, it is unlikely to be acceptable to the Congress, although it might, on the grounds of simplification, to remove the distinction between direct and grass roots lobbying. The

prohibition on participation in political campaigns is related to the lobbying limitations but appears to be considered quite differently. In 2002 a strong lobbying effort was made to permit churches to support candidates for public office. As the bill neared passage a group of moderate church leaders joined to oppose its passage, expressing the belief that churches should remain separate from the political process. The bill containing the amendment was defeated in the House.[30]

Another measure requiring Congressional action is the parameters of disaster relief that are considered charitable under the Code. The Victims of Terrorism Tax Relief Act of 2001 established a separate, distinct standard applicable only to the victims of the September 11, 2001 attacks and of anthrax. A distinction of this sort will inevitably be difficult to apply in the future and the inconsistencies should be addressed before anther acute situation arises.

Despite many calls for amendment of the unrelated business income tax provisions, the overall scheme is effective. Two important changes that would improve its effectiveness would be to clarify the scope of the exception for income from royalties and to establish uniform, meaningful rules governing the allocation of expenses between exempt activities and those subject to UBIT, the latter being the most needed.

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[30] Houses of Worship Political Speech Protection Act, H.R. 2357, 107th Cong., 1st Sess. (2001).

Finally, there is a pressing need for clarification of treatment of joint ventures between exempt and nonexempt entities. The problems in this area stemmed originally from a misunderstanding by the Service of partnership law, the duties of directors of business corporations, and the extent to which activities of a subsidiary corporation can be attributed to its parent.

Underlying the specific issues are unresolved questions as to the proper scope of "commercial activities" for an exempt charity. The arguments that are made against permitting charities to undertake unlimited "business activities" are based on fears of "unfair competition" and that they distract charitable fiduciaries from attending to exempt purposes. However, the unrelated business income tax provisions were designed to and can effectively deal with unfair competition, particularly if the modifications just described are effectuated, while an argument about distraction carries little weight. Based on existing precedents, there appears to be no *per se* limit to the amount of related or unrelated business activity that may be conducted by a charity and that is appropriate. In the case of related activities, the Service's position is that once a business is determined to be related, the broader the market that is reached, the more the organization can fulfill its exempt function. In the case of an unrelated activity, it would be appropriate to look to apply the primary purpose test of the regulations together with a commensurate test based on the extent of the activity vis-à-vis

the related activities (and not the revenues generated). This will not answer the objections from the small business sector nor from commentators who believed that a distinction needs to be made between the private and charitable sectors based on the manner in which they fulfill their purposes.

Financial Reporting

A major drawback to efforts to police charities that pervades both state and federal programs stems from the fact that regulatory schemes rely on financial reporting from the sector and (1) there is basic disagreement among the sector, the accounting profession and the tax bar as to the way in which information should be reported and (2) an unusually high percentage of the reports that are filed contain errors while even more are incomplete. Despite public education efforts by the sector to improve the quality of reporting, particularly after 1990, there is little evidence of improvement. Furthermore, in two surveys of financial executives conducted by The Urban Institute in 2002, 72% of organizations reported using external professionals to prepare Form 990, virtually all of whom were certified public accountants, with almost 70% of them working for a local or regional accounting firm, which often had a nonprofit specialty practice.[31] Prior to this study, it had been assumed that the high incidence of error was attributable to the fact that most returns were prepared by the charities themselves.

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[31] Zina Poletz et al., *Charities Ready and Willing to E-file: Final Report*, (The Urban Institute, June 2002); *Results of Survey on Electronic Filing from GuideStar Web site* (The Urban Institute, 2002).

Based on the findings in the report, it appears that educational efforts need to be readdressed to the professional preparers.

Financial reports that are prepared electronically are reported to be more accurate and, in all events will be more complete. Accordingly, the Service's announcement in March of 2002 that January 2004 had been set as the deadline for implementing universal electronic filing of forms 990 and 990EZ was welcomed by the advocates of improved reporting. In preparation, under a program devised with the help of the National Center for Charitable Statistics and Guidestar, charities in Pennsylvania and Colorado were able to file their returns for the year ending 2001 electronically with both the state and the IRS, while ten other states are in the process of implementing electronic filing. Regulators anticipated that this would drastically reduce the number of incomplete forms as well as those containing inappropriate responses.

While electronic filing should improve error rates, it will not address the underlying flaws in the reporting systems. The lack of agreement as to the appropriate manner in which information is reported is stems from the application by the accounting profession of standards adopted for for-profit corporations to the nonprofit sector without recognition of the basic differences between them. Thus, generally accepted accounting principles (GAAP) do not address many of the special situations applicable to charities, such as the appropriate manner in which to report restricted funds. Second, the

information required on Form 990 is not consonant with that contained in audited financial reports. At the most basic level, Form 990 information is reported on a cash basis while audited financial reports provide information on the accrual basis; Form 990 does not require disclosure of problems identified in an audit, in contrast information on officers and directors and their compensation is reported on Form 990 but not included in an audited financial statement.

In some states, audited financial statements are required of all charities of a certain size or because they solicit funds from the general public. These reports are required to be filed together with a copy of Form 990 or other state reporting form. In all of these states, the audited financial reports are made available to the public but they are available only at the state offices. In contrast, the federal reports must be made available on request or through the internet; they are also available to the public on the internet through Guidestar and in a few states including California and New Mexico, on the internet site of the state charity office.

The requirement that certain charities provide audited financial statements has been considered a self-policing tool, and some state regulators believe it has enhanced performance while others are concerned about the burden the requirement places on smaller organizations who are in effect required to provide two sets of financials - one to meet audit requirements and one to meet state or federal provisions. That there is a need

for uniformity is not disputed. Possible solutions are discussed below in connection with evaluation of the federal reporting requirements.

FEDERAL REGULATION OF CHARITIES

The Internal Revenue Service as Regulator

The role of the Internal Revenue Service as regulator of charitable activities nation-wide was certainly not within the vision of the members of Congress who voted to grant tax exemption to charitable organizations in the first income tax law. Federal regulation has, in fact, gone through four major phases. In the first, broad definitional parameters were established but self-policing was relied on for compliance; in the second, the enactment in 1950 of the unrelated business income tax reflected an attempt to define a border between exempt and nonexempt entities; in the third phase the police function was enhanced with passage in 1969 of the private foundation limitations; and finally, in 1996 the police function was extended with adoption of intermediate sanctions for self-dealing applicable to public charities, provisions that are already changing the way in which charities are making decisions on matters involving conflicts of interest. Whether these limitations will ultimately improve fiduciary behavior will not be apparent for some time, but it would be surprising if this in not the case. The chances for improvement will be fare greater if the Code is amended to permit the IRS to effectively cooperate

with state officials in prosecuting cases involving breach of fiduciary duty. The abatement provisions in section 4958 can be meaningfully used if a state attorney general actively supervises the activities of an affected charity. State courts are in a position to complement federal action, whether through power to issue injunctions or remove fiduciaries or demand restitution. The ability to act in these matters may even be an impetus in some states to increase their regulatory programs, making regulation more effective at both the state and federal levels.

For a regulatory regime that was never intended to police fiduciary duty, and for one that has grown in large part without conscious planning, federal oversight through the Internal Revenue Service has proved far more effective than one might have anticipated. This is due to a number of factors; the requirements for organizing and operating a charity permit great flexibility as to the form of organization and the means of operating; it is also due to the fact that the federal law incorporated many of the common law principles found in state law, rather than establishing a separate set of standards; and it is also undoubtedly due in part to the fact that changes have been adopted at a slow pace with time for the sector to adjust to each change before the next one was adopted. The process has not been without upheavals. Noteworthy is the fact that it has not restricted the growth of the sector; to the contrary, based on preliminary statistics as to the growth in numbers and value of

assets at the end of the century, the regulatory environment could be best characterized as nurturing.

A major factor that has impeded the effectiveness of the IRS as regulator of fiduciary behavior is that it is a large, unwieldy bureaucracy, beset by inadequate funding, particularly since the early 1990's. Staffing for the exempt organization branch was 2,075 in 1975. In 1997 it had grown by 25 to 2,100, a period during which the number of reporting tax-exempt organizations increased from 700,000 to 1.1 million. Unfortunately, when Congress passed the Internal Revenue Service Restructuring and Reform Act in 1998, it failed to increase its appropriations commensurate with the growth in the sector, thereby impeding what would under the best of circumstances have been a difficult process. For the exempt organization branch, it meant that it has continued to deal with inadequate personnel and an outmoded computer systems. Attempts to centralize the handling of exemption applications in one location, begun before the restructuring, had not been accomplished 4 years later. The result has been a dearth of guidance in the form of revenue rulings and procedures, failure to improve reporting forms and a reduction in the number of audits to a level that has raised concern as to the integrity of the system. The lack of guidance provided by the Service has raised concern since the early 1990's. Of 433 exempt organizations revenue rulings published between 1974 and 1997, 406 were published between 1974 and 1983

while 27 were published in the succeeding 14 years.[32] Although efforts were made to increase the amount of guidance to be offered after the restructuring, there was no evidence that there would be rapid improvement.

CHANGING THE SITUS OF REGULATION

Given the shortcomings in both state and federal regulation, one is led to consider whether a different situs for regulation would make it more effective. Although one might have considered delegating regulation to the states at some time during the 1950's, the growth of the sector and complexity of the sector since that time and the concomitant overriding federal interest in its operations, combined with the failure of the states to provide effective enforcement, have rendered this question moot. The question therefore is whether regulation of nonprofit organizations should be moved from the Internal Revenue Service to another existing agency or department or to a newly created agency or bureau. These possibilities received considerable attention from the Filer Commission in the early 1970's and its final report, issued in 1975, contained a strong endorsement of the Internal Revenue Service as the appropriate body to regulate charities. The Commission did recommend certain changes in the Code to improve regulation, in particular adding a prohibition against self-dealing applicable to the trustees and directors of public charities. It also favored granting the

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[32] See Chapter 7.

federal courts equity powers to correct violations similar to those available in the state courts, including the power to remove trustees, appoint receivers and enjoin certain actions. The Commission also called for legislation that would permit the Service to defer to state regulators in situations in which it was clear that the state courts would be able to correct violations and obtain restitution more effectively that the Service, provisions which to some degree are now in effect.[33]

The Filer Commission also recommended establishing an independent quasi-governmental agency, established by Congress but without governmental powers, that would support the sector by sponsoring research and serving as its voice before Congress and the administration. The charitable community was divided in its support of this recommendation but recognized the value of an advocate before the Congress and the public. The outcome of the debate that ensued was the establishment in March of 1980 of Independent Sector (IS), effected by a merger of two other organizations, the Coalition of Voluntary Organizations and the National Council on Philanthropy. The mission of the new organization was that envisioned by the Filer Commission for a quasi-governmental agency, the difference being that IS was wholly voluntary. As of 2002, IS had approximately 800 members representing umbrella organizations for all aspects of the sector and a number of individual organizations. It has become the leading spokesman for the sector. Among the issues affecting

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[33] See Chapter 1.

regulation as to which it has taken a major role are the enactment of section 501(h) which gives public charities a means for assuring compliance with the lobbying limitations and the enactment of the excess benefit provisions in 1996.

The most often mentioned suggestion for improving regulation has been to move it from the Service to a new independent body similar to the Charity Commission in England or to a separate division within the Treasury Department, the SEC or another federal agency. Alternatively, some commentators have suggested giving regulatory powers over organizations with specific purposes or conducting particular activities to another existing agency such as Health and Human Services for hospitals or the Department of Education for schools, colleges and universities or to a new monitoring agency. Thus, Frumkin and Keating called for establishment of an independent accounting board which would receive and review audited financial reports from charities,[34] while Goldschmid believed that SEC-type powers were required to control health care conversions and possibly other aspects of the operations of large health care organizations.[35]

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[34] Keating & Frumkin, "Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation," 12-13.
[35] Harvey J. Goldschmid, "The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms," 23 *Journal of Corporation Law* 631, 651 (1998).

Fleishman, in 1999, concluded that a change should be made.[36] He preferred establishing an independent agency modeled on the SEC or the FTC, empowered with all aspects of the regulation of nonprofit organizations other than determinations of exemption, deductibility of contributions and decisions relating to the tax on unrelated business income. As these were inextricably a part of the tax process and because it would not be good policy to lose the ninety years of IRS experience in the field, he recommended that they remain under the jurisdiction of the IRS but that a new U.S. Charities Regulatory Commission be established with the primary responsibility:

> to keep tabs on the procedural - not substantive - functioning of not-for-profit organizations so as to assure the public that tax exemption is not used as a shield for fraudulent or illegal purposes. It would be empowered to investigate instances of alleged wrong-doing, it would have the power of subpoena, and it could institute civil or criminal proceedings as appropriate on its own motion. It would be charged with supervising interstate charitable solicitation, and creating the guidelines and disclosure requirements necessary to ensure that charitable solicitation is not used for fraudulent purposes. It would be responsible for monitoring the function of the NFP sector as a whole, gathering data and creating databases about the sector, commissioning studies on various aspects of the sector, reporting periodically to Congress on the operation of the sector, issuing regulations to guide the sector in conforming with applicable laws, and making recommendations for legislative changes that may be thought desirable.[37]

Under this proposal the IRS would have authority to certify tax exemption initially and be the primary recipient of financial

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[36] Joel L. Fleishman, "Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform," in *Philanthropy and the Nonprofit Sector in a Changing America*, 172 (Charles T. Clotfelter and Thomas Ehrlich eds., Bloomington: Indiana University Press, 1999).
[37] Id. at 189.

reporting forms. Although he preferred that the separate agency be independent, he recognized that it would per force be small, and that it might thus be more effective if it were part of the SEC. His proposal entailed no change in state regulation, although it included a strong recommendation that the any new agency be empowered to defer to the states if enforcement could best be provided at that level.

As to the situs of regulation of fund raising activities, the Filer Commission had recommended establishment of a new federal agency within the Treasury Department to regulate interstate solicitation of charitable funds, as well as strengthening intra state regulation of fund raising. It rejected giving additional power to the IRS in this area, or lodging it in an independent agency such as the SEC. Yarmolinsky and this author had recommended to the Filer Commission Federal Trade Commission which was already empowered to deal with deceptive advertising.[38] A variant of this suggestion was revived in the late 1990's in regard to regulation of telemarketing. In October of 2001, Congress enacted the USA Patriot Act which contained provisions extending the jurisdiction of the FTC to telemarketing by for-profit entities that entailed fraudulent charitable solicitations. Proposed regulations under the act issued in January of 2002 contained an affirmation that the act did not

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[38] Adam Yarmolinsky and Marion R. Fremont-Smith, "Judicial Remedies and Related Topics," in Department of Treasury, Commission on Private Philanthropy and Public Needs, *Research Papers*, vol. V, pt. 1, 2697, 2703-2704 (1977).

amend the jurisdictional limitations of the Commission to extend to charitable organizations; rather, FTC regulation was to extend only to for-profit organizations soliciting funds for charities.[39]

In England, for more than a century, charities have been regulated by an independent agency, the Charity Commissioners, who have broad regulatory as well as quasi-judicial powers over charitable fiduciaries, and their decisions are accepted by the Inland Revenue in regard to the eligibility of charities for tax benefits. Although a similar system might have great merit in the United States, it is naive to think that the Congress would remove regulation of charities or other exempt entities from the Service. The integrity of the tax system rests in large part on assuring that it cannot be undermined through the use of exempt entities. In addition, as conceded by critics of the Service, tax exemption for charities is inextricably intertwined with administration of the tax on unrelated business income as well as with the deductibility of contributions for purposes of the income, estate and gift taxes. Bifurcating regulation at the federal level would add a third regime of regulation which would add immeasurably to complexity and delay. Viewed from this perspective, the possibility of effecting major change is remote.

There are more positive reasons, however, for keeping regulation of charities in the Internal Revenue Service. A principal objection to the Service as regulator made prior to the early 1970's was that the personnel doing the regulating were

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[39] 67 Fed. Reg. 4492, 4496-4497 (January 20, 2002).

trained to raise tax revenue, not oversee the activities of organizations that were not subject to tax. This changed when the EP/EO division was established following enactment of the Employee Retirement Income Security Act of 1974. The new structure was created to assure adequate federal regulation of tax exempt pension plans and it was logical to group regulation of all exempt organizations together - which meant including charities and other nonprofit corporations. Under the 1999 restructuring, the EP/EO division was retained as a separate administrative branch, to which was added responsibility for governmental entities to create a new TE/GE (tax exempt & government entities) branch under an assistant commissioner. This has assured that personnel have the understanding and experience to handle appropriately the special problems - and needs - of exempt organizations nation wide. Finally, the record of the Service in resisting political pressures, despite challenges to the contrary, has been unusually unblemished. There can be no guarantee that a new agency, whether independent or part of another government branch, would be able to maintin the degree of independence exercised by the Service. It is an advantage that should not be lost. The Service's current efforts to improve the nature and extent of information provided to the public, to streamline administration, to provide more published guidance and to cooperate more meaningfully with state regulators confirm the wisdom of retaining the present scheme of regulation.

THE ROLE OF THE CHARITABLE SECTOR

Discussion of regulation of any segment of society is inevitably accompanied by consideration of self-regulation as an alternative or, at the least, as a complement to government regulation. There are institutions within the sector that do perform a regulatory function. Notable are the organizations that certify charities with common purposes such as educational institutions of all kinds, hospitals and other health care facilities, specific professions, and fundraising organizations. Given the complexity of the sector, it is not surprising that no single group has emerged with power to impose a self regulating regime. Nor would it be advisable, given the diversity of purposes of the components of the sector, and the many methods employed for achieving them, unless the standards which were to be applied were so lenient as to be meaningless.

Cooperative efforts to educate the components of the sector as to the rules that govern their operations and as to means to improve their ability to carry out their purposes should be encouraged by the regulators and by the public. One cannot, however, cannot expect regulators to defer to the sector nor the sector to assume that it can effectively police itself.

In the regulation of charities, by the IRS and by the states, compliance is measured by a set of standards that are framed in financial terms. Compliance with the duty of loyalty requires that one does not benefit financially at the expense of the charity. Compliance with the duty of care is similarly

measured in regard to the degree which the funds of the charity are put at risk. Mention was made earlier of a new public interest in what is termed "venture philanthropy", a phrase that describes attempts to redefine the manner in which grantors interact with potential grantees, evaluating proposals as they would business investments, involving themselves with the day to day operations of the grantees, subsequently evaluating their results as they would in the for-profit sector. It has become common to describe the process of making these final evaluations as "outcomes measurements"; many organizations are attempting to apply these measurements to determine the degree to which they are accomplishing their missions as well as the impact they are having on beneficiaries.

Some scholars and some of the organizations that evaluate charities for the benefit of potential contributors are calling for the addition of nonfinancial measurements to the information required by government. In other words, they want performance outcomes presented along with financial outcomes. At the extreme, argue that charities should not be entitled to tax or other public benefits if they do not carry out their mission in accordance with standards that have to do with efficiency and impact. Adoption of a requirement of this nature would effect a major transformation of the sector and its relationship to government. In instances in which government itself is the grantor, it may be perfectly appropriate. In all other situations it would bring subjective analysis into the regulatory scheme, a

development which would only stifle innovation and reduce charitable efforts to the safest, most pedestrian levels. This may be an appropriate function for self-regulation, particularly if the "science" of measuring outcomes is perfected. It is not a province for government except to the extent that it entails evaluation of the effects of direct government support by the granting agencies.

THE FUTURE OF THE LAW AND REGULATION OF CHARITIES

more to come