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Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative

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I. INTRODUCTION

Charitable organizations are under regulatory siege. After several recent scandals involving major charities, the halo of the nonprofit sector has become tarnished.[1] The Senate Finance Committee, and to a lesser extent the House Ways and Means Committee, have led the charge for increased scrutiny, accountability, and transparency of the nonprofit sector.[2] A series of congressional staff discussion drafts and hearings resulted in 2006 in the passage of the most significant tax legislation affecting nonprofits in four decades.[3]

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[1] Organizations include the Smithsonian and Getty Museums, the Nature Conservancy, the Red Cross and American University. For descriptions and citations, see, JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (3d ed. 2006 & Supp. 2009).

[2] *See* STAFF OF S. FINANCE COMM., 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT (June 22, 2004), *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf. A background document prepared by the Joint Committee on Taxation in conjunction with the June 2004 hearings summarizes the law and includes extensive statistical data on tax exempt organizations. *See* J. COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF PRESENT LAW RELATING TO CHARITABLE AND OTHER EXEMPT ORGANIZATIONS AND STATISTICAL INFORMATION REGARDING GROWTH AND OVERSIGHT OF THE TAX EXEMPT SECTOR (JCX-44-04), (June 22, 2004), *available at* www.house.gov/jct/x-44-04.pdf. Witness statements for the 2004 Senate hearings are available at http://finance.senate.gov/sitepages/hearing062204.htm. J. COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 109TH CONG. (Jan. 27, 2005), *available at* http://www.house.gov/jct/s-2-05.pdf. The House Hearings were informed by a comprehensive document describing the history and present law of tax exemption. *See* J. COMM. ON TAXATION, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX EXEMPT ORGANIZATIONS 109TH CONG.,(April 19, 2005), *available at* http://www.house.gov/jct/x-29-05.pdf. Witness statements for the House hearings are available at http://waysandmeans.house/gov/hearings.asp.

[3] The legislation was embedded in the Pension Protection Act of 2006, H.R. 4, 109th Cong. § 1212 (2006). Prior to this legislation, the last major reform of the nonprofit sector occurred in 1959 when the Private Foundation restrictions were put in place. *See*, Tax Reform Act of 1969, H.R. 13270, 91st Cong. (1969). Additional minor reform efforts occurred in 1996 with the so-called Intermediate Sanctions Legislation that added I.R.C. § 4958 and imposes an excise tax on public charities that engage in excessive benefit transactions. In 1976 Congress added section 501(h) to the Internal Revenue Code, which enabled charities to avoid the vague and subjective standard in section 501(c)(3) "no substantial part of [a charity's] activities . . . which carry on propaganda, or otherwise attempting to influence legislation" and elect to be governed by a more objective and mechanical expenditure test. Organizations that exceeded the mechanical dollar lobbying limits triggered a 25% excise tax on excessive lobbying expenditures. More frequent excesses could trigger a revocation of exemption. In 1987 Congress concluded, in some

Congress has cajoled the primary federal regulator of charities, the Internal Revenue Service (the "Service") to increase its monitoring of charities.[4] Because of its role in American life and a past history of sometimes abusing taxpayers, Congress has overseen the Service's activities to a greater extent than most other regulatory agencies.[5] Public officials are highly responsive to political pressures brought to bear by their elected principals and others. The absence of direct electoral accountability notwithstanding, bureaucratic behavior is buffeted by political forces and bounded by democratic constraints.[6]

Through the use of hearings, press releases, and published letters, the Senate Finance Committee places enormous pressure on and exerts great influence over the Service, hardly an agency with a strong following among the public. Taxes may be the price of civilized society,[7] but there are few who enjoy paying taxes or thank the tax collector. The Service has responded to this challenge less through increased oversight and auditing,

circumstances, revocation of exemption under the original "no substantial lobbying" test might be irrelevant if the organization had no taxable income or had accomplished its political objectives. Congress imposed an excise tax on the charity equal to five percent of the excess lobbying expenditures. An additional five percent tax was imposed on the managers, who made expenditures knowing they were likely to cause revocation. There is no equivalent tax on an organization's managers that has elected section 501(h). Taxes may be imposed on charities and their managers if they engage in proscribed political campaign expenditures. I.R.C. § 4955.

[4] The Service's actual monitoring activities of the more than one million charities are surprisingly modest. In the 2008 fiscal year, a total of 2,946 returns of exempt charities were examined. Another 4,915 returns of related organizations or activities such as unrelated business income, excise taxes imposed on exempt organizations, and exempt organization employer or employee tax returns were also examined. *See*, Internal Revenue Service, 2008 IRS Data Book, Table 13 (2009), *available at* http://www.irs.gov/pub/irs-soi/08databk.pdf.

[5] Robert M. Howard & David C. Nixon, *Local Control of the Bureaucracy: Federal Appeals Courts, Ideology, and the Internal Revenue Service,* 13 WASH. U. J.L. & POL'Y 233, 245 (2003). In other areas of the law Congress will lay down general guidelines and give agencies broad discretion to flesh out principles and adapt them to changing circumstances. Not in tax however. There Congress legislates in great detail, changing the law frequently. Congress has a strong preference for making policy choices itself, rather than leaving them to the Treasury. John P. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead,* 55 ADMIN. L. REV. 39, 87 (2003). When Congress decides to leave policy making to the Treasury, it normally does not rely on the general delegation of authority in I.R.C. § 7805, but delegates specific regulatory authority.

[6] Daryl J. Levinson, *Empire-Building Government in Constitutional Law,* 118 HARV. L. REV. 915, 920 (2005).

[7] The phrase "Taxes are what we pay for civilized society" is by Justice Oliver Wendell Holmes, Jr. in Compañía de Tabacos v. Collector, 275 U.S. 87, 100 (1904).

than by issuing pronouncements and guidelines as to how charities' internal affairs should be ordered. The Service's intervention in areas of corporate governance, once the preserve of state nonprofit corporate law, has little relationship to issues of tax compliance.[8]

This corporate governance initiative has been accomplished in the face of the Service's recognition that it has no statutory authority relating to these issues. Yet, the authority of the Service in recognizing exemption from federal taxation and the method it has used to ensure its vision of corporate governance through a series of questions on an annual information return, available online for public scrutiny, has resulted in substantial compliance with the Service's wishes.[9]

The Service has the responsibility of collecting taxes that are assessed under the Internal Revenue Code (the "Code"). Its mission includes ensuring compliance with the tax laws so taxable revenue owed is collected. The Service's recent initiatives in the area of nonprofit corporate governance, through formal and informal announcements, requirements and requests for information, and the behavior of its agents, have created new standards, which are not found in the normal repository of corporate law — state corporate codes — and generally are not required as a matter of state law.

This Article casts a skeptical eye on the Service's corporate governance initiative from the perspective of federalism. Its thesis is that the Service's regulation of nonprofit corporate governance is a kind of stealth preemption, which undermines the principles of our federal system. The issues of preemption described herein relating to the Service's corporate

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[8] The Service's rationale for its vision of corporate governance is: "The Internal Revenue Service believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance. A charity that has . . . sound management practices is more likely to operate effectively and consistent with tax law requirements. And while the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with the tax law." INTERNAL REVENUE SERVICE, GOVERNANCE AND RELATED TOPICS–501(C)(3) ORGANIZATIONS 1 (2008), *available at* http://www.irs.gov/pub/irs-tege/ governance _practices.pdf.

[9] The Independent Sector, a trade association of larger nonprofits, has willingly adopted most of the good governance practices recommended by the IRS. *See*, PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 20–22 (2005), *available at* http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf [hereinafter FINAL REPORT].

governance initiative are at least one degree separated from traditional constitutional analysis. Ordinarily, there is no question whether an agency can promulgate a regulation, pursuant to direct or indirect Congressional enactment superseding state legislation. The agency in question, the Service, admits that it has no authority pursuant to the Code to mandate its corporate governance recommendations.[10] The preemption relates to the effect that such "recommendations" has upon charities.

Stealth preemption refers to a process by which a federal agency or departmental regulator supersedes state or local officials or imposes legal rules that historically have been matters of state law. This Article argues the corporate governance initiative has no empirical grounding, is inefficient from a cost/benefit basis, and diverts nonprofit organizations from their charitable mission.

II. THE CHARITABLE NONPROFITS

A majority of tax-exempt organizations and nearly all "charities" derive their tax-exempt status from section 501(c)(3) of the Code.[11] This section

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[10] Its publications, particularly the new Form 990, state: "Governance, Management, and Disclosure *(Sections A, B, and C request information about policies not required by the Internal Revenue Code.)*." UNITED STATES TREASURY, RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX 6 (2008). The instructions note: "Part VI requests information regarding an organization's governing body and management, governance policies, and disclosure practices. Although federal tax law generally does not mandate particular management structures, operational policies, or administrative practices, every organization is required to answer each question in Part VI." *See,* UNITED STATES TREASURY, BACKGROUND PAPER FORMS 990, MOVING FROM THE OLD TO THE NEW 12 (2008) *available at*: http://www.irs.gov/pub/irs-tege/moving_from_old_to_new.pdf.

[11] Of the 1,855,067 nonprofit organizations on the IRS's Business Master File in 2008, 1,186,915 or 64% were tax exempt under section 501(c)(3). INTERNAL REVENUE SERVICE, DATA BOOK 2008 Table 25, (2009). The Treasury Regulations expand upon the requirements of section 501(c)(3), providing that an organization must satisfy a formalistic "organizational test" and an objective "operational test." The organizational test relates solely to the language used in the organization's governing document (e.g., trust instrument, articles of incorporation or association, charter; including the language only in the bylaws is insufficient), which must limit the purposes of the organization to one or more exempt purposes described in section 501(c)(3), and not expressly empower the organization to engage (except to an insubstantial degree) in any activities which do not further one or more exempt purposes. Treas. Reg. § 1.501(c)(3)–1(b)(1)(i) (2008). Under the organizational test, it is not enough to show that an organization is actually operated for exempt purposes. Treas. Reg. § 1.501(c)(3)–1(b)(1)(iv). Either in its charter or under applicable state law, the organization must expressly dedicate its assets to one or more exempt purposes in the event of dissolution. The required dedication does not exist if assets may be distributed to the organization's members. This requirement is typically met by providing that upon

applies to organizations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals . . . provided that: (1) no part of the net earnings of the organization inures to the benefit of any private shareholder or individual, (2) no substantial part of its activities may consist of certain activities aimed at influencing legislation, and (3) the organization does not participate or intervene in any political campaign on behalf of any candidate for public office."

Exemption under section 501(c)(3) brings with it a wide range of additional tax benefits and exemptions from other forms of government regulation. Most importantly, virtually all section 501(c)(3) organizations qualify to receive tax-deductible contributions for income, estate and gift tax purposes.[12]

III. THE REGULATION OF CHARITIES

Charities are subject to several regulatory regimes. In almost all cases, they are formally organized at the state level.[13] In order to receive the

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dissolution the assets will be distributed to another section 501(c)(3) organization in furtherance of an exempt purpose. Treas. Reg. § 1.501(c)(3)-1(b)(4). The operational test requires the organization to engage "primarily in activities that accomplish one or more of [the] exempt purposes specified in section 501(c)(3)." Treas. Reg. § 1.501(c)(3)-1(c)(1). This test is not met if "more than an insubstantial part of [the organization's] activities is not in furtherance of an exempt purpose." Treas. Reg. § 1.501(c)(3)-1(c)(1).

Within the universe of section 501(c)(3) organizations is a subset called 'private foundations', which are regulated much more stringently than other charitable nonprofits. Basically, private foundations are charities that have failed several complicated tests of public support under I.R.C. §§ 509(a)(1)-(3). For a simplified description of these public support tests, see FISHMAN & SCHWARZ, *supra* note 1 at 781-790. The tax treatment of gifts to private foundations is much less favorable than other section 501(c)(3) organizations that are termed public charities. *Id.* at 751-752. In 2008 there were 115,340 private foundations. *See generally*, NATIONAL CENTER FOR CHARITABLE STATISTICS, NUMBER OF NONPROFIT ORGANIZATIONS IN THE UNITED STATES, 1998–2008 (2009), *available at* http://nccsdataweb.urban.org/PubApps/profile1.php?state=US. This paper focuses on the relationship of the IRS to public charities.

[12] I.R.C. §§ 170, 2055, 2522. With very few exceptions, other exempt organizations are not eligible to receive tax-deductible gifts. For a comprehensive catalog of the privileges and benefits accorded nonprofit organizations by federal, state, and local governments, see generally Bazil Facchina, Evan Showell & Jan E. Stone, *Privileges and Exemptions Enjoyed by Nonprofit Organizations: A Catalog and Some Thoughts on Nonprofit Policymaking*, 28 U.S.F. L. REV. 85 (1993).

[13] Some charities, such as the Red Cross and the National Geographic Society, are federally chartered.

benefits of exemption from federal taxation, their nonprofit tax-exempt status must be recognized by the Service.[14] The traditional view of laws affecting nonprofits was of a great divide. Corporate law, which governed the organizational structure of a nonprofit organization, arose from state law, and federal tax law governed the permissible activities of tax-exempt entities. Today the nonprofit regulatory landscape is murky. Federal law and administrative agencies (the Service being primary) overlap with state law principles, creating federal models of corporate governance. A similar development has occurred in the business corporate area, but in a much more limited way.[15]

A. The Traditional Locus of Nonprofit Governance Rules and Regulation: State Nonprofit Corporate Codes

Nonprofit corporations, the predominant exempt organizational form, are primarily creatures of state law. Nonprofit corporate law, as its for-profit analogue, is a kind of constitutional law in that its dominant function is to regulate the manner in which a nonprofit corporation is constituted, to define the relative rights and duties of those participating in the organization and to delimit the powers of the organization in relation to the external world.[16]

State nonprofit corporate codes[17] govern the formation of nonprofit corporations and their dissolution, merger or consolidation; internal governance procedures; the election of and removal of directors, quorum and voting requirements; rules of procedure, the rights of members, matters of corporate finance, keeping and inspection of corporate records, and most important for our purposes, the obligations and restriction of directors and

[14] Charities must also pursue state tax exemptions from the income, property and other taxes imposed under the state regime. State tax exemption is often more difficult to obtain than federal. Other federal agencies also impact on charities. *See generally* Facchina, *supra* note 12.

[15] Only corporations registered with the Securities and Exchange Commission under § 12 of the Securities Exchange Act of 1934 must adhere to federal corporate norms. All other corporations are still bound by traditional state norms. In contrast to the dual federal-state system in business corporate law, virtually all nonprofit organizations of any size must adopt the federal corporate norms. An even more significant difference is that federal corporate law is statutorily based, whereas there is no explicit or implicit legislative basis for most of the federal nonprofit corporate governance norms.

[16] *Cf.* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976).

[17] Delaware does not have a separate nonprofit statute. Non-stock corporations are governed by the Delaware Corporate Code, and several sections refer to non-stock corporations. *See*, DEL. CODE ANN. tit. 8, §§ 102, 109 (1953).

corporate boards.[18] The governance structure of nonprofit corporations resembles their profit-seeking counterparts, and the more substantial body of legal precedent in the business corporate area is a helpful referent.[19]

Modern nonprofit corporate statutes are enabling acts, which make it easy for individuals to organize and operate an organization that is large or small. Some corporate statutory requirements are mandatory: "after the corporate existence has begun, an organization meeting . . . shall be held"[20] or "[a] corporation shall not have stock or shares certificates for stock or for shares."[21] Some sections require organizations in formation to obtain certain approvals from state officials before corporate existence can commence.[22] Many more sections of a nonprofit corporate code are supplementary or gap-fillers, meaning they apply if internal corporate documents fail to resolve a disagreement.[23] Thus, a quorum for a members' meeting is a majority of the total votes entitled to be cast, unless the organization selects a higher or lesser number.[24] Corporate certificates of incorporation, or the bylaws or resolutions create other corporate rules that have been determined by the members or the governing body as appropriate for that particular organization. Every corporate code includes some rules that are essentially needlepoint, in that they facilitate paper shuffling in the creation, registration and dissolution of corporations.[25] Other rules define the very nature of the nonprofit corporation. The nondistribution constraint,

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[18] *Cf.* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 35 (2d ed. 2003)

[19] The recent Model Nonprofit Corporation Act (3rd) (2008) differs from its predecessor by aligning itself more closely to the Model Business Corporation Act. Nonprofit corporate law is hindered by the paucity of case law. MODEL NONPROFIT CORP. ACT (2008) *available at*: http://www.abanet.org/rppt/meetings_cle/2008/jointfall/Joint08/ExemptOrgCharitablePlanOrganGroup/BlackLetter.pdf; MODEL BUS. CORP. ACT (2002) *available at*: http://www.abanet.org/buslaw/library/onlinepublications/mbca2002.pdf.

[20] *See*, N.Y. NOT-FOR-PROFIT CORP. LAW § 405 (McKinney's 1971). MODEL NONPROFIT CORP. ACT § 2.05(a) (3d ed. 2008).

[21] N.Y. NOT-FOR-PROFIT CORP. LAW § 501; MODEL NONPROFIT CORP. ACT § 6.03.

[22] N.Y. NOT-FOR-PROFIT CORP. LAW § 404; MODEL NONPROFIT CORP. ACT § 1.20(a)(1) requires or permits filing in the office of the secretary of state.

[23] Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 1001 (1982).

[24] *See*, N.Y. NOT-FOR-PROFIT CORP. LAW § 608. A reduction in the quorum requirement is limited to not less than one hundred votes or one-tenth of the total number of votes entitled to be cast, whichever is lesser. *Id.* at § 608(b); MODEL NONPROFIT CORP. ACT § 7.26.

[25] Ellman, *supra* note 23, at 1002. These rules include the method by which the certificate is filed, agents for service of process are selected. *See*, N.Y. NOT-FOR-PROFIT CORP. LAW §§ 403, 305; MODEL NONPROFIT CORP. ACT § 1.20.

which prohibits the distribution of dividends, income or profit to members, directors, or employees, is one such rule.[26]

Beyond certain fundamental mandates, state nonprofit statutes do not prescribe specific corporate governance approaches. In most jurisdictions, nonprofit governance procedures are matters of internal organizational decision.[27] Nonprofit corporate statutes promote flexibility, so that differing organizations can have different structures, which are most useful and efficient for a particular activity.[28] The Service's corporate governance initiative proceeds from a different vantage point, that it will assist tax compliance. Nonprofit corporations as creatures of state law have been primarily regulated in nontax-exemption matters by state regulators. Of particular state concern have been the areas of charitable solicitation, fraud, and breach of fiduciary duties.

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[26] *See*, N.Y. NOT-FOR-PROFIT CORP. LAW § 515(a) ("A corporation shall not pay dividends or distribute any part of its income or profit to its members, directors or officers."); MODEL NONPROFIT CORP. ACT § 6.40.

[27] New Hampshire offers the broadest prescriptions for governance structure. A charitable nonprofit corporation must have at least five voting members, who are not of the same immediate family or related by blood or marriage. No employee of a charitable nonprofit corporation shall hold the position of chairperson or presiding officer of the board. N.H. REV. STAT. ANN. § 292:6-a (West 1998). Maine and California require a majority of a nonprofit corporation's directors be financially disinterested. CAL. CORP. CODE § 5227 (West 1996); ME. REV. STAT. ANN. tit., 13-B, § 713-a(2) (West 2007). A few states have adopted certain Sarbanes-Oxley type provisions, typically the requirement of an audit committee if the organization reaches a certain level of revenues. *See*, WASH. REV. CODE ANN. § 19.09.540 (West 2007). California requires charities with gross revenues of $2 million or more to prepare independent audits for and establish and maintain an audit committee. CAL. GOV'T. CODE § 12586(e)(1), (e)(2) (West 2000). Executive compensation must be reviewed and approved by the governing board to ensure the payment is "just and reasonable." CAL. GOV'T. CODE § 12586(g); MODEL NONPROFIT CORP. ACT §§ 16.01, 16.20-21 requires keeping of corporate records, such as minutes of meetings and appropriate accounting records, but does not require an audited financial statement.

[28] In Ellman's words: ". . . a corporate code [is] a means by which to facilitate activity . . . Even though it may have a number of mandatory rules, therefore, the corporation code is not regulatory in its essential purpose. Instead, we use the code to create a legal structure that is useful as a vehicle for a particular type of legitimate activity . . . [E]very group of individuals pursuing a lawful activity should be able to find a form of organization that meets its needs: an organization whose defining rules fit the group's *raison d'etre,* whose gap-filling rules tend to meet the participants' expectations, and whose value-based rules help to protect both the participants and third parties from abuses of the organizational form." Ellman, *supra* note 23, at 1004.

B. State Regulation: the Attorney General

In most jurisdictions the attorney general has the responsibility of supervision and oversight of charitable trusts and corporations and may maintain such actions as appropriate to protect the public interest.[29] By definition the objective of a charity is to further the public interest. Therefore, the attorney general represents the public in enforcing the purposes of a trust or corporation. The common law duties of the attorney general reflected the expectations of society: that there should be a single evolving duty to carry out the charitable purposes of the trust, that it was necessary to keep trust property productive, and to ensure trustees do not divert charitable funds for improper purposes or self-dealing.[30] These precepts have been supplemented by statute in most jurisdictions.

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[29] In a few jurisdictions, this role is performed by the district or county attorney or the Secretary of State. Even before the enactment of the Statute of Charitable Uses in 1601, suits were brought by the attorney general to enforce charitable trusts. AUSTIN WAKEMAN SCOTT & MARK L. ASCHER, SCOTT & ASCHER ON TRUSTS § 37.3.10 (5th ed. 2009).Unlike a private trust, the beneficial interest in a charitable trust does not reside in individual beneficiaries but in the community, an indefinite class. The property is devoted to the accomplishment of purposes beneficial to the community at large. The attorney general can institute appropriate proceedings in situations involving the state or public interest and to secure compliance with statutory norms or ensure proper administration of trusts. Brown v. Memorial Nat. Home Fdn., 329 P.2d 118, 132-133 (Cal. Ct. App. 1958). Fishman & Schwarz, *supra* note 1, at 247. The attorney general's jurisdiction extends to suits to protect charities where an attack is made on the organization's property, or to protect against self-dealing, waste and diversion of funds. *See*, Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F.L. Rev. 37, 45-47 (1993). The attorney general has the power to investigate, subpoena witnesses, and require production of books and records. In civil actions he can annul the corporate existence, dissolve corporations that have acted ultra vires or restrain them from carrying out unauthorized activities. He may remove directors or trustees; dissolve corporations under applicable state procedures; enforce the rights of members, directors or officers; bring proceedings and accounts for the assets of corporations upon dissolution; supervise indemnification awards; and investigate transactions and relationships of directors and trustees to determine whether property held or used by them has been allocated to charitable purposes. The attorney general may maintain an action against a plaintiff seeking a declaratory judgment; can bring a *quo warranto* proceeding to assure that absolute gifts to charitable corporations are applied according to the terms of gift (St. Joseph's Hospital v. Bennett, 22 N.E.2d 305 (N.Y. 1939)); must receive notice when suit is instituted by others, MODEL NONPROFIT CORP. ACT § 1.70; and is a necessary party to settlement of litigation where charitable beneficiaries are affected, where there is a sale of assets, or a change of use of assets are considered. Fishman & Schwarz, *supra* note 1, at 247.

[30] MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 305-314 (2004). The common law principles asserted by the attorney general were carried over to America during the Colonial period. *See generally* OFFICE OF THE OHIO ATTORNEY GENERAL, THE STATUS OF STATE REGULATION OF CHARITABLE TRUSTS, FOUNDATIONS, AND

In many jurisdictions the attorney general has been given statutory authority for gathering information about charities and trustees.[31] She also is responsible for the oversight and enforcement of regulations dealing with charitable solicitation. This has become a major area of attorney general focus. Statutes have conferred upon the attorney general broad authority to protect the public and donors from deceptive and fraudulent solicitation practices or diversion or waste of donated funds so as to ensure the proper use of contributed funds for the beneficiaries' benefit. Typically this includes monitoring and enforcement powers over registration requirements for charities and professional fundraisers.

Staffing problems, a multitude of other responsibilities, and sometimes a lack of interest in monitoring nonprofits has made attorney general oversight more theoretical than deterrent in most jurisdictions.[32] Several surveys have indicated the paucity of resources of state attorneys general offices devoted to the oversight of charities.[33] However, this does not mean

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SOLICITATIONS, IN V RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2705, 2710 (1977).

[31] Charitable trusts and nonprofit corporations must register and file reports with his office. Other responsibilities of the attorney general typically include maintenance of a registry of all public benefit organizations, oversight of periodic filing requirements, and monitoring financial filing requirements. *See* FREMONT-SMITH, *supra* note 30, at 315.

[32] *Id.* at 443-47. Professor Harvey P. Dale, a long-time observer of the nonprofit landscape has written: "[G]overnment regulators (and most particularly attorneys general, to whom the law confides the principal role in policing charities) tend to allocate their scarce regulatory resources to other more politically potent portions of their domains. In most states, the Charity Bureau of the Attorney General is inactive, ineffective, overwhelmed, or sometimes a combination of these." Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation,* 25 EXEMPT ORG. TAX REV. 413, 413 (1999). In the same vein former New York State Attorney General Robert Abrams, who was Attorney General of New York from 1978 to 1993, has written: "Aside from Hospitals and other Health facilities, charitable organizations have been relatively free from governmental intrusion, especially in comparison to the business sector. What regulation exists has largely been the product of private self regulatory association . . . Regulation by the state has been minimal." Robert Abrams, *Regulating Charity—The State's Role,* 35 THE RECORD 481, 484-85 (1980).

[33] *See* Peter Swords & Harriet Bograd, *Nonprofit Accountability: Report and Recommendations* (Nonprofit Coordinating Committee of New York, Inc. 1997), *available at* http://www.npccny.org/info/Accountability_97fullreport.pdf. (Only 13 states have charities sections within attorneys general offices. These states are home to 55% of U.S. charities and have 65% of national charitable revenues.). The most recent, conducted through telephone interviews by Professor Gary Jenkins of the Ohio State School of Law found that states have dedicated a median of one full-time equivalent attorney to charity oversight. Seventy-four percent of the states responding had one or fewer full-time equivalent attorneys working on nonprofit oversight, with seventeen states reporting no such

that offices without full-time charities bureaus do no enforcement. Enforcement is often episodic, though some jurisdictions — California, New York and Massachusetts come to mind — have displayed renewed vigor, particularly in correcting abuses involving fraudulent charitable solicitation and charitable trusts.[34] The Service has stepped into this regulatory gap.

C. The Internal Revenue Service and the Nonprofit Sector

Charities' primary contact point with the federal government is the Service. Professor John Simon has identified four essential functions of federal tax policies that shape the treatment of nonprofits. They are the support, equity, border patrol, and police functions.[35] The police function, in which this paper is most interested, regulates the fiduciary behavior of trustees, directors, managers, and donors. Traditionally, this was the role of state law since nonprofits were creatures of state corporate law and state fiduciary standards. The purpose of the federal tax system is to raise revenue. Beginning in 1969 with private foundations, Congress through the Service has played an increasing role.[36]

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lawyers at all. Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128-29 (2007).

[34] For a recent article about proactive use of attorneys general powers, see Ashley L. Taylor, Jr., Anthony F. Troy & Katherine W. Tanner Smith, *State Attorneys General: The Robust Use of Previously Ignored State Powers*, 40 URB. LAW. 507 (2008).

[35] *See* John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 67, 73 (Walter W. Powell ed., 1987). The support function encourages the continuation and expansion of the nonprofit sector through relief from taxation. The Supreme Court has held that tax exemption is a subsidy. Regan v. Taxation With Representation, 461 U.S. 540 (1983). Over the years Congress and the IRS have made certain activities eligible for that subsidy and have taken that eligibility away from others. The equity function, with its goal of redistributing resources, has roots in the history of charity and in Anglo-American law in the Statute of Charitable Uses. The issues here relate to questions as to whether exempt status should be conditioned on service to the poor and how much private benefit donors should receive for their contributions. The border patrol function deals with the limits of activity in which nonprofits may engage. There are absolute prohibitions on participation in political campaigns, constraints on the amount and types of lobbying by nonprofits, and restrictions on commercial and unrelated business activity. These limits patrol the nonprofit-business border. *See* Simon, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK at 73, 89-93 (Walter W. Powell ed., 1987).

[36] There are other federal agencies that oversee nonprofit activity. They include the Federal Bureau of Investigation, through its economic crimes unit; the Federal Emergency Management Agency; the Federal Trade Commission; the United States Postal Inspection Service; and the Office of Personnel Management. *See* U.S. GENERAL ACCOUNTING OFFICE,

If, as Chief Justice John Marshall wrote, ". . . the power to tax involves the power to destroy,"[37] then the power to exempt from tax presents the opportunity to intimidate, harass and bully. One cannot overestimate the Service's influence on the nonprofit sector. In part this results from the fact that its activities touch the lives of most Americans. It is also the product of the theoretical justification for tax exemption, that it is a subsidy by the government of foregone tax revenues, to support certain activities — in other words, a tax expenditure.[38] Thus, tax exemption is a matter of government largess, which is granted or can be revoked by the Service.

The Service has five points of contact with exempt organizations: 1) creating standards for exemption; 2) determining exemption; 3) examining of exempt organizations or in other compliance initiatives; 4) reporting of annual activities and finances in Form 990; and 5) engaging in education and outreach activities.[39] In each of these areas, the Service has introduced corporate governance overtones.

REPORT NO. GAO-02-52, TAX EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS AND STATE OVERSIGHT OF CHARITIES 69–71 (2002) [hereinafter GAO Report]. These agencies play a very minor role compared to that of the Service.

[37] McCulloch v. Maryland, 17 U.S. 316, 431 (1819). Marshall took the phrase uttered in oral argument of the case by Daniel Webster, who said "An unlimited power to tax involves, necessarily, a power to destroy." *Id.* at 327.

[38] "Tax expenditures" are defined under the Congressional Budget and Impoundment Control Act of 1974 (the "Budget Act") as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Control Act, H.R. 7130, 93d Cong. (1974) (enacted). Tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers. The tax exempt status of charities is not classified as a tax expenditure because the non-business activities of such organizations generally must predominate and their unrelated business activities are subject to tax. In general, the imputed income derived from non-business activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal income tax base. However, the ability of donors to such nonprofit organizations to claim a charitable contribution deduction is a tax expenditure, as is the exclusion of income granted to holders of tax exempt financing issued by charities. The tax expenditure estimate of the charitable deduction for 2008-12 is $264 billion. STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012 8 (Comm. Print 2008). The tax expenditure estimate of the charitable deduction for fiscal years 2009-2013, on the other hand, is $237.6 billion—note that the figure is lower because of the impact of the great recession. *See* JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013 (Comm. Print 2010).

[39] ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES, THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX EXEMPT

IV. THE CORPORATE GOVERNANCE INITIATIVE

A. Application for Tax Exemption under I.R.C. § 501(c)(3): The Notice Requirement.

It was not until 1954 that a purportedly exempt organization had to obtain a determination from the Service that it was entitled to that status, though with the exception of churches, almost all organizations that relied on contributions did obtain such a ruling from the Service.[40]

Most nonprofit organizations seeking recognition as tax-exempt charities under 501(c)(3) and as eligible recipients of tax-deductible contributions under I.R.C. § 170 must "notify" the Service that they are applying for exemption and obtain a favorable determination of their exempt status.[41] A 501(c)(3) organization meets the notice requirement by

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ORGANIZATION GOOD GOVERNANCE ISSUES 29 (June 11, 2008), *available at* http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf [hereinafter Advisory Committee].

[40] FREMONT-SMITH, *supra* note 30, at 61. In 1954 Treasury made filing an exemption mandatory, for which the organization received a determination letter that recognized its exemption. Treas. Reg. § 1.501(c)(3)–1(b)(6) (2008). Prior to that time, the Service's focus on charities was assessing whether organizations that held themselves out as charitable actually met the requirements for tax exempt status. For example, the Insular Collector of taxes of the Philippine Islands, then under U.S. control, challenged the right of a Philippine religious order, Sagrada Orden de Predicadores, to qualify for exemption. The Insular Collector argued that though the order was religious, it was not operated exclusively for such purposes because it derived significant revenue from real estate and securities holdings and more modest revenues from the sale of wine, chocolates, and other items for use within its religious missions. The United States Supreme Court held that as long as the profits were dedicated to charitable or exempt purposes, the organization would not lose its exemption. *See generally* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924). The Tax Reform Act of 1950 denied exemption to feeder corporations. A tax on unrelated business income was imposed on some tax–exempt organizations and later imposed on all. I.R.C. § 502.

[41] These requirements apply to all 501(c)(3) organizations formed after October 9, 1969, except for associations of churches, their integrated auxiliaries, conventions and associations of churches, and organizations other than private foundations that normally have gross receipts of $5,000 or less. I.R.C. § 508(a)–(c)(1); Treas. Reg. § 1.508–1(a)(3) (1995). An organization's annual gross receipts are "normally" less than $5,000 if they do not exceed $7,500 for its first taxable year, an aggregate of $12,000 for its first two taxable years, and $15,000 for its first three years. Treas. Reg. § 1.508–1(a)(3)(ii). Organizations covered by a group exemption letter also are exempt from filing. A group exemption letter is a ruling issued to a central organization recognizing the exemption of a group of "subordinate" organizations. Treas. Reg. 1.508–1(a)(3)(i)(C). The notice requirement also applies to 501(c)(3) organizations (other than churches) that seek to avoid private foundation status. *See* I.R.C. § 509(a). In general, any 501(c)(3) organization formed after October 9,

filing an application for recognition of exemption on the Service's Form 1023 within 15 months from the end of the month in which it was organized.[42] Preparing Form 1023 is a time consuming process that requires the founders of the organizations to develop a serious and comprehensive mission and financial plan. Applicants must provide a narrative description of their past, present and planned future activities; detailed financial data, including a proposed three year budget for new organizations; and answer a long list of questions relating to the organization's governing body, its relationship to other organizations, compensation and other financial arrangements with officers, directors, trustees and employees, and its actual and proposed fund raising activities.[43] An organization qualifies as a public charity in its first five years if it can show in its application for exemption a reasonable expectation to receive the requisite public support during the five-year period.[44] Thus, the organization will be classified a public charity for its first five years regardless of the level of public support it in fact receives during this period.[45]

1969 is presumed to be a private foundation unless it notifies the IRS that it is not a private foundation. I.R.C. § 508(b); Treas. Reg. 1.508-1(b).

[42] Treas. Reg. 1.508–1(a)(2)(i). Organizations automatically may extend the filing period to 27 months if they file a completed application within the extended period and indicate that the form is being filed pursuant to Rev. Proc. 92–85, 1992–2 C.B. 490. An additional extension may be granted for good cause. If the application was untimely but the organization qualifies for exemption, the Service's normal practice is to grant 501(c)(4) exempt status up to the date when the 501(c)(3) application was filed and 501(c)(3) status thereafter. *See* Rev. Rul. 80–108, 1980–1 C.B. 119. In that event contributions made before the application was filed are not tax-deductible. I.R.C. § 508(d)(2)(B). If the organization was required to alter its activities or organizational documents during the application process, its exemption will be effective as of the date specified in the favorable determination letter. *See,* Fishman & Schwarz, *supra* note 1, at 352–53.

[43] Certain organizations, such as churches, schools, hospitals, homes for the aged, child–care providers, and successors to for–profit organizations, must provide additional information on special schedules. An organization that receives an adverse determination letter will be advised of its right to file a protest with the IRS Appeals Office. Filing the protest invokes the usual Service appeals procedures, including the right to a conference and the ability to request "technical advice" from the National Office. Exhaustion of all administrative remedies is essential to set the stage for a judicial determination through the declaratory judgment procedure authorized by I.R.C. § 7428.

[44] The new regulations also change the public support computation period for purposes of I.R.C. §§ 170(b)(1)(A)(VI), 509(a)(1) and 509(a)(2) from a four–year period prior to the tested period to a five–year period that includes the current year. Treas. Reg. § 1.170A-9T(f)(4)(v) (2008). Thus, the organization will be classified a public charity for its first five years regardless of the level of public support it in fact receives during this period.

[45] Beginning with the organization's sixth year, if it cannot establish it is not a private foundation, the organization will be liable for I.R.C. § 4940 and other chapter 42 excise

1. Corporate Governance Questions in the Application Process

Form 1023 was revised extensively in 2004 and now includes questions about the applicant's adherence to "best practices," which are identified by the Service as conflicts of interest and compensation policies.[46] These are "recommended" but not yet officially required to obtain exemption, but it would be a reckless charity to ignore the Service's suggestions.[47] None of these recommendations are required under state law. Nor has Congress mandated the adoption of specific governance practices as a condition of tax exemption. However, governance issues have appeared in Service rulings in the healthcare area and as a condition for exemption of healthcare organizations, because of their substantial regulation by federal and state authorities. The governance standard also has been required for approval of tax-exempt credit counseling agencies — organizations frequently found to engage in abusive practices.[48]

The Service's focus has been upon the independence of the board of directors, which demonstrates to the Service that the organization is not controlled by founders, insiders or private interests and is operated for purposes that benefit the community.[49] The Service has also focused on

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taxes. An organization that files its application for exemption within the required notice period (including extensions) and receives a favorable determination letter from the Service will be recognized as exempt from the date of its creation. The organization's donors then will be assured that gifts made from the date of creation are tax–deductible, and the organization's name will be added to IRS Publication 78, the "cumulative list" of all organizations recognized as eligible to receive charitable contributions under § 170. Treas. Reg. § 1.170A-9T(f)(5). Publication 78's list of eligible donees also is included on the IRS's web site at www.irs.gov and is available through several commercial on-line services.

[46] The pre–2004 version of Form 1023, revised in September 1998, had general questions about the organization's governing body, its charitable activities and sources of funding. This version of Form 1023 can be found in Fishman & Schwarz, Nonprofit Organizations Statutory Supplement 2d. ed. 903–928 (2000).

[47] Two areas relating to public charities where Congress has required certain corporate governance practices is with excess benefit transactions under I.R.C. § 4958 and in mandating the public availability of Forms 1023 and 990. See, I.R.C. §§ 6104(a)(1)(A), (B), 6104(d)(4). This is in marked contrast to the strict confidentiality relating to other tax return information. Advisory Committee, *supra* note 39, at 29-30.

[48] *Id.* at Appendix 3. For hospitals, Schedule C of Form 1023, question 14 asks whether a hospital has adopted a conflict of interest policy consistent with the sample health care conflict organization conflict of interest policy. If yes, the organization should submit a copy. If no, the organization must explain how it will avoid conflicts of interest in its business. The simplest answer is to have a conflict of interest policy.

[49] In Rev. Rul. 69-545, 1969-2 C. B. 117, a hospital qualifying for exemption had a board composed of community representatives in contrast to the non-exempt hospital, whose board of directors originally owned the hospital seeking exemption. The IRS has issued

board representativeness and control in its approval of integrated delivery systems and ancillary joint ventures.[50] Healthcare is highly regulated at the federal and state level, and the Service is but one of the players that determine hospital structures and governance. Thus, it is atypical of most other areas of the nonprofit sector.

The question is not whether good governance is desirable. Of course it is. But, has the Service identified appropriate indicators of that behavior, and does the Service have the authority and expertise to demand such steps as it recommends? The approach of state corporate law to corporate governance is very different. For example, with very few exceptions, state nonprofit corporate codes do not require an organization to have a conflict of interest policy.[51] Nonprofit corporate statutes deal with interested transactions, but the focus is upon whom has the burden of proof to show the transaction was fair to the organization at the time it was entered into.[52] Under state law, whether an organization adopts a conflict of interest policy is within the discretion and judgment of the board.

The instructions to Form 1023 explain that though a conflict of interest policy is recommended but not required "by adopting the sample policy or a similar policy, you will be choosing to put in place procedures that will help

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guidelines for use of revenue agents in determining whether a hospital qualifies for exemption. One of the factors in determining whether the hospital meets the community benefit standard of Rev. Rul. 69-545 is whether the hospital has a governing board composed of prominent civic leaders rather than hospital administrators, physicians etc. *See*, I.R.S. Ann. 92-83, 1992-22 I.R.B. 59 (June 1, 1992).

[50] *See*, IHC Health Plans v. Commissioner, 325 F.3d 1188, 1201 (10th Cir. 2003); Rev. Rul. 98-15, 1998-12 I.R.B. 6. An integrated delivery system is a network of healthcare providers that offers a variety of health services ranging from hospital to home health services, outpatient and preventive care. *See* DOUGLAS M. MANCINO & ROBERT C. LOUTHIAN III, TAXATION OF HOSPITALS & HEALTH CARE ORGANIZATIONS, ch. 8 (2nd ed. 2009). An ancillary joint venture is one that involves services or facilities that are ancillary to the primary operations of the hospital or healthcare system. They are secondary in importance and often involve relatively small amounts of revenue or assets in comparison with joint ventures involving entire hospital facilities. Examples include the development and operation of ambulatory surgery centers, dialysis centers, and similar types of programs and services. The Service has issued private letter rulings involving a broad range of health care joint ventures for these types of outpatient services. *Id.* at 19.03.

[51] Arizona requires a nonprofit corporation to have a conflict of interest policy. ARIZ. REV. STAT. § 10-3864 (1999). A few jurisdictions require health care organizations to or other specialized organizations to have conflict of interest policies. *See*, ARK. CODE. ANN. § 20-46-304 (1985) (Community health centers); R.I. GEN. LAWS § 27-19.2-4 (2008) (nonprofit hospitals in accord with IRS guidelines); CONN. GEN. STAT. § 36a-454b (2004) (Credit Unions).

[52] *See, e.g.*, CAL. CORP. CODE § 5233 (2009); N.Y. NOT-FOR-PROFIT CORP. LAW § 715; MODEL NONPROFIT CORP. ACT § 8.60.

you avoid the possibility that those in position of authority over you may receive an inappropriate benefit."[53] There is no empirical data that validates this statement. The Service's comment that the conflict of interest policy is recommended is countered by the unspoken implication that if the organization does not have one, it will become victim to or subject to interested insider transactions. There is also the implication that when the exemption application is reviewed, the Service will take a negative view of the policy's absence.[54]

2. Examining Governance Practices in the Determination of Tax-Exempt Applications

The members of the Service's Advisory Committee on Tax Exemption and Government Entities are a knowledgeable and sophisticated group of exempt organization practitioners. They have suggested on the basis of their experience in representing nonprofit clients seeking exemption that the specific governance practices recommended by the Service are in fact required by Service employees making the actual determinations whether an applicant qualifies for tax exemption. In an undetermined number of cases, changes in Form 1023 applications have been made at the urging of Service employees. Despite what the Form 1023 and its instructions suggest, the Service has denied exemptions because of the lack of an independent board, some independent members, or a conflict of interest policy.[55] However, the Service has not provided guidance to its own auditors in the Internal Revenue Manual[56] or to applicants as to what

[53] INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR FORM 1023, Part V, question 5a (2006).

[54] *See id.*, question 5. Question 5a deals with whether the organization has adopted a conflict of interest policy consistent with the sample Service conflict of interest policy in Appendix A of the instructions. If the answer is no, then there are two follow-up questions, 5b and 5c, that force the applicant to go back to — what else — a conflict of interest policy: "What procedures will you follow to assure that the persons who have a conflict of interest will not have influence over you for setting their own compensation?" and "What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you regarding business deals with themselves?".

[55] Advisory Committee, *supra* note 39, at 33.

[56] The Internal Revenue Manual is "a training and research aid. Its goal is to give practical information that helps [Exempt Organization] specialists successfully process exemption applications, conduct effective examinations, develop technical advice requests, and effectively complete modifications, terminations, and revocations. It summarizes and explains published authority. It does not extend or modify published authority and should not be cited either as precedent or authority in deciding cases." I.R.S., INTERNAL REVENUE MANUAL § 7.25.1.1(6) (Nov. 1, 2003).

applying corporate governance criteria and evaluating governance practices of applicants for exemption to apply and how governance issues should be handled.[57]

Recent denials of applications for tax exemption indicate that these "recommended" corporate governance matters were significant factors in the decision.[58] If the Service's governance initiative was limited to applications for recognition of exemption, and it published guidance to officials and counsel as to governance review criteria, it might be justified as an attempt to raise standards or to place barriers on an enormously expanding sector, where regulators have inadequate controls over entry.

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[57] In May 2009, as part of a continuing professional education program for Exempt Organizations examination agents, determinations specialists, tax law specialists, and managers, the Service conducted a series of two–hour training sessions on governance and tax–exempt organizations. The educational materials used in those programs were posted online in July. They are of little assistance to organizations in ascertaining how agents will actually interpret the corporate governance mandates. *See*, IRS Training Materials—Governance, http://www.irs.gov/charities/article/0,,id=208454,00.html (last visited Nov. 19, 2009).

[58] *See* Ohio Disability Ass'n v. Commissioner, T.C. M. 2009-261 (Nov. 12, 2009), 64 Exempt Org. Tax. Rev. 655 (2009)(upholding exemption denial where organization had single director, and Service requested whether petitioner would modify board to include unrelated individuals selected from community organization to serve and petitioner didn't respond to request); I.R.S. Priv. Ltr. Rul. 2008-30-028 (Apr. 28, 2008) (denying exempt status to a church where, among many other issues, directors consisted entirely of family members, explaining that though not compensated, the "family exercises complete control" and without bylaws or governance specifics, including the lack of a conflict of interest policy, "the structure of your organization indicates that it can be used to benefit private individuals"); I.R.S. Priv. Ltr. Rul. 2008-28-029 (Apr. 18, 2008) (denying exempt status for affordable rental housing, stating "You are not operated by through [sic] a community-based board of directors, and there is no indication that community groups have input into the your [sic] operations. Your board members have been selected based upon their business experience. You have made representations regarding your willingness to expand your board. However, you made the expansion contingent upon your receiving an exemption under section 501(c)(3). In addition, you have also made your present board's participation in decision making, including the adoption of changes in your conflict of interest policy, contingent upon your receiving an exemption, while * * * has proceeded to make significant decisions concerning your organization and operation."); I.R.S. Priv. Ltr. Rul. 2008-24-025 (Mar. 18, 2008) (denying exempt status to organization of member credit unions, stating "[T]he Board of Directors, as presently constituted, gives rise to an obvious conflict of interest, in that any policy decisions made by the board would appear to be solely to promote and protect the financial interests of the [members]"); I.R.S. Priv. Ltr. Rul. 2008-06-021 (Nov. 8, 2007) (denying exempt status to an agribusiness, stating "You have not shown that your earnings do not inure to the benefit of your three key Board members who were the owners of your predecessor for-profit business"). Also, see the private letter rulings discussed in Advisory Committee, *supra* note 39, at 34 nn.116–117.

However, this effort has been extended to the annual Information Return, which impacts on almost all charities of a certain size.

B. The Annual Information Return: Form 990

Most exempt organizations must file an annual informational return that reports all receipts and disbursements and any other information that the Service may require by forms or regulations. Normally, organizations that have annual gross receipts of more than $25,000 must file Form 990 or a simplified form 990EZ.[59] Because Form 990 was substantially revised for tax years beginning in 2008, the Service is phasing in the new form over a three-year period.[60]

It was not until 1942 that the Treasury Department required all tax-exempt organizations to file an annual information return. The two-page form covered the 1941 tax year and consisted of three questions, an income

[59] Organizations with gross receipts of less than $100,000 and total assets of less than $250,000 may file a short form equivalent, Form 990-EZ. Private foundations must file Form 990-PF. Any exempt organization that is liable for the unrelated business income tax also must file Form 990-T and, if the organization expects its tax for the year to exceed $500, it must make quarterly payments of estimated tax on unrelated business income. I.R.C. § 6033(a)(3)(A). The Service also has discretionary authority under section 6033(a)(3)(B) to grant filing exemptions, and it has done so by increasing the annual gross receipts threshold from $5,000 to $25,000 for all exempt organizations that are not private foundations and for most state and U.S. governmental organizations, and for certain organizations affiliated with governmental units, such as state colleges and universities, and public libraries and museums. I.R.S. Ann. 82-88, 1982-25 I.R.B. 23; I.R.S. Ann. 94-117, 1994-39 I.R.B. 19. It will increase the minimum threshold for filing Form 990-EZ to $50,000 in 2010. Mandatory exemptions from the filing requirement are granted to churches, their integrated auxiliaries, and conventions or associations of churches; certain organizations that are not private foundations and have annual gross receipts that normally do not exceed $5,000; and religious orders, with respect to their exclusively religious activities. I.R.C. § 6033(a)(3)(A).

[60] For the 2008 tax year (filing in 2009), organizations may opt to file a Form 990-EZ if its gross receipts are over $25,000 and less than $1 million and if its assets are less than $2.5 million. For the 2009 tax year, organizations may opt to file a Form 990-EZ if its gross receipts are over $25,000 and less than $500,000 and if its assets are less than $1.25 million. For the 2010 tax year, organizations may opt to file a Form 990-EZ if its gross receipts are over $50,000 and less than $200,000 and if its assets are less than $500,000. Beginning in the 2008 tax year, if an organization normally has gross receipts of $25,000 or less, it must file Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ. See*,I.R.S, FORM 990-N, Appendix 4 (2008), *available at* http://www.irs.gov/charities/article/0,,id=169250,00.html. The Service intends to increase the Form 990-N (e-postcard) filing threshold from $25,000 in gross receipts to $50,000 in gross receipts, beginning with the 2010 tax year. I.R.S., Overview of Form 990 Redesign for Tax Year 2008 (Dec. 20, 2007), *available at* http://www.qai.irs.gov/pub/irs-tege/overview_form_990_redesign.pdf.

statement, and a balance sheet. Two officers signed an affidavit. Treasury's authority to impose this requirement was challenged, and compliance was poor.[61] In 1943 Treasury sought statutory authority from Congress, which had become concerned about reports of abuse of charitable status.[62] Congress required certain exempt organizations, principally foundations, to file returns that would disclose their financial affairs.[63] Neither the Service nor anyone else could have imagined that Form 990 would exponentially expand in pages and importance to become the principal disclosure tool for government oversight of exempt organizations.[64] Though only a small percentage of all section 501(c)(3) organizations have the revenue and assets to require filing the Form 990, many charities do so voluntarily.[65] For some it is a symbol to donors and potential contributors of maturity and transparency. For many other organizations, since over thirty states accept the full Form 990 to satisfy their reporting requirements but not the Form 990EZ, filing the full Form 990 enables organizations to prepare one less form.[66]

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[61] FREMONT-SMITH, *supra* note 30, at 65.

[62] *Id.* at 59, 65.

[63] Revenue Act of 1943, H.R. 3687, 78th Cong. ch. 63, § 117 (1944). The Revenue Act of 1943 excluded "churches and other religious organizations, certain educational institutions, and certain publicly supported organizations" from this filing requirement. Laurens Williams & Donald V. Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations*, *in* 4 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS: TAXES 2099, 2101 (1977). One purpose of the 1943 legislation was to provide Congress with sufficient information to determine if further legislative restrictions were needed. *Id.*

[64] The form has continually been revised to contain more information. *See* FREMONT-SMITH, *supra* note 30, at 65–67, which tracks the changes in the form. *See also*, Advisory Committee, *supra* note 39, at 98–100.

[65] According to the Service, as of November 15, 2009, approximately 66 percent of tax-exempt organizations that have filed the redesigned Form 990 could have filed the Form 990-EZ. By contrast, in the 2007 tax year, the last year the old form was used, only 20% of exempt organization filers could have filed the Form 990-EZ. Simon Brown, Most EOs That Filed the New Form 990 Could Have Filed the 990-EZ, Says IRS Official, 64 Exempt Org. Tax Rev. 570 (2009). The Service official justified the increase on the basis of ignorance or state requirements, which certainly don't explain the jump. *Id.* State requirements haven't changed in one year. Ignorance is unlikely for the increase. Seventy percent of Form 990s filed were completed by paid return information specialists, who have the expertise to fill out the complex form and the financial incentive to encourage filing the full form. The alternative reason given was that the organizations assumed that they will be required to file in the future and were getting a lead start. This too is unlikely.

[66] See The Multi-State Filer Project, Appendix of Cooperating States, http://www.multistatefiling.org/n_appendix.htm#financial (last visited Nov. 19, 2009), for states that accept the Form 990.

In marked contrast to the confidentiality of other tax documents, Congress, in a continuing effort to make exempt organizations more accountable, has enacted and expanded a variety of public disclosure and inspection requirements that apply to both the Service and the organization.[67] The Service must make Forms 990 and approved applications for exemption available for public inspection at the National Office and the appropriate field offices.[68] All organizations exempt from tax under section 501(c) or section 501(d) must make available for inspection their application for exemption, along with all supporting documents, and their annual informational returns for the most recent three years.[69] Annual information returns are available over the Internet.[70]

The redesigned Form 990, effective for the 2008 tax year, is the first revision since 1979 and a significant departure from past versions. To its credit, the Service welcomed and received substantial public comment from organizations, accountants, law firms and the interested public.[71] The Form 990 has grown to a core form of eleven pages that must be filled out by all organizations required to file,[72] together with an additional sixteen

[67] *See* FISHMAN & SCHWARZ, *supra* note 1, at 573-76.

[68] I.R.C. §§ 6104(a)(1)(A), (b). Trade secrets and information that would adversely affect national defense are exempt from disclosure, as is the schedule of major contributors that is required as an attachment to the Form 990. I.R.C. §§ 6104(a)(1)(D), (b).

[69] The documents must be made available at the organization's principal office during regular business hours and at regional or district offices with three or more employees. I.R.C. § 6104(d)(1)(A). Tax exempt organizations also must provide copies of their exemption applications and Form 990's for the three most recent tax years to anyone who requests them. I.R.C. § 6104(d)(2). The copies ordinarily must be provided immediately if the request is made in person or within thirty days if in writing. I.R.C. § 6104(d)(1)(B). Organizations that make their documents widely available, such as by posting an exact and downloadable reproduction on a website, are not required to provide photocopies, but they still must make returns available for inspection at their offices. I.R.C. § 6104(d)(4); Treas. Reg. § 301.6104(d)–2 (2000). There are substantial penalties for failure to file an information return. I.R.C. §§ 6652(c), 6685.

[70] *See* GuideStar, http://www.guidestar.org (last visited Nov. 19, 2009).

[71] In June 2007, the Service released a draft Form 990. After numerous public comments it released a revised draft in December 2007. In April 2008, the Service released draft instructions which also were the subject of extensive public comment. Revised draft instructions were released in August 2008. The final forms were published in December 2008. *See* I.R.S., IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transition Relief (Dec. 20, 2007), *available at* http://www.irs.gov/newsroom/article/0,,id=176722,00.html.

[72] This includes most organizations exempt under section 501(a), including organizations described in section 501(c)(3), other than churches and private foundations and organizations described in other 501(c) subsections other than black lung trusts as well as

schedules that require reporting from organizations that conduct particular activities, like healthcare, or engage in political campaign and lobbying activities.

C. Corporate Governance Issues in Form 990

The revised Form 990 contains many questions concerning corporate governance issues. Some derive from Congressional legislation, such as that which added section 4958 to the Code.[73] Those questions dealing with potential of excess benefit transactions under I.R.C. § 4958 relate directly to tax compliance and are appropriate. The Service has made several pronouncements on the participation of charities in joint ventures. Questions relating to the tax-exempt compatibility of joint ventures between nonprofit and for-profit entities relate to this issue.[74] They assist the Service

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section 527 political organizations. There are additional arcane inclusions and exclusions. The instructions, not including the index, consist of 70 pages of small print.

[73] See Code section 4958, which introduced excise taxes for excess compensation and other private inurement. § 4958(c)(1); Treas. Reg. § 53.4958-4(a)(1)–(2) (2002). This section creates a framework for penalizing transactions characterized as excess benefits to insiders. An "excess benefit transaction" is "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any [person in a position to exercise substantial influence over the organization] if the value of the economic benefit provided exceeds the value of the consideration . . . received [by the organization] for providing such benefit." I.R.C. § 4958(c)(1)(A); *see also*, Treas. Reg. § 59.4958-4(a)(1)–(2) (2002). Examples of excess benefit transactions are unreasonable compensation or below market loans to an organization's executives. For a description of the complicated intermediate sanctions regime, see FISHMAN & SCHWARZ, *supra* note 1, at 487–497. The common name of the section is "Intermediate Sanctions" because it creates an intermediate penalty between an organization's revocation of exemption and doing nothing for charities that allow insiders to improperly benefit from transactions at the expense of the organization. Prior to the legislation, all the Service could do was to revoke the charity's exemption, a penalty so draconian that it was rarely invoked. The intermediate sanction is an excise tax on the insider who received the excessive benefit and the organization's executives who authorized it. The law of unintended consequences applies to the requirements of Code section 4958 that organizations determine comparables of other organizations of their size when determining compensation. This has placed *upward* pressures on nonprofit salaries.

[74] *See* St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003); Rev. Rul. 98-15, 1998-1 C.B. 718; Rev. Rul. 2004-51, 2004-1 C.B. 974. The Joint venture question asks whether the organization "invest[ed] in, contribute[d] assets to, or participate[d] in a joint venture or similar arrangement with a taxable entity during the year"; and, if yes, whether the organization "adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements." I.R.S., FORM 990, Part VI, questions 16a, 16b (2008).

in assuring that Congressional intentions are achieved and assist enforcement. Such questions are reasonable efforts to ensure compliance with the Code. Whether or not the legislation has achieved its goals, Congress has spoken, and the questions relating to compensation are within the Service's authority.

Other questions, attenuated to tax law compliance, place new and undefined burdens on organizations. They concern the independence of directors, conflicts of interest, disclosure policies, related party transactions and general issues of corporate governance that have little relationship to tax law compliance. These questions diverge from the approach of state corporate law, which offers an organizational flexibility the Service seems not to recognize.

The corporate governance "recommendations" will be expensive for organizations to introduce, and as the Service admits, are not required by the Code. Because the Service's initiative is couched in the guise of questions on the Form 990 that must be answered and will be observed by the public, the organization is virtually required to answer in the way the Service approves. The structure of the questions creates a catch twenty-two. It is the tax form equivalent of "have you stopped beating your wife?" If the organization says "no" to one of the practices or policies the Service recommends, it must have a good reason because that response also becomes publicly available information on Schedule 0. The organization that does not yield to the Service's view of good corporate governance is asking for trouble. One can only wonder what prospective donors, who view the Form 990, will think of positive answers to some of these questions and negative responses to others.

All organizations that file Form 990 must complete the section, Part VI, that requests information regarding an organization's governing body and management, its governance policies, and disclosure practices.[75] Although federal tax law generally does not mandate particular management structures, operational policies, or administrative practices, every organization is required to answer each question. The major corporate governance questions fall into four categories. The first concerns questions that relate to tax compliance which are appropriate for Service inquiry. The other categories are more attenuated to that primary purpose: governance structure, governance practices and prevention of fraud.

[75] *Id.* at Part VI. The organization uses Schedule O to provide supplemental information.

1. Public Disclosure

Organizations must provide public access to certain documents,[76] and a question asking whether and how the organization's Form 1023, and Forms 990 and 990-T, are made available to the general public is appropriate.[77] However, the question, which also asks the organization to describe in Schedule O whether (and if so, how) the organization makes its governing documents, conflict of interest policy, and financial statements available to the public is not, because it is inconsistent with the proper boundaries of federalism.[78] Neither federal tax law nor state nonprofit law requires such documents be made publicly available, unless they are included in a form that is publicly available.

2. Conflicts of Interests/Transactions with Interested Persons

Interested transactions are those which may involve an impermissible conflict of interest, unless they are disclosed and a procedure is followed to establish that the transaction was fair and reasonable to the organization at the time it was approved by the appropriate officers or board. Revised Form 990 creates the concept of "interested person," which has several meanings, depending on the context in which transaction takes place. Transactions with interested persons must become part of the process of informing the appropriate organizational authority of conflicts of interest.[79] Such transactions include business transactions with interested persons,[80] loans to or from interested persons, and grants or other assistance provided to interested persons. The meanings are complicated and detailed.[81] Relationships between directors, trustees, officers and key employees must be disclosed.[82]

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76 I.R.C. § 6104.

77 I.R.S., FORM 990, Part VI, question 18.

78 *Id.* at question 19.

79 Conflicts are listed on Schedule L.

80 "Business transactions include but are not limited to contracts of sale, lease, license, and performance of services, whether initiated during the organization's tax year or ongoing from a prior year. Business transactions also include joint ventures, whether new or ongoing, in which either the profits or capital interest of the organization and of the interested person each exceeds 10%." I.R.S., INSTRUCTIONS FOR SCHEDULE L (FORM 990 OR 990-EZ), Part IV (2008).

81 There are differing requirements for organizations that file the Form 990-EZ. Listing of interested transactions provides increased transparency to the financial workings of the organization.

82 I.R.S., Form 990, Part VI, Question 2.

The Form 990 and instructions imply that conflicts of interest are substantively wrong. The Service does not recognize that under state law conflicts of interest are matters of procedure, relating to the burden of proof for showing whether the interested transaction was fair or not. So long as the fact of a conflict of interest and the material terms of the interested transaction are disclosed, and the transaction is fair to the nonprofit at the time it is entered into, a conflict of interest is not a wrong as the Service's approach and language implies.

Obviously, in light of the Service's focus at the application for exemption stage, in the Form 990 and as a primary focus during examinations, an organization must have a conflicts of interest policy. For smaller organizations with limited resources, interested transactions may be a necessity. They may be the only way to gain access to sources of credit, services or assistance. As a result of the implications in Service publications, many organizations to their detriment will be reluctant to engage in a perceived conflict of interest, because prospective donors, who view the Form 990 and see lists of interested transactions will have an unfavorable reaction.

3. Independence of Directors

Revised Form 990 introduces the category of "independent" voting members, directors or trustees.[83] There are three requirements for independence: 1) the member was not compensated as an officer or other employee of the organization or of a related organization;[84] 2) the member did not receive total compensation or other payments exceeding $10,000 during the organization's tax year from the organization or from related organizations as an independent contractor, other than reimbursement of expenses under an accountable plan or reasonable compensation for services provided in the capacity as a member of the governing body; and 3) neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported on the Form 990 for the organization's tax year.[85] Outside

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[83] *Id.* at Question 1b.

[84] I.R.S., INSTRUCTIONS FOR FORM 990, Part VI, § A (2008). However, the Service provides for a religious exception, as described *infra* note 85.

[85] It would be reported on Schedule L. A member of the governing body is not considered to lack independence merely because of the following circumstances: 1) the member is a donor to the organization, regardless of the amount of the contribution; 2) the member has taken a bona fide vow of poverty and either (A) receives compensation as an

counsel may not in some circumstances qualify for consideration as an independent director.[86]

Organizations need not engage in more than a reasonable effort to obtain necessary information concerning independence or interested transactions. Donors, no matter how much they contribute, are considered independent. Though the Service does not explain why an independent board is important or require a specific number of directors to fit in that category, in an educational outreach publication, "Governance and Related Topics — 501(c)(3) Organizations," it suggested that a nonindependent board would not represent the public interest and would increase the likelihood for insider transactions. The statement does not explain why independence will cure that and whether independent boards have shown more probity.[87]

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agent of a religious order or a 501(d) religious or apostolic organization, but only under circumstances in which the member does not receive taxable income (see, e.g., Rev. Rul.77-290, 80-332); or (B) belongs to a religious order that receives sponsorship or payments from the organization which do not constitute taxable income to the member (the "religious exception" referred to above); or 3) the member receives financial benefits from the organization solely in the capacity of being a member of the charitable or other class served by the organization in the exercise of its exempt function, such as being a member of a section 501(c)(6) organization, so long as the financial benefits comply with the organization's terms. I.R.S., FORM 990 Instructions, Part VI.

[86] The instructions offer the following example: B is a voting member of the organization's board of directors. B is also a partner with a profits and capital interest greater than 5% in a law firm, C, that charged $120,000 to the organization for legal services in a court case. The transaction between C and the organization must be reported on Schedule L because it is a transaction between the organization and an entity of which B is a more than 5% owner, and because the payment from C to the organization exceeded $100,000 (see instructions to Schedule L, Part IV, regarding both factors). Accordingly, B is not an independent member of the governing body, because the $120,000 payment must be reported on Schedule L as an indirect business transaction with B. If B were an associate attorney (an employee) but not an officer, director, trustee, key employee, or owner of the law firm, then the transaction would not affect B's status as an independent member of the organization's governing body. I.R.S., FORM 990 INSTRUCTIONS, Part VI, Line 1b, Example 1.

[87] I.R.S., Governance and Related Topics–501(c)(3) Organizations, http://www.irs.gov/pub/irs-tege/governance_practices.pdf. The publication states: "Irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships. The Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets. The Service also reviews whether an organization has independent members, stockholders, or other persons with the authority to elect members of the board or approve or reject board decisions, and whether the organization has delegated control or key management authority to a management company or other persons." *Id.* Independent boards

Under state corporate law, the independence of a majority of nonprofit board members has been required in very few jurisdictions.[88] Professor Dana Brakman Reiser has questioned the usefulness of the concept of independence in the nonprofit context, given the broader goals of improving nonprofit governance and strengthening the nonprofit sector.[89] Interested directors may be the most committed to the organization's goals. Many medium and smaller nonprofits have extreme difficulty in recruiting board members. It may be that interested, nonindependent directors are the only source. In the for-profit sector, independence of some board directors has been required by the stock exchanges,[90] and for audit committees under the Sarbanes-Oxley Act, passed by Congress in 2002 ("SOX").[91] However, the empirical validity of the benefits of board independence in the for-profit context is questionable at best. Empirical studies have shown little correlation between board independence and an increase in firm value.[92] There have been no empirical studies relating to the impact of good nonprofit governance on mission outcome. One can only conclude that the Service's push for board independence, as with so much of its corporate governance initiative, represents wishful thinking.

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have been a focus of importance to the Service in the healthcare area and a requirement for § 501(c)(3) exemption for credit counseling organizations, I.R.C. § 501(q)(1). Both have been a source of abusive practices and Congressional concern.

[88] *See*, CAL. CORP. CODE § 5227(a) (West 1996); ME. REV. STAT. ANN. tit 13-B, § 713-A(2) (2007); N.H. REV. STAT. ANN. § 292:6-a (2009); N.D. CENT. CODE § 10-33-27(2) (2003); VT. STAT. ANN. tit. 11B, § 8.13(a) (1995).

[89] Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 FORDHAM L. REV. 795, 797-798 (2007). Professor Brakman Reiser also concludes that director independence makes a relatively limited contribution in addressing real accountability issues facing nonprofit organizations. *Id.* at 832.

[90] *See*, N.Y. STOCK EXCHANGE, LISTED CO. MANUAL ¶¶ 303A.01-07 (2009).

[91] Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7201 et seq. (West 2002).

[92] *See generally* Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002); Kathleen M. Boozang, *Does An Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83 (2008). Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for the Policymakers Too*, 22 GA. ST. U. L. REV. 251 (2005); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

4. Documentation Run Amok

Many nonprofit organizations are more informal in adherence to procedures than their for-profit counterparts.[93] This results from inadequate staff resources or a lack of in-house or permanent outside counsel. The Service favors a more bureaucratic approach. It requires contemporaneous documentation of meetings, not only of the board — standard procedure for all organizations — but also of committees authorized to act on behalf of the governing body.[94] Such documentation may be common practice for larger nonprofits. Smaller organizations often conduct committee meetings informally. It can become a burdensome commitment of staff time to take and prepare minutes of all actions taken, particularly at the committee level.

5. Document Retention and Destruction Policy

Another question inquires whether the organization has a written document retention and destruction policy.[95] Presumably this is derived from the Sarbanes-Oxley legislation, which makes it a crime to alter, cover up, falsify or destroy any document or prevent its use in a federal investigation or bankruptcy proceeding.[96] While that section of the federal statute deals with organizations under federal investigation, the Service has adapted it to encourage a document retention policy. Such policies identify the record retention responsibilities of staff, board members or outsiders,

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[93] This is outside of hospitals, universities and major cultural and social services organizations.

[94] I.R.S., FORM 990, Part VI, Question 8. Documentation of meetings and actions. Answer "Yes" to lines 8a and 8b if the organization contemporaneously documented by any means permitted by state law every meeting held and written action taken during the organization's tax year by its governing body and committees with authority to act on behalf of the governing body (which ordinarily do not include advisory boards). Documentation permitted by state law may include approved minutes, strings of e-mails, or similar writings that explain the action taken, when it was taken, and who made the decision. This requirement does not include advisory bodies. For this purpose, contemporaneous means by the later of (1) the next meeting of the governing body or committee (e.g., approving the minutes of the prior meeting), or (2) 60 days after the date of the meeting or written action. If "No," explain in Schedule O the organization's practices or policies, if any, regarding documentation of meetings and written actions of its governing body and committees with authority to act on its behalf. Presumably, this would include executive committees, which generally act for the board between meetings of the full board.

[95] I.R.S., FORM 990, Part VI, line 14.

[96] *See* Sarbanes-Oxley Act of 2002, 18 U.S.C.A. § 1519-20 (imposing criminal sanctions for altering or destroying documents in federal investigations).

such as accountants and counsel, for maintaining and documenting the storage and destruction of an organization's documents and records.

There is nothing in state law that requires an organization to have a retention or destruction policy, though statutes require organizations to prepare and produce documents.[97] Best practices and the ease of storage of digitalized documents encourage the implementation of such a policy. An organization should retain essential governance documents, business records, minutes, financial reports and items related to tax exempt status, but why this is a concern of the Service is mystifying. The Form 990 is a matter of public record, and presumably a permanent record.

6. Board Review of Form 990

Another question, with no grounding in federal tax or state nonprofit law, asks about the board's *process*, if any, it uses to review the Form 990.[98] If no review was conducted, the organization must so state.[99] This question seems derived from section 906 of Sarbanes-Oxley, which requires the chief executive officer and chief financial officer of public companies to certify financial reports.

The Form 990 is a complicated and time consuming document to understand, let alone review. To expect board members to become familiar

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[97] *See,* N.Y. NOT-FOR-PROFIT CORP LAW § 519-520; MODEL NONPROFIT CORP. ACT. § 16.01. The Model act requires a nonprofit corporation to keep as permanent records, minutes of all meetings of its members, board of directors and a record of all actions taken by committee. The Act does not require minutes of committee deliberations. A nonprofit corporation must maintain appropriate accounting records.

[98] I.R.S., FORM 990, Part VI, line 10 ("Governing Board Review of Form 990").

[99] *Id.* The organization is asked to respond 'yes' only if a copy of the organization's final Form 990, including required schedules, as ultimately filed with the Service, was provided to each voting member of the governing body of the organization, whether in paper or electronic form, prior to its filing with the Service. The organization must also describe in Schedule O the process, if any, by which any of the organization's officers, directors, trustees, board committee members, or management reviewed the prepared Form 990, whether before or after it was filed with the Service, including specifics regarding who conducted the review, when they conducted it, and the extent of any such review. If no review was conducted, the organization must so state. The instructions give the following example, which seems to put organizations that don't have a substantial board process at a disadvantage: "The return preparer e-mails a copy of the final version of the Form 990 to each board member before it was filed. However, no board member undertakes any review of the form either before or after filing. Because a copy of the final version of the return was provided to each voting member of the organization's governing body before it was filed, the organization may answer "Yes" even though no review took place." The organization must describe its Form 990 review process (or lack thereof) in Schedule O. *Id.*, Example 1.

with the intricacies of the form creates a real burden on directors and consumes their valuable time that could be otherwise expended in more worthwhile activities, such as fundraising and development and strategic planning. One of the consequences of this initiative will be to increase the already difficult burden of finding board members willing to serve.[100]

7. Whistleblower Policies

A whistleblower policy encourages staff and volunteers to feel free to come forward with good faith, credible information about illegal practices or violations of adopted organizational policies and assures that the organization will protect the individual from retaliation. The policy is supposed to identify those staff, board members, or outside parties to whom such information can be reported.[101] For a large nonprofit — such as a hospital or university — that policy makes sense. In a smaller organization with few staff, the reality is that a good faith effort which is incorrect may make it impossible for the individual to continue and the organization's dynamics to work as it should.[102]

8. The Specter of SOX: Sarbanes-Oxley for Nonprofits?

In the aftermath of the collapses of Enron, Worldcom and Arthur Andersen, Congress passed the American Competitiveness and Corporate Accountability Act of 2002, known as the Sarbanes-Oxley Act.[103] The legislation requires corporate boards, *inter alia*, to have audit committees consisting of independent directors, mandates the creation of effective financial reporting systems, and requires chief executives and chief financial officers of publicly listed companies to personally certify the validity of their corporation's financial statements and that they validly

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[100] A 2007 study by the Urban Institute found that 70% of nonprofits surveyed stated it was difficult to find board members; 20% said it was very difficult. FRANCIE OSTROWER, NONPROFIT GOVERNANCE IN THE UNITED STATES 16 (Urban Institute 2007).

[101] I.R.S., 2008 INSTRUCTIONS FOR FORM 990, Part VI, Governance, Management, and Disclosure, Line 13 and 14 (whistleblower and document retention policies).

[102] *Cf.* Bohatch v. Butler & Binion, 977 S.W.2d 543, 548 (Tex. 1998) (Justice Hecht, concurring: "I have trouble justifying a 500-partner firm's expulsion of a partner for reporting overbilling of a client that saves the firm not only from ethical complaints but from liability to the client. But I cannot see how a five-partner firm can legitimately survive one partner's accusations that another is unethical. Between two such extreme examples I see a lot of ground.").

[103] Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7201 et seq. (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

represent the financial condition of the company. One of the strangest reactions to the pressures for nonprofit accountability has been the willingness of many charities to embrace Sarbanes-Oxley reforms voluntarily as a statement of improved governance, transparency and accountability.[104]

It is ironic that SOX has such an influence on the nonprofit sector, for it primarily applies only to the one half of one percent of all for-profit corporations that are publicly listed. The statute generally does not apply to nonprofits, nor was it intended for application to the nonprofit sector. As Senator Paul Sarbanes, the co-sponsor of the legislation commented, Sarbanes-Oxley "was not designed for nonprofits, and the two worlds are clearly different."[105] Two sections of SOX theoretically could apply to a nonprofit organization as they are amendments to the federal criminal code, one concerns document destruction in the course of a federal investigation.[106] The other prohibits retaliation against whistleblowers that report federal offenses.[107] For most nonprofits, the danger of violating these provisions is minimal.

SOX has come under substantial criticism for its cost of implementation as well as its underlying assumptions, whose validity have been questioned.[108] A very small handful of jurisdictions, most notably California, have enacted legislation with SOX-type requirements for nonprofits,[109] and the Panel on the Independent Sector's project on Principles for Good Governance and Ethical Practice has incorporated some SOX-type recommendations.[110] Whether SOX should be adopted by

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[104] Almost half of nonprofit organizations responding to a survey said they made changes in their operations as a result of SOX. Grant Williams, *Accountability Law Spurs Charities to Make Changes,* CHRON. OF PHILANTHROPY (Nov. 24, 2004), available at http://philanthropy.com/premium/articles/v17/i04/04002905.htm. *See* Press Release, Drexel University, Drexel Trustees Adopt the Sarbanes-Oxley Act on Governance and Auditing Practices (Feb. 26, 2003).

[105] Senator Paul S. Sarbanes, *Sarbanes-Oxley and Ethical Principles of Corporate Behavior,* Address at Drexel University's Bennett S. Lebow College of Business (May 14, 2004), *see also* Carl Oxholm III, *Sarbanes-Oxley in Higher Education: Bringing Corporate America's "Best Practices" to Academia,* 31 J.C. & U.L. 351, 360 (2005).

[106] *See* Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1519–20 (imposing criminal sanctions for altering or destroying documents in federal investigations); 18 U.S.C. § 1512.

[107] *Id.* at 1513(e).

[108] Clark, *supra* note 92; Romano, *supra* note 92.

[109] California Nonprofit Integrity Act of 2004, CAL. GOVT. CODE § 12586.

[110] INDEPENDENT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS, Appendix 5 (2007) *available at* http://www.nonprofitpanel.org/report/principles/principles_guide.pdf.

charities has raised enormous scholarly interest, with the majority of writers opposed.[111]

The nonprofit sector is far more structurally diverse than the for-profit organizations to whom SOX applies. For the business corporation, financial

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[111] *See generally* Ellen Aprill, *What Critiques of Sarbanes-Oxley Can Teach about Regulation of Nonprofit Governance*, 76 FORDHAM L. REV. 765 (2007); Kathleen Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83 (2008); Robert Britton, Note, *Making Disclosure Regulation Work in the Nonprofit Sector*, 2008 U. ILL. L. REV. 437; Ronald Chester, IMPROVING ENFORCEMENT MECHANISMS IN THE CHARITABLE SECTOR, CAN INCREASED DISCLOSURE OF INFORMATION BE UTILIZED EFFECTIVELY?, 40 NEW ENG. L. REV. 447 (Winter 2006); Nicole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831(2007); Jane Heath, Comment, *Who's Minding the Nonprofits Store: Does Sarbanes-Oxley Have Anything to Offer Nonprofits*, 38 U.S.F.L. L. REV. 781 (2004); Joseph Mead, Note, *Confidence in the Nonprofit Sector through Sarbanes-Oxley-Style Reforms*, 106 MICH L. REV. 881 (2008); Lumen N. Mulligan, *What's Good for the Goose is not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981 (2007); Carl Oxholm III, *Sarbanes-Oxley in Higher Education: Bringing Corporate America's "Best Practices" to Academia*, 31 J.C. & U.L. 351 (2005); Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205 (2004); Dana Brakman Reiser, *There Ought to be a Law: Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559 (2005); Wendy Syzmanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303 (2003); BOARD SOURCE & INDEPENDENT SECTOR, THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS 2 (2006), *available at* http://www.independentsector.org/PDFs/sarbanesoxley.pdf. For a cautionary approach to Sarbanes-Oxley and a thinly veiled critique of the IRS's corporate governance initiatives, see Advisory Committee, *supra* note 39, at 15–17. The arguments in favor of SOX-type approaches for nonprofits assume a need for reform and stress SOX's positive aspects in terms of cost benefit analysis; its need due to a lack of or inconsistent state enforcement; increased accountability resulting; protection of donors enabling them to make more informed choices; the independent audit requirement will ensure complete and accurate financial information and allow problems to be uncovered earlier; nominal costs compared to public benefit as exemplified by the number of organizations that have adopted SOX voluntarily; and limiting SOX to largest charities so as to remove any potential financial barriers to the creation of new nonprofits. The arguments against range from the theoretical to the practical: SOX's rationale doesn't apply to the sector, for the reforms protect investors and provide a stream of information to ensure efficient securities markets; for-profits have a greater incentive to distort financial status; it is cost prohibitive and many nonprofits lack an existing structure of attorneys and accountants; SOX-style reforms would be ineffectual in reducing corruption; donors won't use the information generated in any case; SOX provisions that subject executives to personal liability will inhibit organizations from attracting qualified executives; the increase in costs will come at the expense of mission, which SOX doesn't deal with; and SOX is duplicative to some financial information that already exists on Form 990.

performance and protection of investors is of primary importance. The primary goal of charitable organizations is fulfillment of mission — a very different function. The Service's corporate governance initiatives seem not to realize this difference.

V. STEALTH PREEMPTION

A. Principles of Federalism and Preemption

We live in a federal system. Some powers are constitutionally allocated to the federal government.[112] Others have been left to the states.[113] However, there are relatively few policy areas in which decisions are made wholly either at the federal or state and local level. [114] Usually, there is overlapping jurisdictional authority. The states retain concurrent authority over most of the areas where the federal government can act.[115] The American political system's major twentieth century development was the growth of federal power, particularly federal administrative action, at the expense of traditional state authority. Federal regulators moved into areas once traditionally considered matters of state law, such as corporate governance of business corporations registered with the Securities and Exchange Commission ("SEC"), tort liability for defective products, and environmental protection.[116]

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[112] U.S. CONST. art. I, § 8, cl. 5 (the power to coin money); *Id.* art. II § 2, cl. 2 (the power to enter treaties); *Id.* art. I, § 10, cl. 1 (limitations on states).

[113] Motor vehicle and driver's license registration come to mind.

[114] Brian Galle & Mark Seidenfeld, *Administrative Law's Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power*, 57 DUKE L.J. 1933, 1935 (2008).

[115] *See generally* Caleb Nelson, *Preemption*, 86 VA. L. REV. 225 (2000).

[116] The federal preemption of traditional state corporate law has been well chronicled. *See generally* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793 (2006); Jonathan Macey, *Executive Branch Usurpation of Power: Corporations and Capital Markets*, 115 YALE L.J. 2416 (2006); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143 (2007). In products liability, see generally Richard C. Ausness, *Federal Preemption of State Products Liability Doctrines*, 44 S.C. L. REV. 187 (1993); Catherine M. Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 GEO. WASH. L. REV. 449 (2009). Environmental law has been a particular preemption battleground. *See generally* John P. Dwyer, *The Role of State Law in an Era of Federal Preemption: Lessons from Environmental Regulation*, 60 LAW & CONTEMP. PROBS. 203 (1997); Alexandra B. Klass, *State Innovation and Preemption: Lessons from State Climate Change Efforts*, 41 LOY. L.A. L. REV. 1653 (2009); Howard A. Learner, *Federal Preemption When There is an "Emerging Consensus" of State Environmental Laws and Policies*, 102 NW. U. L. REV. 649 (2008).

When Congress enacts legislation, it may preempt conflicting state legislation under the Supremacy Clause of the U.S. Constitution.[117] Other times when Congress speaks, even without indicating a preemptive intent, the effect of the statute may implicitly preempt a traditional area of state law.[118] For example, in 1996 Congress enacted section 4958 of the Code, which prohibited "excess benefit transactions" by insiders of charities and applied such transactions to nonprofit executive compensation. In effect, this legislation implicitly superseded traditional state corporate law.[119] Neither the legislative history nor section 4958 says anything about preemption. Congress enacted this legislation to better enable the Service to administer and ensure compliance with the Code's prohibition against private inurement. Other times Congress has not completely displaced state regulation in a specific area, but the state law conflicts with federal law, because compliance with both is not possible or state law is an obstacle to achieving Congress's objectives.[120] In most cases Congress does not articulate a specific intent to preempt an entire field of regulation[121] or it may include a savings clause that legitimizes state regulation on the same matter.[122] At other times, Congressional intent is silent, and the courts must referee. The preemption issue becomes even more difficult when the preempting body is a federal regulatory agency, interpreting a federal statute or through its own rulemaking.

The preemption issue discussed in this Article does not directly implicate the seminal case of *Chevron v. Natural Resources Defense Council,*[123] and its progeny, which created a framework for allocating decision-making authority between courts and the executive branch.[124] However, *Chevron* is also increasingly applied to interpretations of statutes

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[117] U.S. CONST. art VI, cl. 2.

[118] Barnett Bank of Marion County v. Nelson, 517 U.S. 25, 31 (1996).

[119] The setting of executive compensation of nonprofit executives was in the purview of the board of directors, and their procedures in reaching a figure was part of the exercise of the board's business judgment.

[120] Hillsborough County v. Automated Med. Labs, Inc., 471 U.S. 707, 715 (1985); Alexandra B. Klass, *State Innovation and Preemption: Lessons From State Climate Change Efforts*, 41 LOYOLA L.A. L. REV. 1653 (2008).

[121] RONALD D. ROTUNDA & JOHN NOWAK, TREATISE ON CONSTITUTIONAL LAW § 12.1 at 270 (4th ed. 2007).

[122] *See,* Securities Exchange Act of 1934, 15 U.S.C.A. § 78bb(a) (West 2000).

[123] 467 U.S. 837 (1984).

[124] *See infra* notes 143-145 and accompanying text.

that allocate interpretative authority either to multiple administrative agencies or to a mix of federal and state institutions.[125]

The formal theory of federalism posits that our political system places limits on congressional action through states' representation in Congress, and the procedural safeguards that function through each state's constituency to restrain the ability of the federal government to reach beyond its powers. When congressional action threatens to infringe upon state sovereignty, the states' interest in preserving the individual liberties of the citizens is enforced through procedural safeguards inherent in the structure of the federal government through state participation in federal government action. The political process is a device ensuring that laws excessively impairing the autonomy of the states, or the rights of the citizens of those states, will not be promulgated, and those enacted will be repealed.[126] Unduly burdensome laws will be corrected by electing representatives responsive to the need to of their own constituents.

Federalism provides citizens the opportunity to make an impact on government at a local level, helping to make it more responsive to the immediate needs and evolving values of individual communities, and less susceptible to bureaucratic inertia that exists on the federal level.[127] The equation becomes more complex when Congress has delegated powers to administrative agencies, whose decision-makers are not elected by the people. Then, the structural principles of federalism can become undermined, which is generally agreed to have occurred in the aftermath of the New Deal.

B. The Presumption against Preemption

Our federal system presumes a balance between federal and state power. Ideally, there should be a cooperative federalism between both state and federal governments. There is a presumption against preemption, particularly in those areas that fall under the "historic police powers of the State."[128] An executive order from the Clinton administration on

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[125] Jacob E. Gersen, *Overlapping and Underlapping Jurisdiction in Administrative Law*, 2006 SUP. CT. REV. 201, 202–03 (2006).

[126] Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 556 (1985).

[127] David A. Herrman, *To Delegate or Not to Delegate—That is the Preemption,* 28 PAC. L. J. 1157, 1167 (1997).

[128] Hillsborough County v. Automated Med. Labs, Inc., 471 U.S. 707, 715 (1985); *see generally* Medtronic v. Lohr, 518 U.S. 470 (1996). "Where . . . the field that Congress is said to have pre-empted has been traditionally occupied by the States 'we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.' " Jones v. Rath

federalism[129] states that federalism is rooted in the belief that issues not national in scope or significance are most appropriately addressed by the level of government closest to the people and, in formulating and implementing policies, orders agencies to have an accountable process to ensure meaningful and timely input by state and local officials in the development of regulatory policies that have federalism implications. According to the order, they shall construe, in regulations and otherwise, a federal statute to preempt state law only where the statute contains an express preemption provision or where there is some other clear evidence that Congress intended to preempt state law.[130]

Federal agencies seem to have ignored this executive order.[131] One Service official has stated that state attorneys general welcomed their approach, hardly the serious analysis of federal implications expected under the executive order.[132] The Service's attitude should not surprise. As Thomas Merrill has written:

> Agencies are specialized institutions, intensely focused on the details of the particular statutory regimes they are charged with administering. By design and tradition, they are not expected to ponder larger structural issues such as the relative balance of authority between the federal and state governments, the importance of preserving state autonomy, the value of allowing policy to vary in accordance with local conditions, or the systemic advantages of permitting state experimentation with divergent approaches to social problems.[133]

Packing Co., 430 U.S. 519, 525 (1977) (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

[129] Exec. Order No. 13,132, 64 Fed. Reg. 43,255 (Aug. 4, 1999).

[130] *Id.* at 43,256.

[131] Ernest A. Young, *Executive Preemption*, 102 NW. U. L. REV. 869, 883 (2008). Though the Order requires federal agencies to analyze the impact of their decisions on federalism values, compliance is rare and when conducted perfunctory. *See* Nina A. Mendelson, *Chevron and Preemption*, 102 MICH. L. REV. 737, 782–86, 794–95 (2004); Catherine M. Sharkey, *Federalism Accountability: 'Agency Forcing' Measures*, 58 DUKE L.J. 2125, 2131–43 (2009).

[132] Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities, Nonprofit Governance—The View from the IRS 7 (June 23, 2009), *available at* http://www.irs.gov/pub/irs-tege/ingram__gtown__governance_062309.pdf.

[133] Sharkey, *supra* note 131 at 2147 (quoting Brief of the Center for State Enforcement of Antitrust and Consumer Protection Laws, Inc. as Amicus Curiae Supporting the Respondent at 23, Wyeth v. Levine, 129 S. Ct. 1187 (2009) (No. 06-1249)).

Agencies have a much narrower focus: their own policy goals rather than the larger issues of governance.[134]

With the growth of the federal government and inconsistent court opinions, some scholars question whether there is a presumption against preemption at all.[135] Others in the preemption debates urge that agency power to displace state lawmaking should be more limited than Congress's power to do so.[136] In a series of cases commencing in the 1990s, the Supreme Court revived meaningful constraints on the exercise of federal power by Congress in the interests of restoring a federal-state balance, which had tilted toward the federal side since the New Deal era.[137]

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[134] *Id.*

[135] Mary J. Davis, *Unmasking the Presumption in Favor of Preemption,* 53 S.C. L. REV. 967, 971 (2002); Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process,* 82 N.Y.U. L. REV. 1, 61 (2007). Professor Alexandra B. Klass states: ". . . it is more difficult today for the Supreme Court and lower courts to apply a presumption against preemption—or more generally, any preemption jurisprudence—in areas where the lack of congressional expressions of preemptive intent have been significantly eclipsed by the growth of the federal regulatory state and aggressive federal agency statements in favor of preemption." Klass, *supra* note 116, at 1659.

[136] See, e.g., Nina A. Mendelson, *A Presumption Against Agency Preemption*, 102 NW. U. L. REV. 695 (2008); Thomas W. Merrill, *Rethinking Article I, Section 1: From Nondelegation to Exclusive Delegation*, 104 COLUM. L. REV. 2097 (2004); Cass R. Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071 (1990) [hereinafter Sunstein, *Law and Administration After Chevron*]; Cass R. Sunstein, *Nondelegation Canons*, 67 U. CHI. L. REV. 315 (2000); Young, *supra* note 131. Professors Merrill and Sunstein assert that these additional limits are necessary for two basic reasons. First, they aver that the work of agencies is less deliberative, democratic, and transparent than legislation. Sunstein, *Law and Administration After Chevron*, *supra*, at 2111–15. Second, because agency rulemaking is easier than legislating, executive action, absent judicial oversight, would upset the balance of federalism. Thomas W. Merrill, *Preemption and Institutional Choice,* 102 NW. U. L. REV. 727, 755–56, 759 (2008); Sunstein, *Law and Administration After Chevron*, *supra*, at 2111–13; Sunstein, *Nondelegation Canons*, *supra*, at 320–21. In contrast, Professors Galle and Seidenfeld argue that in many instances agencies are more democratic and deliberative than Congress and in many instances should be able to preempt, regulate or allocate power between states and the federal government without the need for express Congressional approval. Galle & Seidenfeld, *supra* note 114, at 1936, 2006–17.

[137] *See* Printz v. United States, 521 U.S. 898, 918-25 (1997) (holding that the system of dual sovereignty is incompatible with the commandeering of state executive officials to implement the gun control and registration provisions of the Brady Bill); City of Boerne v. Flores, 521 U.S. 507, 520 (1997) (adopting a "congruence and proportionality" test to measure the validity of legislation enacted under Section 5 of the Fourteenth Amendment); United States v. Lopez, 514 U.S. 549 (1995) (striking down the Gun-Free School Zones Act as exceeding Congress's commerce power); BFP v. Resolution Trust Corp., 511 U.S. 531, 544 (1994) (requiring a "clear and manifest" intent to "displace traditional state regulation" of property foreclosure sales in the context of enforcing federal bankruptcy law); Gregory v.

Aside from the issues in the preemption-presumption debate, it seems clear that the Service's corporate governance initiative violates the norms of federalism, and inadequately respects our constitutional structure. Despite statements to the contrary, the corporate governance initiative creates a one-size fits all view, preempting state approaches. Even if Congress gave authority to the Service to obtain such corporate governance information, the mechanisms of the Service's demands for it through forms, pronouncements and guidelines would not bring it within the *Chevron* penumbra if there was a legal challenge to the Service's initiative.

1. Why Chevron Deference Is Not Due

Chevron created a roadmap for judicial review of agency interpretations of statutes. At step one a court asks "whether the statute through Congress's enactment has directly spoken to the precise question at issue."[138] If Congressional intent is clear, that's the end of the matter. A court or agency must give effect to Congress's intent. If the language of the statute is ambiguous or silent on the particular question at issue, a court does not impose its own construction on the statute.[139] Courts then must advance to step two, and the question for the court is whether the agency's interpretation "is based on a permissible construction of the statute," and if so, "deference," i.e., considerable weight, "should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer."[140]

Chevron seemingly gave agencies the authority to make policy through statutory interpretation and to do what they wish, so long as there was a reasonable connection between their choices and congressional instruction. Cass Sunstein has described the original conception of *Chevron* as a kind of counter-*Marbury*[141] but also the administrative state's own *McCulloch v. Maryland.*[142] Thereafter, the Supreme Court tried to clarify when the *Chevron* framework applied and put the brakes on this view by developing an initial inquiry called "Step Zero," which is applied before proceeding to

Ashcroft, 501 U.S. 452, 460 (1991) (requiring a clear statement of legislative intent before interpreting a statute "to alter the usual constitutional balance between the States and the Federal Government"). *See generally* John F. Manning, *Federalism and the Generality Problem in Constitutional Interpretation,* 122 HARV. L. REV. 2003, 2004–06 (2009); Ernest A. Young, *The Rehnquist Court's Two Federalisms,* 83 TEX. L. REV. 1 (2004).

[138] Chevron v. NDRC, 467 U.S. 837, 843 (1984).

[139] *Id.*

[140] *Id.* at 843–45.

[141] Marbury v. Madison, 5 U.S. (1 Cranch) 137, 176 (1803).

[142] 17 U.S. 317 (1819).

the *Chevron* two-step analysis.[143] At the Step Zero stage a court must inquire as to whether Congress would want the court to defer to agencies on this sort of interpretation of the statute in this particular context.[144] Presumably, the rationale of agency interpretive primacy is its expertise in the matter.

For *Chevron* deference to apply, the agency has to have the power to promulgate rules and regulations pursuant to the applicable statute. The Service's interpretation of its authority to question organization's corporate governance does not rest on congressionally-delegated lawmaking, and therefore is not due *Chevron* deference. The Service has answered the Step Zero inquiry itself, admitting it does not have specific authority under the Code. The Service has made policy with no relationship or verifiable connection with the governing statute. For *Chevron* deference to apply the agency has to have the power to promulgate rules and regulations pursuant to the applicable statute. The Service's interpretation of its authority to question organization's corporate governance does not rest on congressionally delegated lawmaking and therefore is not due *Chevron* deference. Though courts have extended *Chevron* deference to agencies' interpretations of the boundaries of their own statutory jurisdiction, *Chevron* principles have uncertain application to an agency interpretation that significantly expands the agency's previously recognized jurisdiction.[145]

Even if statutory authority was granted by Congress, and an aide to Senator Grassley, Ranking Member of the Senate Finance Committee, has indicated he will seek such power if necessary,[146] *Chevron* deference would not apply as the corporate governance pronouncements have not been in standard forms of publication, such as a treasury regulation, but in more

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[143] Gersen, *supra* note 125, at 217; Cass R. Sunstein, *Chevron Step Zero*, 92 VA. L. REV. 187, 190–91 (2006). The cases that introduced this approach were Christensen v. Harris County, 529 U.S. 576 (2000); United States v. Mead Corp., 533 U.S. 218 (2001); and Barnhart v. Walton, 535 U.S. 212 (2002).

[144] Gersen, *supra* note 125, at 217.

[145] A GUIDE TO JUDICIAL AND POLITICAL REVIEW OF FEDERAL AGENCIES § 4.042 (John Fitzgerald Duffy & Michael E. Herz eds., 2005).

[146] Theresa Pattara, tax counsel to Senate Finance Committee Ranking Member Charles Grassley, has stated that she is concerned about whether the Service has authority to ask about governance but said Senator Grassley agrees with the Service's position. She added: "Congress might need to give the IRS 'specific authority' for enforcement if organizations protest the corporate governance and transparency questions on the new Form 990 . . . ." Fred Stokeld & Simon Brown, *At Conference, Officials Discuss Madoff, Enforcement, Charitable Deduction*, 63 EXEMPT ORG. TAX. REV. 333, 333 (2009).

informal forms as educational pronouncements and forms.[147] Congress has not delegated to any agency the power to make policy decisions that bind courts and citizens through formats such as letters, manuals, guidelines or briefs.[148] The status of guidelines and recommendations in the instructions to forms is uncertain. Chevron principles do not apply to agency interpretations that are embodied in policy statements, manuals, enforcement guidelines, interpretive rules, and other such documents unless the agency's conferred authority and other statutory circumstances demonstrate that "Congress would expect the agency to be able to speak with the force of law" [149] in taking such action.[150]

The Service interprets the Code in four ways: treasury regulations issued pursuant to a specific directive from Congress; regulations issued under the Service's general authority to interpret tax laws, revenue rulings and private letter rulings.[151] The courts have held that *Chevron* applies only to Service rules issued pursuant to a general or express delegation of lawmaking authority.[152] Even if Congress gives specific authority to the Service for the corporate governance initiative, it is uncertain whether treasury regulations would be issued to implement it. The Service has reduced the number of regulations and revenue rulings issued.[153]

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[147] In Christensen v. Harris County, 529 U.S. 576, 587–88 (2006), the Court denied *Chevron* deference to an interpretation or opinion letter signed by an acting administrator in the Department of Labor, which had not been reached after a formal adjudication or notice-and-comment rulemaking. The Court noted "[i]nterpretations such as those in opinion letters—like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law—do not warrant *Chevron*-style deference." *Id.* at 587. When Congress wants the Service to engage in a corporate governance issue, it enacts specific legislation as it did under section 4958. *See supra* note 47.

[148] CHARLES J. PIERCE, ADMINISTRATIVE LAW TREATISE § 3.5, at 154 (4th ed. 2002 & Supp. 2006).

[149] United States v. Mead Corp., 533 U.S. 218, 229 (2001).

[150] A GUIDE TO JUDICIAL AND POLITICAL REVIEW OF FEDERAL AGENCIES, *supra* note 136, § 4.041, at 113.

[151] Bankers Life and Cas. Co. v. United States, 142 F.3d 973, 978 (7th Cir. 1998).

[152] PIERCE, *supra* note 148, § 3.5, at 166–67. It has been argued that *Chevron* deference is even narrower and should only be given to specific authority regulations, not general authority regulations. *See* Coverdale, *supra* note 5, at 83–87.

[153] *See* Thomas F. Field, Eleanor J. Lewis & Marion B. Marshall, *The Guidance Deficit: A Statistical Study*, 13 EXEMPT ORG. TAX REV. 57, 58 (1996) (The number of guidance documents released to the public by the Service has been steadily declining.); Fred Stokeld & Christopher Quay, *Compliance, Reforms Dominate Talk at EO Conference*, 48 EXEMPT ORG. TAX REV. 9, 9 (2005) (Because of a shortage of resources, the technical division might not issue private-letter rulings in subject areas covered by other guidance; it

When *Chevron* does not apply to a particular agency action, the agency decision may be entitled to deference under an older case, *Skidmore v. Swift*, which held that informal adjudications were not binding on courts, but were entitled to "respect."[154] For *Skidmore* respect to apply, the decision must be made in pursuance of official duty, based upon more specialized experience or expertise, and determines policy that will guide applications for enforcement.[155] The Service's corporate governance initiative should not be entitled to *Skidmore* respect, as it has no expertise or experience in good corporate governance. Its conclusions about the impact of "good governance" are based on anecdotal evidence or the opinions of nongovernmental experts, rather than any empirical basis of a link between good governance and tax compliance.[156]

C. The Corporate Governance Initiative As Stealth Preemption

The Service's corporate governance initiative preempts traditional state sources of nonprofit corporate law, eroding a traditional area of state interest, expertise, and control. This occurs not as a result of congressional legislation, agency regulation, court decision, or federal agency statements, but through formal and informal pronouncements that have the effect of superseding state laws and practices. The corporate governance initiative also hinders and undermines states' roles as laboratories of innovation introducing new social, economic and legal experiments.[157] State approaches to nonprofit corporate law differ substantially.[158]

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will publish only continuing professional-education articles when there is need.). For fiscal 2008, there were only 26 guidance publications from the Service for tax exempt organizations. Guidance includes published revenue rulings, revenue procedures, regulations, notices, announcements and information news releases. Internal Revenue Service, 2008 IRS Data Book, Table 22 Tax Exempt Guidance and Other Regulatory Activities Fiscal 2008, (2009) available at http://www.irs.gov/pub/irs-soi/08databk.pdf.

[154] 323 U.S. 134, 140 (1944). In this case the administrator of the Wage and Hour Division of the Department of Labor had interpreted parts of the Fair Labor Standards Act in informal rulings and in an interpretative bulletin instead of a rule issued after notice and comment. The issue was whether the administrator's interpretations were entitled to any deference. *Skidmore* is still good law in that courts should differentiate between *Chevron* and *Skidmore* standards to abide by Congressional Intent. *Mead*, 533 U.S. at 238.

[155] *Skidmore*, 323 U.S. at 139–40.

[156] Marcus S. Owens, *Charities and Governance: Is the IRS Subject to Challenge?*, 60 EXEMPT ORG. TAX REV. 287, n.3 (2008).

[157] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("There must be power in the States and the Nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs. . . . It is one of the happy incidents of the federal system that a single courageous State may, if its

Charities are under enormous pressure to comply with the Service's recommendations. Corporate governance issues are present at every stage of a charity's life cycle: formation, recognition of exemption, the auditing process and filing annual information returns. Failure to follow the Service's recommendations may antagonize the Service, state charity officials, donors, charity rating agencies, or just plain gadflies. The corporate governance initiative limits an organization's freedom to create the structure that best meets its needs. It is misleading to potential donors and other lay people, who may not realize, for example, that conflicts of interest are not negative attributes.

Stealth preemption has been assisted by the silence of state charity officials. In contrast to the aggressive defense of state interests in environmental and products liability issues,[159] state attorneys general and charity officials have been quiescent about this federal incursion. Attorneys general are in a peculiar position. Historically, there was little cooperation between state and federal charity regulators. The Service zealously protected the confidentiality of documents entrusted to it, and federal tax law imposed strict limits on what the Service could disclose about charities to state regulators.

This changed with the passage of The Pension Protection Act of 2006, which enabled increased cooperation and disclosure between state charity regulators and the Service.[160] State regulators can request tax information to

citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

[158] *Compare* CAL. CORP. CODE § 5233 (West 1981) *with* N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (interested transactions); *compare* CAL. CORP. CODE §§ 5111, 7111, 9111 *with* ILL. COMP. STAT. § 105/103–05 (2006) *and* N.Y. NOT-FOR-PROFIT CORP. LAW § 201 (classification of nonprofit corporations). A few jurisdictions have introduced a new form of eleemosynary organization, the low profit limited liability company (L3C), that may become an attractive alternative form of nonprofit organization. The "low profit limited liability company," or "L3C" is organized for a business purpose but: (1) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of section 170(c)(2)(B) of the Code, (2) might not have been formed but for the L3C's relationship to the accomplishment of charitable or educational purposes, and (3) no significant purpose of which is the production of income or the appreciation of property. If a company later fails to satisfy any of these requirements, it ceases to be an L3C and exists as a regular limited liability company. *See, e.g.*, 11 VT. STAT. ANN. tit. 11, § 3001(27) (2008). Similar legislation has been enacted in Michigan, Wyoming, North Dakota, and Utah.

[159] *See supra* note 116.

[160] Pub. L. No. 109–280, § 1224, 120 Stat. 708, 1091–93 (2006) (codified as amended at I.R.C. §§ 6103(p)(4), 6104(c)(2)). This section provides that upon written request by an appropriate state officer, the Secretary of the Treasury may disclose: a notice of a proposed refusal to recognize or a notice of a proposed revocation of tax exemption of a section

enable them to prosecute wrongdoing without the resource consumptive initial investigations. This may explain the reluctance to criticize the Service. One cannot expect attorneys general to bite the hand that feeds them evidence.

The Service's corporate governance initiative supersedes the proper role and responsibility of organizations' governing bodies to choose the governance practices and policies most appropriate to that organization given its size, purposes and expertise. Under state nonprofit law, organizations have a wide range of permissible and suitable governance practices to choose from. The Service's recommendations are not default rules, which organizations can supersede if they think another rule is more favorable. They replace state rules and practices. If these rules, mandatory in all but name, are bad and burdensome, the organization and its beneficiaries lose.[161]

Though the Service maintains its governance principles are only suggestions, underneath its "recommendations" lurks the inference of command. The Service's power and the fear it engenders make its recommendations prescriptive. A responsible board is in the best position to determine what should be good governance for a particular organization. The Advisory Committee on Tax Exempt and Government Entities, hardly a group hostile to the Service, rightly notes that "[e]ffective governance likely is much more a question of attitude of responsibility of those in charge than adoption of specific policies and practices."[162] The governance

501(c)(3) organization; the issuance of a proposed deficiency of tax imposed under Code section 507 or the names, addresses, and taxpayer identification numbers of organizations that have applied for section 501(c)(3) recognition; and returns and return information disclosed by in the process of seeking or losing exemption. This disclosure may be used in civil administrative and civil judicial proceedings pertaining to the administration of state laws regulating tax exempt status, charitable trusts, charitable solicitation, and fraud. There are limitations on use of this information and penalties for unauthorized use. *See* STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, at 328–29 (Joint Comm. Print 2006).

161 A similar argument is made by Judge Easterbrook concerning federal regulation of corporate governance of public corporations. *Cf.* Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 692–98 (2009).

162 Advisory Committee, *supra* note 39, at 46. The Advisory Committee goes on to say "Specific governance practices should be mandated only in rare and limited circumstances and should not be a per se prerequisite for granting exemption or examination of information returns. Best practices is an open issue depending on size, expertise and area of the sector. There is no empirical proof that an adherence to a particular governance practiced will lead to a better outcome in performance of the organization's mission or probity." *Id.* at 48. It adds there is no empirical verification of the Service's assumptions, nor any verified link,

recommendations are not in Service's area of expertise. Nor is there any empirical validation that they will improve tax compliance. Marion Fremont-Smith, a longtime observer of the nonprofit sector, has commented: "We have anecdotes of what fails, but no evidence of what works."[163]

VI. CONCLUSIONS AND RECOMMENDATIONS

Issues of federalism aside, the corporate governance initiative places unnecessary burdens and expenses on charities. It reflects an unwarranted belief in the benefits of transparency. Increased disclosure is supposed to bring greater compliance and ease of enforcement. One should not forget that disclosure comes with a cost to comply with new demands, borne by the organization. Every additional cost in time and money diverts the organization's human and financial resources away from achieving its charitable mission.[164]

The Form 990 is an organization's face to the world, available on the Internet and viewed by the public and the press. No longer is it a document prepared by the organization's accountant to give an accurate financial statement. It has morphed into a legal, fundraising and public relations statement that requires professional assistance from lawyers, development advisors, and public relations personnel.[165] This distorts organizational energy. The Service's bureaucratic focus is on meetings, minutes, discussions of policy and documentation, which conflicts with the mission driven activities that so enrich our diverse nonprofit sector. This burden may be a mere cost of business for larger organizations — hospitals, educational institutions or major social services organizations. But for many nonprofits the time to complete the form and to design and actually implement the policies contained therein will be a substantial financial and resource intensive expense — time better spent on charitable activities.

It is unlikely that the Service will backtrack from this misguided effort. One possibility is to challenge the Service through litigation. It is uncertain

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beyond the most trivial, between the Service's version of good corporate governance and better tax compliance. In fact, there is no agreement as to what good governance is in the nonprofit sector. *Id.* at 35.

[163] *Id.* at. 15 n.39.

[164] Reiser, *supra* note 110, at 596–97. Under the Service's own estimates, the time needed to gather information and to prepare the form requires weeks, and the estimate seems to assume than an individual will complete it. *See* I.R.S., INSTRUCTIONS FOR FORM 990 RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX 40 (2009).

[165] Lisa A. Runquist & Michael E. Malamute, *The IRS's New Regulation of Nonprofit Governance*, 18 BUS. L. TODAY 29 (2009).

whether a legal challenge to the Service's information gathering authority would be successful.[166] Besides, what charity has the resources to make such a challenge and can ignore the public relations issues that would result?

The Service could increase the triggering level for Form 990 so as to allow fewer organizations to file, and to increase the financial information required on the Form 990EZ, which would allow it to be used for state reporting requirements. Or, in a more dramatic change, the Service could divide the core Form 990 so that particularly large and significant areas of the sector — hospitals, educational institutions, and social service organizations — have their own form, and depending on the nature and size of the organization, an appropriate level of transparency. Perhaps the easiest change would be for the Service to redact from public scrutiny the corporate governance information. It would still collect it, but the information would not be on display. There is precedent for this. Names of donors are included on the Form 990 but are not published.

The fact remains that in a time when many charities are struggling to survive and maintain their level of activity, when there are pressures to reduce administrative expenses, the corporate governance initiative is an unwelcome, unnecessary distraction. It increases administrative costs,

[166] The Service has broad authority to request information in ascertaining a tax liability. I.R.C. § 7602(a) empowers it to examine books, records, and other relevant data or material in ascertaining the accuracy of any return, determining a person's tax liability or collecting any liability. I.R.C. § 7605(b) provides that no taxpayer shall be subjected to unnecessary examination or investigations. IRC § 6033(a) requires the filing of returns and maintenance of records that give the Treasury and Service broad authority to design returns to gather information for the purpose of carrying out the internal revenue laws. The standard of relevance is low, below that of probable cause. United States v. Powell, 379 U.S. 48, 57–58 (1964) discussed the criteria that the service had to satisfy to justify a request for information: "[T]he Commissioner . . . must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed.". The relevance standard has been termed a minimal but not non-existent burden of establishing the relevance of material requested. United States v. Goldman, 637 F.2d 664, 667 (9th Cir. 1980). The relevant standard reflects Congress's express intention to allow the Service to obtain items of even potential relevance to an ongoing investigation, without reference to its admissibility, but there must be indication of realistic expectation rather than idle hopes that something might be found. United States v. Arthur Young, 465 U.S. 805, 814–15 (1984). There are some decades old I.R.S. General Counsel Memoranda discussing the limits of seeking information. For an outline of the legal argument that Service has exceeded its authority and impose penalties for failure to answer the governance questions on the Form 990, see Owens, *supra* note 156.

diverts boards and staff from the focus on the charity's mission, and has no verified relationship to tax compliance.