KEEP CHARITABLE OVERSIGHT IN THE IRS

Philip Hackney*

Abstract

Critics are increasingly calling for Congress to remove charity regulation from the IRS. The critics are wrong. Congress should maintain charity regulation in the IRS. What is at stake is balancing power between the state, charity as civil society, and the economic order. In a well-balanced democracy, civil society maintains its independence from the state and the economic order. Removing charitable jurisdiction from the IRS would blind the IRS to dollars placed in the charitable sector increasing tax and political shelters and wealthy dominance of charities as civil society. A new agency without understanding of, or jurisdiction over, tax cannot act as the bulwark as can the IRS. The critics are right that both the states and the IRS are failing at charitable regulation. Ideally, Congress would allocate sufficient resources to the IRS. However, the long history of charity regulation shows that they are unwilling to allocate the resources to this endeavor. This, in fact, is a flaw of the proposals for a quasi-federal charitable regulatory agency. These proposals will not generate new funds but will instead spread scarce resources even thinner. Instead, Congress should acknowledge its unwillingness to adequately fund charity regulation and shrink the tax-exempt sector by removing the parts that have limited justification for charitable benefits, such as hospitals and private foundations.

* Professor of Law, University of Pittsburgh School of Law. J.D. Louisiana State University Paul M. Hebert Law Center, L.LM. NYU School of Law. I presented an earlier version of this paper when providing the Norman A. Sugarman Lecture in 2016 at the Case Western Reserve School of Law and appreciated the comments I received there. I also presented an earlier version of this article at the 2022 AMT Conference. I thank Jordan Barry, Emily Cauble, Brian Galle, Ari Glowgower, David Gamage, David Hasen, Andrew Hayashi, Christine Kim, Ben Leff, Susie Morse, Leigh Osofsky, Shu Yi Oei, Clint Wallace, and Manoj Viswanathan for comments on an earlier version. I also thank my terrific research assistant Joey Scapaletto for his assistance in this effort.

I. INTRODUCTION

Scholars increasingly criticize the Internal Revenue Service's (IRS) regulation of the charitable sector. Many critics argue Congress should remove the function from the IRS.[1] The primary critique is that the IRS has failed absolutely as a regulator. Despite the critics, Congress should maintain the regulation of charity in the IRS. Removing the function would harm the collection of revenue. A separation would lead to significant tax and political sheltering opportunities because the IRS would not be able to see dollars put into the charitable sector. While

[1] *See* Marcus S. Owens, Charity Oversight: An Alternative Approach, Presentation at 2013 Charities Regulation and Oversight Project Policy Conference (2013) *in* COLUM. ACAD. COMMONS, Jan. 2014; Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector through a Federal Charity Oversight Board*, 19 CORNELL J. L. & PUB. POL'Y 1 (2009); Lloyd Hitoshi Mayer, *"The Better Part of Valour is Discretion": Should the IRS Change or Surrender Its Oversight of Charitable Organizations*, 7 COLUM J. TAX L. 80 (2016) (arguing that the deficiencies of IRS oversight are so severe that it is time to consider moving the function out of the IRS); Roger Colinvaux, *Fixing Philanthropy: A Vision for Charitable Giving and Reform*, 162 TAX NOTES 1007, 1013 (2019) (recommending Congress convene a panel to study the question of how to structure the oversight of the tax-exempt sector); Ellen P. Aprill, *The Private Foundation Excise Tax on Self Dealing: Contours, Comparisons, and Character*, 17 PITT. TAX REV. 297, 336 (2020) (arguing the time has come to reconsider whether the IRS is the right agency to regulate charitable organizations); *see also* Jeffrey N. Pennell & Alex Zhang, *Proposals to Restore Faith in Exempt Organizations*, 183 TAX NOTES FED. 285 (April 8, 2024) (proposing a new agency to handle initial applications and maybe some form of annual oversight as well).

state charity law primarily focuses on governance to ensure insiders do not take from charity, charity tax law focuses on the tax benefits involved. These benefits raise distinct and important questions that will not be sufficiently salient, or understood, to and by a regulator outside of the IRS, even one at a federal level. Importantly to this case, introducing a new regulator to the regulation of the sector would simply spread already scarce resources for charity regulation way too thin. We can expect Congress will continue to fail to provide the resources needed to properly oversee the sector. Those interested in good federal oversight of charity should thus focus on improving the IRS as a charity regulator instead.

The IRS charity critics approach the issue from multiple perspectives, but the critiques tend to lead to the same end: removal. Some from the political right believe the IRS "targeted" conservative groups (such as Tea Party affiliates) to try to stop them from obtaining tax-exempt status as social welfare organizations from around 2011–2013.[2] Such critics likely view governmental agencies as populated by unelected biased bureaucrats.[3] Arguably, the end this group desires is a significantly hobbled IRS.[4] Other critics think charity regulation is important but that the IRS fails to engage in enough enforcement to regulate the sector well.[5] Some critics believe that the challenge of the IRS overseeing charity is that it involves the "political" and the IRS simply ought not oversee political matters at all. It forces the Service to stray from its mission of collecting revenue.[6] These latter critics tend to have a common interest in functional tax policy, good enforcement of that policy, and a well-regulated charitable sector. They just think the IRS is the wrong institution to regulate the charitable sector.[7] Some of these U.S. observers argue for a federal charity bureau, while others argue for a more private solution like FINRA.[8]

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[2] Philip T. Hackney, *Should the IRS Never "Target" Taxpayers: A Consideration of the IRS Tea Party Affair*, 49 VAL. L. REV. 453 (2015).

[3] For this general vision of governmental agencies, *see* THEODORE J. LOWI, THE END OF LIBERALISM (1969); *cf.* Anya Bernstein & Cristina Rodriguez, *The Accountable Bureaucrat*, 132 YALE L.J. 1600, 1676 (2023) (arguing that administrative agencies tend to employ systems that promote significant accountability to the public). *See also* Dennis R. Young & John P. Casey, *Supplementary, Complementary, or Adversarial?: Nonprofit-Government Relations*, *in* NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT 37–39 (Elizabeth T. Boris & C. Eugene Steuerle eds., 3d ed. 2016) (discussing the tendency of those who identify as conservative politically to desire more government to be carried out by nonprofits than the government itself).

[4] A review of Judicial Watch's approach to the IRS Tea Party controversy illustrates this vision of the IRS. *See IRS Scandal*, JUD. WATCH, http://www.judicialwatch.org/blog/tag/irs-scandal/ (last visited Jan. 27, 2024).

[5] *See, e.g.*, Mayer, *supra* note 1 (arguing that the deficiencies of IRS oversight are so severe that it is time to consider moving the function out of the IRS); Owens, *supra* note 1.

[6] There are cogent arguments linking the IRS's regulation of tax-exempt organizations to harm to the IRS's ability to collect the revenue. Evelyn Brody & Marcus Owens, *Exile to Main Street: The IRS's Diminished Role in Overseeing Tax-Exempt Organizations*, 91 CHI.-KENT L. REV. 859, 859, 862 n.17 (2016) ("Our focus, however, should not obscure the very real corrosive impact, whether deserved or pretextual, that the IRS's exempt-organization imbroglio has had on the health of the entire agency, and thus to the revenue needs of the federal government.").

[7] This frustration with the IRS as federal regulator is not new. *See, e.g.*, David Ginsburg et al., *Federal Oversight of Private Philanthropy*, *in* 5 RESEARCH PAPERS 2578, 2581 (1977).

[8] *See* Helge, *supra* note 1; Owens, *supra* note 1.

This Article considers this question through the lens of political justice. By this I mean a state that furthers democracy.[9] In the context of charitable organizations and their regulation, the most significant democratic factor to consider is the role of charitable organizations as a part of civil society.[10] Charitable organizations as civil society stand as a bulwark against the state and economic power to protect important civil rights such as the freedom of speech and association.[11] Our institutions and scholars regularly recognize and laud this important value of charity as civil society.[12] Charitable organizations and those connected with them are rewarded with subsidies.[13] Fundamentally, it is important that charity as civil society maintains its independence from the state and from the economic order. This Article maintains that the IRS is the institution best able to maintain this independence between state, charity, and the economic order. If Congress were to remove charity oversight jurisdiction from the IRS, the Service would have little ability to observe dollars in the charitable sector to properly enforce the income, estate, and gift taxes. And obviously, a new charitable agency would have no capacity to do so either. Thus, though the IRS may not be handling this function well today, we can expect this problem to grow much worse with removal.

In addition to arguing that charity regulation should remain with the IRS, I sketch a solution that is hopefully satisfactory to a large part of the critics. Though the critiques may seem like they come from disparate positions driven by stringent ideological views, I believe it is possible to find commonalities and develop a more satisfying solution. If, as almost all of these critics agree, insufficient resources are a significant part of the problem, then moving the function out of the IRS will accomplish nothing. It will fragment oversight and the resources available for that oversight. An acceptance of the under-resourced theory, along with a recognition that the agency mandate is complex, also explains the bungling agency seen by the critics. To cure these problems, Congress, Treasury, and the IRS must make the agency mandate less complex. This narrowing can also aid the IRS in protecting the fisc from misuse of charitable dollars. This Article thus recommends maintaining charitable oversight within the IRS while simultaneously encouraging Congress, Treasury, and the IRS to simplify the task of the IRS on its oversight of

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[9] Philip Hackney, *Political Justice and Tax Policy: The Social Welfare Organization Case*, 8 TEX. A&M L. REV. 271, 274 (2019) [hereinafter Hackney, *Political Justice*]; *see also* Philip Hackney, *Prop Up the Heavenly Chorus? Labor Unions, Tax Policy, and Political Voice Equality*, 91 ST. JOHNS L. REV. 315, 322 (2017) [hereinafter Hackney, *Prop Up*]. Others have made a similar case. *See, e.g.*, Clint Wallace, *A Democratic Perspective on Tax law*, 98 WASH. L. REV. 947 (2023).

[10] Philip Hackney, *Public Good Through Charter Schools?* 39 GA. ST. U.L. REV. 695, 705–06 (2023); *see also* THEDA SKOCPOL, DIMINISHED DEMOCRACY 20–24 (2003).

[11] Jürgen Habermas, *Three Normative Models of Democracy*, 1 CONSTELLATIONS 1, 8 (1994); *see also* JEAN L. COHEN & ANDREW ARATO, CIVIL SOCIETY AND POLITICAL THEORY (1992).

[12] Bob Jones Univ. v. United States, 461 U.S. 574, 609–10 (1983) (Powell, J., concurring) (explaining the "role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints."); *see also* John W. Gardner, *The Independent Sector*, *in* AMERICA'S VOLUNTARY SPIRIT ix, xiii-xv (Brian O'Connell ed. 1983); Elizabeth T. Boris & Matthew P. Maronick, *Civic Participation and Advocacy*, *in* THE STATE OF NONPROFIT AMERICA 394 (Lester M. Salamon ed., 2d ed. 2012).

[13] For example, the charitable contribution deduction (I.R.C. § 170) and exemption from income tax (I.R.C. § 501).

charitable organizations. Though we might like to extend benefits far and wide to all sorts of new charitable organizations, we should instead narrow those benefits only to those who clearly qualify. Where Congress sees abuse, it should eliminate the whole field rather than come up with standards to keep the bad guys out. These possibilities are explored in Part IV(D).

This Article also considers whether Congress should grant the IRS full jurisdiction over the charity governance part of charitable oversight. While it is unlikely that states or the sector would be willing to give this full authority to the IRS, examining this question allows us to see both a significant challenge of the critic's proposals and a fundamental challenge to IRS charity regulation. The Senate Finance Committee considered such a proposal twenty years ago.[14] But the sector pushed back strongly against the idea and has fought all efforts by the IRS to assert any jurisdiction over charitable governance. I discuss this in the Analysis Part IV(C). Bringing the fullness of charity law to bear in one federal entity would connect governance norms found in state charity law in ways that may be helpful, unifying, and educational to both the regulator and regulated. There is much to recommend for bringing governance to the IRS in a clear way.

Many question whether those in the IRS are the right experts to oversee charity. The reality is that the IRS possesses expertise on matters of what is charitable, how charity agents should behave to best further those charitable purposes, and the systems to enforce those rules. The IRS civil service has built that expertise through over a century of enforcing the charitable tax law and interacting with the regulated public. Indeed, the charitable tax expertise of the IRS matters a lot to the enforcement of the income, gift, and estate taxes which are all intimately connected to charitable organizations. Some also worry about the neutrality of the IRS in overseeing this sector. However, because these organizations must either pay tax or not pay tax, the IRS must oversee this sector and confront the matter of neutrality to collect the revenue accurately and fairly. It cannot avoid the neutrality problem and should, therefore, take it on directly in as transparent a manner as it can.[15] Fair enforcement of tax law depends upon that.

What is at stake in charitable organization regulation? In 1960, Karl Karst put the matter as follows: "there remains substantial unanimity on one goal: The greatest possible portion of the wealth donated to private charity must be conserved and used to further the charitable, public purpose; waste must be minimized and diversion of funds for private gain is intolerable."[16] This is too narrow of a vision for charity today. It only looks at the narrowest conception of charity: wealthy people giving money to important charitable classes. The charitable sector is broad including health care, education, low-income housing, and much more, many of which are substantial businesses outside of private wealth being contributed to the

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[14] STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT 16 (2004), *see also* Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613, 638 (2005) (suggesting that part of the challenge with attorneys general not enforcing the law might derive from the belief that the IRS will intervene).

[15] Hackney, *supra* note 2, at 502 (suggesting a transparent process for the IRS to adopt in evaluating applications for exemption involving politics).

[16] Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 434 (1960).

poor.[17] Thus, for tax law purposes the primary purpose of IRS charity oversight is to provide the IRS a means of ensuring that the federal tax system is not eroded. Tax-exempt organizations like charities provide substantial opportunity to avoid the corporate and individual income taxes and the only way the IRS can protect that boundary is by having substantial information from charitable and other exempt organizations proving their deservedness to exemption. Abuse of these high-powered incentives can happen in two primary ways—abuse of charitable deductions and the operation of a nonprofit to benefit private interests.

There is another purpose of the IRS charity law regime that is more consistent with the Karst vision—to ensure that charitable organizations are legitimately operated to further a charitable purpose. Congress built the structure of tax-exemption upon organizations that primarily fulfill a particular purpose and do not have shareholders.[18] This means that these charities must be fulfilling some broad, shared, and legitimate collective purpose.[19] Within the charitable world, this means the IRS is a de facto regulator of charitable organizations. Despite being the de facto regulator, in the 21st century, Congress has not allocated the amount of resources needed by the IRS to carry out its charitable enforcement activities.[20] Still, Congress has historically taken charitable regulation legislation seriously, which we can witness by its enactments of successive tax acts consistently over the past century, passing legislation penalizing misuse of charitable organizations.[21] Thus, there is reason to believe future Congresses may similarly see the IRS rules and enforcement as significant and maybe even someday properly fund it.

In the end, this Article takes a conservative approach to the challenge of charity regulation. It is better to keep the system that has been slowly developed over one hundred years. It is likely the best compromise we can get. It is better to work on fixing the challenges at the IRS than to create a new agency. Additionally, maintaining IRS oversight is important to maintaining civil society's independence from state and economic interests. Furthermore, removing jurisdiction would harm the collection of revenue. In this Article, Part II describes the sector, the state enforcement regime, the federal enforcement regime, and other enforcement parties. Part III describes the various reform proposals. Part IV analyzes the situation and Part V concludes.

II. CHARITABLE OVERSIGHT NOW AND HISTORICALLY

States naturally took jurisdiction over nonprofit oversight. The U.S. Constitution provides only limited powers to the federal government and all the rest to the states.[22] Though there are some legal entities established by the federal

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[17] *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 60 n.25 (1981) (noting the importance of commercial nonprofits that do not depend upon charitable contributions in operating their business).
[18] I.R.C. § 501(c)(3).
[19] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).
[20] *See infra* Part II.C.
[21] *See* Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective*, 106 fig. A *in* I.R.S. SOI BULLETIN (2007–2008) (describing congressional acts focused on tax-exempt organizations from 1894–2006).
[22] U.S. CONST. amend. X; *see* U.S. CONST., art. I, § 8.

government,[23] registration and oversight of legal entities and trusts has mostly been a state law matter. But, because of the national and international impact of charity, it makes little sense to leave oversight to the states alone; it leads to a lack of vision and a lack of scope of response. The IRS became an overseer of the sector upon the creation of federal income tax law. Part II first examines the charitable sector, turns to the relationship of states to charity oversight, then reviews the IRS's relationship to charity regulation, and finally considers other regulators.

A. What Does the Charitable Sector Look Like, and Why Do We Need to Regulate It?

To address the question of the best regulatory institution for charity oversight, we need a definition of the thing to be regulated. Unfortunately, charity is notoriously difficult to define. As Thomas Kelly stated: "[i]n the realm of American law, the term 'charity' is exasperatingly variable and confusing."[24] Indeed, as Kelly notes, we have never agreed upon a uniform concept of charity.[25] The online *Merriam-Webster* dictionary provides the following definitions of charity:

> 1 a: generosity and helpfulness especially toward the needy or suffering
> also: aid given to those in need
> *received charity from the neighbors*
> b: an institution engaged in relief of the poor
> *raised funds for several charities*
> c : public provision for the relief of the needy
> *too proud to accept charity*
> 2: benevolent goodwill toward or love of humanity
> *The holidays are a time for charity and goodwill.*
> 3 a: a gift for public benevolent purposes
> b: an institution (such as a hospital) founded by such a gift
> 4: lenient judgment of others
> *The critic was liked for his charity and moderation.*[26]

These definitions are woefully inadequate to describe the diversity and complexity that we currently accept to be charitable under U.S. state and federal tax law.

A place to start, then, is to note that charity in its legal sense is carried out by nonprofit organizations. Elizabeth Boris and C. Eugene Steuerle define nonprofit organizations as "those entities that are organized for public purposes, are self-governed, and do not distribute surplus revenues as profits."[27] Henry

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[23] KEVIN R. KOSAR, CONG. RSCH. SERV., RL30365, FEDERAL GOVERNMENT CORPORATIONS: AN OVERVIEW (2011).
[24] Thomas Kelly, *Rediscovering Vulgar Charity: A Historical Analysis of the History of America's Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2437 n.2 (2005).
[25] *Id.*
[26] *Charity*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/charity [perma.cc/JTC7-7L83].
[27] Elizabeth T. Boris & C. Eugene Steuerle, *Scope and Dimensions of the Nonprofit Sector*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 66, 67 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

Hansmann noted that the fundamental structural element of nonprofit organizations is the bar on the distribution of net earnings, referred to as the "nondistribution constraint."[28] This feature describes a significant part of the legal entities that carry out charity but does not define charity. This Part II(A) thus keeps this constraint in mind but allows the following discussion of the charitable legal sector to begin to develop the bounds within which our society conceives of charity.

To continue with the legal structure, the two predominant forms of nonprofit organization are the trust[29] and the nonprofit corporation. While the charitable trust is the dominant form in England, the nonprofit corporation became the dominant form in the United States.[30] Those legal structures indelibly shape charity but at the same time make some of its bounds confusing. The confusion derives from the fact that the trust standard for fiduciary duties is much stricter upon its managers than the corporate standard. This leads to challenges in determining the right standard of behavior to apply to the agents of a charity both at state law and for tax law purposes: the stricter trust standard or the more lenient corporate standard that looks like the for-profit corporation standard. Part II(B) considers this matter further.

Despite modern-day confusion regarding the right fiduciary duty to apply, charitable trust law has largely defined the scope of charitable purposes including in tax law. The Restatement (Third) of the Law of Trusts, includes the following purposes as charitable: "the relief of poverty; the advancement of knowledge or education; the advancement of religion; the promotion of health; governmental or municipal purposes; and other purposes that are beneficial to the community."[31] These purposes are largely reflected today in the income tax in section 501(c)(3).[32]

Are charities public or private? Arguably, charitable organizations are a combination of public and private.[33] Some argue that part of the reason we accept that charities can be regulated by the government through an attorney general is because the funds they hold are public.[34] Congress made the tax returns of these organizations publicly accessible in part because their activities are thought to be an important part of our public sphere.[35] Critically, in the dichotomy of nonprofit organizations as either public benefit or mutual benefit, charities are by far the largest group of public benefit nonprofits. Others have taken the position that the

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[28] Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

[29] Though trusts have traditionally been thought of within the law as a fiduciary relationship rather than as an entity, the law has moved in modern times to think of them more as an entity. *See* RESTATEMENT (THIRD) OF TRS. § 2 cmt. A (AM. L. INST. 2023) ("Increasingly, modern common-law and statutory concepts and terminology tacitly recognize the trust as a legal 'entity,' consisting of the trust estate and the associated fiduciary relation between the trustee and the beneficiaries.").

[30] JAMES J. FISHMAN ET AL., NONPROFIT ORGANIZATIONS, CASES AND MATERIALS 22 (5th ed. 2015).

[31] RESTATEMENT (THIRD) OF TRS § 28 (AM. L. INST. 2023) (Alphabetical bullets removed).

[32] I.R.C. § 501(c)(3).

[33] *See, e.g.*, Jonathan Levy, *Altruism and the Origins of Nonprofit Philanthropy*, *in* PHILANTHROPY IN DEMOCRATIC SOCIETIES 19 (Rob Reich et al. eds. 2016) ("Philanthropy, perhaps by definition, is a form of private action. Yet, historically philanthropy has always been clothed with a public character, even if, over time, the clothes have changed.").

[34] Helge, *supra* note 1, at 15 (citing GEORGE G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 411 (3d ed. 2001); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 258–59 (2003)).

[35] STAFF OF THE JOINT COMM. ON TAX'N, 106TH CONG., 2 STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 80 (2000).

funds are private in nature. Early judicial treatment, such as in the *Trustees of Dartmouth College v. Woodward*, made it clear that we grant some private corporate rights to charitable nonprofit corporations.[36] The government could not simply interfere with its contractual arrangements because the Constitution forbids such interference. Regardless, the legal treatment of charity places it at least into a quasi-public sphere.

Sometimes called the Third Sector or the Independent Sector, charitable organizations carry out a wide range of activities in spaces that are neither the government nor for-profit. They range from the very small, like a local book club or a society appreciating an obscure philosopher, to the medium, like local children's sports associations and groups advocating to state legislatures on matters of poverty within the state, to the large, like giant hospital systems and universities spanning the globe.

As mentioned in the Introduction, nonprofit charitable organizations broadly fit into civil society, defined as "institutional spaces and organizations outside of the government, and outside of economic power, that facilitate and influence collective decision-making at the state level."[37] The major democratic traditions of liberalism, republicanism, and deliberative democracy all value this sector in maintaining a strong healthy democratic order.[38] In the liberal model, civil society organizations protect civic rights like freedom of speech, but they also serve to bring citizen needs to the government.[39] Republican theorists particularly value the potential of these organizations to prevent the domination of government over individual interests and rights.[40] Deliberative democrats find civil society also healthy to a democratic order in protecting against government overreach and in allowing citizens to generate important information and develop opinions, and, in turn, to share those opinions with the government.

Nonprofit charitable organizations shape and express who we are as a society. They implement and operate important collective activities of the United States including educating and tending to the healthcare of our population. The nonprofit community engages in a deliberative process with our government to help find out the needs of the people and to meet their needs either through contracting or through other means. We all have a personal and collective interest in ensuring that charitable organizations are well-managed and regulated to further their missions.

According to the Urban Institute, "[t]he nonprofit sector contributed an estimated $1.0472 trillion to the US economy in 2016, composing 5.6 percent of the country's gross domestic product."[41] By far, the largest group of nonprofits are charitable organizations, according to the Urban Institute, making up "three-quarters of revenue and expenses for the nonprofit sector as a whole ($2.04 trillion

[36] Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518 (1819).
[37] Hackney, *Political Justice*, *supra* note 9, at 275.
[38] *Id.* at 284–87.
[39] *Id.*
[40] *Id.*
[41] NCCS Project Team, *The Nonprofit Sector in Brief 2019*, URBAN INSTITUTE, https://urbaninstitute.github.io/nccs-legacy/briefs/sector-brief-2019 [perma.cc/C596-L2NL].

and $1.94 trillion, respectively) and just under two-thirds of the nonprofit sector's total assets ($3.79 trillion)."[42]

The charitable sector has grown over the past twenty years. Over 1.80 million tax-exempt entities were registered with the IRS in 2022.[43] Of those, charities comprised 1.48 million.[44] Comparatively, in 2002 there were 1.58 million tax-exempt entities registered with the IRS and approximately 909,574 charities.[45] In 2022, organizations filed over 131,000 applications with the IRS to be recognized as charities under the Code,[46] while in 2002, organizations filed over 79,000 applications.[47] In 2012, tax-exempt entities filed around 1.4 million returns, while in 2022, they filed around 1.8 million returns.[48] One other note from this data is that there is great variation in the size of the charitable sector in the different states. Tax-exempt organizations in California made over 185,000 returns, for instance, while in Wyoming, tax-exempt entities filed only around 4,000.[49]

Most nonprofits are small. According to IRS statistics,[50] in 2016, about two-thirds of nonprofits had less than $500,000 in expenses.[51] Because the IRS does not require returns from small organizations, that percentage is a significant understatement of small organizations. According to the Urban Sector, in 2016 human services charities were the most numerous, making up over 35% of the charity population.[52] The next most numerous were education at over 17% and health-focused charities at over 12%.[53] Arts organizations make up about 10% and religious organizations a bit over 6%.[54]

These numbers only paint a small part of the picture of the charitable sector. Hospitals, which make up about 2% of charities in number, earned over $1 trillion in revenue in 2016, making up about half of the revenue of the charitable sector.[55] Higher education generated about $226 billion in revenue, while human services brought in about $243 billion.[56] Arts organizations earned around $40 billion in revenue.[57] Approximately $400 billion of charitable revenue comes from charitable contributions. Churches and religious organizations receive almost a third of that

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[42] *Id*.
[43] I.R.S., 2022 DATA BOOK 30 tbl.14 (2022) [hereinafter 2022 DATA BOOK].
[44] *Id.*
[45] I.R.S., 2002 DATA BOOK 30 tbl.22 (2002).
[46] 2022 DATA BOOK, *supra* note 43, at 28 tbl.12.
[47] I.R.S., 2002 DATA BOOK 29 tbl.21 (2002).
[48] 2022 DATA BOOK, *supra* note 43, at 4 tbl.2; I.R.S., 2012 DATA BOOK 4 tbl.2 (2012) [hereinafter 2012 DATA BOOK].
[49] 2012 DATA BOOK, *supra* note 48, at 7 tbl.3.
[50] IRS data is not a perfect picture of the sector. Churches, for instance, are not required to file a return (I.R.C. § 6033(a)(3)(A)(i)), and there is little data on the smallest of organizations, with annual gross profits under $50,000. *See* 2022 DATA BOOK, *supra* note 43, at 7 tbl.3*;* I.R.S., *Annual Electronic Filing Requirement for Small Exempt Organizations — Form 990-N (e-Postcard)*, https://www.irs.gov/charities-non-profits/annual-electronic-filing-requirement-for-small-exempt-organizations-form-990-n-e-postcard [perma.cc/PJ7F-DQJK].
[51] NCCS PROJECT TEAM, *supra* note 41.
[52] *Id*.
[53] *Id*.
[54] *Id*.
[55] *Id*.
[56] NCCS PROJECT TEAM, *supra* note 41.
[57] *Id.*

revenue. Education receives about 13%, human services about 12%, and health care a little under 10%.[58] About a third of charitable revenue comes from government contracting.[59]

The size and diversity of charitable organizations and the complexity of the legal regime make it quite difficult to regulate the sector. As Marion Fremont-Smith has said: "[t]here is no clear-cut body of American-law that can be called 'the law of charity.'"[60] As mentioned above, the main commonality unifying charitable law is the nondistribution constraint, which is not a strong unifying factor. The reality is that charitable law, consisting of a nondistribution constraint, charitable purpose, and fiduciary duties, is not the most salient fact for the various industries or sectors of the charitable community. For example, a hospital has a much different purpose, mode of operation, and applicable set of laws as compared to colleges and universities. These industries, in turn, face different issues from industries like primary and secondary private education or low-income housing. Some charitable organizations do not fit into an industry but instead are primarily grantmaking operations, like private foundations. Many of the different charitable industries have their own national organizations to which they are much more likely to pay attention than to a charitable sector defined by state and federal tax law.[61] Thus, though the state and federal tax law is a component of the compliance world that all charities must consider, it is not as salient to charities as focusing on the broader substantive range of industry issues.

Thus, the concept of charity is undefinable. The charitable sector is large, highly diverse, and complex. There are two primary legal structures through which charity is accomplished, and those two structures apply different legal standards. Our process of assessing whether something is charitable or not is historically based and shaped communally. Part II(B) now turns to closely examine the two legal regimes that provide a structure for the legal carrying out of charity.

B. States

What does the state legal regime look like for charitable organizations? The state legal structure is directed toward ensuring the agents of the charity operate the organization for the beneficiaries and not the agents or some other constituency. While a for-profit business entity has owners with the ability and incentive to advocate and sue on the entity's behalf to ensure its agents operate the entity properly, charitable organizations have no such constituency.[62] There are no

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[58] *Id.*

[59] *Id.*

[60] MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 19 (2008).

[61] For instance, the American Hospital Association represents all types of hospitals, nonprofit, government, and for-profit. AM. HOSP. ASS'N., *About the AHA*, https://www.aha.org/about [perma.cc/SBA5-KTSJ]. There are a range of industry groups for colleges and universities, but the American Association of Colleges and Universities (AAC&U) is one of the major unifying groups for this sector. UNIV. ALA. LIBR., *Higher Education: Organizations in Higher Education*, https://guides.lib.ua.edu/c.php?g=842968&p=6025080 [perma.cc/4MW3-YMU2] (listing the primary industry organizations of higher education with AAC&U showing more than 1,350 member institutions).

[62] *See, e.g.*, Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 227, 237 (1999).

shareholders. This is the nondistribution constraint in action. The states are thus left to ensure the agents (managers) are required to operate the organization for the benefit of a charitable class and not themselves.

States have traditionally regulated nonprofits through state attorneys general using parens patriae power, i.e., power lodged in the king,[63] to ensure the agents stay true to the charity's mission.[64] Though the attorney general was once the exclusive source of enforcement in the states, there has been a move in many states to make them a little less important today, largely by increasing standing to sue.[65] Fremont-Smith contends the courts may even have the predominant power over guidance in the area of charity law at the state level.[66] Indeed, at the state level, courts exercise the primary role in defining what is a charitable purpose under state law when probating a will.[67]

This Part II(B) focuses on (1) the creation of charitable trust law, (2) the development of charitable corporation law, (3) the role of state attorneys general in enforcing state charitable law, and (4) some of the other potential means of enforcing charitable law at the state level. Nonprofit accounting literature helps set the theme for this Part: because (1) beneficiaries do not control a charitable organization, and (2) there are limited market-based incentive structures to guide charitable organization agents—charitable organizations are likely more subject to agent/manager malfeasance than for-profit organizations.[68] This fact drives much of the state regulatory regime.

1. Charitable Organization Law Origins

Charitable trust law is a significant influence on current charity law. The history of charitable trust law is important because it helps explain some of the challenges of the regulatory regime today. It originates in English common law and dates back to before the Statute of Uses of 1601.[69] There were two primary purposes of that statute: (1) define legitimate charitable purposes, and (2) reform the administration of charity with commissioners to inquire into misuse of charitable

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[63] FREMONT-SMITH, *supra* note 60, at 301.

[64] RESTATEMENT (SECOND) OF TRS. § 391 (AM. L. INST. 1959); Garry Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128 (2007); Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information Be Utilized Effectively?*, 40 NEW ENG. L. REV. 447, 449 (2006); Robert Carlson & Caitlin Calder, *Protection and Regulation of Nonprofits and Charitable Assets*, *in* STATE ATTORNEYS GENERAL POWERS AND RESPONSIBILITIES 215 (Emily Myers ed., 4th ed. 2018); Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 938 (2004).

[65] Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 44 (1993).

[66] FREMONT-SMITH, *supra* note 60, at 302.

[67] OLIVIER ZUNZ, PHILANTHROPY IN AMERICA: A HISTORY 65–103 (2012).

[68] William R. Baber et al., *Compensation to Managers of Charitable Organizations: An Empirical Study of the Role of Accounting Measures of Program Activities*, 77 ACCT. REV. 679, 680 (2002); *see also* Karst, *supra* note 16, at 436–37.

[69] FISHMAN ET AL., *supra* note 30, at 45 (citing 43 Eliz. Ch. 4; 5 AUSTIN W. SCOTT & MARK L. ASCHER, SCOTT & ASCHER ON TRUSTS § 37.1.1 (5th ed. 2009)); *see also* FREMONT-SMITH, *supra* note 60, at 19–24 (discussing earlier versions of charitable trust like regimes dating back well before 1601 and connected to religious philosophy).

funds.[70] The statute followed an allowance by Parliament in 1597 for local jurisdictions to levy taxes to take care of the poor.[71] However, Parliament left it to the local jurisdictions on how to take care of the poor, including through charitable provision.[72]

Charitable trust law grew initially because it allowed private property to be held in perpetuity.[73] Judges developed this law by assessing charitable purposes in will contests between heirs and charitable organizations.[74] In the Gilded Age, as wealth grew substantially, Zunz describes that many of these wealthy titans looked to the courts to expand the concept of charitable.[75] Some of the biggest challenges those wealthy philanthropists faced were whether politics and lobbying could be a charitable purpose. The boundaries of charitable purpose began to shift to include more political activity with that effort. Thus, the relationship of taxes, charity, and public provision of collective goods and services has been strong from its origin.

In the American colonies, it would have been natural to adopt charitable trust law. But the original colonies mostly rejected English law when they rejected English rule.[76] For instance, the colony of Pennsylvania expressly rejected the Statute of Uses.[77] Charitable trust law finally became settled in the United States as a legitimate source of law when the Supreme Court held in *Vidal v. Girard's Executors* that even though Pennsylvania had rejected the Statute of Uses, courts should still honor charitable bequests.[78] But this legal development course in the American colonies was enough to make the charitable corporation more prominent than the charitable trust in the United States.

Charitable organization law is also deeply influenced by corporation law. Charitable nonprofit corporations have the same legal antecedent as for-profit corporations.[79] There were corporation-like entities in Roman times and Medieval Europe to facilitate municipalities and municipality function,[80] but the modern forms in the U.S. seem to have sprung more directly from colonial development companies in the sixteenth and seventeenth centuries.[81] Early in the United States, there was no distinction between private and public corporations.[82] These corporations were churches, turnpikes, boroughs, universities, banks, insurance companies, and manufacturing operations.[83]

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[70] John P. Persons et al., *Criteria for Exemption Under Section 501(c)(3), in* 4 RESEARCH PAPERS 1909, 1913 (1977).
[71] *Id.*
[72] *Id.*
[73] FREMONT-SMITH, *supra* note 60, at 19.
[74] ZUNZ, *supra* note 67, at 76–103.
[75] *Id.* at 10–14.
[76] PETER D. HALL, INVENTING THE NONPROFIT SECTOR 16 (1992).
[77] *Id.* at 31.
[78] *Id.*
[79] Philip T. Hackney, *What We Talk About When We Talk About Tax-Exemption*, 33 VA. TAX REV. 114 (2013).
[80] *Id.* at 115.
[81] *Id.* at 115–16.
[82] Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 19 (1945).
[83] Hackney, *supra* note 79, at 116, 121.

Because of these divergent legal forms, a real challenge became how to think about what restrictions are placed on the managers of a charitable corporation as compared to those on the managers of a charitable trust. Early legal thought expressed that charitable corporations were formed to manage charitable trusts. Nevertheless, many early courts explicitly stated that in the corporate form there was no trust but instead "an absolute gift to the corporation to be used for the purposes for which it was chartered."[84] This challenge of which rule should apply to corporate managers of charities continues today and is explored more below in the discussion of fiduciary duties.

2. State Charitable Law

State charity law today focuses primarily on enforcing fiduciary rules on agents of charitable organizations and on ensuring fair charitable solicitation. The primary rules are found in the fiduciary duties of care and loyalty under corporate and charitable trust law.[85] Indeed, charitable trusts are "a fiduciary relationship with respect to property arising from a manifestation of the grantor's intention to create it."[86] There is also often discussed a duty of obedience, though this typically has less import.

As noted above, the two legal regimes of corporation and trust law utilize different standards to guide the behavior of those who control charitable organizations. Though the nonprofit corporate legal structure has operated for a long time, the law has been slow to develop. As late as 1960, when for-profit corporate law was relatively well-developed, critics noted the lack of development of nonprofit corporation law with respect to fiduciary duties owed by nonprofit officers and directors.[87]

Under the duty of care, the trustee, on the one hand, is generally held to the "prudent man rule" or "prudent investor rule" to which all trustees are held.[88] It is a high standard. Justice Cardozo stated that a "trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[89] Corporate directors, on the other hand, are held to a less strict duty. Though some cases have held corporate directors to the same prudent investor standard as trustees, the Model Nonprofit Corporation Act treats nonprofit corporation directors to for-profit corporate standards.[90] A key case expressed the nonprofit corporate standard as the duty to "exercise ordinary and reasonable care in the performance of their duties, exhibiting honesty and good faith."[91] Courts sometimes apply a prudent investor standard to

[84] FREMONT-SMITH, *supra* note 60, at 51.
[85] Brody, *supra* note 64.
[86] FISHMAN ET AL., *supra* note 30, at 45.
[87] Karst, *supra* note 16, at 435.
[88] GEORGE G. BOGERT ET AL., BOGERT'S THE LAW OF TRUSTS AND TRUSTEES § 394.
[89] Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).
[90] MODEL NONPROFIT CORP. ACT § 8.30 (AM. BAR ASS'N 3rd ed. 2008).
[91] Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses, 381 F. Supp. 1003, 1013 (D.D.C. 1974). Forty-three states and the Model Nonprofit Corporation Act § 8.30 have adopted this general standard. FREMONT-SMITH, *supra* note 60, at 208.

the managers of a nonprofit corporation if they believe a contribution created a charitable trust within the corporation.[92]

The nonprofit corporate standard is akin to the forgiving business judgment rule in the for-profit context and is typically called the best judgment rule.[93] The idea imbued within the corporate standard is that if a director has properly informed themselves of the relevant information and attended meetings before making a decision, their judgment will be upheld. In other words, a court will not second guess a director's decision, even if it seems unwise in hindsight.

Courts apply the standard inconsistently. For instance, in litigation over fiduciary duties of charitable nonprofits, courts sometimes find that because most directors are engaged in a voluntary act, they owe no fiduciary duty.[94] This reflects an important, relatively widespread vision held of enforcement in the charitable sector. There is a fear that "aggressive attempts to enforce their [trustee] responsibilities are inappropriate and will discourage individuals from board service."[95] In the end, the nonprofit corporation standard may be, in part, a compromise between camps that might hold directors to a higher standard and those who would hold them to no standard at all.

Trustees and directors also must abide by a duty of loyalty. In a non-charitable trust, the duty of loyalty runs to the beneficiary. However, in a charitable trust, because there is no specific beneficiary, that duty runs to furthering the particular purpose of the trust.[96] It is a particularly strict duty that prevents any self-dealing between the trust and the trustee; the trustee may not, for instance, sell property from the trust to themselves or borrow from the trust.[97] Often, in the trust form, this duty can be waived in part by the settlor, the court, or by statute. Most nonprofit corporate acts also impose a duty of loyalty.[98] But in the nonprofit corporation, the focus is typically on whether the transaction was fair. Most nonprofit acts create a regime in which a director needs to disclose a conflict if one exists, abstain from voting on the matter, and the transaction must ultimately be fair to the corporation.[99] Whether the corporate duty of loyalty is complied with is often seen as procedural today. If the director discloses the conflict and removes themselves from voting on the matter, the director will typically have met the duty of loyalty.

The duty of obedience focuses on ensuring that the directors or trustees carry out the purposes of the charity.[100] This is anchored in the concept that a trustee is supposed to follow the wishes of the settlor.[101] In modern corporate structures with many varied interests involved with large charities it is hard to figure out where that duty of obedience might lie. It has more meaning in a narrow context of a very clear settlor intent.

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[92] GEORGE G. BOGERT ET AL., *supra* note 88, at § 369.
[93] FISHMAN ET AL., *supra* note 30, at 137.
[94] *See, e.g.*, George Pepperdine Found. v. Pepperdine, 126 Cal. App. 2d 154 (1954).
[95] FISHMAN ET AL., *supra* note 30, at 127.
[96] GEORGE G. BOGERT ET AL., *supra* note 88, at § 369.
[97] *Id.*; *see also* RESTATEMENT (THIRD) OF TRS. § 78 (AM. L. INST. 2023).
[98] MODEL NONPROFIT CORP. ACT §§ 8.31, 8.33, 8.60, 8.70 (AM. BAR ASS'N 3rd ed. 2008).
[99] *Id.*
[100] Brody, *supra* note 64, at 960.
[101] SCOTT & ASCHER, *supra* note 69, § 2.2.4.

Obviously, states also care about misuse of charitable funds, and so they care about the fraudulent raising of those funds.[102] Thus, states also oversee charitable solicitation.[103] Initially, municipalities oversaw charitable solicitation.[104] States did not begin to become involved in charitable solicitation regulation until after World War II. Though not all states have fundraising laws, most states have some sort of registration and reporting requirements.[105] There are many holes in these laws; the Supreme Court has interpreted the First Amendment broadly to generally allow solicitation.[106] Still, because it is fairly complex to raise money from contributors from more than one state, there is a Uniform Registration Statement that can be used across many jurisdictions.[107]

Finally, importantly in understanding the regulatory environment to charity, charitable status at the federal level is often used by states as a factor in granting rights and opportunities. While much of the development of state charitable law consists of rules to ensure charities are well managed, legislative bodies at the state, municipal, and local government levels regularly enact laws unrelated to charitable state law that strongly incentivize the use of charitable organizations. For instance, some states provide significant tax credits for contributions made to private nonprofit charitable schools.[108] State and local governments also enact laws that allow only official charitable organizations to carry out certain activities or to contract with the state to provide certain services. Thus, state and local governments create high stakes around obtaining charitable status in the first place. These state-based rules and systems create high-powered incentives that increase the desire to utilize a charitable organization to carry out various activities.

3. State Enforcement

What does state enforcement look like? States tend to provide meager resources to regulate the charitable sector.[109] With the exception of states like California, Massachusetts, and New York, the vast majority of states are lucky if they have one person dedicated to regulating charitable organizations.[110] Some speculate this choice to provide limited regulation has its origins in the fact that nonprofits are often thought to "do good," so the state should have less concern about abuse of these organizations.[111] There is a fear expressed that greater regulation of nonprofits would lead to less charitable giving, fewer board members

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[102] *See* FISHMAN ET AL., *supra* note 30, at 219–20 (listing some high-profile fraudulent raising of charitable funds).
[103] Lloyd H. Mayer, *Regulating Charitable Crowdfunding*, 97 IND. L.J. 1375, 1402 (2022).
[104] FREMONT-SMITH, *supra* note 60, at 370.
[105] Mayer, *supra* note 103, at 1403; Susan Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 621 (1999).
[106] FREMONT-SMITH, *supra* note 60, at 370–72.
[107] *See The Unified Registration Statement*, THE MULTI-STATE FILER PROJECT, http://multistatefiling.org/ [perma.cc/CTF2-4NX3].
[108] Katherine H. Scott, *Is Private School Tuition Tax Deductible?*, U.S. NEWS (Sept. 10, 2021), https://www.usnews.com/education/k12/articles/is-private-school-tuition-tax-deductible [perma.cc/UF3N-UXJW].
[109] Jenkins, *supra* note 64, at 1113; *see also*, Mary G. Blasko et al., *supra* note 65, at 48; Karst, *supra* note 16, at 437 (noting in 1960 the lack of attorney general oversight).
[110] Jenkins, *supra* note 64, at 1128.
[111] FREMONT-SMITH, *supra* note 60, at 2.

willing to serve, and ultimately less "good" done.[112] But there is also a political aspect to these decisions: it can be unwise politically for an elected attorney general to go after a politically protected charity and it may be politically wise for that attorney general to go after a politically unpopular charity.[113] It is possible that our records of enforcement are incomplete because attorney generals often enter settlement agreements to protect the parties involved.[114] Still, the scholarship and the news leave one with the impression that the regulation at the state level is woefully inadequate, even in states where there is a stronger presence.

What about other potential enforcement mechanisms of charitable duties under state law? Beneficiaries could theoretically enforce the law. However, while a key feature of private trusts is that the trustee must provide information to the beneficiary and the beneficiary can sue to enforce the trust,[115] in the charitable context, courts rarely allow a beneficiary standing to enforce fiduciary duties of directors or trustees.[116] Donors could also enforce duties. But donors generally do not have standing unless they reserved such a right in the instrument making the donation.[117] As Terri Lynn Helge points out, typically, donors do not reserve such a right in the instrument because they would forgo the ability to deduct the contribution from taxes if they did.[118] Founders and settlors of trusts (a very specific type of donor) could enforce charitable duties, but typically states do not allow such enforcement either.[119] The power of visitation in some states allows the founder of a trust to enforce some aspects of administration.[120] Karst argues for allowing founders and substantial donors to sue and collect attorney's fees and some of the recovery.[121] Some states have moved to allow such an interest.[122] However, these donors tend to enforce only the terms of their donation rather than broadly attack violations of fiduciary duties.[123] Finally, trustees and directors are possible enforcers of fiduciary duties. Some states allow trustees and directors to enforce fiduciary duties against other trustees and directors.[124] But, this is no real protection as boards are often filled with self-interested individuals; acquaintances rarely work to enforce fiduciary duties.[125]

While the state attorney general has been the traditional and almost only enforcer, state law has increased private rights of action consistent with some of the

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[112] Chester, *supra* note 64, at 452–53.
[113] Brody, *supra* note 64, at 947–48.
[114] *Id*. at 948–49.
[115] Gary, *supra* note 105, at 603–04.
[116] *Id*. at 616.
[117] RESTATEMENT (SECOND) OF TRS. § 391 cmt. e (AM. L. INST. 1959).
[118] Helge, *supra* note 1, at 42 (citations omitted).
[119] *See* Karst, *supra* note 16, at 445–47 (discussing ways to hinder problematic suits such as requiring a certain level of donation to bring a suit and adopting strike suit type protections such as posting security before beginning the case).
[120] *Id*. at 446; FREMONT-SMITH, *supra* note 60, at 338.
[121] *See* Karst, *supra* note 16, at 445–47.
[122] Edward C. Halbach, Jr., *Standing to Enforce Trusts: Renewing and Expanding Professor Gaubatz's 1984 Discussion of Settlor Enforcement*, 62 U. MIAMI L. REV. 713, 725 n.65 (2007) (stating "[m]ost prominent is Unif. Trust Code (§ 405(c)) (amended 2005), 7C U.L.A. 486 (2006))").
[123] Helge, *supra* note 1, at 45.
[124] Gary, *supra* note 105, at 625.
[125] *See* Karst, *supra* note 16, at 445.

ideas above. The attorney general in some states, like California, can appoint a "relator" who can pursue an action against officers and directors at their own cost. That said, the attorney general in California can take over from the relator at any time.[126]

It remains, though, that critics of charitable regulation are quite unsatisfied with state-level regulation. Though, as discussed below in Part III(A), some have suggested that charity boards at the state level might improve state regulation, most have concluded that a larger federal presence is required to provide the oversight needed for a more effective charitable sector. Regulation of charity is not happening at the state level, and it is unlikely to ever happen at a satisfactory level in the states. There are too many forces working against a functional regulatory system in the states.

C. Federal Government/IRS

When Congress enacted the income tax in 1913, a new potential regulator of the nonprofit sector was born.[127] The sector was likely too small then to warrant such an effort. In fact, probably one of the main reasons for exempting this group of potential taxpayers was that it was small and did not generate much revenue at the time—for instance, hospitals were not yet a substantial presence.[128] Under these circumstances, Congress exempted nonprofit corporations and associations exclusively organized and operated for charitable purposes from the income tax.[129] This designation created a latent regulatory regime. As the IRS issued guidance and examined the sector, and courts ruled upon IRS decisions, a federal tax legal regime of a charitable organization organically took shape. There was little reason to believe the IRS would fill a more significant regulatory role until 1969, when Congress implemented a requirement that most charities must register with the IRS.[130]

Congress has promulgated much additional charitable organization legislation since then, and the IRS and Treasury Department have now issued extensive guidance defining charitable organizations. Though section 501(c)(3) does not extend to the IRS the requirement to oversee fiduciary duties like at the state level, this Part II(C) considers some of the efforts by Congress and the IRS to

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[126] Helge, *supra* note 1, at 47.

[127] Tariff Act of 1913, ch. 16, 38 Stat. 114, 172 ("any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual"). Actually, the exemption came in the 1909 Corporate Excise Tax. Tariff Act of 1909, ch. 6, 36 Stat. 11, 113. There Congress exempted from the Corporate Excise Tax, the precursor to the modern income tax, corporations or associations "organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."

[128] HALL, *supra* note 76, at 13 (noting that there were only 12,500 charitable tax-exempt organizations in 1940 and that most of the growth of the large sector he observed in 1992 occurred starting in the 1960s).

[129] Tariff Act of 1913, ch. 16, 38 Stat. 114, 172. Congress had also exempted nonprofits in the income tax enacted during the Civil War and in the income tax enacted in the 1890s that the Court struck down. Hackney, *supra* note 79, at 117–20.

[130] I.R.C. § 508. There was a sense that the IRS mattered as a check upon wealthy family foundations because of the possibility that the IRS might audit them. Karst, *supra* note 16, at 442.

extend jurisdiction over some fiduciary duty-like rules. The section 4958 tax on excess benefit transactions is an example.[131] Congress more recently placed taxes and regulatory systems on specific types of charitable organizations, such as donor advised funds and credit counseling organizations, including upon the governance of those organizations.[132] In an effort to bring greater transparency and democratic control over charities, Congress requires that charities provide information returns (the Form 990) to the IRS that are made public.[133] Thus the IRS regulates nonprofits both by the law it enforces, the rules it promulgates, and the disclosure system that it oversees. This Part II(C) reviews the federal tax law regime that applies to charities more closely.

1. Federal Charity Tax Law

The tax law rules focus first and foremost on ensuring that a charitable organization is operated to further a charitable purpose. Under section 501(c)(3), a charitable organization must be "organized and operated exclusively" for a charitable purpose.[134] The notion of charitable purpose is derived directly from charitable trust law.[135] For example, IRS guidance regarding hospitals holds that the promotion of health is a charitable purpose under the tax law because it is such a purpose under charitable trust law.[136] This same idea repeats in other areas of charitable purposes such as educational,[137] religious, scientific, sometimes the environment,[138] poverty relief, and so on. Though charitable purpose as a matter of United States law was once a question of probate, it is most publicly salient today as a matter of federal income tax law.[139]

In regulating charitable purposes, the IRS must determine how much charity an organization must further to be considered charitable under section 501(c)(3). Congress provides that a charity must be "organized and operated *exclusively*" for charitable purposes.[140] Though "exclusively" sounds absolute, a charitable organization is allowed to further non-substantial purposes other than its charitable purpose. The Supreme Court has held that "an organization must be devoted to [its exempt] purposes exclusively . . . . The presence of a single non-[exempt] purpose,

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[131] I.R.C. § 4958.
[132] I.R.C. §§ 4966, 501(q).
[133] I.R.C. § 6033.
[134] I.R.C. § 501(c)(3).
[135] Bob Jones Univ. v. United States, 461 U.S. 574, 588 n.12 (1983) ("The form and history of the charitable exemption and deduction sections of the various income tax acts reveal that Congress was guided by the common law of charitable trusts."); *see also* Treas. Reg. § 1.501(c)(3)-1(d)(2) (stating that charitable purpose is "used . . . in its generally accepted legal sense").
[136] Rev. Rul. 69-545, 1969-2 C.B. 117 ("In the general law of charity, the promotion of health is considered to be a charitable purpose;" (citing RESTATEMENT (SECOND) OF TRS. §§ 368, 372 (AM. L. INST. 1959); IV SCOTT ON TRUSTS (3rd ed. 1967), §§ 368, 372.)).
[137] Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2017); Rev. Rul. 71-447, 1971-2 C.B. 230, 230; *see also* Treas. Reg. § 1.501(c)(3)-1(d)(3) (as amended in 2017).
[138] *See, e.g.*, Rev. Rul. 76-204, 1976-1 C.B. 152.
[139] Sometimes state property tax regimes or state constitutions are used to exclude hospitals from the notion of charitable. *See, e.g.*, Bruce Japsen, *State Challenging Hospitals' Tax Exemptions*, NY TIMES (Sep. 10, 2011), https://www.nytimes.com/2011/09/11/us/11cnchospitals.html [perma.cc/3QER-X8QA]. But not all states have a property tax, and there is no uniform approach to charitable purpose across states.
[140] I.R.C. § 501(c)(3) (emphasis added).

if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes."[141] Thus, a charity may legitimately pay an employee to carry out a charitable task even though it also accomplishes the selfish ends of the employee. The non-exempt purpose in that case would not be substantial.

Though there are two tests inherent within section 501(c)(3)—the organizational and the operational tests—this Article focuses on the operational test. Treasury regulations state that this requirement is met if the organization engages "*primarily* in activities which accomplish" an exempt purpose.[142] But the regulations further state, "[a]n organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[143]

Congress assigns one other fundamental rule to the IRS in its regulation of the charitable sector: the prohibition on inurement.[144] In order to qualify as a charitable organization, an entity may not distribute the organization's earnings to a "private shareholder or individual."[145] This includes anyone "having a personal and private interest in the activities of the organization."[146] Paying reasonable salaries to executives does not violate the inurement prohibition.[147] The prohibition, though, is an absolute: if one penny is found to have inured, the organization is in violation.[148] This is the "nondistribution constraint" discussed above in Part II(A). There is little corollary to a prohibition on inurement at state law level enforcement. It is true that state law generally prohibits a nonprofit corporation from having shareholders, but there is no systematic process for rooting out such noncompliant corporations at state law.

Courts, together with the IRS, have developed additional doctrines imposing limits on charity. This Article focuses on the private benefit doctrine and the commerciality doctrine. The question both theories raise is whether the private benefit or the commerciality of a charity evinces a substantial nonexempt purpose such that the organization does not meet the operational test.

Fishman, Schwarz, and Mayer suggest that the core of the income tax private benefit doctrine is from charitable trust law requiring that a trust "must benefit a sufficiently large and indefinite charitable class" rather than further the interests of some specific private individuals.[149] Treasury regulations provide the strongest guidance support for the doctrine by providing that a charitable organization must serve "a public rather than a private interest."[150] Thus, a nonprofit created to dredge a waterway that fronted the same property as its donors

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[141] Better Bus. Bureau of Wash. D.C. v. United States, 326 U.S. 279, 283 (1945).
[142] Treas. Reg. § 1.501(c)(3)-1(c)(1) (emphasis added).
[143] *Id*.
[144] I.R.C. § 501(c)(3).
[145] Treas. Reg. §§ 1.501(c)(3)-1(c)(2), 1.501(a)-1(c) (defining private shareholder or individual).
[146] Treas. Reg. § 1.501(a)–1(c).
[147] Founding Church of Scientology v. United States, 412 F.2d 1197, 1200 (Ct. Cl. 1969); *cf*. Bubbling Well Church of Universal Love v. Comm'r, 670 F.2d 104, 105 (9th Cir. 1981) (a finding of an excessive salary supports a case of inurement).
[148] Church of Scientology of Cal. v. Comm'r, 823 F.2d 1310, 1316 (9th Cir. 1987).
[149] FISHMAN ET AL., *supra* note 30, at 430. The doctrine has other critics as well; *see, e.g.*, John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063 (2006).
[150] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

did not qualify for exemption because it served the private benefit of the donors and did not provide enough public benefit.[151] The IRS used the private benefit doctrine in part in Rev. Rul. 69-545 setting the standards for hospitals when it focused on a bad hospital that was controlled by doctors who operated the facility to enrich themselves.[152] The capstone case today of private benefit is *American Campaign Academy v. Commissioner* where the court upheld an IRS denial of an educational organization designed to educate only potential GOP candidates because it served the private benefit of the Republican party.[153] Whether an organization has too much private benefit is determined under the operational test, and the question is whether the activity involved evinces a substantial nonexempt purpose. The challenge of this doctrine is the lack of clarity in determining how much private benefit is enough to become substantial.[154] The difference between inurement and private benefit is that inurement is focused on benefits provided to those who control the organization, while private benefit focuses upon benefits provided to persons who do not necessarily control the organization.

The commerciality doctrine applies when a charity is operated more like a for-profit business than a charitable one.[155] In *Goldsboro*, the U.S. Tax Court stated that it considers factors such as "the particular manner in which an organization's activities are conducted, the commercial hue of these activities, and the existence and amount of profit from these activities."[156] In *BSW Group, Inc.*, the court agreed with the IRS that the petitioner's activity amounted to "the conduct of a consulting business of the sort which is ordinarily carried on by commercial ventures organized for profit."[157] Any organization which is found to have a substantial commercial purpose will not qualify as charitable.

There are also important ancillary legal requirements of the charity tax law regime. These include a prohibition on intervening in a political campaign, a limitation on lobbying, and a public policy limitation. Each of these has a state law charitable trust conception from which it arose, but these doctrines are each ultimately very specific to tax law regulation of charity.

Though engaging in politics in most cases is not considered to further a charitable purpose under charitable trust law,[158] in the 1950s Congress added to section 501(c)(3) an absolute prohibition on "participat[ing] in, or interven[ing] in . . . any political campaign on behalf of (or in opposition to) any candidate for public office."[159] Often referred to as the "Johnson Amendment" because Lyndon B.

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[151] Ginsberg v. Comm'r, 46 T.C. 47 (1966).

[152] *See also* I.R.S. Gen. Couns. Mem. 39,682 (Sep. 14, 1987) (arguing that there was inurement associated with doctors purchasing the revenue from a surgery center, but that it also evidenced too much private benefit).

[153] Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).

[154] *See* Colombo, *supra* note 149 (criticizing the vague way the IRS uses the private benefit doctrine).

[155] W. Marshall Sanders, *The Commerciality Doctrine is Alive and Well*, 16 TAX'N EXEMPTS 209, 209 (2005); *see also* Goldsboro Art League v. Comm'r, 75 T.C. 337 (1980).

[156] *Goldsboro Art League*, 75 T.C. at 344.

[157] BSW Grp., Inc. v. Comm'r, 70 T.C. 352, 358 (1978).

[158] *Cf.* Laura B. Chisholm, *Politics and Charity: A Proposal for Peaceful Coexistence*, 58 GEO. WASH. L. REV. 308, 314–15 (1990); *see also* Jane H. Mavity & Paul N. Ylvisaker, *Private Philanthropy and Public Affairs, in* 2 RESEARCH PAPERS 795 (1977).

[159] Internal Revenue Code of 1954, Pub. L. No. 83-591, § 501(c)(3), 68A Stat. 1, 163.

Johnson was a proponent of the legislation, this has been a controversial part of charity enforcement. Religious groups like Pulpit Freedom Sunday argue it violates First Amendment freedom of speech and religion.[160] Thus far, courts have upheld the Johnson Amendment.[161] Though controversial, in addition to a link to charitable trust law, the limitation has a real link to income tax policy. Congress prohibits the deduction of expenses for political campaigns and lobbying.[162] This policy emanates from a policy position that the country ought to be neutral fiscally as to political campaigns.[163] Were Congress to allow charities to intervene in political campaigns, it would make this neutrality policy an impossibility. Someone who wanted to deduct a political campaign contribution would need only make the contribution to a charitable organization.

The lobbying limitation raises similar constitutional issues as does the political campaign prohibition. It provides that "no substantial part of the activities" of a charity can consist in "carrying on propaganda, or otherwise attempting, to influence legislation."[164] The focus of this limitation is on limiting the charity from advocating before legislative bodies either in a direct manner or in an indirect manner, such as through grassroots lobbying.[165] The limitation has early beginnings. In 1930, Judge Hand in *Slee v. Commissioner* found that the American Birth Control League's lobbying was too central to the organization and belied its charitable status.[166] There is, unfortunately, little clarity on what a substantial part might look like. That said, section 501(h) provides a safe harbor to charities who make an election under that section. A charity with limited revenue might be able to spend as much as twenty percent of its revenue annually on lobbying, but most are limited to less.[167] The Supreme Court upheld the constitutionality of the lobbying limitation in *Regan v. Taxation with Representation*.[168]

Finally, the public policy limitation holds that a charity cannot engage in illegal activity or activity that is against clearly established public policy.[169] This is consistent with charitable trust law.[170] The IRS has to show that the illegal activity or public policy violation is a substantial purpose of the organization.[171] The

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[160] *See* Eugene Scott, *Pastors Take to Pulpit to Protest IRS Limits on Political Endorsements*, CNN (Oct. 1, 2016), https://www.cnn.com/2016/10/01/politics/pulpit-freedom-sunday-johnson-amendment/index.html [perma.cc/FHK6-8E2F]; *see also* Benjamin M. Leff, *Fixing the Johnson Amendment Without Totally Destroying It*, 6 U. PA. J.L. & PUB. AFFS. 115, 119 (2020); Samuel D. Brunson, *Dear IRS, It Is Time to Enforce the Campaigning Prohibition. Even Against Churches*, 87 U. COLO. L. REV. 143, 145 (2016).

[161] Branch Ministries v. Rossotti, 211 F.3d 137, 143 (D.C. Cir. 2000).

[162] I.R.C. § 162(e) (the lobbying limitation was upheld in *Cammarano v. United States*, 358 U. S. 498, 513 (1959)).

[163] Notably though, contributions to veteran's organizations under section 501(c)(19) are deductible from the federal income tax, and there is no similar limitation. I.R.C. § 170.

[164] I.R.C. § 501(c)(3).

[165] Treas. Reg. § 1.501(c)(3)-1(c)(3).

[166] Slee v. Comm'r, 42 F.2d 184 (2d Cir. 1930).

[167] I.R.C. § 501(h).

[168] Regan v. Tax'n With Representation, 461 U.S. 540 (1983).

[169] Rev. Rul. 71-447; Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

[170] *Bob Jones Univ.*, 461 U.S. 574.

[171] *See, e.g.*, I.R.S. Gen. Couns. Mem. 34,631 (October 4, 1971) ("To determine when disqualifying activities are present to a 'significant extent' (that is, when they become 'substantial'), more must be considered than the ratio they bear to activities in furtherance of exempt purposes.").

Supreme Court upheld a public policy violation in the case of race-based discrimination in *Bob Jones*.[172] The biggest challenge for the IRS in enforcing this provision is probably whether the IRS has the competency to determine if an organization has violated a fundamental public policy. That challenge extends to whether the IRS can act on the illegality of a charity without an agency with competency on the legal matter at issue first acting upon the violation.[173]

In 1969, Congress added provisions to charity regulation that took aim at abuses they saw coming from wealthy individuals and their private charities or private foundations.[174] After years of congressional concern of misuse and abuse of charitable organizations to further the interests of wealthy Americans, Congress finally acted in a strict rule-based manner to hinder the worst abuses of what are known as private foundations.[175]

The Tax Reform Act of 1969 created a significant divide between what are known as public charities and private foundations.[176] Private foundations are charities from whom the majority of their funds derive from one donor or one family.[177] Public charities, on the other hand, are substantial institutions like churches, universities, hospitals, and other organizations that get broad financial support from the public.[178] Congress adopted a strict charitable trust regime rule for the self-dealing acts of private foundations insiders, intending to generally prohibit such acts altogether.[179] Concerned that wealthy interests might just park assets in an entity without delivering actual money to charity, Congress required private foundations to generally spend about 5% of their assets per year on furthering charitable purposes.[180] The regime prohibits jeopardizing investments[181] and requires private foundations to limit the amount of ownership the charity holds of any one stock to no more than twenty percent or face an excise tax on excess business holdings.[182] In a symposium reviewing that legislation in 2019, the general consensus was that, though the legislation likely made some improvements on abuse, there is a need for a new architecture to regulate the charitable world of today.[183]

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[172] *Id.*

[173] Jean Wright & Jay H. Rotz, *Illegality and Public Policy Considerations*, I.R.S. EO CPE TEXT (1994).

[174] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

[175] James Fishman, *The Private Foundation Rules at Fifty: How Did We Get Them and Do They Meet Current Needs?*, 17 PITT. TAX REV. 247 (2020).

[176] I.R.C. § 509; *see also* Aprill, *supra* note 1, at 301 (discussing the historical derivation of the private foundation distinction including 1950s legislation imposing a self-dealing regime similar to today's section 4958 intermediate sanctions regime that applies to public charities today (Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906, 947)).

[177] *See* I.R.C. §§ 170 & 509.

[178] *Id.*

[179] I.R.C. § 4941.

[180] I.R.C. § 4942.

[181] I.R.C. § 4944.

[182] I.R.C. § 4943.

[183] Philip Hackney, *The 1969 Tax Reform Act and Charities: Fifty Years Later*, 17 PITT. TAX REV. 235 (2020) (providing an introduction and description of the findings of the articles in the symposium).

That leaves one additional general subject matter—tax provisions that put to the IRS oversight of some fiduciary duty-like rules. Much of the private foundation regime just discussed utilizes some of the strict fiduciary duty rules that apply to charitable trusts, such as strict prohibitions on self-dealing.[184] This effectively adopts the strict charitable trust fiduciary duty of loyalty in tax law. Congress also applies to public charities an excise tax under section 4958, often referred to as intermediate sanctions, that also looks like a fiduciary duty of loyalty.[185] There is an element of a duty of care implicit in the excise tax as well. In 1996, in the Taxpayer Bill of Rights II, Congress enacted this excess benefit excise tax; it applies to the individuals who have control over a charitable organization.[186] Critics had long complained that the IRS had only one tool in its toolbox when charity managers engaged in inurement—revocation of the exempt status of the organization.[187] The IRS rarely made this choice because it would penalize the beneficiaries rather than the bad managers who should be held to account.

The excess benefit regime applies a twenty-five percent tax on what is known as an excess benefit taken by a disqualified person.[188] A disqualified person is one of the people who have control over the charity, such as the officers, directors and substantial contributors.[189] The excess benefit is an amount that the disqualified person received from the charity to which they were not entitled.[190] For instance, assume an executive director provided $100,000 worth of services to a charity. Assume further that the charity pays the executive director $200,000 under these circumstances. In such a case, there would be an excess benefit of $100,000. The regime calls for the disqualified person to pay an excise tax of twenty-five percent of the amount involved and to also repay the amount. If the disqualified person does not pay the tax back within a particular time, the excise tax is increased to 200% of the amount involved.[191]

The excess benefit regulations are highly detailed.[192] As noted above, the tax plays a similar role to the state law fiduciary duty of loyalty.[193] Arguably it may help go after fraudulent charitable solicitation as well.[194] A comparison of these

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[184] I.R.C. § 4941.
[185] I.R.C. § 4958.
[186] Pub. L. No. 104-168, 110 Stat. 1452, 1475 (1996) (codified as amended at I.R.C. § 4958 (2000)); the rule also applies to I.R.C. § 501(c)(4) social welfare organizations.
[187] *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 103rd Cong. 39 (1993).
[188] I.R.C. § 4958.
[189] *Id.*
[190] *Id*.
[191] *Id*.
[192] 26 C.F.R. 53.495-1 to -8.
[193] *See* Carly B. Eisenberg & Kevin Outterson, *Agents Without Principles: Regulating the Duty of Loyalty for Nonprofit Corporations Through Intermediate Sanctions Tax Regulations*, 5 J. BUS. ENTREPRENEURSHIP & L. 243, 244 (2012) (stating "[w]hile state charitable trust law typically enforced by the state attorney general is one mechanism of protection, the federal government is the primary enforcer of the duty of loyalty for tax-exempt corporations.").
[194] James J. Fishman, *Who Can Regulate Fraudulent Charitable Solicitation*, 13 PITT. TAX REV. 1, 2 (2015) (arguing that the IRS should use section 4958 to attack such solicitation and that Congress also ought to change the excise tax to make it a more useful tool for such oversight).

excess benefit rules with the Delaware corporate law fiduciary duty of loyalty suggests the tax rule is stricter and encompasses many more people as potential insiders.[195] Though some thought the rule might curb rising nonprofit salaries, it has not accomplished that goal.[196] The IRS rarely invokes the rule. The rule's failure might be because excess benefit transactions are hard to find or prove. Regardless, it has not been a particularly effective provision.[197] It fails to provide any content for how a charity might establish a system to avoid such a situation.

Since 2000, Congress has made many additions to the charitable tax law. Most of these changes have targeted specific charitable sectors or activities. For instance, in 2005, Congress added an excise tax on tax-exempt entities entering prohibited tax shelters.[198] In 2006, in the Pension Protection Act, Congress added a range of new rules to apply to donor-advised funds, supporting organizations, and credit counseling organizations.[199] The donor-advised fund legislation took aim at sponsoring organizations allowing individual donors to direct charitable dollars in donor-advised funds back to the donors.[200] Congress enacted an excise tax that prohibits such personal transfers through DAFs.[201] Congress tried to also shut down abuses by supporting organizations, a type of organization that allows a charity that primarily derived its funds from one family to be considered a public charity because it is watched over closely by an actual public charity. It directed the IRS to promulgate regulations ensuring a stronger relationship between the supporting organization and its supported organization and applied some excise taxes to insider abuses of the supporting organization.[202] Congress also looked to shut down abuses by credit counseling organizations that appeared to be behaving in predatory ways while ostensibly counseling those in debt about how to get out of debt. The legislation prohibits credit counseling organizations from making loans, requires them to design products that do not abuse their customers with significant fees, and (adopting a governance rule) mandates that they adopt a broadly representative board.[203]

In the Affordable Care Act, Congress added more rules regarding hospitals. Congress focused on ensuring that hospitals adopt financial assistance policies easily accessible to patients and that hospitals conduct and publish a health needs assessment.[204] So, rather than focusing on the sector as a whole, Congress in

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[195] Manne, *supra* note 62, at 270.

[196] Jill Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?* 76 FORDHAM L. REV. 735, 736 (2007).

[197] *See, e.g.,* Carraci v. Comm'r, 456 F.3d 444 (5th Cir. 2006) (rejecting IRS evaluation of value of excess benefit in sale of home health care agency by insiders of a nonprofit to themselves)

[198] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 516, 120 Stat. 345, 368 (enacting I.R.C. § 4965).

[199] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

[200] PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR, ISSUE LAB 39 (2005).

[201] I.R.C. § 4967.

[202] §§ 1241(d) & 1242, 120 Stat. at 1103 (§ 1242 codified additions to I.R.C. § 4958(f) applicable to supporting organizations).

[203] § 1220, 120 Stat. at 1086 (codifying I.R.C. § 501(q)).

[204] I.R.C. § 501(r).

piecemeal began to attack places where it saw abuses. Some of those rules mandate specific behavior and often these rules adopt governance related rules.

In addition to substantive law, the tax information return of charities, the Form 990, plays a crucial role in the charity tax regulatory regime.[205] It serves both as an enforcement tool for the IRS and as a tool of democratic governance-like accountability.[206] Starting in 1942 for tax years ending in 1941, many charities have had the obligation to file an information return called the Form 990.[207] These were made available to the public in 1950 though access was not easy to come by originally.[208] In 1969, Congress held a hearing on the importance to public accountability of having greater public access to the Form 990.[209] Congress made these forms more accessible in 1996.[210] Commentators at the time were hopeful that this public access would bring about a significant improvement in charity oversight.[211] Though not a panacea, this information has become a significant part of oversight of the sector, particularly, with broad access to the Form 990 data via the IRS, GuideStar, and ProPublica. With the recent move to make the data more electronically accessible, it is likely that this form will become more important to broad public oversight.[212]

2. IRS Enforcement

When Congress enacted the Tax Reform Act of 1969, many had big hopes for the IRS to be the important regulator of the charitable sector on the national level. The Commissioner then committed to reviewing the tax-exempt status of all private foundations every five years.[213] That commitment was short-lived as the IRS could not maintain that even into the 1970s.[214] As detailed by commentators, Congress has failed to dedicate the resources needed for oversight of the charitable sector.[215]

According to the Congressional Budget Office ("CBO"), the IRS budget fell by 20% in real (inflation-adjusted) dollars between 2010 and 2018.[216] This lack of investment in the IRS led to a 22% decrease in employees. This resulted in a

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[205] 26 U.S.C. § 6033; 26 C.F.R. § 1.6033-2.
[206] Philip Hackney, *Dark Money Darker? IRS Shutters Collection of Donor Data*, 25 FLA. TAX REV. 140 (2021).
[207] T.D. 5125, 1942-1 C.B. 101, 102.
[208] Revenue Act of 1950, Pub. L. No. 81-814, § 341, 64 Stat. 960 (enacting I.R.C. § 153(c)).
[209] *Tax Reform: Hearing Before the H. Comm. on Ways & Means*, 91st Cong. 12 (1969).
[210] *See* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).
[211] Gary, *supra* note 105, at 620–21.
[212] Husam Abu-Khadra & David Olsen, *Toward Automating Shredding Nonprofit XML Files: The Case of IRS Form 990 Data*, 37 J. INFO. SYST. 169, 171 (2023) (discussing access to Form 990 data, demonstrating how to convert IRS data into a searchable format and noting how charities since July 1, 2019, are now required by the Taxpayer First Act to file electronically.).
[213] Ginsburg et al., *supra* note 7, at 2585.
[214] Owens, *supra* note 1, at 2.
[215] *See* Mayer, *supra* note 1.
[216] CONG. BUDGET OFF., TRENDS IN THE INTERNAL REVENUE SERVICE'S FUNDING AND ENFORCEMENT, 1 (2020). I have recounted some of the following information associated with infra. Notes 215–226 in testimony before U.S. Congress. *See Laws and Enforcement Governing the Political Activities of Tax-Exempt Entities: Hearing Before Subcomm. on Tax'n and IRS Oversight of the S. Comm. on Fin.* (2022) (testimony of Philip Hackney).

30% decline in enforcement employees.[217] IRS Data Books show the IRS went from over 94,000 full time equivalent ("FTEs") employees in FY 2010 to 73,554 FTEs in FY 2019.[218]

The IRS's tax-exempt organization group became almost a shell of its former self. The IRS's exempt organization workforce shrank from 889 FTEs in 2010 to around 550 FTEs in FY 2019.[219] Congress recently increased the budget for the IRS, but it is not clear that those dollars will find their way to the exempt organization group.[220]

The exempt organizations group of the IRS operates an application system called the determinations process, and an examination program, i.e., the auditing process. In determinations, annual applications for exempt status have increased significantly, but annual rejections have gone down.[221] In FY 2019, the IRS reviewed over 101,000 applications for exempt status, it rejected only 66 of those applications.[222] Comparatively, in FY 2010, the IRS reviewed over 65,000 of such applications and rejected 517.[223] When looking at examinations, the IRS had about a 0.38% examination rate in 2010.[224] TIGTA counted the examination rate in 2019 at 0.13%.[225]

It is hard to prove that this lack of resources has led to consistent oversight failures.[226] The IRS has rarely found significant noncompliance among charitable organizations.[227] Still, anecdotal evidence based on following the news suggests that something is wrong,[228] and prominent groups say there are problems. For

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[217] CONG. BUDGET OFF., *supra* note 216.

[218] I.R.S., DATA BOOK, 74 tbl. 31 (2019), https://www.irs.gov/pub/irs-prior/p55b--2020.pdf [hereinafter 2019 DATA BOOK]; I.R.S., DATA BOOK, 66 tbl. 29 (2010), https://www.irs.gov/pub/irs-soi/10databk.pdf [hereinafter 2010 DATA BOOK].

[219] I.R.S. TAX-EXEMPT & GOVERNMENTAL ENTITIES DIV., FISCAL YEAR 2019 ACCOMPLISHMENTS LETTER (2020), https://www.irs.gov/pub/irs-prior/p5329--2019.pdf [perma.cc/2GTT-XJUX].

[220] COUNCIL OF ECON. ADVISORS, EMPOWERING THE IRS: UNDERSTANDING THE FULL POTENTIAL OF THE INFLATION REDUCTION ACT'S HISTORIC INVESTMENT IN THE INTERNAL REVENUE SERVICE (Feb. 8, 2024) (discussing the $80 billion investment in the IRS budget) https://www.whitehouse.gov/cea/written-materials/2024/02/08/empowering-the-irs-understanding-the-full-potential-of-the-inflation-reduction-acts-historic-investment-in-the-internal-revenue-service/#:~:text=The%20Inflation%20Reduction%20Act%20provided,by%20the%20wealthiest%20tax%20evaders [perma.cc/W3AL-D9MB].

[221] Philip Hackney, *The Real IRS Scandal Has More to Do with Budget Cuts than Bias*, THE CONVERSATION (Apr. 15, 2018), https://theconversation.com/the-real-irs-scandal-has-more-to-do-with-budget-cuts-than-bias-95026 [perma.cc/FNL9-5XD3].

[222] 2019 DATA BOOK, *supra* note 218, at 27 tbl. 12.

[223] 2010 DATA BOOK, *supra* note 218, at 56 tbl. 24.

[224] *Id.* at 33 tbl. 13.

[225] TREASURY INSPECTOR GEN. FOR TAX ADMIN., OBSTACLES EXIST IN DETECTING NONCOMPLIANCE OF TAX-EXEMPT ORGANIZATIONS, 6 (Feb. 17, 2021), https://www.oversight.gov/sites/default/files/oig-reports/TIGTA/202110013fr.pdf.

[226] *See, e.g.*, FREMONT-SMITH, *supra* note 60, at 13.

[227] *See generally* Mayer, *supra* note 1, at 94–96. In a Hospital study and in a Colleges and University study, the IRS found little major noncompliance. I.R.S. EXEMPT ORG., HOSPITAL COMPLIANCE PROJECT, FINAL REP. (2014); I.R.S. EXEMPT ORG., COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT, FINAL REP. 2–6 (2013).

[228] The author weekly receives multiple inquiries from reporters about misuse of charities and nonprofits generally. While writing this, the National Rifle Association was found by a jury to have

instance, the National Taxpayer Advocate in 2012 highlighted in the title of a part of its report: "Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations."[229] The Taxpayer Advocate has continued to note this decline in IRS resources generally in its 2015[230] and 2016[231] reports. The Panel on the Nonprofit Sector reviewed the sector in 2005 and found that while there was wide compliance in the charitable sector, there were ways in which the sector could be improved.[232] It provided a list of recommendations to the IRS and to Congress to ensure better compliance.[233]

To conclude, the IRS became a regulator of nonprofits because of the enactment of the federal income tax. This brought about improvements in charity oversight. Perhaps the most significant addition is the development of what is a charitable purpose and transparent information made publicly available regarding these organizations through the Form 990. But the IRS never became the robust regulator of the sector some hoped it would become. It is not on the beat, stopping bad acts as they happen, and even the enforcement that does happen is so sporadic as to call into question whether its enforcement effort has much effect at all. Various scholars have highlighted the ways in which they perceived that the IRS simply is not up to the task of ensuring a strong compliant charitable sector.[234] More concerning, Congress has disinvested in the IRS, leading to a workforce that is not up to the task of regulating the sector.

3. Other Regulators

This final Part II(D) considers a range of other sources of oversight of the sector including some governmental agencies, potential self-regulatory bodies, and the press.

As already established, there is no explicit regulator of charitable activity, but a number of federal agencies beyond the IRS oversee some of the activity engaged in by nonprofits. The Government Accounting Office (GAO) in a 2002 report identified five federal agencies with some oversight of the sector: Federal Bureau of Investigation (FBI), Federal Emergency Management Association (FEMA), Federal Trade Commission (FTC), United States Postal Inspection

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mismanaged its finances. Meredith Deliso et al., *Jury Finds NRA Liable for Mismanagement, Says Wayne LaPierre Violated Duties*, ABC NEWS (Feb. 23, 2024) https://abcnews.go.com/US/jury-finds-nra-liable-mismanagement-wayne-lapierre-violated/story?id=107269909 [perma.cc/7U9B-PYJC].

[229] NAT'L TAXPAYER ADVOC., 2012 ANNUAL REPORT TO CONGRESS 15 (2012), https://www.taxpayeradvocate.irs.gov/reports/2012-annual-report-to-congress/full-report/.

[230] NAT'L TAXPAYER ADVOC., 2015 ANNUAL REPORT TO CONGRESS 12 (2015), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC15_Volume1.pdf.

[231] NAT'L TAXPAYER ADVOC., 2016 ANNUAL REPORT TO CONGRESS 3–4 (2016), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC16_Volume1.pdf.

[232] PANEL ON THE NONPROFIT SECTOR, *supra* note 200.

[233] NAT'L TAXPAYER ADVOC., *supra* note 229, at 15.

[234] *See, e.g.*, Roger Colinvaux, *Charity in the 21st Century: Tending Towards Decay*, 11 FLA. TAX REV. 1 (2011); Marion Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORG. TAX REV. 25 (2003); Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT L. REV. 803, 804–07 (2005).

Service (USPIS) and Office of Personnel Management (OPM).[235] Of these, none of them has substantial jurisdiction over charities. The FBI has no charity division but encounters charities in telemarketing and mail fraud, as well as international charities engaged in terrorism.[236] The other agency with not insignificant jurisdiction would be the FTC, which is engaged in overseeing consumer protection associated with charitable solicitation but only by for-profit organizations, not by charities.[237]

But the government regulates charities more than the GAO report would suggest. Various industries have distinct federal and state regulators to oversee the activity of those types of charities. Though it does not strictly regulate charities, the U.S. Department of Education is extensively involved in overseeing elementary and secondary education,[238] as well as higher education.[239] Of course, state and local governments are engaged in that regulation as well. Hospitals, which make up over half of the revenue of the charitable sector, as noted above in Part II(A), are overseen by the Department of Health and Human Services, as well as state authorities involved in administering Medicare and Medicaid. And there are many other sub-fields, like low-income housing that have federal and state regulators—such as the U.S. Department of Housing and Urban Development (HUD).[240] Finally, governments enter contracts with charitable organizations to deliver certain services—Medicare being a prime example.

Many have worked toward creating a self-regulatory regime of some sort. After the Filer Commission Report recommended a quasi-governmental regulator, the Independent Sector formed in 1980 as a merger of two nonprofits.[241] The group set out to be the spokesperson for the sector and has made strides toward that, but its membership is only a small slice of the entire sector.[242] It has issued its Principles for Good Governance[243] which originated as a Code of Ethics in the 1990s.[244] Other national organizations include Board Source, National Council of Nonprofit Organizations, and the Urban Institute on Nonprofits and Philanthropy.[245] But there is nothing close to a national leader of the entire sector that can command the attention of a large segment of charities to claim an ability to drive the behavior of charities. Again, there are industry-specific trade associations like the American

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[235] U.S. GOV'T ACCOUNTABILITY OFF., GAO-02-526, TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES 69–71 (2002).
[236] *Id*. at 69.
[237] FREMONT-SMITH, *supra* note 60, at 424.
[238] U.S. DEP'T. OF EDUC., *An Overview of the U.S. Department of Education* (Sep. 2010), https://www2.ed.gov/about/overview/focus/what.html [perma.cc/6NAK-ALGC].
[239] U.S. DEP'T. OF EDUC., *Negotiated Rulemaking for Higher Education 2023-2024*, https://www2.ed.gov/policy/highered/reg/hearulemaking/2023/index.html [perma.cc/N63M-EZQC].
[240] *See, e.g.*, OFF. OF POL'Y DEV. & RSCH., *Low-Income Housing Tax Credit (LIHTC)*, U.S. DEP'T OF HOUS. & URBAN DEV., https://www.huduser.gov/portal/datasets/lihtc.html [perma.cc/CQB8-ADE7].
[241] FREMONT-SMITH, *supra* note 60, at 466.
[242] *Id*.
[243] INDEPENDENT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS (2d ed. 2015) (the author was a member of the advisory committee that participated in creating the second edition of these principles).
[244] FREMONT-SMITH, *supra* note 60, at 467.
[245] *Id*.

Hospital Association and the American Association of Colleges and Universities that command substantial attention of the sub-sector of charities such as hospitals and colleges and universities.

Congress and states provide a range of means for other groups to potentially hold nonprofits accountable. Congress requires the public disclosure of Forms 990. Some have written about the potential for cyber-accountability because of the access to such information.[246] The press makes use of this extensive information, but understanding it calls for expertise in law and accounting. GuideStar used to be the main source of access to this data electronically but others like ProPublica have moved into the space to serve as an accountability agent.[247] Nevertheless, there are only so many stories that can be written, and if there is no regulator to back up and enforce the rules, the press effort can only go so far. Still, the press has been an important force in regulating charity.

Thus, there are a handful of agencies that have jurisdiction over charity. We should not forget those. Indeed, at times, the primary regulator of hospitals or universities is likely more significant to those industries than the IRS or state charity aspect of their operation. The fact that Congress has made Form 990s available has been a success story in regulation in part. The press has used this information. But it is difficult to use it as it requires expert knowledge to interpret what is going on.

III. PROPOSALS TO REMOVE CHARITABLE OVERSIGHT

There is no shortage of concern regarding the regulation of charity. It is cogently expressed through studies, reports, and proposals to solve the problem. In just recent history, Senator Grassley, in the mid-2000s, pushed the Senate Finance Committee to explore a range of solutions to charity regulation including publishing a discussion draft of some potential solutions.[248] Before these more recent efforts, long and intense work went into thinking through issues of charity to support the enactment of the 1969 Tax Reform Act[249] that transformed charity regulation at the IRS. Leading up to that Act, the Treasury Department conducted a significant study on wealth and charitable tax benefits that it published in 1965 where it made recommendations on private philanthropy.[250] In the mid-1970s, the privately created Filer Commission published a study considering federal oversight of charity.[251] The authors concluded that the IRS should continue to be the federal regulator of choice,[252] but it also prominently discussed another group studying the

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[246] Caroline K. Craig, *The Internet Brings 'Cyber-Accountability' to the Nonprofit Sector*, 13 J. TAX'N EX. ORG. 82 (2001); *see also* Evelyn Brody, *Sunshine and Shadows on Charity Governance: Public Disclosure as a Regulatory Tool*, 12 FLA. TAX REV. 183 (2012).

[247] Andrea Suozzo et al., *Nonprofit Explorer*, PROPUBLICA, https://projects.propublica.org/nonprofits/.

[248] STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT (2004).

[249] Fishman, *supra* note 175.

[250] STAFF OF S. COMM. ON FIN., 89TH CONG., TREASURY DEP'T REP. ON PRIV. FOUNDS. (Comm. Print 1965).

[251] Ginsburg et al., *supra* note 7.

[252] *Id*. at 2578.

issue that recommended the creation of a new federal agency to oversee charity.[253] The solutions over time have been quite varied and include public and private and state and federal approaches as well as relatively simple fixes to wholesale removal. This Part III considers some of those efforts.

A. Some State and Federal Recommendations for Modest Change

Scholars have discussed the need for significant improvement of charitable regulation for a long time. Some of the efforts are state-focused. In 1960, before the reform to the IRS in 1969, Karst proposed a state board of private charities to regulate charities like the English model, which employs a charity commission.[254] Jim Fishman argued in 1985 for an expanded use of relator status to allow private modes of enforcement given the anemic enforcement by attorneys general in most states.[255] In an effort to modify the law but continue to use the same structure generally, Deborah DeMott argued in the early 1990s that the trend to adopt duty of loyalty standards of for-profit corporations where conflicts can be easily waived was a mistake.[256] Some state-level suggestions have focused on transparency. Evelyn Brody, for instance, encouraged states to consider publicly reporting about their enforcement activity such as had been done in part by the Pennsylvania and Massachusetts Attorneys General.[257] Manne argued for creating private for-profit monitoring companies.[258]

In a federally focused fiduciary duty governance-based proposal, Henry Hansmann, in the early 1980s, suggested extending a strict prohibition on self-dealing for all charities between a director and the nonprofit they govern.[259] Peter Swords encouraged improved reporting on Form 990s.[260] Indeed, some of those suggestions came to fruition when the IRS revised its reporting, and Congress made more reporting on Forms 990 available. Congress also made it easier for the IRS to share enforcement information with state enforcers. In the 2000s, national charitable associations and state enforcement agencies led discussions focused on whether Sarbanes-Oxley-type reforms could help improve the behavior of managers of charity.[261] Running with the Sarbanes-Oxley requirement of independent audit committees, advocates and politicians proposed requiring

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[253] *Id.* at 2640 (citing, *inter alia*, discussion by Sheldon Cohen, Thomas A. Troyer, Marion R. Fremont-Smith, and John Nolan, ultimately published as *Public Supervision of Philanthropy and Charity, Can it be Improved?*, NONPROFIT REPORT (December 1973 & January 1974)).

[254] Karst, *supra* note 16, at 476–83.

[255] James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 673–74 (1985). Gary, *supra* note 105, at 647 (making a similar argument).

[256] Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 137–43 (1993).

[257] Brody, *supra* note 64, at 949.

[258] Manne, *supra* note 62.

[259] Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 569 (1981)

[260] Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571 (1998).

[261] Chester, *supra* note 64, at 461; Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 FORDHAM L. REV. 765 (2007). Sarbanes-Oxley (SOX) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

nonprofits of a certain size to obtain an independent audit.[262] Some of the same groups proposed another requirement—having a CPA sign off on the internal controls of the nonprofit—and though there was some support, others were concerned it would be too costly for smaller nonprofits.[263] Like many in the corporate world,[264] a number of nonprofit leaders rejected the idea of the federal government entering into the field of governance that they believed was dedicated to, and the proper domain of, the states.[265]

In 2010, Lloyd Mayer and Brendan Wilson utilized an institutional choice analysis to consider the best regulator of charity. The two concluded that regulation of the charitable sector would be most aided by relying upon state agencies connected but independent of the attorney general of each state.[266] They start from the premise that there is "relative consensus regarding the goal of ensuring compliance by charity directors, trustees, and officers with their generally agreed upon fiduciary duties."[267] Based on this, they do not focus their institutional choice analysis upon goal choice but only the choice of institution.[268] An independent state agency then performs well as states clearly have more authority in the field of charity law than would a new federal entity outside of the IRS.[269] Furthermore, they take the position that the IRS does not have authority to do much in the way of governance and, therefore, has no expertise in the space of governance.[270]

Some of these proposals have been enacted in various ways at the state level and at the federal level. Nevertheless, there continues to be a deep level of dissatisfaction with charity regulation at the state level.

B. Remove from the IRS/Create a New National Agency

Some critics frustrated with both state and IRS regulation of charity propose removing charity regulation from the IRS and creating a new national agency to enforce charitable law. Some of these critics simply suggest it is time to begin seriously considering removal/new agency creation. Others say it is time and have made proposals for the creation of federal agencies with varying levels of independence from the federal government.

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[262] Aprill, *supra* note 261, at 771 (discussing a Senate Finance White Paper, Panel on the Nonprofit Sector, and California's Nonprofit Integrity Act all requiring audits for organizations with annual gross revenues of some amount); STAFF OF S. FIN. COMM., 108TH CONG., STAFF DISCUSSION DRAFT 9 (2004); PANEL ON THE NONPROFIT SECTOR, *supra* note 200, at 35; CAL. GOV'T CODE § 12586(e) (West 2022).

[263] Aprill, *supra* note 261, at 774–75.

[264] *Id*. at 780.

[265] *See, e.g.*, PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A SUPPLEMENT TO THE FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 28 (2006) (explicitly stating "Congress should not expand the equity powers or jurisdiction of the Tax Court over charitable fiduciaries"); *see also* Aprill, *supra* note 261, at 785 (noting the potential issue with the constitutionality of extending such jurisdiction to the IRS or to the Tax Court).

[266] Lloyd H. Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 514–15 (2010).

[267] *Id*. at 505.

[268] *Id*.

[269] *Id*. at 521.

[270] *Id*. at 522. *Cf*., Aprill, *supra* note 261, at 792.

The idea of a new federal regulatory agency is not new. As noted above, the Filer Commission considered but rejected one such proposal.[271] In the late 1990s, Joel Fleishman proposed a new federal agency, but only if a couple of other proposals were tried and did not work.[272] Fleishman, inspired in part by the fact that IRS charity enforcement was underfunded in the 1990s,[273] argued that the nonprofit accountability enforcement mechanisms were not working.[274] He argued first for a self-regulatory regime. To Fleishman, the nonprofit sector should voluntarily join with groups like Independent Sector, the Council on Foundations, and other similar organizations, to create enforcement mechanisms.[275] At the same time, he argued that these groups should work directly with state attorneys general to improve charity enforcement.[276] Additionally, Fleishman argued Congress ought to try to get more resources to the IRS for proper enforcement. Failing that, Fleishman believed we should consider a federal charities commission.[277] Were we starting from scratch, Fleishman says he would propose an SEC like solution. Since that is not an option, he argued instead for maintaining significant control at the IRS. Ultimately, his federal charities commission would be a separate independent agency, perhaps housed within the SEC, that has control over matters not directly given to the IRS and, therefore, focused more on fiduciary duty functions.[278]

Marcus Owens, who served as the Division Director of Exempt Organizations at the IRS for ten years,[279] argues for the formation of a new quasi-public agency modeled on FINRA.[280] Owens contends that the IRS is not the ideal institution for the regulation of charity. He points to many factors, including: (a) inadequate funding, (b) civil service constraints, (c) institutional constraints (IRS is focused on tax-collecting), and (d) IRS anomalies (enforcement based on tax returns and tax privacy).[281] To Owens, the IRS is set up to collect tax and not to regulate. Any actions the IRS might take against an errant nonprofit are based on a tax return that is not filed until well after the fact of the actions that an organization takes that might be problematic.[282] According to Owens, even if the IRS determines that a nonprofit has behaved badly, its ability to share this information with state authorities, though better today, is still clumsy at best.[283] Owens is also concerned about the lack of ability of a wide range of interest groups to be at the legislative

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[271] Ginsburg et. al., *supra* note 7.
[272] Joel L. Fleishman, *Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform*, *in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999).
[273] *Id.* at 182 (citing James T. McGovern & Phil Brand, *EP/EO – One of the Most Innovative and Efficient Functions Within the IRS*, 97 TAX NOTES TODAY 164 (1997)).
[274] *Id*. at 185.
[275] *Id*. at 186.
[276] *Id*. at 186–87.
[277] *Id.* at 188–89.
[278] *Id*.
[279] Loeb & Loeb LLP, Marcus S. Owens, https://www.loeb.com/en/people/o/owens-marcus-sherman [perma.cc/8UY2-67KQ].
[280] Owens, *supra* note 1.
[281] *Id*. at 4–6.
[282] *Id.* at 6.
[283] *Id*.

table to be involved in the making of charity tax law.[284] The expertise needed to comment upon tax law needlessly hinders some who might reasonably want to comment upon charitable legislation from engaging in the process.

Owens recognizes that some may be concerned about the charitable sector regulating itself. He thus makes the case for why and when self-regulation makes sense. The advantages he sees are primarily knowledge regarding the charitable universe—knowledge of rules that will be effective, knowledge of the likely harms, and knowledge of situations where the harm is likely to fall on the participants themselves anyway.[285] Owens argues that the charitable sector is like the securities sector because group member behavior affects others in the group in both sectors.[286] Sometimes also, members are engaged in joint projects and the entire community has an interest in "common rules in the interest of ensuring a level playing field."[287] Finally, for both the securities sector and the charitable sector, the success of the sectors depends upon the public perceiving the sectors as well-regulated.

Owens recommends adopting an institutional structure like the Financial Industry Regulatory Authority (FINRA)[288] or the Public Company Accounting Oversight Board (PCAOB).[289] FINRA derives its legal authorization from the Securities and Exchange Act of 1934 which requires securities dealers to be members of a self-regulated organization (SRO) as either an exchange or a larger group like FINRA. The SRO must prove to the Securities Exchange Commission (SEC) that it can enforce its rules and those of the 1934 Act.[290] Owens believes that FINRA has the ability to avoid the worst aspects of conflicts that an SRO typically faces, while at the same time, its institutional structure provides a significant opportunity for the regulated group to be an important participant in the creation of the rules by which they must live.[291] Furthermore, FINRA is not confined by civil service regulations because it is not considered to be the government.[292] Congress created the PCAOB as a part of the Sarbanes Oxley Act of 2002 primarily to oversee the audits of public companies. It is effectively a public company accounting SRO. But it is different from FINRA in that it does not have a competitor, so there is no market for lower fees or lesser regulation from another exchange, and its members are all chosen by the SEC rather than in part from industry.[293]

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[284] *Id*. at 8 (discussing the lack of representatives from all sectors of charity as the Senate created the nonprofit legislation that became a part of the Pension Protection Act).
[285] *Id*. at 10.
[286] *Id.*
[287] *Id*.
[288] Carrie Johnson, *SEC Approves One Watchdog For Brokers Big and Small*, WASH. POST (July 27, 2007) https://www.washingtonpost.com/wp-dyn/content/article/2007/07/27/AR2007072700108_pf.html [perma.cc/5NQM-D3UM].
[289] *Auditing the Auditors: Creating the Public Company Accounting Oversight Board*, SEC. & EXCHANGE COM. HISTORICAL SOCIETY, https://www.sechistorical.org/museum/galleries/pcaob/ [perma.cc/8E9N-5SAR].
[290] Owens, *supra* note 1, at 13.
[291] *Id.*
[292] *Id*. at 14.
[293] *Id.* at 15.

Owens proposes Congress adopt a Charity Oversight Board ("COB") with some elements of both FINRA and the PCAOB.[294] To be an organization recognized as exempt from tax under section 501(c)(3), the organization would need to be a member in good standing of the COB.[295] Membership would be composed of seven industry directors, seven IRS-appointed directors, and seven independent directors.[296] Though a challenge would be determining its rulemaking jurisdiction, Owens suggests Congress grant it jurisdiction to enforce core charity tax law rules.[297] The IRS would have the final say both about rules and enforcement, though. For Owens, a key feature of the COB would be its ability to timely enforce the law outside the tax return process.[298] The entity would be funded primarily by fees for being members of the COB on a sliding scale and some by payments for services or actions. Owens suggests that this arrangement would avoid some of the big problems with IRS regulation detailed above.[299]

Terri Lynn Helge comes to a similar conclusion as Owens. Consistent with the discussion in Part II, Helge describes oversight of the charitable sector as too minimal because of significant bureaucratic constraints placed on both the IRS and attorneys general.[300] She argues that this causes harm to an important sector of our economy and that we need to make a change.[301] She notes that there are "forty [state charity] jurisdictions that do not require annual reporting from non-soliciting charities . . . and thus cannot discern breaches of fiduciary duties from a substantial majority of charitable organizations."[302] In other words, there are many jurisdictions into which an unscrupulous nonprofit could operate undetected by the local jurisdiction. Thus, a change is needed.

Helge joins Owens in arguing for a federal overseer of the charitable sector. She argues though, that it should be more independent than Owens's suggestion of an SRO.[303] She proposes a Federal Charity Oversight Board (FCOB) that would be more like the PCAOB than FINRA, the model to which Owens hews closer. Congress would be the overseer of this FCOB.[304] The membership of the governing body would broadly represent the interests of the sector, including donors and members who operate different types of charitable organizations. However, a majority of the board would be composed of members of the government that oversee the sector.[305] This board would likewise be funded by requiring all charities to be members and to pay a fee on a sliding scale. Helge's board would replace the IRS in overseeing charitable tax law, though the IRS would retain jurisdiction over tax matters such as charitable contributions, employment tax, unrelated business

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[294] *Id.* at 18.
[295] Owens, *supra* note 1, at 13.
[296] *Id.*
[297] *Id.* at 20.
[298] *Id.* at 22.
[299] *Id.* at 24–26.
[300] Helge, *supra* note 1.
[301] *Id.* at 7–8.
[302] *Id.* at 14–15.
[303] *Id.* at 70.
[304] *Id.* at 70.
[305] Helge, *supra* note 1, at 71.

income tax, etc. Finally, it would have the authority to promulgate regulations and guidance.[306]

Mayer, who previously suggested state oversight enhancement, now believes it might be better to move enforcement out of the IRS and to another federal regulatory body.[307] He thinks that the recent failures of the IRS mean that it is time to seriously begin to consider the alternatives. He also notes that given the size of the nonprofit sector as compared to all other taxpayers it would be unlikely, and likely untenable, for the IRS ever to dedicate the type of resources that are needed to regulate the sector.[308] Ellen Aprill, too, has concluded that it is time to consider alternatives to the IRS.[309]

At this point, some critical voices within the charitable sphere have spoken regarding what is perceived as a broken system of charitable regulation that needs to be revamped. Additionally, many critics express a complete lack of confidence today that the IRS can be reformed to regulate the charitable sector well.

IV. ANALYSIS

This Part IV evaluates whether oversight of charities would be better removed from the IRS, or if the function should remain within. First, this Part IV evaluates the most salient recent history, raising the question of whether the IRS is capable of being a major regulator of charity. Second, it evaluates goals that we might be aiming toward when we discuss charity regulation in as broad a sense as possible to ground the analysis. Without the big picture, we can miss some goals that might be inherent in the entirety of the system but that are missing when we just think about charity oversight itself. Third, this Part IV evaluates the challenges to the various regulatory state and federal solutions and how those match up against the goals we ostensibly seek. Finally, it considers the removal solution.

Fundamentally, this Analysis concludes that it is best, even if not perfect, to keep charity regulation in the IRS. It contends that those arguing for removal are devaluing several factors. The charity regulation we know today is both created by and structured in response to the strong incentives created by the income tax as well as the benefits that come from obtaining tax-exempt status with the IRS. Removing the IRS from regulation will create significant tax and political activity shelters. It would also make it more likely that charity, a major part of civil society, would be more likely to be captured problematically by the economic order. Though it may not be intuitive, IRS regulation is the most likely institution to maintain a separateness between the state, civil society, and the economic order. Additionally, it is highly unlikely that the states would be willing to turn nonprofit governance over to the federal government. Furthermore, the charitable sector does not have enough in common among its different sectors to find a coalition to support national governance standards. Finally, those who propose another agency must assume that with a new agency, our government or the charitable sector will commit more resources to the regulation of charity. I believe this assumption is wrong.

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[306] *Id*. at 78.
[307] Mayer, *supra* note 1, at 121.
[308] *Id*. at 98.
[309] Aprill, *supra* note 1, at 336–37.

A. Recent History Highlighting a Challenged IRS

As demonstrated above in Part II, neither state attorneys general nor the IRS have the resources or the mettle to regulate the sprawling charitable sector. Because it informs the more recent calls for removal, in this Part IV(A), I keep in mind the public situations where IRS actions most significantly caused its critics to question its capacity to be the regulator of charity. Though many crises have come before,[310] there really is one key matter that began to seriously turn the tide in the evaluation of the IRS as a regulator of the sector. In 2013, the Treasury Inspector General concluded that the IRS failed in the Tea Party matter for three reasons: 1) it picked organizations for scrutiny based on names, 2) it found many questions the IRS asked were improper, and 3) the length of delays the IRS put these organizations through was unacceptable.[311] This set off a political firestorm and arguably led to the IRS being underfunded for about a decade.

In a previous article, I found the Inspector General's claim that the IRS could not use names as an enforcement tool without merit.[312] Still, the IRS had no procedure in place detailing how to handle applications of organizations associated with one another through ideological ties. This left the IRS bereft of defenses in response to claims that it acted in a biased manner. Additionally, the IRS seemed confused and paralyzed by a lack of clarity in the law it was trying to enforce on section 501(c)(4) organizations.[313] This led to the IRS unfairly taking much too long to make determinations on applications. This controversy still resonates today very strongly among many conservatives as an indication that the IRS is run by individuals who are ideologically minded and not interested in enforcing the rule of law. No investigations corroborated this claim, but the belief remains.[314] Under any circumstances, the incident painted the portrait of an agency overwhelmed with workload, incompetent at times, and plodding in its enforcement of the law. The perception is now that the IRS does not have the capacity or the interest to enforce these laws and that it actively avoids handling these matters.

Given the challenges exposed in the Tea Party controversy, the IRS adjusted its operations. It adopted a much-criticized Form 1023-EZ to eliminate its backlog of applications and to, it claimed, focus its human resources on audits instead.[315] It has also tried to pick certain sectors of the charitable sector to focus enforcement upon.[316] Because the IRS does not have the human resources to actually review the

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[310] *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., REPORT OF INVESTIGATION OF ALLEGATIONS RELATING TO INTERNAL REVENUE SERVICE HANDLING OF TAX-EXEMPT ORGANIZATION MATTERS (2000).

[311] TREASURY INSPECTOR GEN. FOR TAX ADMIN., INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX EXEMPT APPLICATIONS FOR REVIEW, No. 2013-10-053, at 7 (May 14, 2013).

[312] Hackney, *supra* note 2.

[313] *Id*.

[314] TREASURY INSPECTOR GEN. FOR TAX ADMIN., REVIEW OF SELECTED CRITERIA USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW, No. 2017-10-054 (September 28, 2017) (finding no intentional efforts by the IRS to act in a biased manner); *see also*, S. REP. NO. 114-119 (2015).

[315] *See* Terri L. Helge, *Rejecting Charity: Why the IRS Denies Tax Exemption to 501(C)(3) Applicants*, 14 PITT. TAX REV. 1 (2016) (discussing the IRS's reasons for adopting the form and critiquing that choice).

[316] *See, e.g.*, I.R.S. EXEMPT ORG., *supra* note 227.

significant number of applications it receives annually, moving to the Form 1023-EZ made sense, even if it is far from a good solution. It acknowledges the IRS's limited resources and tries to maximize them. The Taxpayer Advocate has pointed to changes the IRS ought to consider that could ensure a more reliable system.[317] Same with the focus on sectors. It allows the IRS to try to make real improvements in sectors in ways that can create consistent regulatory action and ideally educates the community in important ways through the process. However, these moves are not enough to build a functional charity regulatory regime.

To summarize, there have long been concerns that regulation of the charitable sector is lacking. Most have given up on the states to fulfill this role and have put their trust in the IRS instead. But the IRS encounters significant resource constraints and role challenges. The Tea Party controversy highlights the real problems that can result from the IRS trying to fill that role while lacking the resources and trying to fulfill at least two different functions: revenue collector and impartial regulator of nonprofits. It has significant trouble getting the law right in a timely manner and can appear in that instance to be a biased agency. The Tea Party episode also critically hampered the IRS's ability to collect the revenue. The GOP used the episode to cut the IRS budget and undermine the efforts of the agency generally.

Still, because of the significant tax benefits involved, it makes sense to maintain IRS control of these charitable sector benefits that are primarily tax-based. Congress should provide more resources to the IRS for charity regulation but should simultaneously lower the burden upon the IRS exempt organization group by making smart choices regarding the legal rules applicable to charitable organizations.

B. What Are the Goals of Charity Regulation?

This Part IV(B) examines the goals of establishing and maintaining charity regulation. It starts first with a consideration of what values we should foster as we design public policy. I focus upon insuring a politically just order, meaning one that meets the general conception of a democratic order.[318] Utilizing those principles, it moves from big-picture conceptions of charity regulation goals to narrower ones. By big-picture, I mean to anchor into larger community goals such as a well-ordered society. In other words, the system of charity is only a small part of our society, as is a system of taxation, but both systems fit into larger goals of creating a world in which all individuals feel at home in the world.[319] The section then considers some narrower goals of charity regulation.

This more global focus is intended to help orient a complex challenge. The discussion of the removal of charity regulation from the IRS takes place in a

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[317] NAT'L TAXPAYER ADVOC., 2015 ANNUAL REPORT TO CONGRESS, RECOGNITION AS A TAX-EXEMPT ORGANIZATION IS NOW VIRTUALLY AUTOMATIC FOR MOST APPLICANTS (2015), https://www.taxpayeradvocate.irs.gov/reports/2015-annual-report-to-congress/recognition-as-a-tax-exempt-organization-is-now-virtually-automatic-for-most-applicants/ [perma.cc/4VK2-DD75].

[318] Hackney, *Prop Up*, *supra* note 9, at 327–40 (examining why democracy is the politically just solution).

[319] THOMAS CHRISTIANO, THE CONSTITUTION OF EQUALITY: DEMOCRATIC AUTHORITY AND ITS LIMITS 61 (2008) ("The interest in being at home in the world is fundamental because it is at the heart of the well-being of each person.").

dialogue that tends to move back and forth between conceptions of state law charity regulation, in which a tax system is for the most part absent, and a taxation system, where charity fiduciary duties for the most part are absent. This movement of the discussion makes this topic of where to place charity regulation challenging to get a handle upon.

1. Political Justice: Charity and Tax in a Democratic Order

I have previously made the case that our tax system should be designed to not hinder political justice, and ideally, it should advance political justice.[320] These same principles that I explore below should apply to our charity regulation. By political justice, I mean a state that furthers democracy.[321] Though democracy is quite complex, I utilize an ideal model against which to evaluate the justness of a system. In its simplest, ideal, utopian sense, democracy is built on the idea that everyone is entitled to shape their own lives.[322] This means with respect to any collective decision, everyone has the right to participate in creating the agenda, developing information about the decision before the group, and most importantly the right to vote on any final decision. This notion could be called political voice equality (PVE).[323] In this Article, I try to keep in mind this drive toward political justice or PVE in the regulation of charity.

The ideal democratic state is a utopian vision. Modern states are numerous in population, highly complex in collective decisions, and depend upon representation for actual voting on final decisions. Thus, instead of the people directly engaging in deliberation, they elect representatives to represent their interests. Modern states also rely upon groups that represent the interests of people in a society and to develop information and opinions to share with the state. These groups make up a part of civil society. Charitable organizations fit into that mix of civil society.[324] Indeed, many who laud charitable organizations as a part of civil society highlight the theory of pluralism to support the sector.[325] The pluralism theory recognizes the impossibility of pure democracy and finds that groups supporting citizen interests can fill that gap.[326] The strongest version of pluralism

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[320] Hackney, *Political Justice*, *supra* note 9. Note that a democratic system and just social outcomes are not necessarily the same thing. Keith Dowding, *Are Democratic and Just Institutions the Same?*, *in* JUSTICE AND DEMOCRACY: ESSAYS FOR BRIAN BARRY 25 (Keith Dowding et al. eds., 2004); *see also* JOHN RAWLS, POLITICAL LIBERALISM 13 (2005) ("a political conception [of justice] tries to elaborate a reasonable conception for the basic structure alone and involves, so far as is possible, no wider commitment to any other doctrine.").

[321] *Id.*; *see also* Hackney, *Prop Up*, *supra* note 9, at 322. Others have made a similar case. *See, e.g.*, Wallace, *supra* note 9.

[322] ROBERT A. DAHL, ON POLITICAL EQUALITY 4 (2006) (describing this equal value of each person as "intrinsic equality"); *see also* Hackney, *Political Justice*, *supra* note 9, at 273.

[323] Hackney, *Prop Up*, *supra* note 9, at 333 (discussing "political voice equality"); *see also* ROBERT A. DAHL, ON DEMOCRACY 76 (1998) ("Except on a very strong showing to the contrary in rare circumstances, protected by law, every adult subject to the laws of the state should be considered to be sufficiently well qualified to participate in the democratic process of governing that state.").

[324] Hackney, *supra* note 10, at 698; *see also* SKOCPOL, *supra* note 10.

[325] Bob Jones Univ. v. United States, 461 U.S. 574, 609–10 (1983) (Powell, J., concurring) (explaining the "role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints"); *see also* Gardner, *supra* note 12; Boris & Maronick, *supra* note 12.

[326] Hackney, *Prop Up*, *supra* note 9, at 335–39.

suggested that any group that wanted to form could form and represent the diversity of views of citizens across the political spectrum.[327] These groups could then represent the voice of something close to all citizens at some point. Collective action theory, though, has significantly called that proposition into question.[328] It is much harder for large groups and poorer groups to form and maintain form than it is for small and wealthy groups to form and maintain form.

Though the ideal conception of democracy is utopian, it is possible to make rough judgments regarding tax policy where the incentives and detriments imposed by Congress through a tax system take a position that impacts political voice.[329] In the case of business leagues and labor unions, Congress provides an exemption from tax to each but a deduction only to business interests for payments of dues.[330] Both organizations are classic interest groups that advocate for their member's interests.[331] Based on collective action theory and research, we know that it is much easier for business interests to form than for labor groups to form.[332] Still, the benefit of tax exemption and the deduction does not take this reality into effect. The tax law regime enhances business interests more. This is politically unjust because the tax law is enhancing the voice of one interest and doing very little to enhance the voice of the other—a failure of PVE. Congress could improve the circumstance by ending exemption and deduction associated with both. But, given the long-established political voice inequality between business and labor, Congress could justifiably maintain the exemption for labor and ensure that its members are able to deduct their dues while ending both policies for business interests.[333]

A greater challenge for the PVE critique arises when the incentive cannot be said to directly impact the voice of interests before legislative bodies, as is the case with interest groups receiving tax benefits like business leagues and labor unions. Thus, in evaluating the rationales for the exemption of social welfare organizations that are not interest groups, the question becomes modestly different.[334] However, mutual benefit nonprofits like social welfare organizations are carrying out collective decisions. Under democratic theory there should be some connection between the decision-making and a democratic process.[335] Given the lack of clarity in the law and IRS guidance and a process lacking in transparency I recommended that either Congress provide more clarity as to which organizations qualify or end exemption for the vague social welfare category.[336] Thus, if we want to make dental insurance available through tax-exempt means, Congress ought to specify exactly what type of insurance such organizations need to provide rather

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[327] *See* Philip Hackney, *Taxing the Unheavenly Chorus: Why Section 501(c)(6) Trade Associations are Undeserving of Tax-Exempt Status*, 92 DEN. L. REV. 265, 275 (2015).
[328] *See id.* at 274–87.
[329] Hackney, *Prop Up*, *supra* note 9, at 340.
[330] *See id.;* Hackney, *supra* note 327.
[331] JOHN R. WRIGHT, INTEREST GROUPS AND CONGRESS: LOBBYING, CONTRIBUTIONS, AND INFLUENCE 22–23 (1996).
[332] Hackney, *Prop Up*, *supra* note 9, at 342–51.
[333] *See id.* at 377–82.
[334] Hackney, *Political Justice*, *supra* note 9, at 276.
[335] *Id.*
[336] *Id.*

than have the IRS loosely accept any health-related insurer into the tax-exempt club.[337]

In examining charitable organizations, Congress and the IRS provide more clarity and direction as compared to social welfare organizations. However, charitable organizations are more richly rewarded with subsidies and are still carrying out collective decisions, some of which ought to be made through a democratic process or at least be highly determined and conscribed at the legislative level. As the collective decision involved gets closer to a matter that ought to be determined by a democratic process, political justice as a value is more and more implicated. For instance, primary and secondary education ought to be democratically determined.[338] Thus, Congress should require charitable charter schools to be more linked to democratic processes.[339]

With these principles in mind, how should we think about the merits of political justice as it applies to the regulation of charity? First, all charity is engaged in providing collective goods and services that the state has failed to provide. It is reasonable to expect that these decisions ought to be made through some democratic procedure. Thus, it is reasonable to consider how charity is regulated by using a political justice lens. There are a number of factors to evaluate: (1) are there incentives or detriments imposed by the government dependent upon the behavior or purpose of an organization? (2) if there are incentives provided, who in society has access to them, and does the regulation of those incentives have an impact on how those benefits are allocated? (3) are the organizations involved a part of civil society? (4) what is the ideal relationship in a democratic sense between the state and the charitable organizations? (5) how transparent is the governmental regulatory system that makes determination and enforcement decisions? (6) does the system adopted ensure the collection of revenue needed to support the state?

2. Factors to Consider Regarding Charitable Regulation

What incentives or detriments does our system of government provide to or place upon charitable organizations? As discussed in Part II, both the federal government and state and local governments provide a range of incentives and impose some detriments upon charitable organizations. Charities receive a wide range of exemptions from federal, state, and local taxes. The two most substantial exemptions are likely the exemption from the federal income tax[340] and the exemption from state and local property tax. There is debate about whether the exemption from the federal income tax is a subsidy,[341] but many, including the Supreme Court, treat it as such.[342] The subsidy is equal to the current corporate tax rate (21% currently)[343] times the earnings exempted from taxation. As a direct result of gaining charitable status, charities obtain the benefit of the charitable

[337] *Id.* at 323.
[338] Hackney, *supra* note 10.
[339] *Id.*
[340] I.R.C. § 501(a) & (c)(3).
[341] Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 284 (2011); *see also* Ellen P. Aprill & Lloyd H. Mayer, *Tax-Exemption Is Not a Subsidy – Except for When It Is*, 172 TAX NOTES FED. 1887 (Sept. 20, 2021).
[342] Regan v. Tax'n with Representation of Wash., 461 U.S. 540, 544 (1983).
[343] I.R.C. § 11.

contribution deduction, which is potentially deductible from the federal income, gift, and estate taxes by the donor.[344] This benefit is considered to be a subsidy, though the income tax subsidy is only available to a small cohort of high-income earners today, perhaps around 9% of federal income tax filers.[345] This benefit is thus available almost exclusively to top-income earners. Local property tax exemptions result in significant amounts of forgone tax revenue that state and local authorities fight over with hospitals and other charities relatively often.[346] There is a debate as well regarding whether exemption from property tax is a subsidy or is simply part of the base.[347] But it is hard to understand what theory justifies the granting of large property tax exemptions to organizations like hospitals and universities. There are numerous other benefits,[348] including the ability to issue tax-exempt bonds.[349] These benefits primarily turn upon whether an organization meets the requirements to further a charitable purpose under section 501(c)(3) of the Code.

Who has access to these benefits? Anyone can form a section 501(c)(3) charitable organization, and they can be formed to further any purpose that is charitable. Nevertheless, because of the complexity of forming and operating a charitable organization, access to these benefits likely accrues in much greater amounts to those who are educated and those with wealth.[350] As noted above, the charitable contribution deduction is almost exclusively available to high-income and wealthy individuals. Because of a generous standard deduction, only about 9% of taxpayers have the itemized deductions necessary to allow them to make use of the charitable contribution deduction.[351] The federal gift[352] and estate tax[353] also provides charitable contribution deductions.[354] An individual generally has to have in the tens of millions of dollars of wealth in order to be subject to those taxes in the first place. While low-income individuals are sometimes beneficiaries of direct charity, they are not the primary beneficiaries of these organizations. Higher education, hospitals, and churches are some of the largest parts of the charitable sector, and each of these often benefits middle-class and very wealthy individuals.

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[344] I.R.C. §§ 170, 2055, & 2522.

[345] Hackney, *supra* note 10, at 771; *see also* TAX POL'Y CTR., *Briefing Book: How Did the TCJA Affect Incentives for Charitable Giving?* 342–345.

[346] FISHMAN ET AL., *supra* note 30, at 411–15 (discussing the battles over property tax exemptions).

[347] Evelyn Brody, *Legal Theories of Tax Exemption: A Sovereignty Perspective*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD 149–51 (Evelyn Brody ed., 2002).

[348] *See* Bazil Facchina et al., *Privileges & (and) Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85 (1993).

[349] I.R.C. § 145.

[350] This gets into the incidence of the benefit, which is hard to assess. Some poor beneficiaries surely obtain some of the benefit of exemptions and deductions but given the size of hospitals and universities and the individuals to whom they cater it is highly unlikely that the benefits accrue in even modest amount to low-income or even middle-income individuals.

[351] Congress raised the standard deduction in the 2017 Tax Act, Sec. 11021, Pub. L. 115-97 (Dec. 22, 2017). The Tax Policy Center for instance estimates that it reduced the number of households deducting their charitable contributions from 21% of households to about 9% of households. TAX POL'Y CTR *supra* note 345.

[352] I.R.C. § 2501.

[353] I.R.C. § 2001.

[354] I.R.C. §§ 2522, 2055.

Are these groups part of civil society? Charities are absolutely a part of the groups that make up civil society.[355] "[C]ivil society consists of associations and institutions that facilitate the formation of public opinions in spaces located outside of the for-profit or governmental sectors."[356] Civil society is at its strongest when allowing citizens to generate ideas of the good to further through government and to bring that information to legislators for hopeful enactment. It tends to also be a major protector of our civic freedoms like that of speech and association. Charitable groups arguably go beyond civil society when they directly carry out activities that we might think of as governmental, which ought to have the "buy-in" of society generally.

What relationship is ideal between charity and the state? As part of civil society, the relationship of charity to the government is necessarily both a tense and a supportive one. It is tense in the sense that charities exist outside the state and serve to generate ideas and solve problems outside the state. In that sense, charity as civil society can be perceived as a threat to those who currently control the state.[357] Like the separation of church and state, we also want a separation of civil society and state. Civil society most powerfully supports the state as an independent force and as a check on its excesses. The challenge is that there can never be a complete separation between the two. They are necessarily intertwined in many ways already discussed above. Also, in the tense sense, we do not want to allow charity as civil society to dominate the government. This is the fear of interest groups as the dominator of the common good of the United States identified and evaluated by James Madison in Federalist 10 as "faction."[358] Faction recognizes that interest groups can have selfish interests and might come to dominate a political body in a harmful way by overriding the common interests of the community.[359] But, equally important, we do not want a civil society controlled by economic power.[360] Capture by the state or economic power renders civil society's protection of freedom of speech and association defective.

All that said, civil society can also be quite supportive of the state by developing and bringing to the state important information necessary for governing.[361] It can also aid the state, in a traditional charity role, by fulfilling some community needs typically handled by the government. Ironically, its most supportive function is likely maintaining independence from the state and economic power in order to be a critical bulwark against attacks on freedom of speech and association.

Thus, the state interested in a democratic system has an interest in being supportive of civil society. So, in the United States, we provide benefits to charitable civil society with this in mind. Meanwhile, the significant benefits the

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[355] Hackney, *Political Justice*, *supra* note 9, at 309.
[356] *Id*.
[357] Oonagh B. Breen et al., *Regulatory Waves: An Introduction*, *in* REGULATORY WAVES: COMPARATIVE PERSPECTIVES ON STATE REGULATION AND SELF-REGULATION POLICIES IN THE NONPROFIT SECTOR 6 (Oonagh B. Breen et al. eds., 2017).
[358] THE FEDERALIST NO. 10, at 47 (James Madison) (Ian Shapiro ed., 2009).
[359] *Id*. at 48.
[360] Habermas, *supra* note 11 (noting that civil society exists outside of the state and the economic power).
[361] Hackney, *Political Justice*, *supra* note 9, at 287–88.

state provides to charitable organizations through our taxing systems incentivize many to further their selfish interests through this charitable system. Abusers of charity try to disguise their selfish interests in the cloak of charity. The government must, therefore, tread into a sacred democratic space that becomes a more adversarial relationship as a result. The regulation of charitable civil society necessarily elevates some groups and pushes down others as the government entity charged with this task picks winners and losers. The state must play a border guard role, defending the boundary between non-taxable and taxable.

How transparent should the governmental regulatory system be that makes determination and enforcement decisions regarding charity? Given the potentially tense nature of the relationship, there should be transparency as to the process for determining the rules and making enforcement decisions. Because it cuts across all of society, there should be an inclusive process for developing rules. That transparency should, of course, not just be at the legislative level but also at the executive level and should extend to rulemaking activity of the administrative agency.[362] Though initial conceptions of the administrative state imagined that federal agencies overseen by the President did not make final decisions on behalf of the people, the reality is that agencies do more than carry out the direct will of the legislature.[363] Managing a significant economy and regulatory state like that of the United States requires expertise that legislators do not have and most people do not possess. Thus, we give great discretion to a bureaucracy to operate parts of the government on our behalf.[364] But that bureaucracy should ideally make those rules transparently.

Finally, in managing any such system, there is a necessary relationship between the state and charity to tax. Because there is such a strong conception within the United States that a charity ought not pay tax, we have built a system that places those charitable organizations into a space protected from the IRS. But there is nothing about charity that makes it clear that it deserves benefits. But where tax benefits are created, the regulation of charity involves ensuring that it does not create a space for tax shelters.

3. Big Picture Approach to Charity Regulation

In regulating the charitable sector, the regulating agency should be perceived as impartial, and it must also help to ensure that the activities it recognizes as legitimately charitable are consistent with what the people of the state demand. Thus, big picture goals are**: (a) charity regulation ought to be carried out in an impartial manner; (b) the public should perceive the regulation in an impartial manner, and (c) the charitable organizations the government picks as legitimate should be publicly seen to be organizations that further the general interests of the people of the United States at some general level at**

[362] This is of course consistent with a just democratic order to begin with. CHRISTIANO, *supra* note 319, at 46–74 (discussing the importance of publicity of equality by the state).

[363] THOMAS CHRISTIANO, THE RULE OF THE MANY 239 (1996); JAMES E. ANDERSON, PUBLIC POLICYMAKING 216 (7th ed. 2011) ("Administration on the other hand, was concerned with implementing the will of the state, with carrying the effect the decisions of the political branches.").

[364] *See* KENNETH CULP DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY (1969); *see also* ROBERT A. DAHL, DEMOCRACY AND ITS CRITICS 335 (1989) (discussing the concern of the complexity of the administrative state cutting policy elites from a tie to the people of a democracy).

least. Goal (c) is probably the most challenging as part of being impartial is that the charity regulator must not impinge, and must not be seen to impinge, on freedom of speech or association. But in making determinations about which organizations are legitimate it can appear to be making decisions regarding speech and association.

These are big-picture goals. What about narrower goals specific to charity oversight? Some have argued that the goal of charity regulation is primarily to enforce fiduciary duties of the leadership of these organizations.[365] The Karst goal noted in the Introduction suggests this model. Such a goal assumes that we know what a charitable purpose is and that most charities are organized to further such a purpose. In other words, the primary concern of charity governance is making sure the agents of charity carry out the mission of the charity. This idea is consistent with the history and reality of a lack of internal accountability mechanisms endemic to charitable organizations. As noted above, there are no shareholders like in a for-profit corporation to ensure that a corporation is acting for the benefit of the corporation's beneficiaries. Thus, though perhaps a narrower goal, **(d) charity regulation should ensure enforcement of fiduciary duties**. This has been the primary role of state oversight, and Congress has gradually extended this goal to IRS oversight as well, and for good reason discussed in Part III.

In addition to fiduciary oversight, there is another narrow goal of charity regulation that we must consider in association with tax law: **(e) charity regulation should ensure the collection of revenue**.[366] Our income tax system is designed to tax most economic activity that occurs in the United States so that every person bears their share of tax. Perhaps based on the idea of ability to pay, levying a tax on income allows the government to set rates that apply to a person's accession of wealth. But the United States built an income tax that recognizes that certain activities in certain organized forms do not owe the corporate income tax, estate tax, gift tax, or trust income tax. And the rationale for that exemption matters to the goal of charity tax regulation. Thus, the state can correctly pursue goal (e) by ensuring benefits only accrue to those whom Congress intended and by enforcing the law consistently with the reasons Congress decided to provide those benefits. This focuses the IRS on determining a legitimate charitable purpose that Congress intended to remove from the income tax system and to which to allow deductible charitable contributions. State and local governments must do the same with their property tax exemptions and any other exemptions they provide for charitable activity.

Breen, Dunn, and Sidel highlight a few other potential goals of charity regulation. **(f) Regulation in the charity sector should prevent unfair competition.**[367] For instance, Congress enacted the unrelated business income tax in part to protect for-profit businesses from what it perceived as unfair competition from charities, which had no obligation to pay taxes like its for-profit competitor.[368]

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[365] Mayer & Wilson, *supra* note 266, at 505.

[366] *See* Philip T. Hackney, *Charitable Organization Oversight: Rules v. Standards*, 13 PITT. TAX REV. 83, 90 (2015).

[367] Breen et. al., *supra* note 357, at 4.

[368] Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947–53, 957–59. *See* Susan

Additionally, **(g) charitable regulators should protect vulnerable beneficiaries**.[369] This one is subsumed in part by the ideas expressed above about fiduciary duties and charitable purposes. Still expressly acknowledging this goal is worthwhile. Finally, a charitable regulation regime could adopt a goal of *incentivizing giving to charitable causes*.[370] The various benefits of the Code, such as the charitable contribution deduction and tax exemption, both further this goal.[371]

In discussing the removal of charity regulation from the IRS, those who argue for removal but who want good state regulation tend to have a narrower conception of charity goals. These critics tend to focus upon overseeing fiduciary duties. But focusing upon fiduciary duties alone fails to provide attention to charitable purpose and abuse of the tax law. This failure matters because high-powered tax-law incentives make the stakes of charitability much more legally and economically salient. This review highlights that the tax charity law regime looks much different from the state law regime because the stakes are much different. It seems far from clear that the two regimes are aimed at the same goals. Similarly, a new entity to regulate charity will likely not prioritize the type of values that are prioritized within the IRS.

C. Challenges to Some of the Regulatory Solutions

This Part IV(C) first considers the challenges of charity regulation in a general sense and then turns to the specific regulatory solutions. I focus on six general challenges: (1) the lack of a precise definition of charity; (2) the naturally contentious relationship between civil society, where charity lays, and the state; (3) the lack of evidence on both the extent of charity mismanagement and abuse and on how to solve it; (4) the consistent failure to provide resources allocated to regulate the sector; (5) the heterogeneity of the sector; and (6) the limited sophistication of the vast majority of charity leaders. This Part IV(C) then evaluates the specific challenges associated with state regulation, IRS regulation, and regulation by some quasi-federal agency.

The lack of a clear definition of what is charitable, including the fact that it changes over time, makes charity regulation a costly endeavor. As a Filer Commission study stated: "[o]ne reason that there have been few attempts to provide a comprehensive definition [of charity] is that charitable activity constantly changes, and formulating a definition is extremely difficult when the object to be defined is in flux."[372] Naturally, as recognized by the Supreme Court in *Bob Jones*, the definition of charity changes over time.[373] Thus, standards rather than rules reign in charitable tax law. The IRS regularly uses an all the facts and circumstances

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Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS 394–405 (Susan Rose-Ackerman ed. 1986) (discussing whether there is unfair competition between nonprofits and for-profit corporations).

[369] Breen et. al., *supra* note 357, at 4.

[370] *Id*.

[371] I.R.C. §§ 2055, and 2522. *See also* I.R.C. § 642(c) (allowing a charitable contribution deduction from the trust income tax).

[372] Persons et al., *supra* note 70, at 1934.

[373] Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

test to evaluate whether an organization qualifies as charitable.[374] As with any standard, substantial costs are placed on both the regulator and the regulated as they try to enforce and comply with the law.[375]

The vague definition of charity makes it hard to tell when a charity is being run well. How do you know when an organization is validly furthering a purpose? Thus, it can be unclear to the charity regulator as to whether there is a systemic problem with a charity operation. This makes it quite hard to derive best practices for regulating the sector.[376] Unlike a for-profit company where there are objective measures of whether an organization is succeeding by its profits, a nonprofit does not have such clear indicators.[377] Even with reporting of the financial health of a charity to those who can ensure agents are running the charity for its beneficiaries, it can be quite difficult to determine whether a charity is furthering its purpose.[378] The publicization of the Form 990 was a major effort toward increasing accountability of nonprofit organizations.[379] But the Form 990 information fails to provide an easy means of determining whether the charity is furthering a charitable purpose.

Charity regulation takes place within a conflicted society, and that regulation is often at the center of that conflict. The concept of charity has been part of a political battle within society to determine the virtuous collective activities that society and the state deem worthy of charitable benefits. That battle puts the regulator in the crosshairs of those aggravated when the charity regulator either honors or does not honor a particular purpose.[380] As a significant part of civil society, the charitable sector and its regulator must be open to possibility, to dialogue, to ideas, to people, to purposes, to goals; any effort to confine charity is contentious. Where the government must confront potentially critical voices, as the IRS must, people will publicly worry about the intentions of the government.[381] The charity regulator walks on a tightrope as they regulate the sector—it must be defined enough so that the sector can be regulated, but the sector itself will push back against efforts to define it or to confine it. After laying out the ingredients of

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[374] *See, e.g.*, Rev. Rul. 2007-41, 2007-1 C.B. 1421 ("Whether an organization is participating or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office depends upon *all of the facts and circumstances* of each case." (emphasis added)).

[375] Hackney, *supra* note 366, at 108.

[376] There have been attempts to recommend best practices for charities themselves. *See, e.g.*, INDEPENDENT SECTOR, *supra* note 243.

[377] Robert N. Anthony, *The Nonprofit Accounting Mess*, 9 ACCT. HORIZONS 44, 44 (1995); *see also*, Breen et. al., *supra* note 357, at 6 (discussing the difference between government/commercial collaborative governance relationships where the goals and indicators are much clearer than in the nonprofit sphere).

[378] Baber et al., *supra* note 68, at 680.

[379] Elizabeth K. Keating & Peter Frumkin, *Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation*, 63 PUB. ADMIN. REV. 3, 3 (2003).

[380] *See, e.g.*, Joseph Crespino, *Civil Rights and the Religious Right*, *in* RIGHTWARD BOUND 90 (Bruce J. Schulman & Julian E. Zelizer eds., 2008) (examining the "controversy over the IRS and religious schools" and noting it "deserves a central role in any account of America's turn toward the Right in the 1970s").

[381] Breen et al., *supra* note 357, at 3–4 (noting the tension that can be created between civil society organizations and the state).

a legal accountability regime, Kearns notes, "[t]hese ingredients of a fully functioning system of legal accountability appear fairly straightforward, but upon close inspection it is clear that having all of them in place at any given time is a rather tall order."[382]

Though there have been some empirical studies of nonprofit regulation, there is sparse evidence of whether charity regulation is failing or not. As Mayer notes, "it is not clear to what extent this reduced IRS oversight has led to increased violations of the applicable federal tax laws by exempt organizations."[383] The sense that there is something wrong is based on little empirical evidence.[384]

The IRS appears to be trying to remedy this situation with data, but so far has not been too successful. A recent GAO study indicates that the IRS is using data to flag nonprofits for examination and may be having some success.[385] The GAO found that, of the returns selected through this process, 87% ended up in changed returns.[386] The GAO notes that the IRS only began using significant data in 2012. Importantly, it may be that we are at the beginning of thinking about charity and accountability. International academic literature has also only more recently been concerned about the lack of accountability in nonprofit organizations.[387] In any case, there is a lack of empirical evidence of whether nonprofits are behaving badly or whether regulators are regulating well or poorly. If you do not know where you are going, it is awfully hard to get there.

Arguably, the lack of funds our governments (federal, state, and local), as well as the charitable sector itself, are willing to dedicate to regulating charity is the most significant problem anyone arguing for greater regulation faces. There is likely not a single article looking at the question of charitable oversight for over fifty years that does not mention the significant lack of funds to regulate the sector.[388] Thus, since the beginning of a vibrant charitable sector, it is doubtful there has ever been a moment when any charity expert thought that the ideal amount of resources was being devoted to charity oversight. With that record it is highly optimistic to think that there is a solution to the resource problem. This is not to argue that we cannot dedicate more resources to regulating charity, but that it is

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[382] Kevin P. Kearns, *Accountability in the Nonprofit Sector*, *in* THE STATE OF NONPROFIT AMERICA *supra* note 12, at 589.

[383] Mayer, *supra* note 1, at 94.

[384] *Id*.; *see also* FISHMAN ET AL., *supra* note 30, at 9–10 (using anecdote to show some of the abuses, but also noting that the abuses might not be as widespread as these events might suggest); Sidel, *supra* note 234, at 804–07.

[385] U.S. GOV. ACCOUNTABILITY OFF., GAO-20-454, TAX EXEMPT ORGANIZATIONS: IRS INCREASINGLY USES DATA IN EXAMINATION SELECTION, BUT COULD FURTHER IMPROVE SELECTION PROCESSES (2020).

[386] *Id*. at 13.

[387] Andrew P. Williams & Jennifer A. Taylor, *Resolving Accountability Ambiguity in Nonprofit Organizations*, 24 VOLUNTAS: INTER. J. VOL. & NONPROFIT ORG. 559, 564 (2013).

[388] *See supra* Part II.B, II.C. *See also* Mayer & Wilson, *supra* note 266, at 480 ("For more than fifty years scholars have expressed concerns that while there is a general consensus regarding the legal duties of nonprofit, and particularly charity, officers, directors, and trustees, enforcement of those duties has been spotty and haphazard at best."). Mayer and Wilson also note the uniform assumption critics adopted at the time of their writing was that the solution to charities behaving badly is to properly fund the government agencies regulating them, rather than asking whether the agency was the right agency to regulate. *Id*. at 490 n.58.

highly unlikely that we will provide the resources close to an ideal level. A useful exercise in this domain would be to put together a budget providing an ideal expenditure by the IRS or some other regulator to have the best regulatory effect.

The charitable sector is heterogeneous. A reason that we have not seen a common cause arise within the charitable sector to create a national regulator, either public or private, is likely this heterogeneity. It is substantial. Within the public securities market, like that which makes up the groups that care about FINRA or PCAOB, all the players have a common interest in generating profits in a market that has an equal playing field. There is no such similar connectivity that arises in the charitable sector because of heterogeneity of purpose. The commonality of a nondistribution constraint simply is not a connective force in the way profits and access to a public securities market are such a force. The charitable contribution deduction could be a unifying force, but the reality is that charitable contributions make up only a small part of the revenue of charitable organizations. It just could not unify the collection of organizations that are considered charitable.

Digging deeper into the heterogeneity problem we find that diverse charitable industries each have significant and important regulators that often matter much more than the charitable status of the members. Hospitals, for instance, have many regulators, including the Centers for Medicare & Medicaid Services (CMS), the Drug Enforcement Administration (DEA), and the Environmental Protection Agency (EPA), to name a few.[389] Realistically, CMS at least likely takes precedence over the governance of nonprofit hospitals as compared to the nonprofit regulators. The same goes for universities and colleges. They have many other regulators, and the Department of Education likely takes precedence over the way colleges and universities think of nonprofit governance.

The list of the sub-groups within the charitable space is broad and wide. For instance, religion as an interest group is highly unlikely to be willing to come to the table on this type of matter. The group that might have some interest in coming to the table to such discussions are private foundations where wealthy interests are uniquely interested in ensuring that they have as big a scope to make decisions on their own as possible—sponsoring organizations of donor-advised funds are likely to have such an interest as well.

In the end, the heterogeneity problem results in great difficulty in finding unanimity across the sector for a new regulator, developing rules that apply to all, and in generating the resources necessary to form some new agency through a political process to create the agency.

Finally, though there are some sophisticated officers and directors who lead charities at the hospital and university level, most directors and officers are likely made up of parties who have little knowledge of the laws regulating nonprofits and charities. In this environment, where the laws are complex, it is likely that the laws have little influence on many within the sector because they are not even aware the laws exist. For instance, evidence shows that many in the nonprofit world do not understand what financial information is available or even how to read various financial reports that are available.[390]

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[389] Erica Mitchell, *Who Regulates Hospitals?*, EOSCU: HEALTH. CARE. AN EDUCATIONAL BLOG (Oct. 15, 2021), https://blog.eoscu.com/blog/who-regulates-hospitals [perma.cc/G4E6-2F2X].
[390] Keating & Frumkin, *supra* note 379, at 4.

Are there any challenges of state level charity regulation that are different from the above? All the general challenges listed above apply equally to states. In fact, the resource constraints at the state level appear to be more significant than at the federal level.[391] Additionally, the influence of the political structure is surely worse. Housed within attorneys general's offices, the position is highly political.[392] Though there have been suggestions of states adopting charity commissions, given past behavior it seems likely that the political problem at the state level will remain significant. Because of the great importance of a transparent unbiased enforcement approach identified above in Part IV(B), this political nature of state enforcement undermines hope of improvement at the state level if it continues to use the traditional approach. This suggests, too, that having a well-trained civil service manage the enforcement of charity likely matters a lot. It helps professionalize and depoliticize the activity. Another challenge of utilizing state enforcement is that the states simply lack the ability to handle the national and international scope of today's charitable sector. The final challenge is that state-level enforcement focuses upon governance and solicitation but lacks a focus upon tax matters. This again makes the states unsuitable for being a real charity regulation force.

What about the challenges of the IRS as a charity regulator? The IRS faces the same general challenges mentioned above, but there are additional points to be made. A significant challenge to the IRS functioning as a good regulator is that it operates on a tax time frame, not a regulatory time frame. Thus, the IRS is unable to take enforcement action soon after an organization engages in problematic acts. Owens ably points this problem out.[393] A somewhat related problem is that many within the tax world do not think the IRS is the appropriate place to regulate charity. Instead, the IRS should focus upon the collection of revenue alone.[394] Thus, as an institutional matter, it becomes hard for the IRS leadership to devote the right level of resources and attention to its regulation. Because charity generally does not generate revenue, the IRS as an institution is simply unlikely to put significant resources towards charitable regulation. The agency is also seriously disliked by constituencies who have an interest in hampering the agency.[395] This also makes it hard for the IRS to operate as a regulator of charity.

There is another significant problem that comes with any charity tax solution. Those who study regulatory agencies note the way the choice of who will do the regulating (i.e., what specialty they come from: scientist, attorney, banker, economist) can deter those interested in the regulatory area but who are not specialists from discussing the policy with the regulator. As Marc Allen Eisner says, "The 'barrier to entry into policy discourse' created by specialists both within the agency and in the larger policy community limits the access and influence of groups incapable of mustering the necessary resources."[396] Tax law as a subject

[391] *See supra* Part II.B.
[392] *See supra* Part II.B.
[393] Owens, *supra* note 1.
[394] *See supra* Part I.
[395] *See, e.g.*, Jim Jones, *One of the Most-Hated Federal Agencies Deserves Some Love From Congress*, THE HILL (April 19, 2022) https://thehill.com/opinion/finance/3273321-one-of-the-most-hated-federal-agencies-deserves-some-love-from-congress/#:~:text=The%20agency%20was%20on%20the,included%2049%20percent%20of%20Republicans [perma.cc/YV8M-NL4K].
[396] MARC ALLEN EISNER, REGULATORY POLITICS IN TRANSITION 23 (1993).

matter may very well lock out more people from access to the specialty than a charity bureau might.[397]

That said, the IRS arguably has largely managed to be perceived as an unbiased regulator. Though the Tea Party crisis was a major blow to the IRS in that regard, no investigations found the IRS acted in a biased manner.[398] The IRS also is the only place where collection of revenue and a strong understanding of the high-powered charitable incentives exists.

One significant challenge at the IRS level exists because of the split regulation at the state and federal levels. IRS charity oversight law is partially divorced from traditional charitable trust law and corporate law that is focused upon enforcing fiduciary duties of care and loyalty.[399] Congress has adopted fiduciary-like rules such as the prohibition on inurement and excess benefit transactions.[400] However, in none of those instances is there found a connection to the traditional duties of care and loyalty. This lack of connection of charity tax law to governance rules means charity tax law fails to provide guidance to charity leaders on how to comply with governance obligations. A similar problem exists at the state regulatory level. State charity law rarely considers the idea of a charitable purpose in a public sense.[401] This disconnects state enforcers from the charitable tax incentives involved.

In the mid-to-late-2000s, the IRS under then TEGE Commissioner Steve Miller began an effort to encourage good governance of nonprofit organizations.[402] He received much pushback from practitioners saying that it is not the IRS's role to enforce governance matters.[403] A good case can be made that the IRS has the authority to regulate nonprofit governance based on section 501(c)(3), the additional governance oriented Code based sections, and the importance Congress put into making the Form 990 publicly available for broad public accountability. However, for the sake of clarity, Congress could consider extending governance requirements into the Code so that a basic level of governance is expected of nonprofits. Having clear governance benchmarks that the IRS could enforce might

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[397] Owens, *supra* note 1, at 8 (making the point that IRS as charity regulator likely locks out many interests who might comment upon charitable regulatory rules).

[398] *See supra* Part IV.A.

[399] There is a co-relative problem with state charity law, which is that the state generally cares little about whether a charitable organization that forms a charitable nonprofit is indeed furthering a charitable purpose.

[400] I.R.C. §§ 501(c)(3) & 4958.

[401] GEORGE G. BOGERT ET AL., *supra* note 88, at § 369. (discussing that the restatement of trusts does not provide a definition of charitable but instead leaves it to courts to determine whether a particular purpose qualifies or not). Though probate courts ask this question, it is mostly a private matter of concern to heirs rather than the public. ZUNZ, *supra* note 67, at 76–77 ("Some judges relied on these [British] precedents to invalidate a will… intended to support a politically controversial activity, or propaganda, as it was called time and again. Other judges interpreted these precedents loosely or ignored them, and in doing so they not infrequently broadened the scope of philanthropy.").

[402] *See, e.g.*, Steven T. Miller, Comm'r, I.R.S. Tax Exempt & Gov. Entities, Remarks at the Georgetown Seminar on Exempt Org. Panel on Nonprofit Governance (Apr. 23, 2008).

[403] *See, e.g.*, ADVISORY COMM. ON TAX EXEMPT AND GOV'T ENTITIES, THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES (June 11, 2008), https://www.irs.gov/pub/irs-tege/executive_summary_actgovernancerept.pdf.

help to make the charity tax law more coherent. Nevertheless, this divorce of fiduciary duty rules from IRS enforcement creates some discontinuity in the legal regime enforced by the IRS.

What are the challenges of a quasi-federal agency such as Helge and Owens propose? Obviously, in addition to the above challenges, the cost of setting up a new agency is enormous, and the resource constraints would likely continue. Indeed, as jurisdiction is split across agencies, the resource constraints may become more acute as Congress or the industry divides scarce resources across two agencies. The solutions involved have the charitable sector providing the dollars for their own regulation.[404] However, we will likely still, as a society, be drawing from the same scarce resources. Additionally, the heterogeneity challenge will make it difficult to build the support and resources needed for this quasi-governmental agency. Though Owens noted that there are reasons that the sector might have a common cause to be interested in shaping the regulatory world that they face,[405] one would think that common cause already would have come together either at the state level or at the federal tax level. But it has not.

Most fundamentally, though, I fear that the separation of tax from charity will lead to large blind spots for the IRS as it tries to collect the revenue. No one proposing the removal of regulation from the IRS also suggests eliminating the tax benefits that come with charitable status. Those benefits are varied and significant, not just to charitable entities but, more importantly, to those connected to charitable entities. Congress and the IRS have long fought misuse of the charitable contribution deduction. Though it might appear that the two issues are separable, very often, the question of whether a deduction is legitimate depends upon the relationship with the organization. If the IRS is not focusing both on the substantial contributor's organizations and the activities of the organization itself, there will likely be a dark space to drop tax-deducted funds that the IRS will no longer be able to see. The same goes for the exemption from gift and estate taxes. Charity will become more of a space for tax shelter, and possibly political shelter too, than before simply because the IRS will not be able to see as clearly the activity associated therewith. The new agency is unlikely to have the expertise or the focus upon ensuring that the high-powered incentives of charitable organizations are not abused. Some of this will remain with the IRS, but these are likely to be quite confusing destabilizing arrangements.

From a civil society perspective, this separation between the tax law and the domination of a charity would also likely lead to economic power having a more commanding relationship to charity. This could significantly harm charity as a civil society bulwark protecting freedom of speech and association. Because the IRS has the incentive to observe whether wealthy individuals are abusing the tax law in their relationship with a charitable organization, the IRS is more likely than a charity regulator outside a tax system to police the relationship between economic power and the charitable sector. Thus, the IRS is much more likely to be the bulwark that charity needs to separate itself from economic power.

Some might contend that the IRS already is a weak charitable law enforcer

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[404] *See supra* Part III.B.
[405] Owens, *supra* note 1.

and that we would not lose that much even if there were a blind spot as I suggest. However, and most importantly, just because we are in a period of poor enforcement of the tax law now does not mean we should accept that poor enforcement structure as permanent. It would be foolhardy to eliminate the ability of the IRS to be a good enforcer of charity and the tax incentives associated therewith just because Congress has been deprived of money recently. Once that charitable jurisdiction is given up, it will be hard to get back. My expectation is that if the jurisdiction were given up for most purposes the IRS would largely eliminate institutionally its human and equipment resources focused on tax-exempt organizations, meaning we would lose substantial knowledge and ability that will be extremely hard to build again.

Splitting jurisdiction among the IRS and a federal charities bureau of some sort would come with challenges as well. The IRS has norms, and the charity bureau would have norms. These would likely conflict.[406] Silber raises an important question of divided jurisdiction leading to two regulators who fail to oversee the issues because each thinks the other is going to carry out regulation.[407] Silber was concerned that having AGs and the IRS responsible for the same matters leads to both ignoring matters because they think the other will handle a particular abuse.[408] A third regulator likely makes this split jurisdiction problem even worse.

A final note is that this new agency would likely need to receive authority to regulate the governance of nonprofit organizations. Given that nonprofit governance has long been dedicated to the states and the strong pushback from the sector to the idea of the IRS recommending governance as a factor in its oversight, it seems questionable that we could find a political agreement to extend this authority to a new agency. This seems a significant challenge in creating a new agency. It would of course be able to have jurisdiction over that which the IRS has jurisdiction.

There is much to recommend working to improve the current state of charity regulation. There are some factors that favor a new agency as described by scholars like Owens and Helge. For instance, it could be a significant improvement to have an agency that is able to act in real-time rather than within a tax schedule. Additionally, a new agency would likely be more inclusive in its guidance process than is complex tax law. Furthermore, it would be ideal not to impose upon the IRS the duty to regulate such a lightning rod of a sector. But the harms to revenue collection, the opportunities for tax and political shelters, and the ability of the economic powers to gain control of charity remain too great to support the creation of such a new agency.

D. Solution

Though there are many reasons to be disappointed in the IRS's performance regarding the regulation of charity, and the case for a charity bureau has merit, it would be a mistake to remove charity jurisdiction from the IRS. The most significant problem would be that the IRS would lose critical information to enforce

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[406] EISNER, *supra* note 396, at 16 (noting this type of typical conflict when there are agencies of different specialties both with jurisdiction over a matter).
[407] *See* Silber, *supra* note 14, at 638.
[408] *Id*.

the tax law broadly. The split would likely open a significant space into which those looking to avoid tax could take advantage of to engage in economic activities unseen by the IRS. At the same time, the new agency would have no connection or deep understanding of the complex benefits to which charities and those who work with, or contribute to, those charities are entitled to because of the tax-exempt charitable status. It would be a problematic mismatch of systems. Additionally, developing a new agency would likely split scarce resources between that agency and the IRS, further harming the resource constraint of charity regulation. In this Part IV(D), I first acknowledge the specific challenges the IRS has faced. Then I try to sketch an IRS as charity regulator path that can work better than the charity regulation situation we find ourselves in at present.

The charitable community years ago turned to the IRS to be the national regulator. Because section 501(c)(3) requires an organization to further a charitable purpose and there are significant tax incentives provided, the IRS seemed a natural place from which to regulate the sector. Revenue collection needs to be protected, but also, the IRS is most likely to understand the consequences of the tax benefits provided to charity. Furthermore, given the tax benefits involved, the IRS as regulator is highly salient to the charitable sector because it has natural leverage over charities to get them to behave within a certain range of norms. Additionally, the IRS has a large workforce in place to enforce the laws. An ideal solution would be for Congress to assess what resources the IRS needs as an effective charity regulator and dedicate real resources to the agency. Though this has been tried before, perhaps Congress could require a small charge to charities to enhance the resources of the IRS for regulating charity.[409]

That said, the evidence is strong that though the IRS has overseen the sector for a long time, it has not been a reliable regulator of the sector.[410] Because of this length of time that the IRS has not been a robust regulator of the sector, it is hard to make a strong claim that the IRS will ever be the regulator that many wish it would be of the charitable sector. Though Congress and the IRS might someday allocate more resources to the area, the history is a strong indicator that the regulation of the sector at the IRS will always be under-resourced.

As becomes clear from this review of the challenge of charity regulation, whichever institutional path we take, we must collectively lower our expectations of charity regulation. The messiness of the relationship between the state, civil society, and the U.S. federalism governance structure, makes this a nearly impossible regulatory tussle for the government. The concept of what is legitimate charitable activity will always be in a contentious flux that puts a burden on the government as it legally interacts with the sector. Most importantly, though, given the past, there is no reason to believe that we will in the future come up with the resources to support charity regulation that policy experts believe would be ideal.

Arguably, charity tax law works to ensure the IRS has the best vision of as many participants in our economy as possible to stop tax evasion. Maintaining this

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[409] Admittedly this was tried for private foundations with initially a 4% charge on net investment income, the revenue of which was to be dedicated to the examination of private foundations. Tax Reform Act of 1969, Pub. L. No. 91-172, § 101, 83 Stat. 487, 492 & 498 (codifying I.R.C. § 4940). That money never found its way to enforcement at the IRS.

[410] *See infra* Part II.C.2.

function within the IRS, therefore, is important. When we think of this as part of the rationale, it lessens concern regarding having over and under-inclusive rules. The key is to bring as many economic participants into the revenue-collecting fold as possible, not to ensure ideal charitable regulation.

The IRS will not be the ideal enforcer of charity norms. Both Congress and the IRS need to adjust accordingly. Instead of asking the IRS to enforce amorphous standards looking for the good in the world, we need to adopt as simple rules as possible. Congress should work hard to narrow the group of organizations that are considered charitable under the Code. For instance, scholars have long questioned whether hospitals, the largest sector of charitable organizations, should be seen as charitable.[411] Congress could reconsider the exemption for private foundations too.[412] This will mean there will be instances where good organizations are kept out that maybe, in some ideal world, would be recognized as charitable and some bad organizations will achieve that status. The regime will be both over and under-inclusive. It is time to recognize that in the effort to get everything precisely right in a justice sense, we are getting a lot of things very wrong.

The law and regulatory needs for the charitable sector are still going to be highly complex even if Congress makes such changes. However, I have argued before that the IRS should use its delegation for rulemaking in the charitable sector to actively engage in promulgating simple rules so that the overwhelmed agency, as well as unsophisticated tax-exempt organizations, know the law and can comply with them.[413] While standards rather than rules might be more ideal in regulating the sector, the great number of unsophisticated parties trying to comply with the law and the significant lack of resources for enforcement strongly favor rules over standards.[414] The IRS needs to find ways to expeditiously handle its workload. It needs a series of primarily simple, transparent rules that allow it to dispose of cases on a fair and consistent basis. Without this, it seems likely that the IRS will run into further "scandals" over its enforcement choices where there is significant ambiguity regarding the rules. This recommendation may not be supported strongly by those who believe the IRS should be the national regulator of charitable organizations. Nevertheless, consistency of enforcement and likely greater compliance would be significant attributes of such a shift.

Additionally, adopting a more rule-based regime should importantly help to protect the IRS against charges of acting politically because the rules and decisions would be more transparent than is currently the case. The IRS should make no mistake that this is some panacea against such charges, but only protection. Many conservatives today object to the rules limiting campaign and lobbying activities of

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411 *See, e.g.*, Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 405 (1991) (questioning the correctness of hospitals receiving charitable status under I.R.C. § 501(c)(3) and proposing a new theory of exemption for charity that would exclude many hospitals from exemption status); Hansmann, *supra* note 17, at 70 ("it is not clear that this theory helps to justify the exemption in such important fields as hospital care, where the contract failure theory of nonprofits seems weakest.").

412 *See* Hackney, *supra* note 183 (suggesting on a democratic basis Congress consider eliminating private foundations because inherently private activity that supports wealthy interests alone).

413 Hackney, *supra* note 366.

414 *Id.*

charitable organizations. Assuming they continue to disagree with the rules on that front, they are likely to find trouble with the IRS enforcing such rules. Nevertheless, if the rules are clearer, the IRS has a much stronger fallback position should it be investigated again. It would be harder for the critics to allege bias with clearer rules.

Finally, the IRS needs to continue to use data and electronic means to hone its enforcement choices. The data will need to be better, though. This means it will need to define the information it collects on the Form 990 much more directly so that when people report on the Form 990 we are much more likely to be comparing apples to apples. Professor Mayer has detailed what we can see from the public record about the forays of the IRS into using Big Data.[415] One thing that comes through in Mayer's terrific article is that Big Data is no panacea for an under-resourced agency.[416] Key problems, though, are getting it wrong based on bad data or misuse or misanalysis of the data. The most significant problems, though, are the increased harm to privacy and potential big government overreach.

Still, improving Form 990 information collection, as well as searches of its information, should redound to better regulation of the sector. Good financial information is likely even more important in nonprofit management as compared to the for-profit context.[417] Literature in this area, though, is not that old.[418] Nevertheless, accounting literature suggests that "accounting measures to ensure stewardship of contributed resources" can mitigate the natural danger of agents without principals.[419]

V. CONCLUSION

Charitable regulation in the United States is failing. The states do not put resources towards its regulation, and when they do, it can appear to be politically motivated. Congress has refused to fund the IRS charitable regulatory function at close to a level where it could be a force in the oversight of charity. Additionally, the IRS, as a tax authority, does not fulfill our natural conception of a governance regulator. Its focus is the collection of revenue and so its regulatory schedule falls on a tax timeline, not a governance enforcement timeline. Furthermore, Republicans have conducted a coordinated attack on the IRS with a focus on its charity regulation division, trying to undermine the agency's ability to collect the revenue. In this environment, critics are recommending Congress move national charity regulation from the IRS to some other national agency. Though they make a good case for a quasi-federal regulator, there are several significant reasons Congress should not follow their lead. Instead, Congress should maintain charity regulation in the IRS.

First, given the demonstrated inability of our government to devote adequate resources to charity regulation, we should be skeptical that the government or charity will well fund a new national charitable agency. Instead, the government and charity are likely to simply spread limited resources thinly.

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[415] Lloyd Hitoshi Mayer, *The Promises and Perils of Using Big Data to Regulate Nonprofits*, 94 WASH. L. REV. 1281 (2019).
[416] *Id*. at 1305–06.
[417] *Id*.
[418] Kearns, *supra* note 382, at 588.
[419] Baber et al., *supra* note 68, at 680.

Second, creating a new agency would split jurisdiction between the states, the IRS, and the new agency. Most troublingly, this would make the IRS blind to the tax shelters of the very wealthy. It is key to the collection of revenue that the IRS has information on the use of charity. In 2020, IRS Statistics show that charities reported an aggregate of over $5.5 trillion in assets.[420] It is no small amount that the IRS would likely begin to ignore and lose the capacity to observe with a new agency involved. Third, finally, and relatedly, the IRS is in the best position to maintain a neutral approach and provide strong oversight of charity as civil society. In a democratic order we ideally maintain a separation between the state and civil society, but also maintain independence of each of these from the economic order. The IRS rather than a new federal agency is more likely to maintain both the neutrality needed for overseeing civil society and provides the best shot at ensuring that the economic power controls neither civil society nor the state.

Congress should evaluate the resources the IRS needs to oversee a greater than $5 trillion sector and dedicate those resources to the IRS. Scholars could help with research modeling what good regulation of the sector from the IRS would look like. However, on the strong assumption that Congress will continue to provide too little resources for the IRS, Congress should scale down what it expects the IRS as charity regulator to accomplish. It should use rules to eliminate large parts of the charitable sector to make the task of oversight scalable to the IRS Congress is willing to fund. Two possibilities I suggested here are eliminating most hospitals and private foundations from charitable exemption. There are good arguments for eliminating both from qualifying as charitable and eliminating them would reduce the number of entities with which the IRS must contend in a charitable regulatory way. The key is finding ways to reduce the load upon the IRS division focused on charity.

[420] I.R.S., *SOI Tax Stats - Charities & Other Tax-Exempt Organizations Statistics*, Statistical Tables, 501(c)(3), 2020 XL Spreadsheet, https://www.irs.gov/statistics/soi-tax-stats-charities-and-other-tax-exempt-organizations-statistics [perma.cc/399Z-LCL4].