

The Catholic University of America, Columbus School of Law

CUA Law Scholarship Repository

Scholarly Articles and Other Contributions

Faculty Scholarship

2011

Charity in the 21st century: Trending toward Decay

Roger Colinvaux

The Catholic University of America, Columbus School of Law

Follow this and additional works at: <https://scholarship.law.edu/scholar>



Part of the [Tax Law Commons](#)

Recommended Citation

Roger Colinvaux, *Charity in the 21st century: Trending toward Decay*, 11 FLA. TAX REV. 1 (2011).

This Article is brought to you for free and open access by the Faculty Scholarship at CUA Law Scholarship Repository. It has been accepted for inclusion in Scholarly Articles and Other Contributions by an authorized administrator of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.

FLORIDA TAX REVIEW

Volume 11

2011

Number 1.

CHARITY IN THE 21ST CENTURY: TRENDING TOWARD DECAY

by

Roger Colinvaux*

PART I. INTRODUCTION	3
PART II. SYNOPSIS OF THE DEVELOPMENT OF THE TAX PREFERENCE FOR CHARITABLE ORGANIZATIONS – OPEN ENDED GROWTH	8
PART III. SCANDALS AS SYMPTOMS OF A NEED FOR REFORM	18
A. <i>Overview</i>	18
B. <i>Some Specifics of Some of the Scandals</i>	20
1. <i>Scandals at Certain Iconic Charitable Institutions</i>	20
2. <i>Contributions of Noncash Property</i>	23
3. <i>Tax Shelters</i>	28
4. <i>Private Foundations</i>	29
5. <i>Grant-Making Public Charities: Supporting Organizations and Donor Advised Funds</i>	31
6. <i>Hospitals</i>	33
7. <i>Credit Counseling Organizations</i>	35
8. <i>Use of Charities by Members of Congress</i>	36
9. <i>“Excess” Compensation</i>	37
C. <i>Summary</i>	38
PART IV. PIECEMEAL REFORM	39
A. <i>The Legislative Response</i>	39
B. <i>Frustration with the Breadth of the Charitable Designation</i>	44
1. <i>Credit Counseling Organizations</i>	45
2. <i>Hospitals</i>	50
C. <i>Breakdown of the Public Charity-Private Foundation Distinction</i> ..	53
1. <i>In General</i>	53

* Associate Professor of Law, The Catholic University of America, Columbus School of Law. Copyright Roger Colinvaux. As Legislation Counsel to the Joint Committee on Taxation on tax-exempt organization issues from March 2001 to June 2008, the author was directly involved in the formulation and drafting of the charity reform and incentive legislation enacted over the period and discussed in this Article. I am grateful to Ellen Aprill, Evelyn Brody, and Karla Simon for comments on an earlier version of this Article, to Ron Schultz for comments on the penultimate draft, and to the Law and Society conference participants for their feedback. Also, a dedication to Gary Bornholdt, a great colleague and good friend, who contributed to the charity reform legislation, and who left us much too soon.

2. <i>Selectively Importing Private Foundation Rules for Public Charities</i>	588
3. <i>Summary</i>	64
D. <i>Toward Brighter Enforcement Lines</i>	64
PART V. CONCLUSION: A DAMAGED CHARITABLE FORM AND FRAMEWORK	69

PART I. INTRODUCTION

The turn of the century seemed to bring with it a sharply critical focus on charity.¹ Under federal tax law, a charity includes organizations that are “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes.” This single phrase provides a standard not just for tax exemption for over 1.2 million organizations (which are diverse in purpose, size, function, complexity, and effectiveness) but also access to several tax and nontax preferences, including eligibility to receive tax deductible contributions (for income, estate, and gift tax purposes),² access to tax-exempt financing,³ State property tax exemptions,⁴ and regulatory relief, among other benefits.⁵ The concerns about charities surfaced largely through press reports and are legion: spending of earmarked contributions for non-earmarked purposes; excess compensation to organization insiders; mission drift—deliberate, or aided by faulty corporate governance; acceptance of property contributions when donors or others are the principal beneficiaries; participation in illicit tax shelter transactions; spending for non-charitable purposes; accumulations of income; failure to provide charitable services; use of the charitable form for non-charitable purposes; questionable investment practices; participation in political campaigns; and self-dealing transactions, to name a few.⁶

The response to ongoing scandals by the Internal Revenue Service (IRS) and the Congress was mixed. As the scandals unfolded, the IRS continually pointed to abuses and the need to address them,⁷ but also asserted

1. For ease of reference, when used in this Article, the terms “charity” and “charitable organization” include reference to the principal organizations described in § 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). This includes religious, charitable, scientific, literary, and educational organizations. Unless otherwise indicated, all section references are to such Code.

2. IRC §§ 170, 2055(a)(2), 2522(a)(2).

3. IRC § 145.

4. See Evelyn Brody, *All Charities are Property Tax-Exempt, But Some are More Exempt Than Others*, 44 *New Eng. L. Rev.* 621 (2010); Janne Gallagher, *The Legal Structure of Property-Tax Exemption*, in *Property-Tax Exemption for Charities 3* (Evelyn Brody ed., 2002).

5. See Staff of Joint Committee on Taxation, 109th Cong., *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations*, at Appendix (Joint Comm. Print 2005) [hereinafter *JCT Historical Development*] (including in Appendix a memorandum by Congressional Research Service that documents a variety of benefits provided to charitable organizations under Federal and State law).

6. The reported scandals are surveyed and discussed in Part III of this Article.

7. See Letter from Mark W. Everson, Commissioner of Internal Revenue, to The Hon. Charles E. Grassley, Chairman, S. Comm. On Fin. 3 (Mar. 30, 2005),

that the charitable sector is “compliant,” notwithstanding a minimal examination rate.⁸ As part of its enforcement efforts, the IRS completed an

available at <http://finance.senate.gov/imo/media/doc/Letter%20from%20Everson.pdf> (“We are concerned that tax-indifferent parties are being used as accommodation parties to enable abusive tax shelters.”; *id.* at 5 (“[Some charities are] established to benefit the donor . . . a donor receives a charitable contribution deduction while maintaining control over the contributed assets, often using them for personal gain.”); *id.* at 7 (“We also have persistent problems in taxpayers’ valuation of deductions taken for non-cash charitable contributions.”); *id.* at 8 (“[T]here is a major risk that organizations that effectively allow key executives too great a voice in determining their own compensation will not end up with objective and reasonable compensation levels.”); *id.* at 13 (“In many areas of our jurisdiction, our remedial tools are not effective. Often our only recourse is revocation of tax-exemption, a ‘remedy’ that may work a disproportionate hardship on innocent charitable beneficiaries Moreover, even where we have an intermediate sanction, it may not work as intended.”); *Charity Oversight and Reform – Keeping Bad Things from Happening to Good Charities: Hearing Before S. Comm. on Fin., 108th Cong. 128 (2004)* (written statement of Mark W. Everson, Commissioner of Internal Revenue) (“[T]here are abuses of charities that principally rely on the tax advantages conferred by the deductibility of contributions to those organizations.”); *id.* at 130 (“[W]e have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives.”); *id.* at 134 (“[S]tronger governance procedures are needed for exempt organizations.”); *id.* at 138 (“IRS has no sanctions [to address participation by exempt organizations in tax shelter transactions] comparable to those that can be imposed on promoters or investors.”).

8. See *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 110th Cong. 12 (2007)* (written statement of Steven T. Miller, Commissioner, Tax Exempt and Gov’t Entities Div., Internal Revenue Serv.) (noting that although compliance “problems do exist . . . on the whole, the charitable sector is very compliant with the Tax Code”). Steven Miller’s comments came one year after passage of the PPA (and after control of Congress shifted from Republican to Democrat); whereas Mark Everson’s comments, *supra* note 7, preceded enactment of the PPA. During his oral testimony, Miller provided some data on exams of tax-exempt organizations (including more than just charitable tax-exempt organizations): “Last year we examined more than 7,000 returns, up 23 percent from 2003 and the most we have examined since the year 2000.” *Id.* at 10. Representative Xavier Becerra questioned Mr. Miller about this statement, confirming that the 7,079 returns examined were of the universe of 1.8 million tax-exempt organizations for an exam rate of less than one-half of one percent. *Id.* at 110-111. Intimated, but not explicitly laid out in Mr. Miller’s testimony was that the examinations conducted were not necessarily audits, but compliance checks of an information return (e.g., the Exempt Organization Compliance Unit “contacts taxpayers by letter to conduct ‘compliance checks’ or to obtain information for studies”), with the result that the audit rate is lower than the “examination” rate stated above. *Id.* at 17. In another exchange with Mr. Becerra, Mr. Miller spoke about the process of reviewing applications for charitable tax-exempt status, noting that for the vast majority of the approximately 55,000 new

ambitious overhaul of the annual information return charitable (and other tax-exempt) organizations file each year (the Form 990);⁹ undertook intensive studies on the two largest segments of the charitable sector: hospitals,¹⁰ and colleges and universities;¹¹ made an inquiry into executive compensation practices;¹² and raised new questions about governance.¹³ The

organizations applying each year, “it is the only time we will ever have a real one-on-one conversation with them.” *Id.* at 110.

9. Effective for the 2008 tax year, organizations with gross receipts of at least \$1 million or total assets of at least \$2.5 million were required to file the redesigned Form 990. (The thresholds decrease to \$500,000 gross receipts and \$1.25 million total assets for the 2009 tax year and \$200,000 gross receipts and \$500,000 total assets for the 2010 tax year.) See Form 990 Redesign for Tax Year 2008 (Filed in 2009): Effective Date of Redesigned Form, IRS.gov, <http://www.irs.gov/charities/article/0,,id=176671,00.html>. (last reviewed or updated Nov. 15, 2010). According to the IRS the new form was needed because

“[f]orm 990 ha[d] not been significantly revised since 1979, and it [wa]s universally regarded as needing major revision. It ha[d] failed to keep pace with changes in the law and with the increasing size, diversity, and complexity of the tax-exempt sector. As a result, the [old] form fail[ed] to meet the Service’s tax compliance interests and the transparency and accountability needs of the states, the general public, and local communities served by the organization.”

See Form 990 Redesign for Tax Year 2008 (Filed in 2009): Purpose of Form 990 Redesign, IRS.gov, <http://www.irs.gov/charities/article/0,,id=176670,00.html> (last reviewed or updated Jan. 21, 2011).

10. See IRS, Exempt Organizations (TE/GE), Hospital Compliance Project; Final Report (2009), <http://www.irs.gov/pub/irs-tege/frepthospproj.pdf> (178-page report assessing the community benefit activities and executive compensation practices at charitable hospitals, based on information from over 500 questionnaires to hospitals sent by the IRS).

11. See IRS, Exempt Organizations, Colleges and Universities Compliance Project: Interim Report (2010), http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf; News Release IR-2008-112 (Oct. 1, 2008) (“[T]he questionnaires are part of “the agency’s focused effort to study key areas in the tax-exempt community. The college and university questionnaire will focus on unrelated business income, endowments and executive compensation practices. The questionnaires are being sent to a cross-section of small, mid-sized and large private and public four-year colleges and institutions.”).

12. See IRS, Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II (2007), http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf (reporting on results of compliance check letters sent to 1,223 organizations in 2004 and examinations of 782 organizations). The report concludes that there was not evidence of “widespread concerns other than reporting” but since “this was not a statistical sample, no definitive statement can yet be made concerning

IRS's continuing actions indicate, at a minimum, suspicion that the charitable sector indeed has large pockets of noncompliance and that oversight, or the perception of it, is necessary. But the IRS can only do so much. Meaningful change of any underlying weaknesses in the tax law of charities ultimately must come from Congress.

Congress clearly was moved by the heavy volume of bad press about charities. The many reported scandals directed attention to the size of the sector and the importance of the charitable designation apart from just tax exemption. This in turn raised the issue of the sufficiency of a broad purpose-based approach to defining charity, and highlighted weaknesses in the law's ability to respond to abuse. The reported scandals also undermined the prevailing manner of categorizing charity as either "public," and thus legally preferred for exemption, deductibility, and compliance purposes, or "private," and thus subject to a series of anti-abuse rules. The many scandals at *public* charities were strong indicators that the public designation of present law was not sufficient to protect against abuse. In some cases, the public charity form was used precisely to escape the rigors of the private foundation regime. In others, public charities engaged in questionable conduct that might have been subject to sanction had the charity been a private foundation. Moreover, the series of abuses by donors with respect to contributions of non-cash property to public charities further, albeit indirectly, raised the question of the distinction between the two types of charity, considering that different deductibility rules apply with respect to each. In short, the all-or-nothing nature of tax exemption, the relative absence of bright enforcement lines, the paucity of intermediate sanctions, combined with unchecked growth of the charitable sector, a very low audit rate, and limited enforcement resources made it increasingly evident that some change was warranted.

The decibel level reached a crescendo mid-decade with multiple hearings, reports, and detailed legislation, most significantly, Title XII of the Pension Protection Act of 2006 (PPA).¹⁴ The PPA, among other things, fashioned new restrictions for many kinds of charitable contributions and

the compliance level in this area. Continued work in the area of executive compensation is warranted." *Id.* at 1.

13. Sarah Hall Ingram, Commissioner of Tax-Exempt and Government Entities, IRS, Remarks at the Georgetown University Law Center Conference: Issues in Nonprofit Governance (June 23, 2009), available at http://www.irs.gov/pub/irs-tege/ingram_gtown_governance_062309.pdf; see Lloyd Hitoshi Mayer & Brendan M. Wilson, Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis, 85 Chi.-Kent L. Rev. 479 (2010); James J. Fishman, Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative, 29 Va. Tax Rev. 545 (2010).

14. Pub. L. No. 109-280, 120 Stat. 780 (2006).

essentially created new hybrid forms of charity.¹⁵ Yet although the PPA is the most significant legislation affecting charitable organizations since 1969, the PPA's significance may lie less with the particulars of its directives than with the legislative precedents it established: precedents for distinct charitable exemption standards based on the type of organization, a weakening of the basis for distinguishing among charities as "public" or "private," and a related preference for brighter enforcement lines and frustration with the status quo. In short, the PPA represents an effort at piecemeal reform of the charitable designation. What has occurred in the past several years—through scandal and legislation—has been a sustained challenge to the longstanding way in which charity is perceived, and ultimately, regulated.¹⁶ The time is ripe for a reexamination of how charity is governed for federal tax purposes. It is likely that until such an examination occurs; charity will not readily return to its comfortable place out of the critical spotlight.

This Article is an effort to spur such a reexamination. Part II of this Article provides a snapshot of the historical development of the federal income tax law relating to charity in the twentieth century and shows that the statutory law has passively accommodated significant growth of the

15. This was accomplished through new rules for donor advised funds and supporting organizations. These and other provisions of the PPA are described *infra* text accompanying notes 99-105 and 130-142.

16. Of course, charity has been under siege before, most notably in the 1940s and the 1960s. On both occasions, however, the result was reform legislation fairly well targeted to the perceived abuses. Introduction of the unrelated business income tax (UBIT) and related reforms in 1950 closed the door on tax-exempt charitable businesses. See generally Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906; IRC §§ 511-514. For an excellent history of the UBIT see Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 *Emory L. J.* 1475 (2005). For discussion of the rationales of the UBIT, see *id.* at 1488-1494; Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *Va. Tax. Rev.* 605 (1989). See also JCT Historical Development, *supra* note 5, at 100-109. In 1969, the separate classification of private foundations from other (better) charities, and promulgation of special anti-abuse rules with respect to foundations, largely put to rest years of concern about endemic abuse in the private foundation world. The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; IRC §§ 509, 4941-4945. In the lead-up to the 1969 legislation, Congressman Wright Patman conducted a number of investigations into private foundations and published three reports. Staff of H. Select Comm. on Small Business, 89th Cong., *Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy* (First Installment 1962, Second Installment 1963, Third Installment 1964). Subsequently, in response to Congressional requests, the Treasury Department issued a report that became the foundation for the seminal changes enacted in 1969. Staff of S. Comm. On Fin., 89th Cong., Treasury Department, *Report on Private Foundations* (Comm. Print 1965).

charitable sector without demanding any rigor of the sector in the form of positive requirements or quantitative measures. This has led to growth without meaningful oversight—a recipe for continuing problems. Part III of this Article provides an overview of many of the scandals that engulfed the sector during the early twenty-first century and shows that the scandals (regardless of their underlying merits) not only seriously eroded the “halo” effect of charitable organizations and enabled passage of reform legislation, but also illustrated the consequences of unchecked growth. Part IV of the Article discusses the central features of current law that are under pressure in part because of this growth without oversight. As highlighted in this Part I, these are the breadth of the charitable standard, a regulatory framework based on the distinction between public charity and private foundation, and a facts and circumstances and all-or-nothing approach to enforcement. This Part of the Article also shows how the reform legislation enacted in 2004-2006 and in 2010, though not comprehensive reform, nevertheless planted seeds indicative of a shifting legislative policy toward charity, one that favors more substantive distinctions among charities for exemption purposes, undermines the current basis for distinguishing among charities, and points toward a need for brighter enforcement lines. Part V of the Article suggests that such piecemeal reform should be understood as a symptom of the law’s inability to make substantive demands upon charitable organizations, and that absent a rethinking of how we regulate and define charity, the trends established by recent legislation are likely to continue. The Article concludes that the time to reconsider the current framework is upon us, and suggests a new approach based on developing different standards for the charitable tax benefits in order to focus our attentions more directly on the tax system’s support for the charitable sector.

PART II. SYNOPSIS OF THE DEVELOPMENT OF THE TAX PREFERENCE FOR CHARITABLE ORGANIZATIONS – OPEN ENDED GROWTH

A review of major developments in federal charity tax law in the 20th century shows that although the rules have largely accommodated growth of the charitable sector, such growth has not been paired with any material demands upon charitable organizations.

From the outset of the federal income tax in 1913, there has been an exemption from tax for:

“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 shareholder.”¹⁷

This initial charitable exemption had the following eight characteristics:

- (1) The exemption was self-enforcing. There was no requirement that the organization apply for the exemption or report regularly to make sure the statute’s terms (such as they were) continued to be met.
- (2) No limits were placed on the activities of a charitable organization.¹⁸
- (3) The exemption was a complete or blanket exemption, that is, it covered all of a charitable organization’s income.
- (4) The exemption applied equally to all organizations meeting its terms. No effort was made to distinguish among charitable organizations.
- (5) The exemption was all or nothing: either the organization met the requirements and was free from income tax or it did not meet the requirements and was subject to income tax.¹⁹ There were no alternative or “intermediate” sanctions. The answer to the exemption question was based on the facts and circumstances, i.e., there was no bright line test.
- (6) The exemption was conditioned on a “good” purpose; no effort was made to define in any substantive way what such a

17. The Tariff Act of 1913, Pub. L. No. 71-361, 46 Stat. 590. Additional purposes were later added to the list: the prevention of cruelty to children or animals (1918), literary purposes (1921), testing for public safety (1954) (note that unlike other organizations described in section 501(c)(3), contributions to public safety organizations are not deductible), and to foster national or international sports competition (1976). The 1913 Act was not the first statutory effort to exempt charitable organizations from income tax. See the Tariff Act of 1894, ch. 349, § 73, 28 Stat. 570 (declared unconstitutional by *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601 (1895)). In addition, an excise tax on corporate incomes imposed in 1909 also provided for a similar charitable exemption. The Payne Aldrich Tariff Act of 1909, ch. 6, 36 Stat. 11.

18. In 1919, however, the Treasury adopted a regulation for purposes of the charitable contribution deduction of 1917 stating “associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.” Reg. 45, art. 517 (1919), in T.D. 2831, 21 Treas. Dec. Int. Rev. 285 (1920).

19. This stems from the requirement that the organization be “operated exclusively for” charitable or other purposes, and the present tense of the no private inurement restriction, which ensures that the purpose and inurement requirements are ongoing (i.e., “no part of the net income of which inures to . . .”).

purpose might consist of in concrete terms, based on outcome, content, or other quantifiable measure.

(7) The exemption was conditioned on the private inurement restriction; that is the profits of the organization were required to go to the good purposes of the organization, and not be paid out to private persons or private interests.²⁰

(8) The standard for tax exemption was used as a basis for other, distinct tax benefits. For example, as of 1917, the language of the exemption was linked to a federal income tax deduction for contributions to organizations meeting the exemption's requirements.²¹ That is, there were no separate tests required: if an organization qualified for the charitable exemption, the organization also was eligible to receive tax-deductible contributions.

It comes as no surprise that today, almost 100 years later,²² the law has changed significantly. For instance, the tax preference *is not self-enforcing*. Over time tax exemption became conditioned on an explicit determination by the IRS, and was subject to ongoing oversight. Thus, applications for tax exemption²³ and annual information return filings²⁴ are

20. The private inurement restriction is now commonly referred to as the "nondistribution constraint" and is a distinguishing feature of the charitable form. See Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *Yale L. J.* 54, 56 (1981).

21. See War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

22. The current exemption language reads:

"Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

IRC § 501(c)(3).

23. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(a), 83 Stat. 487; IRC § 508.

24. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(d)(1), 83 Stat. 487; IRC § 6033. The annual information return provides the basis to enforce the

required for most²⁵ charitable organizations, and a separate division of the IRS exists to police, educate, and serve the charitable sector.²⁶ In addition, Congress decided that certain *activities* were inconsistent with tax exemption. Accordingly, charities may not participate in political campaigns²⁷ or engage in substantial lobbying.²⁸ Limitations also apply to the investment and spending activities of private foundations.²⁹ Further, the exemption from income tax today is *not a blanket exemption*. All charitable organizations are subject to tax on income from business activities that are not related to the organization's charitable purpose;³⁰ and some charitable organizations (i.e., private foundations) are subject to tax on their investment income.³¹ Finally, the *exemption no longer applies equally to all charitable*

operational test and the many other requirements of the charitable tax preference. Revenue Act of 1943, Pub. L. No. 78-235, § 117(a), 58 Stat. 21 (1943) (requiring that certain organizations file information returns, excluding religious organizations, schools, certain fraternal organizations, certain government entities, and publicly supported charitable organizations).

25. Churches, certain other religious or very small organizations (e.g., public charities with not more than \$5000 in annual gross receipts), and other organizations exempted by regulation, are not required to file an exemption application with the IRS or file an annual information return. IRC §§ 508(c), 6033(a)(3).

26. The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, ushered in a major restructuring of the IRS, including the division of the IRS with oversight of tax-exempt organizations, the Tax-Exempt and Government Entities Division (TE/GE). Prior to the 1998 Act, oversight of charitable organizations was conducted by a smaller office. Enforcement of the charitable tax preference is not unified within the IRS, however. Although TE/GE has jurisdiction over tax exemption, a separate division within IRS has jurisdiction over the charitable deduction. For a description of the organization of TE/GE, see Bruce Hopkins, *The Law of Tax-Exempt Organizations*, § 2.2(b) (9th ed. 2007).

27. Internal Revenue Code of 1954, 68A Stat. 163; IRC § 501(c)(3) (a charity may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office").

28. The Revenue Act of 1934, 48 Stat. 700; IRC § 501(c)(3) (a charity is not exempt unless "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation").

29. Private foundations are subject to excise taxes for various transgressions, which arguably could be characterized as limits on certain types of activities (e.g., risky investments, excess holdings of a business, and non-charitable spending). See IRC §§ 4943, 4944, 4945.

30. Revenue Act of 1950, Pub. L. No. 81-814, § 301, 64 Stat. 906; IRC §§ 511-514.

31. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487; IRC § 4940.

organizations. Charities are divided into broad categories: public charities and private foundations;³² with the former being preferred to the latter for purposes of the charitable deduction,³³ tax exemption,³⁴ and permissible activities and surveillance.³⁵

These changes are all significant legal responses to experience with charitable organizations over the course of a century. Yet of the eight initial characteristics of exemption described above, the changes pertain to the first four (self-enforcing, blanket exemption, unlimited activities, and no distinction among charities). There has been less change with respect to the other four initial characteristics. Indeed, much of the foundational statutory laws and historical approaches to charitable status and enforcement have remained the same. The two core statutory requirements of the 1913 exemption are unchanged: charitable exemption still (of course) requires a “good” purpose (and in general the statutory law does not attempt to quantify the purpose);³⁶ and the exemption still is conditioned on the private

32. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(a), 83 Stat. 487; IRC § 509 (defining a private foundation). As discussed *infra*, the PPA has complicated the public charity-private foundation division by recognizing donor advised funds and supporting organizations as in effect something of a hybrid of the two.

33. A donor to a public charity is allowed to deduct more as a percentage of the donor’s income than a donor to a private (nonoperating) foundation. IRC § 170(b).

34. Private foundations are required to pay a tax on their net investment income. Public charities do not have to pay such a tax. IRC § 4940.

35. Private foundations are subject to excise taxes that do not apply to public charities for a variety of missteps. IRC §§ 4941-4945.

36. Of course, a century’s worth of experience provides considerable precedent as to what qualifies as a charitable organization as determined over time by the IRS and the courts. For a description of the many types of organization that are described in § 501(c)(3), see Hopkins, *supra* note 26, chs. 7- 11. Hopkins denotes in categorical and specific terms the many organizations that qualify as § 501(c)(3) organizations. These include organizations that provide relief for the poor; relief for the distressed; housing; down payment assistance; credit counseling; health (including hospitals, clinical departments of hospitals, medical research organizations, homes for the aged, health maintenance organizations, integrated delivery systems, peer review organizations, fitness centers, and other health care organizations); relief of the burdens of government; organizations that advance education, science, or religion (such organizations are distinct from educational, scientific, or religious organizations proper, i.e., the advancement of a non-charitable § 501(c)(3) purpose is considered a charitable purpose); organizations that promote social welfare, the arts, patriotism, or sports; environmental organizations; local economic development organizations; educational institutions (colleges and universities, schools, museums, libraries); day care centers; organizations engaged in an educational activity (e.g., vocational training, subject-specific instruction (dance, sailboat racing), the conduct of discussion groups, engagement in study or research;

inurement restriction.³⁷ In addition, the requirements for the charitable deduction remain linked to the requirements for charitable exemption, i.e., the law does not require separate tests for two rather different tax benefits.³⁸ Further, charitable status remains, for all intents and purposes, an either/or proposition. Revocation of exemption, which is based on an inquiry into all the facts and circumstances, remains the primary sanction for failure to meet a condition of charitable status.³⁹

personal service organizations that provide an educational benefit to the public (e.g., instruction on money management, instruction on a method of painless childbirth); personal counseling organizations (group counseling to widows and widowers, marriage counseling, counseling to immigrants); instruction for civic betterment (e.g., dissemination of information on the need for international cooperation); study and research organizations (e.g., “[t]he variety . . . is nearly limitless”); organizations that publish educational material; organizations engaged in scientific research; churches; other religious organizations; cruelty prevention organizations; amateur sports organizations; literary organizations, to name a few. See also JCT Historical Development, *supra* note 5, at 64, 73-81. The National Center for Charitable Statistics at the Urban Institute maintains an elaborate and informative coding scheme for charitable organizations, from A to Z, available at <http://nccsdataweb.urban.org/PubApps/nonprofit-overview-sumRpt.php?v=ntee&t=pc&f=0>.

37. To suggest that the core requirements have not changed is not to imply that there are no differences in application, or that specific standards have not arisen for particular types of organizations. Of course they have. The point is that the statutory language remains much as it was, and notwithstanding that standards have arisen for many types of charities, hospitals being perhaps the most prominent example, the statutory language over time has come to encompass an ever-expanding range of organization much broader than that originally included within the ambit of the charitable tax preference.

38. See *supra* note 21 and accompanying text.

39. There are of course exceptions. The private inurement restriction can be enforced by an excise tax on the person who benefits from the inurement (and on the manager of the charity) instead of by loss of charitable status. In the case of public charities, the excise tax, known as intermediate sanctions, is provided by IRC § 4958. The Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311(a), 110 Stat. 1452. In the case of private foundations, the excise tax is on “self-dealing” and is provided by IRC § 4941. The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487. The public charity-related intermediate sanctions cover any case of private inurement where an excess benefit is provided in a transaction by the charity to one of its insiders. Additional intermediate sanctions are available with respect to private foundations. Excess lobbying results in an excise tax and not in loss of charitable status if the charity makes an election into a separate lobbying statutory regime and the excess lobbying is within certain limits. IRC §§ 4911, 501(h)(1). And, arguably, expenditures for political campaign activity may be subject to an excise tax and not to loss of exemption. IRC § 4955. This is arguable because as a general matter, the excise tax on political campaign expenditures is not

Thinking, broadly, about what has changed and what has stayed the same, a number of observations can be made. First, the historical trend is toward more restrictions on the charitable designation. What began in 1913 as a fairly innocent and sweeping tax exemption, devoid of detail or conditions, has been incrementally pared back and subjected to more rules and requirements. Charities must apply for the charitable designation, may not engage in certain activities, and must pay tax with respect to some income, and some charities will be treated better than others.

Second, the form these restrictions generally have taken has been negative rather than positive. Positive requirements are the things a charity must do to secure and keep charitable status. By contrast, negative requirements are the things a charity must refrain from doing. The tax preference of 1913 was very simple, with essentially one negative requirement and one positive requirement. The negative requirement was the sensible but general proscription against private inurement.⁴⁰ The positive requirement was that the organization be organized and operated for a good purpose.⁴¹ Although the charitable designation has been narrowed considerably over time, limits have come via new negative restrictions. That is, charity has been asked to refrain from doing certain things, such as politicking or lobbying, or engaging in (untaxed) business activity. But charity has not, in general, been asked to do anything affirmative, apart from file forms.⁴² Thus, the century's narrowing of the charitable designation has

an intermediate sanction but applies in addition to revocation of charitable status. "The adoption of the excise tax sanction does not modify the present-law rule that an organization does not qualify for tax-exempt status as a charitable organization, and is not eligible to receive tax-deductible contributions, unless the organization does not participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office." H.R. Rep. No. 100-391, at 1623-24 (1987). As a practical matter, however, the IRS has imposed the § 4955 excise tax without revoking tax-exempt status. See Lloyd Hitoshi Mayer, *Grasping Smoke: Enforcing the Ban on Political Activity by Charities*, 6 *First Amend. L. Rev.* 1 (2007).

40. The private inurement restriction in a sense is both a positive and a negative requirement: it is positive in that it in effect requires that a charity organize as a nonprofit; and it is negative in that a charity must not allow its assets to be used for the benefit of organization insiders.

41. As a positive requirement, however, this was hardly rigorous. It was more descriptive of a Good Purpose Organization (we know it when we see it), an assumption, than a requirement really to do anything.

42. The principal exception to this is imposition of a pay out requirement on private foundations. IRC § 4942. One reason for the relative preference of negative over positive restrictions may be due to the nature of each. Negative restrictions often are reactive and impose only indirect restraints on conduct making them somewhat easier fodder for the legislative process. For example, a charity steps into an arena, say political activity, by endorsing a candidate for public office. The

occurred not through an effort to limit eligibility for the preference or to demand something quantifiable in return for tax benefits, but through rules that constrain the scope of the preference once eligibility has been established.

A third observation relates to a consequence of a century of retreat from the scope of the original tax preference in the form of negative and not positive restrictions: the facilitation of a large and growing charitable sector. Without positive requirements, becoming and remaining a charity is relatively easy.⁴³ Although a charity in 2011 faces a lot more rules and restrictions than a charity of 1913, apart from a vague entreaty to remain “operated” for its purpose,⁴⁴ the exemption, once granted, is unlikely to be withdrawn.⁴⁵ With such a pluralistic approach to the definition of charity, the

question then is presented: is this activity appropriate? Congress generates a response in the form of a negative restriction, which provides “no, charity may not engage in political activity.” Congress, often a reactive institution, is well positioned to address such questions and provide responses. Although the scope of “charitable” conduct is limited by the negative restriction, charitable organizations have not been told to engage in a particular activity, or otherwise perform an act in a certain way. By contrast, positive requirements impose an affirmative burden, arguably are less reactive than negative requirements, and require a more nuanced, and so more difficult, legislative response. Although a negative restriction imposes a burden by limiting conduct, such restrictions are comparatively less intrusive to the organization than a positive requirement. A positive requirement requires action, with a failure to act resulting in an excise tax and possibly loss of charitable status. The “action” requirement embedded within a positive restriction presents, as a practical matter, a higher legislative threshold normatively, practically, and politically.

43. Rob Reich, Lacey Dorn & Stefanie Sutton, Stanford University Center on Philanthropy and Civil Society, *Anything Goes: Approval of Nonprofit Status by the IRS* (2009).

44. Introduction of the unrelated business income tax substantially weakened the operational test. The statute requires that a charity be operated “exclusively” for exempt purposes; but “exclusively” now means in regulations “primarily.” Reg. § 1.501(c)(3)-1(c)(1) (“An organization will be regarded as ‘operated exclusively’ for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in § 501(c)(3).”). Any other outcome would be wholly inconsistent with the UBIT, which by definition applies only to business activity unrelated to exempt purposes, IRC § 512(a)(1), and which was devised to allow such activity without revocation of charitable status.

45. According to a list maintained by the IRS, 510 organizations had their charitable status revoked over approximately a five-year period. See *Recent Revocations of 501(c)(3) Determinations—Latest Additions and Table of Links*, <http://www.irs.gov/charities/charitable/article/0,,id=141466,00.html> (providing a regularly updated list of revocations from January 1, 2005 through the present). There is no indication of the reason for revocation, i.e., the organization might have

term evolves to accommodate societal change and as it does so, the activities encompassed by section 501(c)(3) grow.⁴⁶ Further, because the requirements for the charitable deduction are linked to requirements for charitable exemption, the amount of support provided by the federal government to the sector via the charitable designation also naturally increases⁴⁷ along with the definition of charity.

Accordingly, notwithstanding the restrictive trend in the law, the scope of the charitable designation has grown significantly in terms of the number of organizations, the amount of assets and revenues, and the types of activities. Today, the charitable designation covers over 1.1 million organizations.⁴⁸ Revenues of charitable organizations are approximately \$1.4 trillion.⁴⁹ The value of assets held by charitable organizations is approximately \$2.6 trillion.⁵⁰ Comparable numbers from the mid-1970s demonstrate the enormous recent growth of charities. In 1976, there were 259,523 charitable organizations and in 1975 (using constant 2001 dollars) revenues were approximately \$155 billion and assets were approximately \$361 billion.⁵¹ Thus, since the mid-seventies, the charitable sector has grown by about 324 percent in terms of the number of organizations, 918 percent in terms of revenues, and 786 percent in terms of assets. Entire classes of organizations continue to be recognized—churches, hospitals, colleges and

ceased to exist, voluntarily changed its status, or been subject to audit and revocation for violations of charitable status requirements.

46. In 1959, the Treasury Department issued new regulations defining charity in the legal sense, which was an expansion over the previous definition of charity in the ordinary sense, in force since 1913. See JCT Historical Development, *supra* note 6, at 61.

47. The five-year (2009-2013) tax expenditure for the charitable tax deduction is estimated to be \$237.6 billion. See Staff of Joint Comm. on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, at 39, 41, 42 (Joint Comm. Print 2010) (combining 32.4 billion for education, 184.1 billion for social services, and 21.1 billion for health).

48. Molly F. Sherlock & Jane G. Gravelle, Cong. Research Serv., R40919, *An Overview of the Nonprofit and Charitable Sector 3* (2009). This figure does not include organizations that do not file an exemption application with the IRS, which could number in the hundreds of thousands (e.g., churches, other qualifying religious organizations, and very small organizations). Approximately 116,000 of the 1.5 million organizations are private foundations. *Id.*

49. *Id.* at 9-12 (reporting as of July 2009). Again, this does not include organizations that do not report to the IRS on the annual information return (Form 990 series) such as churches and small organizations. Of this amount, \$181 billion is revenue of private foundations. *Id.* at 12.

50. *Id.* at 11-12 (reporting as of July 2009, not including non-filing organizations). Of this amount \$621 billion is held by private foundations. *Id.* at 12.

51. See JCT Historical Development, *supra* note 5, at 20, 24.

universities—though such organizations look much different today than 100 years ago.

A fourth observation relates to enforcement. Significant growth has not been accompanied by strong enforcement. Indeed, audit activity is negligible. For the 2007-2008 filing year, the IRS received 888,412 information returns.⁵² To review all of these returns, the IRS assigned 461 employees, with the result that 2,946 returns were examined,⁵³ for an audit rate of returns of about one-third of one percent. Thus, the risk of audit for a charitable organization is extremely low.

Regardless, even if there were a dramatic increase in resources and a corresponding uptick in audits and examinations, there likely would be little meaningful change in growth or in the nature of organizations qualifying for charitable status. This is because, with respect to public charities, there is, in truth, very little “hard” law for the IRS to enforce. In general, to enforce the charitable status designation, the IRS is limited to an inquiry into “purpose,”⁵⁴ with the thrust of the inquiry being not on the substance of the purpose, or the direct accomplishments of the organization, but on the more ethereal inquiry into whether the organization really is benefiting private interests more than public ones, i.e., “is the organization generally operated more for private than public benefit?” Importantly, this existential question is the heart of the matter primarily because of the all-or-nothing, facts and circumstances nature of enforcement. The principal sanction available to the IRS is revocation of charitable status, and to a certain extent, this sanction drives the either/or inquiry. An organization either qualifies as a charity or it does not, there is no middle ground. And there also is no bright line test. Further, because the sanction is severe, an already delicate query is to a certain extent tilted in favor of the organization. Revocation of the charitable designation is a serious step, and, as a practical matter, is not undertaken lightly.⁵⁵

A final related observation, occupying the balance of this paper, is that the consequences of regulation by negative restriction and the relative absence of bright enforcement lines are beginning to stress the viability of the regulatory system and the charitable designation. The all-or-nothing

52. IRS Data Book, 2008, Publ’n 55B, at 33, tbl.13 (2009).

53. *Id.* The number of returns examined does not equate with the number of organizations examined because some organizations examined file multiple returns.

54. Where there are bright lines to enforce, for example, excise taxes for excess lobbying, the inquiry can be more focused on a less existential issue.

55. This in part explains the recent IRS governance initiative. See *supra* note 13. The dearth of enforcement tools and positive requirements leaves the IRS with little leverage over charitable organizations. To the extent good governance can be linked to “tax compliance,” which in this case should mean operating for charitable purposes, making governance a priority of enforcement and education is a tool the IRS is using to promote more charitable outcomes.

nature of the tax preference combined with the vague positive requirement to be operated for charitable purposes and no other meaningful positive requirement, has limited the ability of the IRS, for better or for worse, effectively to police abuse or to check the growth of the charitable sector in any meaningful way or even to provide any strong degree of confidence that the organizations receiving the public charity designation, typically at the outset of their existence, met their promises or are actually serving a public benefit. The outcome is a large and growing charitable sector, legal standards that accommodate growth, and a weak enforcement presence.

This is a recipe for problems, problems that are revealing themselves in different ways. One manifestation is through the deluge of recently reported scandals and the resulting reform legislation. As described in the next Part of this Article (Part III), the wide ranging nature of the reported scandals left a deep impression that something was not quite right in the charitable sector, and that legislation was required. Another manifestation is evidenced by the subtext of the reform legislation. As discussed in Part IV of this Article, the legislation signals weaknesses in the current regulatory approach, namely the breadth of the charitable designation, the basis for distinguishing among charitable organizations, and the facts and circumstances-based approach to enforcement.

PART III. SCANDALS AS SYMPTOMS OF A NEED FOR REFORM

A. Overview

In the initial decade of the twenty-first century, there were two broad legislative themes respecting charitable organizations. The first was to encourage private philanthropy through new charitable giving incentives. The second, and slower to develop theme, was reform of the rules relating to charitable organizations. The century began with the election of President George W. Bush who had made the “faith-based initiative” a part of his campaign. The idea was to allow direct federal funding of religious institutions irrespective of hiring practices, proselytizing, or religious-based discrimination.⁵⁶ Related to it was a federal income tax deduction for charitable contributions by taxpayers who take the standard deduction: the so-called “non-itemizer” deduction.⁵⁷ Upon election, the President submitted these two proposals, and a handful of other charitable giving incentives to the

56. White House, Rallying the Armies of Compassion (2001), available at <http://archives.hud.gov/reports/rally.pdf>.

57. *Id.* Taxpayers who take the standard deduction are not allowed to claim itemized deductions, including the charitable contribution deduction. IRC § 63(b).

107th Congress as part of the Fiscal Year 2001 budget.⁵⁸ Although there was an initial push to pass the charitable giving legislation, it stalled, perhaps because of the controversy connected with the faith-based initiative. Accordingly, between 2001 and 2003 (covering the 107th and 108th Congresses) there were four markups and three floor votes, but no law.⁵⁹

Meanwhile, as the legislative process on the faith-based initiative and charitable giving incentives took its lumbering course, the second theme took hold. Between the fall of 2001 and the summer of 2004, scandal spread across the charitable sector, sullyng the names of many leading charities and industries. Brand name charities that were associated with a scandal or questionable practice included the United Way, the Nature Conservancy, the American Red Cross, the Smithsonian Institution, and American University, to name some of the more prominent. Entire swathes of the charitable sector also were tarnished: nonprofit hospitals as a class came under fire, organizations formed to provide credit counseling were investigated, and private foundations were criticized, as were other grant-making charities known as donor advised funds and supporting organizations. Particular issues also repeatedly arose involving charities: valuation and other abuses relating to charitable contributions of noncash property, the participation of charities in tax-shelter transactions, and the questionable use of charities by Members of Congress, among others.

To any particular scandal, one could respond, and many did respond, that these were just the actions of a “few bad apples” or “outliers.” No doubt, there is some truth to this. The media tends to report on the worst cases (those that make the best news); the worst cases are by definition the exception, and press reports rarely tell the entire story, are not legal opinions, and are not always accurate. But, as the review of scandals below should indicate, the range of the reported abuses and questionable conduct was too

58. White House, *A Blueprint for New Beginnings: A Responsible Budget for America's Priorities* (2001), available at www.gpoaccess.gov/usbudget/fy02/pdf/blueprnt.pdf.

59. In the 108th Congress, charitable giving legislation (H.R. 7) passed the House by a vote of 408-13 and (S. 476) the Senate by a vote of 95-5. Notwithstanding the lopsided support in both House and Senate, however, conferees were never appointed and the legislation lapsed. See generally Staff of Joint Comm. on Taxation, 107th Cong., *Description of an Amendment in the Nature of a Substitute to H.R. 7, The “Community Solutions Act Of 2001”* (Joint Comm. Print 2001); Staff of Joint Comm. on Taxation, 107th Cong., *Description of the “CARE Act of 2002”* (Joint Comm. Print 2002); Staff of Joint Comm. on Taxation, 108th Cong., *Technical Explanation of the Revenue Provisions of S. 476, The “Care Act of 2003”, As Passed by the Senate* (Joint Comm. Print 2003); Staff of Joint Comm. on Taxation, 108th Cong., *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 7, The “Charitable Giving Act of 2003”* (Joint Comm. Print 2003).

wide merely to be shrugged off by policymakers. The breadth of organizations involved and the scope of alleged abuse pointed to underlying problems, not just at one or another charity, but with the system of rules itself. It is well outside the scope of this Article to discuss or cite every reported questionable practice or tarnished charity of the past several years. Rather the point of the following survey is to highlight and emphasize the far-reaching nature of issues that were raised. Scandal is relevant, apart from the merits, because of the reputational damage to charity, and perhaps more importantly, because the scandals, and the legislative solutions they prompted, suggest that our current system of rules and oversight is not sufficient.

B. Some Specifics of Some of the Scandals

1. Scandals at Certain Iconic Charitable Institutions

Scandals at iconic charitable institutions often drive perceptions about the charitable sector as a whole—in the eyes of the public and policymakers. The development of the reform theme was to a certain extent driven by early scandals at such organizations, including the United Way, the American Red Cross, and the Nature Conservancy.

(i) The United Way

Early in the decade, the United Way was widely criticized for questionable accounting of donor funds. An article in the *New York Times* began: “Some United Way organizations, trying to appear more successful and more efficient with their donors’ money, are counting contributions in ways that make the numbers look more robust—and expenses look smaller.”⁶⁰ The article went on to describe United Way guidelines that allowed double counting of contributions in order to make the United Way appear to have more public support than it had. The practice, and the fallout, followed the devastating frauds at Enron and Worldcom, and hinted that cooking the books was not necessarily isolated to for-profit enterprises. United Way, an iconic charity if ever there was one, found itself compared to two of the most reviled organizations of the decade.

(ii) The American Red Cross

After the terrorist attacks of September 11, the Red Cross mounted a 9/11-related fundraising campaign, and raised hundreds of millions of

60. Stephanie Strom, *Questions Arise on Accounting at United Way*, *N.Y. Times*, Nov. 19, 2002, at A1.

dollars. However, the money raised greatly exceeded the amount the Red Cross believed was needed to help those harmed by the attacks. So the Red Cross announced that it would instead use some of the money for other charitable purposes. This decision, fairly or not, sparked outrage in the media and on Capitol Hill, resulting in hearings and tough questioning of (and eventual change in) the leadership of the Red Cross.⁶¹ At the time, it was an isolated incident involving a brand-name charity. But the fallout was considerable, and contributed to an erosion of confidence in charities, later reinforced by continuing press reports of scandals in the sector.⁶²

(iii) The Nature Conservancy

In May 2003, the Washington Post ran a series of front-page articles questioning practices at The Nature Conservancy (TNC), a leading environmental organization.⁶³ The articles (and the ensuing investigation launched by the Senate Finance Committee staff) directly or indirectly raised a number of issues relating to organization size, mission, and governance. It came as a shock to some to learn how big and complex a charity could become. A trusted name for environmental issues, TNC grew from a small

61. See Grant Williams, Turmoil at the Red Cross, *The Chronicle of Philanthropy*, Nov. 1, 2001, at 72 (“Critics charge that Red Cross headquarters has been intentionally fuzzy in describing how money donated after the recent terrorism attacks would be spent on victims.”); Ian Wilhelm, Red Cross Plans to Spend All Donations to Help September 11 Attack Victims, *The Chronicle of Philanthropy*, Nov. 29, 2001, at 30 (“After enduring weeks of criticism, the American Red Cross appears to have assuaged the concerns of government officials and donors by declaring that it will spend all the money it collected after September 11 solely to help the victims of the terrorist attacks.”); Response by Charitable Organizations to the Recent Terrorist Attacks: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 107th Cong. (2001).

62. See Stephen G. Greene, In Disaster’s Wake, *The Chronicle of Philanthropy*, Sept. 5, 2002, at 4 (quoting Paul C. Light, director of the Center for Public Service at the Brookings Institution, “I think the sector has been damaged by the aftermath of September 11, and it will take more than denial to address the erosion of public support,” and noting that by May 2002, the number of Americans expressing lots of confidence in charities had fallen to 18 percent from 25 percent the summer before).

63. David B. Ottaway & Joe Stephens, Nonprofit Land Bank Amasses Billions: Charity Builds Assets on Corporate Partnerships, *Wash. Post*, May 4, 2003, at A01; Joe Stephens & David Ottaway, How a Bid to Save a Species Came to Grief, *Wash. Post*, May 5, 2003, at A01; Joe Stephens & David Ottaway, Nonprofit Sells Scenic Acreage to Allies at a Loss, *Wash. Post*, May 6, 2003, at A01; David Ottaway & Joe Stephens, Landing a Big One: Preservation, Private Development, *Wash. Post*, May 6, 2003, at A09; Joe Stephens & David Ottaway, Developers Find Payoff in Preservation, *Wash. Post*, Dec. 21, 2003, at A01.

group of scientists who formed the “Ecologist’s Union” in 1946 to a significant corporate enterprise operating in all 50 States and over 30 countries.⁶⁴ In TNC’s fiscal year 2002, the year before the Washington Post profile, TNC reported assets of \$2.93 billion, annual revenues of \$972.4 million, and expenses of \$632.5 million.⁶⁵ Size and growth often are signs of success and strength, and not a reason to criticize. But size can also breed mistrust, misunderstanding, and comparison to other large, often for-profit, organizations. And with size may come questionable decisions. To what extent did the facilitation of oil drilling in a bird refuge advance the mission of TNC? Were partnerships with General Electric to sell pollution credits manifestly the best way to protect the environment? Were corporate sponsorship agreements with cereal companies to sell granola bars in direct furtherance of environmental purposes? TNC later said that some of its transactions were ill-advised, and related in part to the unstructured growth of the organization.⁶⁶ One explanation was a lapse in good governance practices. Large boards and the potential conflicts of interest presented by appointing to the Board senior representatives from the oil and other industries, which, some would say, operate in contravention to TNC’s stated mission, were highlighted. As a result, TNC hired outside consultants to recommend changes to its governing structure, changes later adopted.⁶⁷ Additional questions were raised about insider dealing, charitable contributions, and other issues.⁶⁸ At the end of the day, TNC voluntarily undertook many changes to internal governance, cut back or cancelled certain programs, and claimed to be a much better organization as a result of the intense scrutiny.⁶⁹

64. See The Nature Conservancy, <http://www.nature.org/> (visit pages “About Us” and “Where We Work”); Staff of S. Comm. on Fin., 109th Cong., 1 Rep. of Staff Investigation of The Nature Conservancy, Exec. Summary 3-5 (Comm. Print 2005).

65. Staff of S. Comm. on Fin., 109th Cong., 1 Rep. of Staff Investigation of The Nature Conservancy, Exec. Summary 5 (Comm. Print 2005).

66. Joe Stephens & David Ottaway, Nature Conservancy Suspends Land Sales: Board of Nonprofit to Review Practices, Wash. Post, May 13, 2003, at A03; Joe Stephens & David Ottaway, Conservancy Abandons Disputed Practices: Land Deals, Loans Were Questioned, Wash. Post, June 14, 2003, at A01.

67. Press Release, The Nature Conservancy, Release of Senate Finance Committee Staff Report, 2005 Tax Notes Today 110-14 (June 7, 2005), available at www.nature.org/pressroom/press/press1955.html.

68. See generally Staff of S. Comm. on Fin., 109th Cong., Rep. of Staff Investigation of The Nature Conservancy (Comm. Print 2005).

69. Edited Transcript of the Sept. 16, 2005 Meeting of the Am. Bar Ass’n Sec. of Taxation’s Exempt Organizations Comm., Statement of Philip Tabas, General Counsel of the Nature Conservancy, 2005 Tax Notes Today 219-35 (Sept. 16, 2005) (“[A]s a result of [the Washington Post] articles, the Senate Finance Committee launched an investigation into The *Nature Conservancy* and the IRS

2. Contributions of Noncash Property

Scandals relating to contributions of noncash property to charitable organizations raised a number of issues, which fit broadly into two categories: valuation-based scandals, in which charities are used (passively or not) to facilitate unwarranted tax deductions through overvaluation claims; and churning, in which charities are in effect used as conduits for sales or other transactions that generate deductions for donors and revenue for third parties and the charities involved. Public charities that were implicated were diverse; private foundations, however, were largely unaffected because of the different tax rules that apply.

Abuse associated with the charitable deduction is in part a result of the general rule that allows a federal income tax deduction for charitable contributions to public charities equal to the fair market value of property contributed. Under such a rule, in any case in which the value of the property is overstated, intentionally or not, the federal government is cheated. For example, if property is worth \$1,000, but a taxpayer (say in a 35 percent marginal tax bracket) overstates the value by 10 percent (claiming the property is worth \$1,100), the taxpayer gets a deduction of \$385 instead of \$350. Will the IRS target the excess deduction of \$35? Probably not.⁷⁰ Will the IRS pursue a 10 percent overvaluation of significantly more magnitude, resulting in an excess deduction of \$35,000 (actual value \$1,000,000 and claimed value of \$1,100,000)? Possibly, but consider the costs to the IRS of proceeding and the many uncertainties of prevailing, especially given the imprecise nature of valuation and that taxpayers can and do support their claims with appraisals. In short, the valuation-based deduction for contributions of noncash property is an administrative headache, an opportunity for abuse, and thus also for scandal.⁷¹

began to conduct an *audit* of our practices. I am pleased to report that in both cases we have concluded those investigations successfully, and I think the Conservancy is a better organization for having gone through it, although it was painful, to say the least, while we were involved in those.”)

70. And the loss to the Treasury is not huge. It would take one million of such taxpayers to reach a loss of \$35 million, which though a large number, is not a lot of money in the context of a \$2 trillion budget. That said, this sort of “gap” between taxes owed and taxes paid is the subject of ongoing concern. See, e.g., IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007); IRS, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* (2009).

71. See, e.g., *Charities and Charitable Giving – Proposals for Reform: Hearing Before the Comm. on Fin., 109th Cong., 166* (2005) (written statement of Mark Everson, Commissioner of Internal Revenue) (“I have read with much interest the Joint Committee on Taxation’s description of problems in the area of clothing, household items, and other contributions of property and I agree that these are

Perhaps the highest profile of the valuation-based scandals involved contributions of easements to charity for environmental purposes.⁷² Although numerous issues arose involving easement contributions,⁷³ the principal one concerned “façade easements,” wherein a homeowner would contribute to a local charity an easement that restricted the homeowner from making changes to the façade of his house. Homeowners might claim that the easement was worth at least 10 percent of the value of the home, not an insignificant amount, especially during a time of rapidly escalating home

resource-intensive for us to audit. Overvaluations are difficult to identify, substantiate, and litigate. Further, donors and the recipient charities do not have adverse interests that would help establish a correct valuation.”). Others argue there is little policy rationale for allowing a deduction for the appreciation in contributions of capital gain property. See Daniel Halperin, A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains, 56 Tax L. Rev. 1 (2002).

72. An easement typically is a partial interest in property (i.e., the easement represents but part of the property interest of the holder with respect to the underlying property). Although the general tax rule is that no charitable contribution deduction is allowed for contributions of partial interests of property, there is an exception for conservation easements or “qualified conservation contributions,” which are, in brief, contributions of partial property interests exclusively for conservation purposes. IRC §§ 170(f)(3), 170(h). As with The Nature Conservancy, scandals relating to conservation easements also were publicized by the Washington Post. Joe Stephens, For Owners of Upscale Homes, Loophole Pays; Pledging to Retain the Facade Affords a Charitable Deduction, Wash. Post, Dec. 12, 2004, at A01; Joe Stephens, Tax Break Turns Into Big Business, Wash. Post, Dec. 13, 2004, at A01; Joe Stephens, Group Ends Pitches for Home Easements; Criticism of Tax Deductions Leads National Architectural Trust to Halt Practice, Wash. Post, Jan. 12, 2005, at A08 (“The National Architectural Trust, the country’s fastest-growing historic preservation organization, has stopped soliciting facade easement donations after complaints that homeowners have used the donations to claim millions of dollars in excessive income tax deductions.”).

73. *Turner v. Commissioner*, 126 T.C. 299 (2006) (property acquired adjacent to Mt. Vernon subject to floodplain restrictions on development but developer erroneously claimed a \$342,781 conservation easement charitable deduction arguing that easement also restricted the development); *Glass v. Commissioner* 124 T.C. 258, aff’d 471 F.3d 698 (6th Cir. 2006) (taxpayer claimed a charitable deduction for the contribution of two small, non-contiguous conservation easements in separate tax years on the same parcel of land with little or no discernable public benefit and without encumbering the retained property for development purposes); Dep’t of Treasury, General Explanations of the Administration’s Fiscal Year 2006 Revenue Proposals 112 (explaining proposed penalties on charities that fail to enforce conservation easements) (2005); Steven Small, Proper – and Improper – Deductions for Conservation Easement Donations, Including Developer Donations, 2004 Tax Notes Today 198-44 (Oct. 11, 2004). See also Joe Stephens & David Ottaway, Developers Find Payoff in Preservation, Wash. Post, Dec. 21, 2003, at A01.

prices.⁷⁴ But there were reasons to question many valuations, especially considering that often, the homeowner resided in a historic district and therefore already was prohibited by local law from making changes to the façade of the home. This manifestly made assertions of high values for façade easements questionable and converted a run-of-the-mill valuation problem into an eye-grabbing scandal (involving Members of Congress no less).⁷⁵ It was made worse by the fact that some charities appeared to have been formed exclusively to facilitate easement donations in historic districts and actively promoted them.⁷⁶

Other valuation-related scandals included contributions of intellectual property (corporate donors claiming valuations of patents in the millions of dollars);⁷⁷ clothing and household items (hard to verify value of used clothing);⁷⁸ taxidermy (taxpayers either overvalue the property or

74. See e.g., Gen. Couns. Mem. 200738013 (Aug. 9, 2007) (“Some taxpayers claim reliance upon a Market Segment Specialization Program Guide (Guide) and also upon a Topical Tax Brief, which were posted on the IRS website. These documents at one time suggested a range within which a facade easement might be expected to reduce the value of property. However, they also described the ‘before and after’ method as the proper method by which to value a facade easement, making it clear that a full analysis of the value of the property both before and after the donation was necessary. The Guide expressly stated that its material was designed specifically for training purposes and could not be used or cited as authority for a technical position. Nevertheless, this language was removed from the Guide and the Topical Tax Brief years ago and does not support an otherwise insufficient valuation.”); *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (applying the “before and after” valuation approach and upholding a valuation at 12 percent of the property determined before the easement contribution); *Griffin v. Commissioner*, T.C. Memo 1989-130 (1989) (upholding a value of 20 percent of the underlying property).

75. Joe Stephens, *For Owners of Upscale Homes, Loophole Pays; Pledging to Retain the Facade Affords a Charitable Deduction*, Wash. Post, Dec. 12, 2004, at A01.

76. Joe Stephens, *Senators Vow to End Tax Break on Easements; Wealthy Homeowners Have Taken Advantage*, Wash. Post, Dec. 18, 2004, at A03; see *supra* notes 74-75.

77. Stephanie Strom, *IRS Focuses on Noncash Donations to Charities*, N.Y. Times, Dec. 24, 2003, at A18 (quoting IRS Commissioner Mark Everson, (“We’re seeing an increasing number of donations [of patents] that don’t pass the smell test.”)).

78. See Tom Herman, *Tax Report: Software for Preparing Taxes is Getting Better—Top Sellers Offer More Tips and Clearer Instructions; Free Advice on Web Sites*, Wall Street J., Feb. 23, 2005, at D2 (“[H]ere is a tip for many people who itemize and donate bulging bags of old clothing and other items to charity: Consider buying ‘Its Deductible’. . . . Many people who give away household items don’t know how to value them. . . . This program values thousands of items based on

include as part of their donation the costs of killing the animal; taxidermy stored in trailers and not accessible to the public);⁷⁹ and art (taxpayers donate a percentage of a valuable painting to a museum without any transfer of possession).⁸⁰ Problems with valuation led the staff of the Joint Committee on Taxation to propose eliminating the deduction for contributions of noncash property in some cases,⁸¹ and the Commissioner of the IRS to highlight the administrative difficulties associated with such contributions.⁸²

In addition to valuation abuse, the existence of the fair market value deduction for contributions of noncash property presents abuse opportunities that do not depend on (though may be enhanced by) overvaluation. This is so especially with respect to property that is not, and was never intended to be, used for charitable purposes. In such churning-type transactions, the charity is not the end user of the property, but rather a conduit for property that goes from the donor to someone other than the charity, briefly “resting” with the charity to secure a charitable contribution deduction.⁸³

The most pertinent illustration is in the contribution of vehicles to charity. Many well-known charities advertised (and still do advertise) their “car donation” programs.⁸⁴ The basics of the transaction are that a charity and a for-profit organization enter into an agreement whereby the charity agrees to solicit contributions of vehicles, and the for-profit organization agrees to pick up and then sell the vehicle. For its role in the transaction, the charity receives a percentage of the proceeds from the sale.⁸⁵ Although this

whether they are in good, fair or poor condition.”); Guy Trebay, *Old Clothing Never Dies, It Just Fades Far, Far Away*, N.Y. Times, Dec. 5, 2000, at B10.

79. Marc Kaufman, *Big-Game Hunting Brings Big Tax Breaks; Trophy Donations Raise Questions in Congress*, Wash. Post, April 5, 2005, at A01.

80. Rachel Emma Silverman, *Wealth Manager: Joint Custody For Your Monet—‘Fractional Giving’ Hits the Art World, as Donors Share Works With Museums*, Wall Street J., July 6, 2005, at D1.

81. Staff of Joint Comm. on Taxation, *109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures, Part VIII* (Joint Comm. Print 2005). The author served as Legislation Counsel to the Joint Committee on Taxation at the time, with chief responsibility for exempt organization issues, and directed the exempt organizations portion of the report.

82. See *supra* note 71.

83. This is not to suggest that any such conduit arrangement is abusive. Many are not: the typical charity auction for example. What makes a charity auction different (and a good fundraiser for charity) is that charities generally receive more than the product is worth—and absence of middlemen improves the bottom line.

84. A “Google” search of “donate car to charity” will yield more than one million “hits.”

85. See Gen. Accounting Office, *GAO-04-73, Rep. to S. Comm. On Fin., Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight* (2003). The GAO noted that some charities operate their vehicle donation programs in-house and do not rely on third party agents. Such in-house programs,

may sound like harmless fundraising, there can be a considerable cost to taxpayers. Take a hypothetical case: a used car worth \$500 is donated to charity, sold for \$500, and the donor (in the 35 percent bracket) claims a \$500 deduction. The agreement between the charity and the for-profit organization lets the charity keep 50 percent of the sales proceeds. The charity gets \$250, the for-profit organization gets \$250 (some portion of which may be taxable after taking expenses into account), and the federal government loses \$175 in tax revenue. As long as the amount forgone by the government is less than the amount received by the charity (plus any tax on the proceeds received by the for-profit), the transaction does not appear to raise special concerns. But the tipping point comes (or should come) at about the juncture when the charity receives less than the government loses. As documented by the Government Accountability Office, in one egregious case, a 1983 GMC Jimmy truck was donated to charity in 2001 and sold at auction for \$375. Net proceeds from the sale were \$62 (after taking into account third-party and advertising costs), and were split 50/50. The taxpayer claimed a \$2,400 deduction, based on a fair market value published in a used car guidebook.⁸⁶ Net result: \$31 to charity at a cost of \$840 to the government (assuming a 35 percent bracket taxpayer). Further, the propensity of such transactions for valuation abuses and sales at firesale prices greatly increases the potential revenue loss to the government and decreases the amount received by the charity.

This type of scheme can seriously damage public perception of charity because unlike a valuation abuse where perhaps only the donor is complicit, in a conduit-type scheme, the charity is leveraging its tax-exempt status for the sake of a few extra dollars,⁸⁷ and at a cost (revenue lost to the government) ultimately borne by all taxpayers. That said, charity writ large also can be tarnished in a more straightforward case of valuation abuse when circumstances indicate that the charity knows or should know that a donor may be claiming an excess valuation⁸⁸ or when the charity accepts property on the condition or with the expectation that the property later be sold.

though perhaps improving the bottom line to the charity, raise appearance issues: Why is a charity running a used car selling business?

86. *Id.* at 15-16.

87. See Rachel Jacobson, *The Car Donation Program: Regulating Charities and For-Profits*, 2004 *Tax Notes Today* 168-55 (Aug. 2004) (discussing car donation programs and noting that fraudulent overvaluation of contributions to charity not only erodes the tax base but “brings the integrity of the *charity* into question.”).

88. One prominent example involved the donation of 4 Stradivarius violins to the Smithsonian with the taxpayer claiming a \$50 million deduction. See Jacqueline Trescott, *Smithsonian Benefactor Arrested in Germany*, *Wash. Post*, June 18, 2004, at C01 (noting that Smithsonian director Lawrence Small said that the Smithsonian does not perform independent appraisals of gifts and that the Smithsonian had valued the violins at various times for insurance purposes, \$5

3. Tax Shelters

The tax shelter industry appeared to run rampant in the late 1990s, prompting a government effort to protect the tax base.⁸⁹ One result of the increased scrutiny of the tax shelter industry came to many as a surprise: charities commonly were participants in tax shelters. A tax shelter involving a charity (or other tax-exempt organization) typically involves a taxpayer trading (with cash or property) with a tax-indifferent party for a tax benefit. If the tax benefit can be extracted from the tax-indifferent party at less cost than the value of the benefit, both parties are better off (and the government is worse off).

Perhaps the best-known example was the so-called SC2 transaction. The transaction involved a charity and a corporation organized under subchapter S of the Internal Revenue Code (S Corporation). S Corporations are not subject to an entity level tax (as are "C" Corporations); rather the income of the corporation flows through to the corporate owners, the shareholders. Under SC2, in order to defer income tax, shareholders of the S Corporation directed that S Corporation nonvoting stock (which was issued for purposes of the transaction) be contributed to a charity. The value of the contribution (relatively low) not only flowed through to the S Corporation shareholders as a deduction, but more importantly, income attributable to the contributed stock escaped taxation because it was "allocated" but not distributed to a tax-exempt charity. The income, however, remained under the control of and could be reinvested by the S Corporation. Later, pursuant to a redemption agreement, the S Corporation repurchased the nonvoting stock (this was the charity's "profit" for its role in the transaction) and when the income was subsequently distributed to the S Corporation shareholders, the shareholders were advised (in opinion letters by accounting firm KPMG) that they could claim that the income was capital gain income not ordinary

million in 1986, \$20 million the next year, \$30 million two months later, and in 1997 at the time of the actual gift, \$55 million, based on the value asserted by the taxpayer).

89. See Permanent Subcomm. on Investigations, Staff of S. Comm. on Homeland Sec. and Governmental Affairs, 109th Cong., *The Role of Professional Firms in the U.S. Tax Shelter Industry* (Comm. Print 2005). See also, e.g., Cassell Bryan-Low, *KPMG Didn't Register Strategy – Former Partner's Memo Says Fees Reaped From Sales of Tax Shelter Far Outweigh Potential Penalties*, *Wall Street J.*, Nov. 17, 2003, at C1 ("It was during the late 1990s that sales of tax shelters boomed as large accounting firms like KPMG and other advisers stepped up their marketing efforts."); David Cay Johnston, *Crackdown on Tax Cheats Not Working*, *Panel Says*, *N.Y. Times*, Oct. 20, 2003, at C2 (noting that witnesses before a Senate Finance Committee hearing would conclude that notwithstanding the efforts of the IRS, tax cheating continues "unabated" and is estimated to cost the government \$14 to \$18 billion a year (in 2000), if not substantially more).

income and thus subject to a lower tax rate. In short, through a sham transaction, the S Corporation shareholders were told they could defer taxation of income (a valuable tax benefit in itself) and then, when tax eventually was owed, pay at a reduced rate.⁹⁰

The Commissioner of the IRS testified to the Senate Finance Committee in 2005 that: “Of the 31 categories of listed [i.e., suspected] transactions, nearly half may involve tax-indifferent parties either as accommodation parties or as active participants.”⁹¹ This raised the obvious question of why any charitable organization (or other tax-indifferent party) would facilitate tax avoidance.

4. Private Foundations

A reader of the Boston Globe’s “Spotlight” series on private foundations that ran in the fall of 2003 likely would leap to the conclusion that something was rotten in the foundation world.⁹² The poster-child for the

90. See Minority Staff of Permanent Subcomm. on Investigations, S. Comm. on Governmental Affairs, 108th Cong., No. 108-34, U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Appendix B: Case Study of S-Corporation Charitable Contribution Strategy (SC2) (Comm. Print 2003). The IRS effectively shut down the SC2 transaction via Notice 2004-30, 2004-1 C.B. 828.

91. Charities and Charitable Giving: Hearing Before the S. Comm. On Fin., supra note 71, at 162, (written statement of Mark Everson, Commissioner of Internal Revenue). The IRS sought to identify potentially abusive tax shelter transactions and stem their use by “listing” the transaction in an official document—in effect putting the world on notice that the transaction was legally suspect.

92. Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Some Officers of Charities Steer Assets to Selves, Boston Globe, Oct. 9, 2003, at A1; Beth Healy, Foundation’s Sale of Nonprofit Hospital a Windfall for Administrator, Boston Globe, Oct. 9, 2003, at A42; Francie Latour, One Chance Encounter Pays Huge Dividends, Boston Globe, Oct. 9, 2003, at A43; Michael Rezendes & Sacha Pfeiffer, Underfunded IRS Unable to Monitor Trusts, Boston Globe, Oct. 9, 2003, at A43; Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Charity Money Funding Perks, Boston Globe, Nov. 9, 2003, at A1; Francie Latour, Costly Furnishings Come at Charities’ Expense, Boston Globe, Nov. 9, 2003, at A27; Michael Rezendes & Sacha Pfeiffer, The Trustees’ Perk That Keeps on Giving, Boston Globe, Nov. 9, 2003, at A27; Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Foundations Veer Into Business, Boston Globe, Dec. 3, 2003, at A1; Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Foundation Lawyers Enjoy Privileged Position, Boston Globe, Dec. 17, 2003, at A1; Beth Healy, Charity in Worcester: An Insiders’ Game, Boston Globe, Dec. 17, 2003, at B8; Walter V. Robinson, Trustees’ Fees are Talk of San Antonio’s Elite, Boston Globe, Dec. 17, 2003, at B9; Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Philanthropist’s Millions Enrich Family Retainers,

series was the Paul and Virginia Cabot Charitable Trust. The son of the Trust founder (son and founder were both named Paul Cabot), and trustee of the Trust, paid himself a salary totaling \$5,185,216 from 1998 through 2002, while paying an average of only \$400,000 each of those years to charitable causes. Apart from his salary, Cabot used \$200,000 of Trust funds to pay for his daughter's wedding (in Boca Grande, Florida—"these things don't come cheaply in Florida" Cabot explained to the *Globe*).⁹³ Cabot admitted that his salary was "probably excessive" and that the work he performed (overseeing the foundations investments) probably could have been done by hiring someone for \$100,000 a year.⁹⁴ Cabot said he needed a large salary because "[t]he only way I can pay my taxes is to take more money out of the [foundation]."⁹⁵ Noting that he needed after-tax income of \$30,000 a month for living expenses (plus another \$10,000 a month for his wife: "She seems to think it's not enough, like most women"), and that he had mortgages to pay (a \$1.3 million home in Needham, Massachusetts, two waterfront homes in Boca Grande, Florida, a twenty-five acre waterfront home in North Haven, Maine), Cabot told the *Globe*, without a sense of irony: "I do not squander this money on Ferraris or 85-foot yachts . . . I live a fairly modest life."⁹⁶ The *Globe* series uncovered similar problems at other foundations.⁹⁷ In short, the *Globe* series portrayed that for many foundations charity was an afterthought—it came after the salary, the corporate jet, the Persian rug, and the opportunity to benefit the private business activities of insiders. All these trappings were costs of charity, funded by tax-deductible contributions.⁹⁸

Boston *Globe*, Dec. 21, 2003, at A1; Francie Latour & Beth Healy, How to be a Philanthropist—or Just Look Like One, Boston *Globe*, Dec. 21, 2003, at A31; Sacha Pfeiffer, Good as Gold: Inheriting a Trustee Seat Can Pay Rich Dividends, Boston *Globe*, Dec. 21, 2003, at A31; Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Foundations' Tax Returns Left Unchecked, Boston *Globe*, Dec. 29, 2003, at A1.

93. Beth Healy, Francie Latour, Sacha Pfeiffer, Michael Rezendes & Walter V. Robinson, Some Officers of Charities Steer Assets to Selves, Boston *Globe*, Oct. 9, 2003, at A1.

94. *Id.*

95. *Id.*

96. *Id.*

97. The *Globe* reporters found that "[t]he cost of charity is also steep at the William T. Morris Foundation"; in 2001 the foundation "spent \$2.8 million to give away \$1.8 million with the salaries of top officials rising rapidly even as the foundation's assets diminished." *Id.*

98. See also Christine Ahn, Pablo Eisenberg & Channapha Khamvongsa, The Center for Public and Nonprofit Leadership, Georgetown Public Policy Institute, *Foundation Trustee Fees: Use and Abuse* (2003).

5. *Grant-Making Public Charities: Supporting Organizations and Donor Advised Funds*

The Boston Globe series on foundations resuscitated dormant skepticism about the foundation form, raising the spotlight on two foundation-like charities: the “supporting organization” and the “donor advised fund.”

A supporting organization is an organization established by the Internal Revenue Code in 1969 to describe a charity that would be classified as a private foundation but for its relationship to an established charity that is not a private foundation (a.k.a. a “public charity”).⁹⁹ This matters because private foundations are subject to a much stricter legal regime than public charities—so a supporting organization designation is desirable. The relationship of a supporting organization to a public charity is, in theory, supposed to inoculate the supporting organization from abuses that prompted the stricter legal regime applicable to private foundations.¹⁰⁰ But, apart from this relationship, a supporting organization in general is very similar to a private foundation: it is a fund, and it pays out money for charitable purposes. Accordingly, if abuses occur at supporting organizations,¹⁰¹ one response is: close the loophole, abolish the category of supporting organization.

One type of supporting organization, the “Type III supporting organization” required only a very informal relationship with a public charity,¹⁰² thus fostering the creation of supporting organizations without the

99. IRC § 509(a)(3).

100. See, e.g., *Quarrie v. Commissioner*, 603 F.2d 1274, 1277 (7th Cir. 1979), *aff’d* 70 T.C. 182 (1978) (“[T]heir exposure to public scrutiny and their dependence on public support [is believed to] keep them from the abuses to which private foundations [are] subject.”).

101. Stephanie Strom, *Big Tax Break Often Bypasses Idea of Charity*, N.Y. Times, April 25, 2005, at A1 (describing a supporting organization controlled by George Kaiser that received about \$1 billion but made distributions of just over \$3.4 million and another controlled by Carl Icahn that received over \$118 million but made distributions of just \$2.9 million to charity); Letter from Mark W. Everson, Commissioner of Internal Revenue to The Hon. Charles E. Grassley, Chairman, S. Comm. on Fin., (Mar. 30, 2005), at 5, available at <http://finance.senate.gov/imo/media/doc/Letter%20from%20Everson.pdf> (describing abuses at supporting organizations as a top compliance problem); Jonathan Weisman, *HHS Secretary’s Fund Gave Little to Charity*, Wash. Post, July 21, 2006, at A01 (describing a supporting organization founded by then HHS Secretary Mike Leavitt, loans made by the supporting organization to support family business ventures, and minimal charitable pay outs).

102. In general, there are three types of supporting organization: a “Type I” is similar to a parent-subsidiary relationship between the supported public charity (parent) and the supporting organization (subsidiary); a “Type II” is similar to a

knowledge or input of any public charity. The supported public charity would receive a check every year but otherwise might have no knowledge or concern about the supporting organization sending the money (i.e., the supporting organization is just another donor). In the meantime, the supporting organization, funded by tax deductible contributions may be making loans to its founder, paying little to charity, or holding business assets to keep control of a family corporation in the family (and out of the family's estate for estate tax purposes): all practices that likely would be subject to excise taxes if the organization were a private foundation.¹⁰³

The donor advised fund is another private foundationesque public charity, but unlike a supporting organization, did not (at the time) have any official designation in tax law. Often referred to as the "poor man's" private foundation, a donor advised fund is, as its name suggests, a fund, established for charitable purposes, and with respect to which a donor to the fund may provide nonbinding advice as to the fund's investment and expenditure. Donor advised funds take two basic forms: large funds that resemble mutual funds¹⁰⁴ and smaller funds housed at a "community foundation" (which

brother-sister relationship wherein the supported and supporting organizations have overlapping Board membership; and a "Type III" wherein the supporting organization must meet both a "responsiveness" test and an "integral part" test. See IRC § 509(a)(3)(B)(i), 509(a)(3)(B)(ii), and 509(a)(3)(B)(iii) respectively. See also Reg. § 1.509(a)-4(g), (h), & (i). For a description of the legal requirements applicable to supporting organizations prior to enactment of the PPA see Staff of Joint Comm. on Taxation, 110th Cong., General Explanation of Tax Legislation Enacted in the 109th Congress, at 644-650 (Joint Comm. Print 2007); Jonathan Weisman, HHS Secretary's Fund Gave Little to Charity, Wash. Post, July 21, 2006, at A01 ("The Internal Revenue Service has said the category is rife with abuse, designating 'supporting organizations' this year as one of its 'Dirty Dozen' top tax scams, along with Internet identity theft and offshore banks.").

103. IRC § 4941(d)(1)(B) (defining as self-dealing the "lending of money" between a private foundation and a disqualified person); IRC § 4942 (requiring private foundations to pay out a percentage of assets for charitable purposes each year); IRC § 4943 (limiting the business holdings of a private foundation). Some supporting organizations were marketed because of the freedoms offered. See, e.g., Albert B. Crenshaw, Doing Good for Charities and Your Taxes, Wash. Post, Oct. 26, 2003, at F04 ("Individuals who are interested in charitable giving, especially to a specific cause, and want to continue to exercise considerable control over where their money goes without some of the restrictions that apply to private foundations, can consider what is called a supporting organization.").

104. As of April, 2009, the three largest donor advised funds are the Fidelity Charitable Gift Fund (\$3.6 billion in assets under management), the Schwab Charitable Fund (\$1.7 billion in assets under management), and the Vanguard Charitable Endowment Program (\$1.6 billion in assets under management). Mike Spector, Family Charities Shift Assets to Donor Funds, Wall Street J., April 22, 2009, at D1.

despite the name is a public charity under the tax law, and not a private foundation, e.g., New York Community Trust). The key difference between a donor advised fund and a private foundation is that donor advised funds generally have many different, unrelated donors. This enables the fund to be defined as a public charity and not a private foundation for tax purposes, and also introduces a level of oversight between the donor and the owner of the funds (the sponsoring charity). But like the Type III supporting organization and the private foundation, the donor advised fund also is a fund of money subject to the influence of its funder. And like the supporting organization, the donor advised fund is not subject to the private foundation anti-abuse legal regime. Accordingly, it is a magnet for potential abuse. Without proper oversight by the charity housing the fund, donors may be able to use a donor advised fund to pay personal expenses, compensation, and even to dilute the meaning of charity. There was no poster-child for donor advised fund abuse; but they had long been a subject of discussion in government and by legal practitioners, and increasingly had become a tool of promoters trading in tax schemes.¹⁰⁵

6. Hospitals

Tax exemption for nonprofit hospitals as a class has deep historical roots, and hospitals are the largest segment of charitable organizations, accounting for 41.25 percent of revenues and 29.13 percent of assets though comprising just .65 percent of organizations.¹⁰⁶ As such a large and important part of the sector, hospitals have long been in the spotlight, often presenting key questions in many areas regarding, for example: the scope of tax exemption, conflicts of interest, the provision of charitable services,

105. Letter from Mark W. Everson, *supra* note 101, at 5-6, available at <http://finance.senate.gov/imo/media/doc/Letter%20from%20Everson.pdf> (describing abuses at donor advised funds as a top compliance problem: “We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer’s personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible. . . . Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donor . . . to reimburse them for their expenses, or to fund their children’s educations.”); See e.g., Crenshaw, *supra* note 103, at F04 (quoting a wealth adviser from J.P. Morgan Private Bank: “A lot of people find those extra [private foundation] duties are more onerous than they would like and more onerous than they expected when they got in,” and so opt for a donor-advised fund. “It has to be a real donor-advised fund . . . but then you can relieve yourself from all the rules and regulations” and still achieve your initial goals “in a much simpler fashion.”).

106. Molly F. Sherlock & Jane G. Gravelle, Cong. Research Serv., R 40919, *An Overview of the Nonprofit and Charitable Sector 10* (2009).

participation in joint ventures with for-profit companies and other complex structures, conversion from non-profit to for-profit status, tax-exempt financing, and compensation practices. During the period of mounting scandal in the charitable sector, many hospitals added fuel to the fire. One noteworthy exposé in the New York Times Magazine provided an account of Michael Loncar, a poor and uninsured patient who died; his \$40,000 hospital debt kept him at home instead of seeking emergency care.¹⁰⁷ After his death, the hospital, Advocate Christ Medical Center in Chicago, pursued the debt by attaching his widow's (a Walmart clerk) wages.

When a faith-based hospital sues a grieving widow over medical debt, plunging her family deeper into poverty, some part of the health care system has clearly failed. But which part, exactly? One answer is to blame the hospital, which is precisely what many advocates, elected officials and academics have been doing as stories like the Loncars' have made headlines in the last year. "To put so much silent agony on hapless, hard-working low-income Americans, that's just absolutely unacceptable as conduct," says Uwe Reinhardt, the well-respected Princeton health economist.¹⁰⁸

According to the article, the hospital charged exorbitant rates, rates at which no insured patient (or rather, no insurance company) would ever pay and followed up with threats and harassment by a debt-collection agency in its employ. Another hospital system, Resurrection Health Care based in Chicago was reported to have drafted or adopted policies that aimed to deny nonemergency care to the uninsured, and Resurrection stood accused of pursuing debts against seventy-seven indigent patients over a four-year period.¹⁰⁹ This was "charity" being described at its worst. Unfortunately, the tale was not an isolated one. Class action lawsuits were mounted with respect to the billing and debt-collection practices of hospitals regarding the uninsured, gaining considerable media attention (if not legal success).¹¹⁰ States took note. Illinois revoked the property tax exemption of a prominent

107. Jonathan Cohn, *Uncharitable?*, N.Y. Times Magazine, Dec. 19, 2004, at 51.

108. *Id.*

109. *Id.*

110. Holbrook Mohr, *Suit Alleges Lack of Charity at Nonprofit Hospitals*, Wash. Post, June 18, 2004, at E03 (reporting on suits in eight states by attorney Richard Scruggs targeting "[s]ome of the country's largest nonprofit hospitals" and "alleging they have distorted the extent of their charity care while using punishing tactics to obtain payments from uninsured patients"). The suits were not successful. See, e.g., *McCoy et. al. v. E. Tex. Med. Cent. Reg'l Healthcare Sys.*, 388 F. Supp. 2d 760, 768 (E. D. Tex. 2005) (finding that § 501(c)(3) of the Code did not establish a contract between the federal government and the hospital and, thus, class members (patients) could not be third-party beneficiaries); *Sabeta v. Baptist Hospital of Miami, Inc.*, 410 F. Supp. 2d 1224, 1234-35 (S.D. Fla. 2005) (same).

hospital¹¹¹ and the State legislature considered a bill to require nonprofit hospitals in Illinois to provide a measure of free care each year as a condition of tax exemption.¹¹²

7. Credit Counseling Organizations

No less distracting to those following events were reports from a much smaller segment of the charitable sector: credit counseling organizations. Originally established to provide education and free counseling to consumers about use of credit and sound financial practices,¹¹³ the credit counseling organization of the twenty-first century had become an opportunistic industry, resembling a for-profit service provider in all but tax status. The educational component of many credit counseling organizations became nominal at best; instead, an organization would encourage consumers to sign up for debt management plans, for which the organization received a fee and often a for-profit organization (a bank or other service provider) would get a referral. Managers of credit counseling organizations were paid large sums in compensation. According to one estimate, the industry grew five-fold between 1990 and 2002 (for a total then of 1,000 organizations), and saw 810 applications for tax exemption between 2000 and 2003.¹¹⁴ Many believed that section 501(c)(3) status was attractive not so much for the tax benefit (tax exemption, though not deductibility for contributors, also might be available under another section of the Code, section 501(c)(4)), but because section 501(c)(3) organizations also obtained

111. See *Dept. of Revenue v. Provena Covenant Med. Ctr.*, No. 04-PT-0014 (Sept. 29, 2006), available at <http://www.revenue.state.il.us/legalinformation/hearings/pt/pt06-26.pdf> (upholding revocation of Provena's property tax exemption), *aff'd*, 925 N.E.2d 1131 (Ill. 2010). For a discussion of the Provena saga, see John D. Colombo, *The Provena Tax Exemption Case: The Demise of Community Benefit?*, 2007 Tax Notes Today 30-51 (Feb. 2007).

112. See the Tax-Exempt Hospital Responsibility Act, Ill. H.B. 5000, 94th Gen. Assemb. (2006) (generally proposing that tax-exempt hospitals (with some exceptions) must provide uncompensated care in an amount equal to at least 8 percent of their total operating costs).

113. Rev. Rul. 69-441, 1969-2 C.B. 115 (recognizing as a § 501(c)(3) organization an organization that (1) educates the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit and (2) providing individual counseling to low-income individuals and families without charge).

114. Permanent Subcomm. on Investigations, S. Comm. on Homeland Security & Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling* 5 (2004).

favorable treatment under consumer protection laws (and for example escaped jurisdiction of the Federal Trade Commission).¹¹⁵

8. *Use of Charities by Members of Congress*

Many, if not most, elected public officials are motivated to run for public office out of some desire to serve the public interest. So it is not surprising that many charities have the support of and even are founded by Members of Congress. But the 2000s saw a plethora of news stories about charities being used for political purposes.¹¹⁶ The issues of concern are several. One is that a lobbyist (or representative of a “vested interest”) is encouraged to make a contribution to a charity controlled or influenced by a politician. The charity has on its payroll friends of the politician or members of the politician’s family. Thus, the charity in effect launders the lobbyist’s

115. See Staff of Joint Comm. on Taxation, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures, Part VIII, 329 (Joint Comm. Print 2005).

116. Paul Kane, Members Feel Very Charitable, Roll Call, Mar. 16, 2004 (“At least 48 current Members of Congress have either set up charitable foundations or had supporters establish such organizations in their names. . . . Critics of the growing trend of Members connecting themselves to charities question whether this is little more than another means for lobbyists and corporations to curry favor with a lawmaker, giving large dollars to a favorite charity to enhance one’s interests.”); Paul Kane, Lobbyists Help Stevens Charity, Roll Call, Mar. 11, 2004 (reporting the christening of a foundation founded by Senator Ted Stevens, the opening event of which was run by a 14-member steering committee, all registered lobbyists, and which raised at least \$2 million from “hundreds of supporters, including dozens of lobbyists with business before his panel”); Damon Chappie, Delay Foundation Exploits New Rules, Roll Call, Jan. 20, 2003 (reporting that then House Majority Leader Tom DeLay engineered a change to House rules to permit lawmakers to accept free travel and lodging in connection with charity events, thus permitting travel to a golf tournament fundraiser in Florida held for the benefit of the DeLay Foundation); Philip Shenon & Stephanie Strom, DeLay Charity for Children Financed by Corporations, N.Y. Times, Apr. 21, 2005, at A16 (reporting that the DeLay Foundation “has been underwritten by several of the nation’s largest companies and their executives, including companies that routinely lobby lawmakers on issues before Congress”); Eliza Newlin Carney, Charitable Chicanery, Nat’l J., June 24, 2006 (“What do scandal-plagued politicians Duke Cunningham, Tom DeLay, and Alan Mollohan, along with disgraced lobbyist Jack Abramoff, all have in common? . . . the alleged abuse of so-called ‘charities’ for political gain.”); Editorial, Charities on the Hill, Wash. Post, Mar. 7, 2006, at A16 (expressing concern that a charity created by then-Senator Rick Santorum paid large salaries to fundraisers who also helped Santorum fund his political campaigns). For a detailed discussion of many of the issues see Jack B. Siegel, The Wild, the Innocent, and the K Street Shuffle: The Tax System’s Role in Policing Interactions Between Charities and Politicians, 54 Exempt Org. Tax Rev. 117 (2006).

payment resulting in personal benefit to the politician from the contribution. Another is that lobbyist contributions to charity are used to fund travel by politicians to desirable locations, where lobbyists also are present.¹¹⁷

9. "Excess" Compensation

Compensation to a CEO or other insider is a lens through which the charitable sector is sometimes judged. The issue strikes a populist chord, in part because, arguably, the general public's perception of charity and what it means to do charity is consistent, or at least not inconsistent, with penury. So it can come as a shock for some to learn that executives or employees of charitable organizations earn hundreds of thousands or even millions of dollars a year, even if the amount is reasonable in legal terms or is established pursuant to arm's length negotiations and at a "market" rate.¹¹⁸ Thus, compensation is an ongoing pressure point for the charitable sector, with one or a handful of cases able to affect opinion.

If there was a catalytic compensation-related scandal in the lead-up to charitable reform legislation, most likely it was that involving American University President Benjamin Ladner. The scandal began when an anonymous letter claimed that Ladner used University money for extravagant personal expenses. The letter led to an investigation and report by outside counsel, which identified \$500,000 in questionable expenses (including over \$200,000 for a chef). During the investigation, the reasonableness of Ladner's \$800,000 salary, the oversight of his compensation package by the

117. Charities also were used in novel ways: Representative Tom Delay and Senator Bill Frist planned to use charities in connection with events at the 2004 Republican National Convention. John Bresnahan, *Texas Starts New Charity, Roll Call*, Nov. 13, 2003 (reporting that Majority Leader Tom DeLay created a new charity in connection with the upcoming Republican convention; a contribution of \$500,000 yields private dinners with Delay, golf tee times, a yacht cruise, concert tickets, and access to a luxury suite during the convention); Editorial, *The Hammer Eyes Manhattan*, N.Y. Times, Nov. 18, 2003, at A24 (same); Michael Slackman, *G.O.P. Leader Solicits Money for Charity Tied to Convention*, N.Y. Times, Nov. 14, 2003, at A1 (noting that Bill Frist appeared to follow Delay's lead).

118. In general, if a charitable organization pays unreasonable compensation to an insider of the organization, excise taxes apply to the disqualified person and possibly to managers of the charity. IRC § 4958. There is generally no sanction for unreasonable compensation paid by a public charity to someone not an insider unless the "private benefit" doctrine can be invoked, resulting in loss of charitable exemption. (In contrast, under § 4946, an excise tax may be imposed on a private foundation with respect to unreasonable compensation paid to someone not an insider or, technically, a disqualified person as defined in § 4946). For a discussion of whether current public charity excise taxes should be extended to cover compensation to non-insiders, see Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 *Fordham L. Rev.* 735 (2007).

Board of Trustees, and the manner of disclosure to the IRS of Ladner's compensation were all questioned.¹¹⁹ There were similar scandals and raising of eyebrows at "high" compensation levels at a number of charitable organizations.¹²⁰

C. Summary

The reported scandals demonstrated a widespread abuse of the charitable form. "Charity" is not only a word that evokes feelings of concern toward others and thoughts of public goods, but also a label that happens to be a valuable asset. A charity can be used in many non-charitable ways: as an accommodating party for tax avoidance transactions, as a tool of a private interest (including a Member of Congress), or as a way to facilitate charitable contributions with little or no benefit to charitable beneficiaries and at real cost to the government (and thus, to the taxpayer). The car donation programs embraced by so many charities showed complacency about the tax preference. Charities of course wanted money and would accept pennies even though the cost to the government plausibly was far greater. In other cases, charities accepted contributions with the likely knowledge that the taxpayer was claiming a deduction in excess of the value of the asset.¹²¹ Worse, some charities were formed for the sole purpose of encouraging contributions of arguably worthless assets (façade easements) or directing benefits to an insider (supporting organizations and donor advised funds), or were paid for the act of participating in a transaction (SC2). Some credit counseling organizations arguably were formed to escape regulation of consumer protection laws. Some educational organizations were used by

119. For a discussion of the scandal, see Michael W. Peregrine & Robert C. Louthian, *American University: Significant Implications for Nonprofits*, 50 *Exempt Org. Tax Rev.* 337 (2005); Grant Williams, *American University Faces Scrutiny Over President's Pay, Spending*, *The Chronicle of Philanthropy*, Oct. 13, 2005.

120. Riva D. Atlas & Stephanie Strom, *Doesn't Anyone Want to Manage Harvard's Money?*, *N.Y. Times*, Aug. 5, 2005 (noting that some of the salaries of Harvard's investment managers exceeded \$35 million); Noelle Barton & Peter Panepento, *Executive Pay Rises 4.6%*, *Chron. of Philanthropy*, Sept. 20, 2007; Joann S. Lublin & Daniel Golden, *Golden Touch: Vanderbilt Reins In Lavish Spending By Star Chancellor—As Schools Tighten Oversight, A \$6 Million Renovation Draws Trustees' Scrutiny—Marijuana at the Mansion*, *Wall St. J.*, Sept. 26, 2006, at A1 (reporting on the repercussions from Chancellor Gordon Gee's \$1.4 million dollar salary and spending practices); Elizabeth Schwinn, *Big Nonprofit Salaries Face Government Scrutiny*, *Chron. of Philanthropy*, June 24, 2004 (noting that "[d]espite the slow economy, the salaries of chief executives rose 4.3 percent in 2002").

121. Although no cases of aiding and abetting the avoidance of income tax were raised, and could be difficult to prove, it is against the law to facilitate the tax avoidance of others. IRC § 6701.

lobbyists to advance a viewpoint.¹²² One must be careful not to paint with too broad a brush: most charities do not engage in such behavior. But the widespread examples showed that charity could and was being used abusively, even by the well-intentioned.

The scandals also show that the charitable sector, viewed in its entirety, is an extremely difficult thing to understand, much less address legislatively, in a holistic or comprehensive fashion. To a certain extent, the scandals speak to everything, and suggest that something is wrong here, but what? They present a case-by-case call for “reform” without neatly presenting what the deeper problems might be. Upon reflection, the scandals place a focus on how charity is regulated at the turn of the century, on a charitable sector that looks much different today than the one that was in existence when the original tax benefits were offered, and highlight fundamental issues in the design and stability of the rules governing charitable organizations. As discussed in the next Part of this Article (Part IV), although the legislative response is to a certain extent cryptic on the big picture, a careful reading of the legislation shows that the legislative policy toward charitable organizations is shifting. Emerging from the reform legislation is a frustration with the breadth of the charitable designation, a resulting trend toward more categorical distinctions among charities based on purpose, the breakdown of the public charity-private foundation distinction, and a resort to brighter lines to aid enforcement.

PART IV. PIECEMEAL REFORM

A. The Legislative Response

The many scandals involving charitable organizations demanded a Congressional response; and Congress responded. A flurry of hearings and papers ensued,¹²³ and resulted in three pieces of legislation containing

122. Minority Staff of S. Comm. on Fin., 109th Cong., Investigation of Jack Abramoff’s Use of Tax-Exempt Organizations (Comm. Print 2006).

123. In the 107th Congress, the post-9/11 controversy involving the American Red Cross led to a hearing, see *supra* note 61. In the 108th Congress, the hearings continued. Nonprofit Credit Counseling Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 108th Cong. (2003); Pricing Practices of Hospitals: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 108th Cong. (2004); Charity Oversight and Reform: Hearing Before the S. Comm. on Fin. *supra* note 7 (including two witnesses who appeared with distorted voices, behind black curtains, and with anonymous names—a “Mr. Car” described car-donation schemes, and a “Mr. House,” described abuses related to down payment assistance organizations). In connection with the latter hearing, the staff of the Senate Finance Committee released a “Staff Discussion Draft,” a list of proposals contemplating major change

in the charitable sector. See Staff of S. Comm. on Fin., Tax-Exempt Governance Proposals: Staff Discussion Draft, available at <http://finance.senate.gov/imo/media/doc/062204stfdis.pdf> (last visited Feb. 3, 2011). The Finance Committee also subsequently conducted a closed door meeting (at which the author was present) with representatives of the charitable community. Senate Finance Committee, Roundtable Discussion on Exempt Organizations, July 22, 2004.

The papers and hearings continued in the 109th Congress. See Staff of Joint Comm. on Taxation, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures 220 (Joint Comm. Print 2005) [hereinafter JCT Options Report]. In this 400-plus page document, over 100 pages provided detailed reform proposals relating to tax-exempt organizations. The author served as Legislation Counsel to the Joint Committee on Taxation at the time, with chief responsibility for exempt organization issues, and so directed the exempt organizations portion of the report. See also Panel on the Nonprofit Sector, Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector (2005) (responding to a request from Senator Grassley, the nonprofit group Independent Sector convened a panel of nonprofit experts resulting in this report, recommending a variety of legislative, regulatory, and self-regulatory initiatives); Charities and Charitable Giving: Hearing Before the S. Comm. on Fin., *supra* note 71; The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform: Hearing Before the S. Comm. on Fin., 109th Cong. (2005). The House Committee on Ways and Means conducted a hearing that seemed to have the potential for a groundbreaking review of the foundational law. Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways & Means, 109th Cong. (2005). The Comptroller General, the Joint Committee on Taxation Chief of Staff, the Director of the Congressional Budget Office, two law professors, a former IRS Commissioner, and a leading nonprofit expert testified on the development of the law of charity and generally portrayed it as chaotic, often without a clear rationale, and suggested that a major reconsideration of the law was in order. *Id.* at 9 (statement of David M. Walker, Comptroller General, U.S. Government Accountability Office) (“On a broad scale, a comprehensive re-examination [of the tax-exempt sector] could help address whether exempt entities are providing services to our citizens commensurate with their favored tax status, whether the current number and nature of exemptions continue to make sense, whether restrictions on the activities of tax-exempt entities remain relevant, and whether the framework for ensuring that exempt entities adhere to the requirements attendant to their status is satisfactory.”); *id.* at 48 (statement of George Yin, Chief of Staff of the Joint Committee on Taxation) (“[T]hirty-six years after Congress first drew a meaningful legal distinction between publicly supported organizations and private foundations, it may not be as clear, given the growth and diversity of publicly supported organizations, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose.”); *id.* at 50-51 (statement of Douglas Holtz-Eakin, Director of Congressional Budget Office) (testifying with respect to the “untaxed business sector”); *id.* at 60 (statement of John D. Colombo, Professor, University of Illinois College of Law) (“[W]hile we have this vague notion that we grant exemption to charities because they ‘do good things’ for society, there has never been a

specifically-articulated rationale that allows us to tie down exactly what good behavior should be rewarded with exemption. . . . So in some cases we have ended up with a sort of disconnect between our traditional views of charities and the way they operate in the real world today.”); *id.* at 64 (statement of Frances R. Hill, Professor, University of Miami School of Law) (“While current law indeed provides that provision of benefits to the designated class of beneficiaries is the foundational requirement for exemption, this requirement has not been developed as an affirmative requirement. Instead, administrative efforts, policy discussions, and academic analyses focus largely on preventing impermissible private benefit. Preventing misuse of exempt organizations’ resources is a matter of central importance. But, it does not provide either a rationale for exemption or an analytical framework for understanding exemption. As exempt entities engage in an ever-broadening range of activities and as the exempt sector grows larger, more dynamic and more diverse, this is an appropriate time to consider the reasons for the exemption and the relationships between these fundamental rationales and current law.”); *id.* at 71, 74 (statement of Sheldon S. Cohen, IRS Comm’r from 1965-1969) (“Questions about the tax-exempt sector are increasingly important given that the sector is growing in both size and assets and has been playing an ever more important role in our society. . . . The question of whether the IRS is devoting appropriate audit attention to these organizations may depend to a large extent on budgetary constraints and the need for enforcement efforts in other areas.”); *id.* at 75, 77 (statement of Bruce Hopkins, Attorney) “[T]he statutory law concerning tax-exempt organizations has evolved over the decades in a disorderly, unplanned fashion. . . . The state of the federal tax law today is that it is unbalanced and uneven. . . . As the sector has grown, this situation has fostered or facilitated misunderstandings and abuses by certain tax-exempt organizations and tax law planners. Federal tax statutory law that addresses the gaps in the present-day overall statutory regime would provide a full legal structure that would address this problem. This, in turn would facilitate the ability of the IRS to provide meaningful guidance within that framework.”). This hearing was followed by separate hearings on the hospital sector, *The Tax-Exempt Hospital Sector: Hearing Before the H. Comm. on Ways & Means, 109th Cong. (2005)*, and on the deduction for façade easements, *To Review the Tax Deduction for Façade Easements: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 109th Cong. (2005)*. Notwithstanding many of the above claims, Congress was also given a different message, and opposition to reform efforts was stiff. Senator Santorum in particular was skeptical of the need for reform. See *Charities on the Frontline – How the Nonprofit Sector Meets the Needs of America’s Communities: Hearing Before the Subcomm. on Soc. Sec. and Family Policy of the S. Comm. on Fin., 109th Cong. 75 (2005)* (written statement of Sen. Rick Santorum, Chairman, Subcomm. On Soc. Sec. and Family Policy) (urging passage of the CARE Act and characterizing the reform initiative as a “specter of a series of proposals that would collectively require the charitable community and its donors to bear a significant burden for dubious public benefit. There are enough laws on the books to ensure that donors are protected—the question is enforcement.”). Letters signed by reams of charitable organizations also circulated the halls of Congress protesting the need for reform.

significant reform-oriented provisions. The American Jobs Creation Act of 2004 (AJCA)¹²⁴ enacted new rules to curtail donations of vehicles¹²⁵ and intellectual property¹²⁶ to charitable organizations.¹²⁷ The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)¹²⁸ enacted a stiff new excise tax on exempt organizations that acted as accommodation parties in tax-shelter transactions.¹²⁹ And Title XII of the Pension Protection Act of 2006 (PPA) enacted eighteen separately-described reform provisions.¹³⁰ Six of these concerned noncash charitable contributions, with new rules applying to contributions of façade easements,¹³¹ taxidermy,¹³² fractional contributions (typically of art),¹³³ clothing and household items,¹³⁴ and property intended

124. Pub. L. No. 108-357, 18 Stat. 1418 (2004).

125. Id. § 884(a) (codified as amended at IRC § 170(f)(12)) (generally limiting the amount allowed to be deducted for charitable contributions of vehicles (valued at over \$500) to the actual sales price of the vehicle, unless the vehicle actually is used by the charity for charitable purposes, in which case a fair market value deduction is allowed).

126. Id. § 882 (codified as amended at IRC § 170(e)(1)(iii),(m)) (providing that no deduction was allowed for appreciation with respect to charitable contributions of intellectual property, but that additional charitable deductions could be awarded based on income to the charitable donee that is attributable to the contributed property).

127. In addition, rules to improve valuation standards and require appraisals in certain instances also were added. Id. § 883(a) (codified as amended at IRC § 170(f)(11)). This provision was estimated to raise \$102 million over ten years. Staff of the Joint Comm. on Taxation, 108th Cong., Estimated Budget Effects of the Conference Agreement for H.R. 4520, The “American Jobs Creation Act of 2004,” at 9 item D.3 (Joint Comm. Print 2004).

128. Pub. L. No. 109-222, 120 Stat. 345 (2006).

129. Id. § 516 (codified as amended at IRC § 4965). The provision was based on a proposal from the JCT Options Report, *supra* note 123. It imposed a 100 percent excise tax on proceeds attributable to participation by a tax-exempt organization in a “prohibited tax shelter transaction,” which are transactions identified by the Treasury Department as such (technically, as a “listed transaction”) in a Notice. If the transaction becomes a prohibited transaction after the exempt organization enters into it, an excise tax of 35 percent applies to proceeds attributable to the transaction and allocable to the period after the transaction became a prohibited transaction. For additional discussion, see text accompanying notes 232-236.

130. Staff of Joint Comm. on Taxation, 109th Cong., Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 283-351 (Joint Comm. Print 2006)

131. Pub. L. No. 109-280, 120 Stat. 780, § 1213 (codified as amended at IRC § 170(h)(4)(B)).

132. Id. § 1214 (codified as amended at IRC § 170(f)(15)).

133. Id. § 1218 (codified as amended at IRC § 170(o)).

for a charitable use but not so used.¹³⁵ New valuation penalties applied in the case of overvaluations (for income and estate and gift tax purposes).¹³⁶ All cash contributions (and not just those of \$250 or more as under prior law) were required to be substantiated with either a bank record or by an acknowledgement of the charity.¹³⁷ New rules were written for supporting organizations¹³⁸ and donor advised funds.¹³⁹ Credit counseling organizations were subject to new standards for exempt status.¹⁴⁰ The tax rates that applied to the main private foundation excise taxes were doubled,¹⁴¹ as were the dollar caps that limit the overall amount of tax that can be paid by a charity manager under the intermediate sanctions regime.¹⁴² And after this initial

134. Id. § 1216 (codified as amended at IRC § 170(f)(16)).

135. Id. § 1215 (codified as amended at IRC §§ 170(e)(7), 6050L(a), 6720B).

136. Id. § 1219 (codified as amended at IRC §§ 6662 (changing thresholds in IRC § 6662(e), (g), (h)), 6664(c), 6696, 6695A).

137. Id. § 1217 (codified as amended at IRC § 170(f)(17)). Unlike many of the other reform provisions, substantiation for cash contributions was not a topic of special concern and not under much discussion at the time. The provision was introduced in part in the Senate bill to pay for the nonitemizer deduction, and also bore a rational connection to it, since a nonitemizer deduction would introduce millions of new taxpayers into the charitable deduction system, arguably warranting a need for greater substantiation. However, the substantiation provision survived the nonitemizer deduction's demise in part because it was by far the biggest revenue raiser of all the reform provisions. See Staff of Joint Comm. on Taxation, 109th Cong., Estimated Budget Effects of H.R. 4, the "Pension Protection Act of 2006," as Introduced in the House of Representatives on July 28, 2006, at 5 item XII.B.5 (Joint Comm. Print 2006) (scoring the substantiation provision, combined with a provision relating to changes in deductions for clothing, as raising \$480 million over 10 years).

138. Pub. L. No. 109-280, 120 Stat. 780, §§ 1241-1245 (codified as amended at IRC §§ 509(f), 4942(g)(4), 4943(f), 4945(d)(4)(A)(ii), 4958(c)(3)(f)(1)(D), 6033(l)).

139. Id. §§ 1231-1235 (codified as amended at IRC §§ 170(f)(18), 508(f), 2055(e)(5), 2522(c)(5), 4943(e), 4958(c)(2), (f)(1)(E), (f)(1)(F), (f)(7), (f)(8), 4966, 4967, 6033(k)). In addition, the Department of Treasury was told to study both types of entity. Id. § 1226.

140. Id. § 1220 (codified as amended at IRC §§ 501(q), 513(j)).

141. Id. § 1212 (codified as amended at IRC §§ 4941(a)(1), (a)(2), (c)(2), 4942(a), 4943(a)(1), 4944(a), (d)(2), 4945(a), (c)(2)).

142. Id. § 1212(a)(3) (codified as amended at IRC § 4958(d)(2)). In addition, the base for the tax on the investment income paid by private foundations was expanded to include appreciation from capital gain and income from alternative investments. Id. § 1221 (codified as amended at IRC § 4940(c)(2) and 4940(c)(4)(A)). There were also three disclosure-related provisions. Id. § 1223 (codified as amended at IRC §§ 6033(i), 6033(j), 6652(c)(1)(E), 7428(b)(4)) (requiring certain small exempt organizations, otherwise exempt from annual filing requirements, to file a short return with the IRS each year); Id. § 1225 (codified as

wave of legislation, in March 2010, additional exemption standards for charitable hospitals were enacted as part of the Patient Protection and Affordable Care Act (PPACA).¹⁴³

With well over 100 pages of statutory text, and multiple new sections and subsections of the Internal Revenue Code, the reform provisions are a lot of new law, but to what end? On the one hand, the legislation was not comprehensive reform. Rather, it may be characterized as a targeted response to specific problems raised by the scandals, rather than a rethinking of regulatory approach. On the other hand, the legislation represents an effort, conscious or not, at piecemeal or incremental reform, or perhaps, reform by stealth.¹⁴⁴ In this regard, as discussed in the sections that follow, the legislation charts a path toward a new regulatory approach for charitable organizations, one that favors more substantive distinctions among charities for exemption purposes, questions the current basis for distinguishing among charities, and points toward brighter enforcement lines.

B. Frustration with the Breadth of the Charitable Designation

As discussed in Part II, the federal tax law has been reluctant to impose affirmative positive requirements on charitable organizations.¹⁴⁵ Until recently, if an organization was a hospital, a university, a museum, an opera, a soup kitchen, an advocacy organization, a credit counseling organization, a homeless shelter, a local charity with \$50,000 in annual

amended at IRC § 6104(d)(1)(A)(ii)) (making the unrelated business income tax return a public document); Id. § 1224 (codified as amended at IRC §§ 6103(a)(2), (p)(3)(A), 6104(c)(2)-(c)(6), 7213(a)(2), 7213A(a)(2), 7431(a)(2)) (facilitating information sharing between the IRS and State attorneys general). There were also two other provisions. See id. § 1211 (codified as amended at IRC § 6050V), § 1223 (codified as amended at IRC § 7701(o)).

143. Pub. L. No. 111-148, 124 Stat. 119, § 9007.

144. Often, legislation is a product of the process that precedes it. Virtually all the charity-reform legislation originated on the Senate side, and the process there was focused on stopping abuse. The hearings produced a sense that something in the charitable sector was not right and needed fixing, but in general were designed just to make that very point. This ultimately proved to be a successful strategy for getting legislation enacted, but was less successful in producing legislation that addressed issues beyond the fairly limited scope of a given provision's target, whether it be contributions of façade easements or donor advised funds. That said, the Senate provisions were mindful of the larger context in which they were presented, and to a certain extent are legislative seeds, planted in the Internal Revenue Code, for later possible growth (or, perhaps, extinction). The process in the House was to lay a foundation for legislation that could address fundamental issues, but, at the end of the day, the House ran out of time to develop an alternative product to the Senate.

145. Also as noted above, the main exception to this is the private foundation payout requirement. IRC § 4942.

receipts, an international charity with \$10,000,000 in annual receipts, a fee-for-service organization that does not rely significantly on donations, or a charity that primarily raises money through donations and gives away its services, the same open-ended statutory standards apply for purposes of the charitable designation.¹⁴⁶

Although such an open-ended standard has benefits, it also comes with costs. The lack of affirmative standards for charity makes measurement and enforcement of charity difficult, a problem magnified the size of the sector. One alternative might be to impose requirements in the nature of how charitable resources are spent and for whom or to narrow the current broad scope of “charity.”¹⁴⁷ Another, less divisive, response is to focus on process. Positive but process-oriented requirements do not mandate that a specific type or amount of “charity” be provided, but nonetheless require action by the charity, action intended to facilitate production of the charitable good. The reform legislation took significant steps toward a more process-oriented approach to defining charity, one that can be tailored to distinct charitable purposes. As such, the reform legislation signals a shift away from a one-size fits all statutory standard for charitable organizations. As discussed below, credit counseling organizations and hospitals are cases in point.

1. Credit Counseling Organizations

The credit counseling industry is only a small part of the charitable sector—but, importantly, like hospitals, or colleges and universities, it is distinct and severable in terms of function. Indeed, the problem presented by credit counseling organizations is in many ways a perfect microcosm of what can go wrong. The original purpose of the credit counseling organization

146. The IRS may and does require that different types of organizations provide different information for purposes of an exemption application or information return. For example, hospitals and schools must file a distinct schedule with their application and annual return. Private foundations file a completely different annual information return, the Form 990-PF, than do public charities, which file the Form 990 or Form 990-EZ.

147. For example, charity for federal income tax purposes could be defined in its ordinary sense: relief of the poor. However, this approach to charity, for better or worse, was abandoned in 1959 when the Treasury adopted the legal definition of charity. See, e.g., JCT Historical Development, *supra* note 5, at 65. Although rhetoric is often expressed that charitable organizations should be those that serve the needy, and the failure of a need-based component to charity often plays a role in criticism of charitable organizations, there is not much evidence that Congress is seriously interested in providing a more substantive and positive definition of charity. However, as discussed herein, there is increasing evidence that the breadth of the charitable designation, and the relative absence of standards, is becoming less acceptable as the status quo, and that more must be asked of charity in some fashion.

was to educate consumers about the judicious use of credit. The traditional role of credit counseling organizations was described in a Senate Hearing as follows:

Since the 1960's, consumers with credit card debt regularly turned to their local non-profit credit counseling agency for advice and financial education. Consumers were given face-to-face counseling sessions with trained counselors. Credit counselors conducted a detailed budget analysis with a consumer, analyzed their spending habits, determined why the consumer was in debt, and educated the consumer in how to avoid falling back into debt. . . . Under traditional social service models, consumers who could not afford to make all their monthly credit card payments often enrolled in a debt management plan . . . which allowed them to consolidate their debts from several credit cards, reduce their monthly payments, and lower their interest rates. The traditional credit counseling agencies provided counseling, education, and debt management plans free of charge or for minimal contributions.¹⁴⁸

The IRS recognized the charitable status of such credit counseling organizations in the 1960s by revenue ruling.¹⁴⁹ However, the industry found the limitations in the ruling too constraining, and sought charitable status notwithstanding that services would not be restricted to the poor and nominal fees would be charged for enrolling in debt management plans. The IRS rejected charitable status for such groups, but was overturned in court.¹⁵⁰ Thus an incremental expansion of charitable status was allowed.

By the early 2000s, the industry had changed. Pursuant to an investigation of credit counseling organizations in 2004, the Senate Committee on Governmental Affairs described the industry as follows.

New and aggressive credit counseling agencies have changed the manner in which consumers are treated. These changes have resulted in consumer complaints about

148. Profiteering in a Non-Profit Industry – Abusive Practices in Credit Counseling: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Governmental Affairs, 108th Cong. 1-2 (2004) (opening statement of Sen. Norm Coleman).

149. Rev. Rul. 69-441, 1962-2 C.B. 115.

150. *Consumer Credit Counseling Serv. of Ala., Inc. v. United States*, 44 A.F.T.R. 2d (IRA) 5122 (D.D.C. 1978) (involving 24 agencies throughout the United States); see also *Credit Counseling Ctrs. of Okla., Inc., v. United States*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979).

excessive fees, pressure tactics, nonexistent counseling and education, promised results that never come about, ruined credit ratings, poor service, in many cases being left in worse debt than before they initiated their debt management plan.¹⁵¹

Some credit counseling agencies were described as “telemarketing sweatshops designed to take advantage of thousands of people in bad financial positions.”¹⁵² Their primary purpose it was said was to “sell a product—the Debt Management Plan—not to deliver a service of education and counseling.”¹⁵³

One explanation for the demise of credit counseling organizations rings true: “[M]oney is the root cause of these problems.”¹⁵⁴ The new credit counseling agencies were conglomerates, with the charitable organization the lure to bring in consumers who would be sold a debt management plan for excessive fees that would be “siphoned off” by affiliated for-profit companies. The credit counseling organization would pay affiliates for promotional materials, advertising, processing of applications, and other services. Managers of the credit counseling organization and the affiliates would be enriched at the expense of the consumer, who would receive no counseling and end up in worse financial condition than before.

Although greed may explain the abuse, if the enforcement apparatus had been effective, the abuse should have been stopped earlier. Many credit counseling organizations were in clear violation of the operational test of section 501(c)(3) and were not operated for public benefit. But it was only once abuses became widely reported, and Congress started looking into the matter, that the IRS began a serious investigation of the industry, placing tens of organizations under audit (including 40 percent of the entire revenue of the industry) and eventually revoking the charitable status of many of them.¹⁵⁵

Importantly, notwithstanding the enforcement effort, Congress decided to legislate new exemption standards for credit counseling organizations. In so doing, Congress carved out credit counseling organizations from the generic framework of section 501(c)(3), and provided a series of distinct bright-line standards for charitable status. Thus, after the PPA, if an organization has the provision of credit counseling services as a

151. Profiteering in a Non-Profit Industry: Hearing Before the S. Comm. on Governmental Affairs, *supra* note 148, at 3 (opening statement of Sen. Norm Coleman).

152. *Id.*

153. *Id.*

154. *Id.* at 4.

155. Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 109th Cong. 609-10 (Joint Comm. Print 2007).

substantial purpose, then, to be charitable, six extensive requirements must be met.¹⁵⁶ These include rules about the composition of the governing body, rules requiring a reasonable fee policy (one that requires provision of services even if the consumer does not have the ability to pay), rules about permissible practices (no loans to debtors, no separate charges for improving credit records, no solicitation of voluntary contributions from its customers), rules about ownership of related entities, and rules limiting the amount of allowable revenue from debt management plans.¹⁵⁷

Such statutory precision, some would say micro-management, regarding the conditions of charitable status for a particular type of organization was unprecedented. It represents a significant conceptual shift, considering that the general operating principle of federal charity tax law has been that for purposes of the exemption standard, all public charities are created equally; that is, if you have a “good” purpose, the law will not adversely discriminate because of such purpose.¹⁵⁸ Even when Congress created second-class citizenship for private foundations, foundations generally were disfavored because the form of the foundation could lead to abuse, and not because of the substance of their charitable activity.¹⁵⁹ By contrast, credit counseling organizations now are singled out by their purpose, and special rules are applied on this basis.

Further, any class of charitable organization could be given its own subsection of the Code. Indeed, as if to signal as much, in describing the new requirements imposed on credit counseling organizations, the legislative history to the provision¹⁶⁰ provides in a footnote that the requirements to

156. The statutory language preceding the requirements is that the credit counseling organization must be “organized and operated in accordance with the following requirements. . . .” IRC § 501(q). By contrast, the normal blanket charitable exemption standard (the organizational and operational test) is that the organization be “organized and operated exclusively for . . . charitable . . . purposes.” IRC § 501(c)(3).

157. IRC § 501(q).

158. There is some affirmative discrimination based on purpose: churches, hospitals, and colleges and universities are generally considered to be “public charities” (and not private foundations) by definition—that is, based on their purpose. IRC § 509(a)(1).

159. See *infra* note 176.

160. JCT PPA Technical Explanation, *supra* note 130, at 263-363. Typically, legislation such as the Pension Protection Act would have “official” legislative history in the form of a conference report. For political reasons, the conference committee that would have reported out the PPA was disbanded, and the final legislation was negotiated outside of formal conference procedures. Accordingly, there is no conference report. The floor managers of the legislation, William Thomas (for the House) and Charles Grassley (for the Senate) both made statements on the floor to the effect that the Technical Explanation of the PPA written by the staff of the Joint Committee on Taxation was to be treated as if it were

provide services irrespective of ability to pay, the requirement to establish a reasonable fee policy, and the necessity of an independent governing body are

*core issues that are related to tax-exempt status and that have proved to be problematic in the credit counseling industry. . . . No inference is intended through the provision of these specific requirements on credit counseling organizations that similar or more stringent requirements should not be adhered to by other exempt organizations providing fees for services. Rather, the provision affirms the importance of these core issues to the matter of tax exemption, both to credit counseling organizations and to other types of exempt organizations.*¹⁶¹

In sum, the credit counseling legislation speaks to a frustration with open-ended exemption standards and with an enforcement apparatus that was slow to respond to a growing problem. The theory of the legislation is that if the statute provides more precise standards and brighter lines as to when a particular type of organization may qualify as charitable, then it will be easier to prevent bad entrants from sullyng an otherwise important industry. Afterward, the immediate question then became whether credit counseling organizations presented a unique situation, or whether this was a legislative precedent and model for the future for any organization that provides a particular type of service or performs charity in a particular manner.

the conference report. 152 Cong. Rec. S. 8747, 8763 (daily ed. Aug. 3, 2006) (statement of Sen. Max Baucus) (“A fair and good explanation of the bill can be found in The Technical Explanation of H.R. 4 prepared by the Joint Committee on Taxation.”); *id.* (statement of Sen. Charles Grassley) (“I would like to incorporate by reference a technical explanation being prepared by the staff of the Joint Committee on Taxation that describes the legislative intent with respect to H.R. 4, the Pension Protection Act of 2006. This document expresses our understanding of the provisions in the bill, and it will be a useful reference in understanding the legislation. Chairman [of the House Ways and Means Committee William] Thomas also made a statement on the floor of the House of Representatives last Friday that he had requested this technical explanation. The technical explanation will be published by the staff of the Joint Committee on Taxation as document number JCX-38-06, Technical Explanation of H.R. 4, The Pension Protection Act of 2006, as passed by the House on July 28, 2006, and as considered by the Senate on August 3, 2006.”).

161. JCT PPA Technical Explanation, *supra* note 130, at 318 n. 435 (emphasis added). The clear implication is that good governance, reasonable fees, provision of free services to the needy are “unwritten” conditions of charitable status.

2. Hospitals

As it quickly turned out, the credit counseling approach was a harbinger. In March 2010, following the lead of the credit counseling provision, Congress adopted new exemption standards for charitable hospitals.

As a class, hospitals are perhaps the most prominent part of the charitable sector, and have long raised questions about the breadth and amorphous nature of the charitable designation. Many hospitals are charitable for tax purposes yet may seem indistinguishable from a non-charitable and taxable for-profit hospital. Both, after all, perform similar functions. One obvious base for distinction is organizational form. The no-private-inurement requirement of section 501(c)(3) dictates that a charitable organization not have shareholders or stakeholders, a requirement clearly not met by a for-profit hospital. But organizational form is an unsatisfying basis to distinguish a for-profit and charitable hospital. Surely, there must be an operational difference. Thus the questions have been what a charitable hospital must do that is different from a for-profit hospital and what specifically is charitable about a section 501(c)(3) hospital. Since 1969, the legal answer has been that a charitable hospital must provide a “community benefit”,¹⁶² a standard, however that has been widely criticized for its lack of positive requirements.¹⁶³ Accordingly, the pressure point for charitable hospitals as a class of organization has been whether to impose affirmative positive requirements, such as free or charity care, as a condition of the charitable designation, or whether general open-ended standards are sufficient.

Although the PPA deferred hospital-specific legislation to another day,¹⁶⁴ that day came in March 2010. Pursuant to the PPACA, hospitals, like

162. Rev. Rul. 69-545, 1969-2 C.B. 117.

163. It is beyond the scope of this article to weigh into this important and ongoing debate. See, e.g., John D. Colombo, *The Failure of Community Benefit*, 15 *Health Matrix* 29 (2005); Minority Staff of S. Comm. on Fin., *Tax-Exempt Hospitals: Discussion Draft* (2007), available at <http://grassley.senate.gov/releases/2007/07182007.pdf>; Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 *Yale J. on Reg.* 139 (2007); Robert Pear, *Hospitals Mobilizing to Fight Proposed Charity Care Rules*, *N.Y. Times*, June 1, 2009, at A12.

164. After enactment of the PPA, then-Chairman of the Ways and Means Committee William Thomas introduced legislation that would have required hospitals to provide free care to the poor, limited the amount hospitals could charge to the uninsured, and limited the debt collection practices of hospitals. H.R. 6420, 109th Cong. (2006). The IRS also took steps by releasing a new schedule to the annual information return for hospitals to complete annually (Schedule H to the Form 990), requiring hospitals to document the community benefit provided. The IRS also completed a study of the charity care and community benefit provided by

credit counseling organizations before them, now are subject to additional requirements to satisfy the charitable designation. Under PPACA, to maintain charitable status, hospitals must, among other things, conduct a “community needs assessment” at least once every three years,¹⁶⁵ establish a written financial assistance policy¹⁶⁶ and a written policy relating to the provision of emergency medical care,¹⁶⁷ limit the amount of charges to certain patients for emergency or other medically necessary care,¹⁶⁸ and refrain from engaging in “extraordinary collection actions” without first making reasonable efforts to discover whether a patient is eligible for financial assistance.¹⁶⁹ New reporting requirements¹⁷⁰ and excise taxes also apply.¹⁷¹

A full discussion of these new requirements is outside the scope of this Article, but a few points are noteworthy here. The legislation signals that Congress has, at least for a time, waved the white flag on imposing affirmative positive requirements on hospitals. The central issue driving the hospital debate was identifying the *charitable* characteristic of a hospital, and was often framed in terms of whether section 501(c)(3) hospitals provided a significant measure of charity care or could otherwise demonstrate a benefit to the community that differed from a community benefit provided by non section 501(c)(3) hospitals. Yet, the new standards for hospitals do not squarely address this issue. Instead of imposing a substantive positive requirement of charity, the legislation settles instead for process-oriented rules that are designed to promote a more charitable outcome. For example, the financial assistance and emergency care policies, and requirements to stop overcharging the indigent and performing unreasonable collections are anti-abuse oriented:¹⁷² i.e., focusing on stopping manifestly uncharitable behavior. Although important, this of course is different from affirmatively requiring charitable activity. To refrain from behaving badly is not, or should not be, equated with behaving well. The community needs assessment comes closer to addressing the charity question. By requiring section 501(c)(3) hospitals formally to assess the needs of their communities, the legislation

nonprofit hospitals and of their compensation practices. See *supra* note 10. In 2007, the Senate Finance Committee Minority Staff released a discussion draft of proposals, including recommendations that hospitals be required to provide some charity care as a condition of tax-exempt status. Minority Staff of S. Comm on Fin., *Tax Exempt Hospitals: Discussion Draft* (2007).

165. IRC § 501(r)(3).

166. IRC § 501(r)(4)(A).

167. IRC § 501(r)(4)(B).

168. IRC § 501(r)(5).

169. IRC § 501(r)(6).

170. IRC § 6033(b)(15).

171. IRC § 4959.

172. IRC § 501(r)(5), (6).

aims to force hospitals to consider how they are integrated within the communities they serve and, therefore, to take active steps to foster a community (and charitable) benefit. Notably, however, the legislation stays well on the side of process, providing no hint as to what a community benefit might be in substance.¹⁷³

The legislation also floats a trial balloon, which might be styled as the “mother of all process-oriented” positive requirements—a rule that the Treasury review at least once every three years “the community benefit activities of each hospital organization” covered by the legislation.¹⁷⁴ Although time will tell whether or not such a rule can make a meaningful impact (especially if funding is not available), the reason for such a rule in conjunction with the other process-oriented requirements is to keep the pressure on the hospital actually to do something charitable. A three-year review, in effect of charitable status, is a specter held over the hospital to provide proof of charity. Because there is no actionable definition of charity, or community benefit, however, there is likely to be frustration on both sides: how is a hospital to know whether its “community benefit activities” are sufficient; and how is the IRS to prove that a hospital is not discharging its obligations, whatever they may be? To a certain extent, the three-year review requirement is undermined by the presence of the other new hospital-level requirements: if a hospital conducts the community needs assessment and has in place the requisite policies, on what basis will the IRS revoke charitable status? The answer must be for failure to provide a community benefit. But this argument will be more difficult for the IRS to win if a hospital has fully complied with required processes.

In addition to highlighting the difficulty of imposing substantive positive charitable requirements, the legislation shows that Congress continues to wrestle with the all-or-nothing nature of the charitable designation. The new requirements are all conditions of charitable status. In theory at least, this means that if a charitable hospital violates a requirement, for example by engaging once in an unreasonable collection activity, the hospital’s charitable status is revoked. This outcome is highly unlikely, however, making these new requirements aspirational in nature—i.e., a

173. The advantage to such an approach is that a “community” based standard is local in nature and so arguably not amenable to a prescriptive top-down approach. Nonetheless, Congress clearly remains concerned about charity care, as evidenced by the requirement that the Secretary of the Treasury, in conjunction with the Secretary of the Department of Health and Human Services, submit an annual report to Congress regarding the level of charity care provided by all hospitals (taxable, charitable, and government) and, in five years, to provide a study on the trends shown in the annual reports. Pub. Law No. 111-148, 124 Stat. 119, § 9007(e).

174. *Id.* § 9007(c). The three-year review proposal is reminiscent of a five-year review proposal suggested for all charities suggested by the staff of the Joint Committee on Taxation in 2005. JCT Options Report, *supra* note 123, at 220-229.

sanction is plausible only in the most egregious of cases. There is one additional sanction, however. The failure to conduct a community needs assessment results in an excise tax of \$50,000.¹⁷⁵ Yet the excise tax is not an intermediate sanction, but comes in addition to loss of charitable status. On its face, therefore, it would seem to provide no additional incentive to perform the community needs assessment, or even give the IRS an additional enforcement tool. In practice, however, it may turn out to be an intermediate sanction, imposed independently of revocation.

In sum, the new rules for hospitals highlight the law's continuing struggles with developing workable standards within the current legal framework. This latest effort to tighten the standards for charitable status highlights how difficult it is when there are no positive charitable obligations to enforce and the principal sanction is revocation of charitable status. The most plausible outcome will be more process, more bureaucracy, and arguably, even less charity. Regardless, the fact that Congress, following the credit counseling model, has decided further to fragment the charitable sector, is more evidence of frustration with the historical approach of one statutory standard for all.

C. Breakdown of the Public Charity-Private Foundation Distinction

1. In General

As discussed in Part II, initially, the law made no distinction among charitable organizations: all charities in effect were treated equally. Yet, as time passed, the private foundation, as it came to be called, was singled out for adverse treatment.¹⁷⁶

175. IRC § 4959. Interestingly, on its face, the \$50,000 excise tax appears to apply to for-profit as well as charitable hospitals. Organizations subject to the tax are "hospital organization[s] to which section 501(r) applies." *Id.* Section 501(r) applies by its terms to "an organization which operates a facility which is required by a State to be licensed, registered, or similarly recognized as a hospital." IRC § 501(r)(2)(A)(i). For-profit hospitals, like nonprofit hospitals, generally are required to be licensed by a State as a hospital. It follows that the other requirements of § 501(r) also apply to for-profit hospitals, but the sanction for failure to meet such other requirements is loss of charitable status, not a financial penalty. Loss of charitable status would of course have no effect on, and so would not be applicable to, a for-profit hospital.

176. Although not formally codified until 1969, the private foundation existed, and was disfavored, beforehand. For an overview of the pre-1969 legal differences between public and private charities, see JCT Historical Development, *supra* note 5, at 85-89. Notwithstanding a complex legal definition, IRC § 509, at its core, a private foundation is a fund of money, typically a large fund, controlled by a few people (i.e., "private," shielded from public control or influence) and established for a worthy cause. However, the close control of the foundation, often by persons

The private foundation is defined in the negative, as a charity that cannot qualify as a public charity.¹⁷⁷ The question defining the distinction then is what makes a charity “public.” Some organizations are deemed public charities because of their function and role in the community: hospitals, colleges and universities, and churches.¹⁷⁸ For most other organizations to qualify, they must satisfy a public support test.¹⁷⁹ The theory is that all such “public” organizations will be overseen effectively by their donor or service-based community. Such oversight, lacking for a private foundation, means in theory that the public charity is less susceptible to abuse, and so should escape additional regulation.¹⁸⁰ In effect, by distinguishing public charity

with a sense of entitlement to its assets, means that the temptation to spend foundation money for personal use or extravagance is always present. This structural problem, among other things, made foundations a target of reform in the mid twentieth century. See *infra* note 179. See Thomas A. Troyer, *The 1969 Private Foundations Law: Historical Perspectives on Its Origins and Underpinnings*, 27 *Exempt Org. Tax Rev.* 52 (2000). IRC §§ 509, 4941-4945. Over forty years later, the private foundation rules have withstood criticism and remained remarkably intact, considering their stringency and the tendency of Congress to relax rules over time.

177. IRC § 509 (defining a private foundation negatively, as everything other than an organization described in § 509(a)(1)-(4)). Although the term “public charity” is not itself a defined term in the Code, it has become a term of art to describe all charities other than private foundations.

178. IRC §§ 509(a)(1), 170(b)(1)(A)(i)-(iii).

179. IRC §§ 509(a)(1), 170(b)(1)(A)(iv), 170(b)(1)(A)(vi), 509(a)(2). There are other public charities: a supporting organization (IRC § 509(a)(3)), a governmental unit also organized as § 501(c)(3) organization (IRC §§ 509(a)(1) and 170(b)(1)(A)(v)), and a public safety organization (IRC § 509(a)(4)). Although very complex, the public support tests are designed to ensure that the organization has widespread public support, something a private foundation, classically understood, will not be able to do if it is funded by a single donor or family. Regs. §§ 1.170A-9, 1.509(a)-3.

180. As Thomas Troyer noted in discussing the history of the 1969 Act: “For public charities . . . there was no even remotely similar body of evidence of abuses of the sort that were the principal focus of the foundation legislation; and Congress quite naturally did not prescribe the foundation remedies where it found no foundation-like ills.” Troyer, *supra* note 176. In 1996, Congress realized that insider dealing was a problem at public charities as well as private foundations, that revocation of charitable status was not an effective sanction, and so enacted the “intermediate sanctions” regime for public charities. See *infra* note 39. The notable difference between the two self-dealing regimes is that the private foundations are generally barred (through imposition of steep excise taxes) from insider deals (including loans, sales of property, use of charitable assets for non-charitable purposes) while the public charity regime permits such transactions, so long as they are at fair market value. Where the two regimes coalesce is on compensation: it is allowed, but must be reasonable. Compare IRC § 4941, with § 4958.

from private foundation in this way, Congress assumed that public charities did not raise the same concerns, either as a matter of form or substance.

The consequences of being public or private are stark. Operationally, a comprehensive anti-abuse regime—a series of negative restrictions—applies to private foundations, and is enforced by stiff excise taxes. The anti-abuse rules target four areas: self-dealing between the foundation and foundation insiders, excessive ownership of a for-profit business, the making of risky investments, and spending for non-charitable purposes.¹⁸¹ In addition, private foundations are subject to a key positive requirement—they must pay out a percentage of investment assets each year for charitable purposes.¹⁸² Private foundations also are disfavored for purposes of the charitable deduction rules: a smaller percentage of a taxpayer's gross income may be deducted as a charitable contribution to a private foundation than to a public charity,¹⁸³ and a fair market value deduction generally is not available for charitable contributions of appreciated noncash property to private foundations (other than publicly traded securities).¹⁸⁴ Finally, as noted earlier, most private foundations but not public charities also must pay a tax on investment income.¹⁸⁵

The existence of the distinction is important conceptually because it demonstrates in law and policy a preference for certain categories of charitable organizations over others. Relatedly, the distinction also shows that, at least with respect to certain types of charity, affirmative positive requirements can be made a condition of exemption: i.e., the private foundation pay-out requirement. That said, the public charity-private foundation distinction is largely one of form and not substance. The differential treatment between the two types is based not on whether a specific activity or purpose should be preferred (e.g., by providing greater incentives for soup kitchens over the opera), but rather on the likelihood of abuse occurring at one or another type of charity. In addition, public charities also are preferred to private foundations, especially for charitable deduction purposes, because of the manner in which charity is delivered. A public charity directly provides a charitable benefit through operation of charitable

181. IRC §§ 4941, 4943, 4944, 4945. It is beyond the scope of this Article to inquire into the rationales and rules for each of these provisions.

182. IRC § 4942. Even prior to 1969, Congress was concerned about unreasonable accumulations of income. See Pub. L. No. 81-814, § 331 (1950) (imposing a reporting requirement for income accumulations by certain charitable organizations).

183. IRC § 170(b). Charitable contributions to public charities are deductible up to 50 percent of the taxpayer's adjusted gross income (30 percent in the case of capital gain property) as compared to 30 percent for contributions to most private foundations (20 percent in the case of capital gain property).

184. IRC § 170(e)(1)(B)(ii), (e)(5).

185. IRC § 4940.

programs; whereas a private foundation indirectly provides a charitable benefit through grants to others who will perform a charitable task. Thus, money given to a public charity arguably will get to the charitable beneficiary faster than money given to a private foundation, wherein there typically is a pause between the contribution and the realization of charity.¹⁸⁶ The distinction also evidences a resort to a brighter-line enforcement regime when abuse of charitable status becomes a concern.

The scandals of the early 2000s challenged the basis for the public charity-private foundation distinction. Notwithstanding the Boston Globe Spotlight series criticizing private foundations, most of the charities subjected to media scrutiny during this period were public charities. The allegations of abusive practices at iconic (and other) public charities such as the United Way and The Nature Conservancy, and at charities viewed as pillars of the community, hospitals and colleges and universities in particular, showed that the public support or inherent status approach to a public charity did not necessarily protect against abusive activity. Further, abuses reported at donor advised funds and supporting organizations directly called the distinction into question. Both donor advised funds and supporting organizations resembled private foundations in terms of function (as grant-making organizations) and by the influence of a donor over the distribution of assets. Yet both are considered public charities (supporting organizations because of a relationship to a public charity, and donor advised funds by satisfying the public support test), and so were not subject to the tougher rules.

With the focus thus on abuses at public charities, a question arose whether additional anti-abuse rules are necessary for public charities, and if so, which ones? Should the private foundation anti-abuse regime simply be extended to public charities?¹⁸⁷ To the extent that self-dealing with organization insiders at public charities is not sufficiently addressed by current law,¹⁸⁸ current law could be replaced with the less forgiving private-foundation self-dealing rules.¹⁸⁹ Similarly, the accumulation of charitable

186. This is also expressed through the provision that, for purposes of the percentage limitations, treats charitable contributions to certain “operating” private foundations, i.e., those that conduct active charitable programs, and to private foundations that distribute all of their income from contributions each year (conduit foundations), the same as charitable contributions to public charities. IRC §§ 170(b)(1)(A)(vii), 170(b)(1)(F).

187. See Marion Fremont-Smith, *Is it Time to Treat Private Foundations and Public Charities Alike?* 2006 Tax Notes Today 112-102, June 12, 2006.

188. IRC § 4958.

189. IRC § 4941. See Staff of S. Comm. on Fin., *Tax Exempt Governance Proposals: Staff Discussion Draft*, <http://finance.senate.gov/imo/media/doc/062204stfdis.pdf> (last visited Feb. 1, 2011) (suggesting that the private foundation self-dealing rules apply to public charities).

funds is not the exclusive province of private foundations. Public charities of course raise and accumulate money, the most obvious example being that of the large endowments held by many colleges and universities. Should public charities, like private foundations, be subject to private foundation-like payout rules?¹⁹⁰ Public charities commonly are owners of for-profit enterprises—a generally accepted and largely unexamined facet of the charitable sector. Private foundations, however, generally may not own significant portions of a business.¹⁹¹ Should the excess business holdings rules be extended to public charities?¹⁹² Public charities, like private foundations, make investments and spend money. But private foundations and not public charities face excise taxes for investments that jeopardize exempt purposes and for expenditures not for a charitable purpose.¹⁹³ Should public charities or their managers be subject to tax for imprudent investments or non-charitable spending?¹⁹⁴

Although the scandals directly or indirectly raised these questions, Congress did not explicitly consider the ongoing validity of the public charity-private foundation distinction in the PPA or other legislation. Indeed, the public charity-private foundation distinction remains a conceptual backbone of federal charity tax law. However, the very presence of the private foundation regime serves as a ready-made panacea for concerns about public charities. Accordingly, Congress made liberal use of the private foundation rules in its reform efforts for two types of public charity, namely donor advised funds and supporting organizations. As discussed below, Congress applied private foundation-like rules for such organizations in the areas of the charitable deduction, self-dealing, payout, excess business holdings, and taxable expenditures. The result is that the distinction, already a questionable basis for distinguishing among charities, is beginning to collapse from its own weight.

190. IRC § 4942.

191. IRC § 4943; see IRC § 512(b)(13) for special unrelated business income tax rules applicable to payments by a business controlled by a public charity.

192. IRC § 4943. See e.g., Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 *Tax L. R.* 59 (arguing, not suggesting, for reconsideration of the private excess business holdings and jeopardizing investments as applied to private foundations).

193. IRC §§ 4944, 4945.

194. See S. Comm. on Finance, *Tax Exempt Governance Proposals: Staff Discussion Draft*, available at <http://finance.senate.gov/imo/media/doc/062204stfdis.pdf> (last visited Feb. 1, 2011) (suggesting that a prudent investor standard be adopted for public charities). The recent controversy relating to disgraced financier Robert Madoff, and the heavy investment by university endowments in alternative investments are ongoing illustrations of the issue.

2. *Selectively Importing Private Foundation Rules for Public Charities*

(i) *Selective incorporation with respect to the charitable deduction*

The first recent blurring of the line between public charity and private foundation came from an unlikely source, the Katrina Emergency Tax Relief Act of 2005 (KETRA).¹⁹⁵ KETRA was the legislative response to the devastating hurricane that hit the Gulf Coast region in August 2005, and included a package of temporary charitable giving incentives.¹⁹⁶ With respect to one such incentive, which waived the percentage limitations that apply to charitable contributions,¹⁹⁷ Congress without warning expressed its dissatisfaction with the allocation of the charitable deduction among charities by carving out donor advised funds and supporting organizations (as well as private foundations) as ineligible charities for purposes of the incentive.¹⁹⁸

Although the policy rationale for the carve-out was not made explicit, the context of the bill provides an explanation. The purpose of the provision was to encourage charitable contributions to charity in the wake of a disaster. By declaring donor advised funds and private foundations as ineligible categories of charity for this purpose, Congress said that donor advised funds and private foundations were not the right sort of charity, regardless of their “public” or “private” character. This conclusion is consistent with the understanding that private foundations and donor advised

195. Pub. L. No. 109-73, 119 Stat. 2016.

196. *Id.* at §§ 301 (amending IRC § 170(b) to waive the percentage limitations for certain charitable contributions), 303 (amending IRC § 170(i) to increase the standard mileage rate for the charitable use of vehicles), 304 (providing an exclusion for certain mileage reimbursements to charitable volunteers), 305 (amending IRC § 170(e) to provide an enhanced charitable deduction for certain contributions of food inventory), 306 (amending IRC § 170(e) to provide an enhanced charitable deduction for certain contributions of book inventory).

197. Normally, charitable contributions to public charities are deductible up to 50 percent of an individual taxpayer’s adjusted gross income (or ten percent of a corporation’s adjusted taxable income). IRC § 170(b)(1)(A). KETRA waived this limitation, allowing a charitable deduction to completely offset adjusted gross income. The income limitation waiver was later extended to cover relief efforts related to Hurricanes Wilma and Rita. See IRC § 1400S(a). This was the first time Congress had recognized the existence of a “donor advised fund” as a technical legal matter, though without actually using the term. See Pub. L. No. 109-73, 119 Stat. 2016, § 301(d)(2). The legislative history to the provision gave additional guidance. Staff of the Joint Comm. on Taxation, 109th Cong., Technical Explanation of H.R. 3768, “The Katrina Emergency Tax Relief Act of 2005” as Passed by the House and the Senate on September 21, 2005, at 16 (Comm. Print 2005).

198. Pub. L. No. 109-73, 119 Stat. 2016, § 301(d)(1)(A) & (d)(2).

funds are primarily grant-making organizations and Congress wanted to favor not public charities as such, but charities that would spend the money quickly and not accumulate funds.¹⁹⁹ Accordingly, in KETRA, Congress took a significant step by disfavoring a public charity, as against other public charities, based on the manner in which the donor advised fund provided charity, and by analogizing to the private foundation regime.

The PPA followed through on this development with respect to the so-called “IRA rollover” provision.²⁰⁰ This charitable giving incentive allows owners of an individual retirement account (IRA) to exclude from tax distributions from an IRA to a charitable organization. Although the proposal had been “in play” for years, there had been no effort to discriminate as to which types of charities would benefit.²⁰¹ However, the House-Senate negotiations on the provision introduced a rule that declared gifts to private foundations, donor advised funds, and supporting organizations as ineligible for the exclusion.²⁰² Thus, following the lead of KETRA, Congress again

199. The rationale for the provision is made somewhat murky by its history. Moving quickly after the hurricane, both House and Senate adopted their own tax incentive packages. See Staff of the Joint Comm. on Taxation, 109th Cong., Technical Explanation of H.R. 3768, “The Katrina Emergency Tax Relief Act of 2005” as Passed by the House and the Senate on Sept. 21, 2005, at 1 (Comm. Print 2005). One key difference between the two packages was that the House charitable provisions generally provided incentives only for activities related to the provision of disaster relief. By contrast, the Senate charitable provisions were not so limited. In the Senate, the theory was that charities other than disaster-relief charities needed relief, in part because the normal flows of charitable dollars were being redirected to disaster relief organizations. Compare, e.g., S. 1696, 109th Cong. § 301 (as introduced in the Senate, Sept. 13, 2005) (defining a qualified contribution for purposes of waiving the charitable contribution limitations as a charitable contributions for any purpose), with H.R. 3768, 109th Cong. § 102 (as introduced in the House, Sept. 14, 2005) (defining such contributions as made for purposes of hurricane relief efforts).

200. “IRA rollover” is an inapposite name, as no “rollover” of funds is involved.

201. The provision was part of the original package of charitable giving proposals in President Bush’s first budget to Congress. In the original H.R. 7 considered by the House and the Senate Finance Committee, all charities were eligible beneficiaries. See H.R. 7, 107th Cong., § 102 (as passed by the House, July 19, 2001); H.R. 7, 107th Cong., § 102 (as reported in the Senate, July 19, 2001). In general, there were two principal ongoing issues: whether distributions could be made to split interest trusts as well as charities, and the age an IRA owner must attain before making excludable distributions (59 1/2 or 70 1/2). Under the PPA, distributions to split interest trusts do not qualify for the exclusion and the threshold age of the IRA owner is 70 1/2. IRC § 408(d)(8).

202. Compare The Tax Relief Act of 2005, S. 2020, 109th Cong., § 302 (as passed by the Senate, Nov. 18, 2005) (defining all charities as eligible beneficiaries), with Pub. L. No. 109-280, 120 Stat. 780, § 1201 (excluding private foundations,

lumped donor advised funds and supporting organizations with private foundations and disfavored both as compared to other public charities. Further, unlike KETRA, the IRA distribution giving incentive is generally applicable, that is, it is not a one-time incentive in response to a particular event (Hurricane Katrina) and so has greater force as a matter of policy.

The PPA (and AJCA before it) also began to bridge the public charity-private foundation divide on the charitable deduction through new rules on certain types of noncash charitable contributions. The many scandals involving such contributions prompted a variety of legislative responses, some of which explicitly invoked the private foundation rule on noncash contributions. As noted above, with respect to appreciated property, a fair market value-based deduction is available for contributions to public charities but generally not to private foundations.²⁰³ Appreciated property contributions to private foundations generally are limited to the donor's basis (or cost) in the property. This takes away the incentive to provide inflated valuations, thus significantly minimizing the opportunities for abuse. In AJCA, Congress was concerned about the high valuations of intellectual property contributions, particularly with respect to patents, and adopted the private foundation rule for such contributions.²⁰⁴ Similarly, though on a more narrow issue, Congress responded to valuation concerns with respect to contributions of taxidermy property by following the private foundation rule.²⁰⁵

(ii) Selective incorporation with respect to self-dealing

Of the five operational issues addressed by the private foundation anti-abuse rules, self-dealing is the only one with a corollary in the public charity context. In 1996, Congress determined that an "intermediate sanction" was needed to allow the IRS to punish acts of private inurement at public charities without necessarily revoking the charitable tax status of the organization. Unlike the private foundation self-dealing approach, however,

donor advised funds, and supporting organizations from the definition of a qualified charity). See IRC § 408(d)(8)(B)(i).

203. IRC § 170(e)(1). There is an exception for publicly traded securities. IRC § 170(e)(5).

204. IRC § 170(e)(1)(iii). Congress used the private foundation rule as the baseline for the deduction, but also provided that additional charitable deductions were available depending on whether the contributed property produced income for the charitable donee. See IRC § 170(m).

205. IRC § 170(e)(1)(iv). In addition, Congress adopted a special rule relating to calculating the cost basis of taxidermy property. See IRC § 170(f)(15). Congress took different approaches with respect to other types of noncash property where valuation was an issue in the case of vehicles, easements, fractional contributions, and clothing and household items.

Congress adopted a more permissive regime for public charities, one which generally allows transactions between a public charity and organization insiders, so long as the transaction is at fair market value. By contrast, the private foundation regime generally taxes most transactions between a foundation and its insiders.²⁰⁶

The PPA, in addressing concerns about insider-dealing at donor advised funds and supporting organizations, modified the public charity intermediate sanctions rules by borrowing from the private foundation approach. For example, certain transactions are subject to tax whether or not at fair market value. Any grant, loan, compensation, or other similar payment from a donor advised fund to a donor or donor adviser with respect to the fund (or a related person) automatically is treated as an excess benefit transaction, and, like the private foundation rules, the entire amount of the transaction is considered an excess benefit, thus providing the base for the tax.²⁰⁷ The modified rules also follow the private foundation approach by specifying particular classes of “insider” instead of using a general standard.²⁰⁸ In addition, a new excise tax was introduced with respect to donor advised funds if charitable assets are used (pursuant to advice of a donor or donor adviser) for the benefit of the donor or donor adviser. This approach is akin to the private foundation self-dealing rule barring the use of private foundation funds for the benefit of a disqualified person.²⁰⁹ Accordingly, at least with respect to two types of public charity, the prevailing, more facts and circumstances-oriented intermediate sanctions regime was considered insufficient, and the private foundation bright-line approach of discouraging the transaction altogether was preferred.

(iii) Selective incorporation with respect to payouts and business holding

Regarding payouts and business holdings, one issue was whether donor advised funds and certain supporting organizations paid out funds

206. There is an exception for compensation, which is allowed if reasonable and necessary. IRC § 4941(d)(2)(E).

207. Compare IRC § 4958(c)(2), (c)(3)(A), with IRC § 4941(a)(1), (d)(1). The rules do not fully embrace the private foundation approach, however. The general fair market value approach of the intermediate sanctions rules is retained for other transactions with insiders.

208. Compare IRC § 4958(c)(3)(B), (c)(3)(C), (f)(7), (f)(8) with IRC § 4946(a)(1). The intermediate sanctions rules generally define an insider as a person with substantial influence over the affairs of the organization. IRC § 4958(f)(1). The private foundation rules define particular kinds of insiders (substantial contributors, managers, owners of related corporations). IRC 4946(a)(1).

209. Compare IRC § 4967, with IRC § 4941(d)(1)(E).

regularly and in sufficient amounts for charitable purposes.²¹⁰ Another related issue was whether the donor advised fund and supporting organization could be abused by donors to retain assets for the benefit of the donor (for example, to allow a donor to keep control of a business, or escape the estate tax).²¹¹ The original Senate-passed bill contained detailed new payout requirements on both donor advised funds and certain supporting organizations, both of which were based on the private foundation payout regime.²¹² Although the donor advised fund payout did not survive the House-Senate negotiations, as a substitute, the private foundation excess business holdings rules were applied to donor advised funds.²¹³ In addition, although the payout imposed on certain Type III supporting organizations was taken out in the House-Senate negotiations, it was replaced by a requirement that the Treasury Department provide for a payout in regulations.²¹⁴ The PPA also subjected certain supporting organizations to the private foundation excess business holding rules.²¹⁵ Accordingly, policy issues typically of concern in the private foundation realm—payouts and excess business holdings—became issues of concern for select types of public charities, and the remedy sought was to adopt, in modified form, the private foundation approach.²¹⁶

210. See *supra* notes 99-105 and accompanying text.

211. *Id.*

212. Compare The Tax Relief Act of 2005, S. 2020, 109th Cong., §§ 331, 342 (as passed by the Senate, Nov. 18, 2005), with IRC § 4942.

213. IRC § 4943(e)(1) (“For purposes of this section, a donor advised fund . . . shall be treated as a private foundation.”).

214. Pub. L. No. 109-280, § 1241(d). The legislative history explained that the purpose of the payout was “to ensure that a significant amount is paid” to the supported charity. JCT PPA Technical Explanation, *supra* note 130, at 360. See ANPRM Reg-155929-06, 2009-47 I.R.B. 665; Prop. Reg. 155929-06.

215. The Tax Relief Act of 2005, S. 2020, 109th Cong., § 344 (as passed by the Senate, Nov. 18, 2005). See IRC § 4943(f) (“For purposes of this section, [certain supporting organizations] shall be treated as a private foundation.”).

216. Not long after the PPA was enacted, the issue came up immediately: should the endowments of colleges and universities be subject to a payout? See e.g., Karen W. Arenson, Senate Looking at Endowments as Tuition Rises, *N.Y. Times*, Jan. 25, 2008, at A1; Letter from Sens. Max Baucus and Charles Grassley to 136 Colleges and Universities (Jan. 24, 2008), available at <http://nacua.org/documents/BaucusGrassleyLetterReEndowments.pdf> (asking questions about endowment and spending policies). Colleges and universities accumulate funds, and the large endowments at some institutions could exceed in the eyes of some the reasonableness threshold. But colleges and universities present a much trickier problem than donor advised funds or supporting organizations because they are active charities, not passive grant-making organizations, and so the private foundation model is not as apposite as it is with similarly situated, i.e., primarily grant-making, charities. The recent dramatic decline in endowment value also makes

(iv) Selective incorporation with respect to spending

Finally, the PPA looked to the private foundation rules for a response to the issue of spending for non-charitable purposes. Under federal tax law, if a public charity spends money not for a charitable purpose, there are a number of possible consequences: nothing, revocation of charitable status, or imposition of intermediate sanctions. Most likely, the answer will turn out to be nothing because the intermediate sanctions regime applies only to transactions with insiders of the charity and not to non-charitable spending generally.²¹⁷ And revocation of charitable status generally requires that the violation show that the charity is no longer operated primarily for a charitable purpose (a high threshold), which leaves doing nothing. If a private foundation spends money for a non-charitable purpose, however, there is a directly applicable remedy: imposition of an excise tax for a “taxable expenditure.”²¹⁸

The PPA adopted the private foundation concept of taxable expenditures and applied it in the donor advised fund context. This was accomplished by providing that a distribution by a donor advised fund to an individual or for a non-charitable purpose is taxable.²¹⁹ Further borrowing from the private foundation rules, the PPA provided that even distributions that are for a charitable purpose nonetheless are taxable if made to a organization other than a public charity and the distributing charity (termed a “sponsoring organization”) fails to conduct due diligence (termed “expenditure responsibility”) with respect to the distribution.²²⁰ Accordingly, at least with respect to donor advised funds, Congress determined that bright lines backed by sanctions were necessary to control abuses in the expenditure of charitable assets.

the issue politically less salient. Abby Goodnough, *Hard Times at Harvard Are Making Inroads Into Students’ Lives*, N.Y. Times, Oct. 9, 2009, at A12; Andrew Ross Sorkin, *Investment Indigestion at Stanford*, N.Y. Times, Oct. 6, 2009, at B1. The broader point, however, is that the policy concern—unreasonable accumulation of assets by a charity—is no longer relegated to the private charity. See also Sara E. Waldeck, *The Coming Showdown Over University Endowments: Enlisting the Donors*, 77 *Fordham L. Rev.* 1795 (2009).

217. IRC § 4958(c)(1) (defining an “excess benefit transaction” as one between the charity and a “disqualified person”).

218. IRC § 4945.

219. Pub. L. No. 109-280, 120 Stat. 780, § 1231; IRC § 4966.

220. Compare IRC § 4966(c)(1)(B)(ii), with IRC § 4945(d)(4)(B).

3. Summary

If nothing else, the recent Congressional actions described above show two things: (1) if anti-abuse rules are to be applied to public charities, the private foundation rules will be the initial model; and (2) the public charity-private foundation distinction is breaking down. The first point may reflect little more than legislative inertia: it is easiest first to look to existing rules for solutions to present problems and extend them, than to craft brand-new approaches. The second point, although an extension of the first, shows that the more Congress borrows from the private foundation regime for public charities, the less distinct public charities and private foundations become, leading to further conceptual and technical complexity. With each new scandal at public charities, the pressure will increase to extend the private foundation anti-abuse rules to cover the new scandal.

The trouble with the selective incorporation approach, however, is that it neglects to address the underlying issues. Granted that our current system treats some charities better than others, does the current basis for doing so make sense? Should we assume that some charities are inherently deserving of “better” treatment because of their function, or sources of support? Or can we draw different lines? Rather than selectively incorporating aspects of the private foundation regime to public charities, a more sensible approach would be to reexamine the basis for the distinction altogether and analyze each abuse currently regulated and decide the extent to which the abuse remains a concern, and if so, with respect to what types of charities. Should all charities be subject to an excise tax for non-charitable spending? Should there be tax consequences to imprudent investing? Should we distinguish charities for purposes of the charitable deduction, not just on the basis of whether they are operating charities (as opposed to primarily grant-making), but also depending on the type of charity provided? Although answering these questions is beyond the scope of this Article, what can be concluded here is that the scandals and the legislative response show that it is time to make it a priority to reexamine the public charity-private foundation distinction.

D. Toward Brighter Enforcement Lines

A common response to the reported scandals was for more and better enforcement of the laws. With over 1.1 million charitable organizations, an IRS exempt organization staff of about 830,²²¹ and an audit rate of less than

221. Tax Exempt and Government Entities Division—Exempt Organizations, IRS, Annual Report and FY 2009 Work Plan (2008), available at http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf. IRS exempt

one-half of one percent,²²² there is much to be said for more enforcement. But one of the difficulties with the “more enforcement” argument, apart from the political question of resources,²²³ is the question of what exactly would the IRS enforce? On the private foundation side, there is considerable federal tax law to enforce, and the Boston Globe investigators were able easily to uncover what appeared to be facial violations of some of the private foundation rules.²²⁴ A more robust enforcement presence certainly could have an impact on some private foundation abuses.²²⁵

organization staff are of course responsible not just for charitable organizations but other nonprofits as well.

222. See *supra* note 8.

223. Originally, the excise tax on the net investment income of private foundations (IRC § 4940) was intended to fund enforcement of the law for all charitable organizations. Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1969, 29 (Joint Comm. Print 1970). But this never came to pass. Staff of Joint Comm. on Taxation, 2 Study of the Overall State of the Federal Tax System and Recommendations for Simplification, 459 (Joint Comm. Print 2001). During the mid 2000s, the budget for the Tax Exempt and Government Entities Division of the IRS (TE-GE) increased, reflecting the priority Commissioner Everson made of the area and a receptive audience on Capitol Hill for such increased enforcement. However, a modest increase in resources is not likely to result in a dramatic increase in enforcement. The main purpose of the IRS is to collect taxes; and accordingly the resources of the IRS are primarily going to be devoted to large and wealthy taxpayers, not to parties that do not pay taxes. It is why, in the charitable sector, State enforcement can be critical to prevent abuse of public trust. However, States in general do not have large or active charity enforcement bureaus. See *Charity Oversight and Reform: Hearing Before the S. Comm. on Fin., 108th Cong. 2 (2004)* (statement of Mark Pacella, President, National Association of State Charity Officials) (“Despite their broad authority over charitable assets and fiduciaries, many states lack the resources to effectively regulate the charitable organizations operating within their jurisdictions. Of our fifty states, less than half are able to be regular and active participants in NASCO’s annual conferences and most do not have personnel dedicated to the exclusive regulation of charities.”); see also Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation (2004)*. In recognition of the institutional and other problems relating to enforcement, some in the charitable community have argued for a new separate enforcement agency for charities, or for increased federal funding for State enforcement efforts. See, e.g., 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 & Brendan M. Wilson, *Regulating Charities in the 21st Century: An Institutional Choice Analysis*, 85 *Chi.-Kent L. Rev.* 479 (2010).

224. See *supra* note 92.

225. Regarding private foundations, the best Congress could do here was to double the rates of excise tax that apply to the private foundation anti-abuse rules.

But it is different for public charities. As noted earlier, there are no meaningful affirmative obligations on a public charity,²²⁶ few anti-abuse rules, and so not much really to enforce except broad purpose requirements or negative restrictions that depend intensively on facts and circumstances determinations: for example, no private inurement, no private benefit,²²⁷ no intervention in a political campaign, and no substantial lobbying.²²⁸

Further, because of the all-or-nothing nature of charitable tax exemption, enforcement of any of the cardinal federal rules of charity tax law generally means revocation of charitable status, a step with political ramifications and one that, with respect to large or established charities, may simply be unreasonable for the IRS to take. The chief exception to revocation as the exclusive sanction is the intermediate sanctions rules, but these are fairly generous as compared to the private foundation rules on self-dealing (except in the case of compensation),²²⁹ are process-oriented, and fairly limited in scope.²³⁰

Pub. L. No. 109-280, 120 Stat. 780, §1212, IRC §§ 4941(a)(1), (a)(2), & (c)(2), 4942(a), 4943(a)(1), 4944(a) & (d)(2), 4945(a) & (c)(2).

226. The only affirmative obligation on a private foundation is to pay out a percentage of its assets each year—enforced by an excise tax. IRC § 4942.

227. A component of the requirement that charitable organizations be operated exclusively for exempt purposes is that the organization be operated for a public interest, not a private interest. Reg. § 1.501(c)(3)-1(d)(1)(ii). If an organization is found to operate for a private benefit, it loses charitable status. See, e.g., *Am. Campaign Acad. v. Commissioner*, 92 T.C. 1053 (1989).

228. With respect to lobbying, charities that make an election under § 501(h) of the Code are subject to an extensive set of regulatory rules, and so not subject to the default facts and circumstances “no substantial part” test. In addition, one area where there is a fair amount of Code-based law to enforce, the unrelated business income tax (UBIT), was not a primary topic of concern in the 2000s. But even here, catching evasion for UBIT is made difficult by generous allocation rules that make it fairly easy for a charity to defend allocating what should be considered an expense for a charitable activity to an unrelated business activity—thus creating a deduction for UBIT purposes, and reducing or eliminating tax. See e.g., *JCT Historical Development*, *supra* note 5, at 105.

229. IRC § 4941(d)(2)(E) (payment of compensation to a disqualified person is not self dealing if the compensation is not excessive). Compare IRC § 4958(c)(1) (defining an excess benefit as occurring when the benefit provided exceeds the consideration received), with IRC § 4941(d) (defining self-dealing in absolute terms, e.g., “any direct or indirect sale or exchange, or leasing of property . . .”).

230. See generally, Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 *Fordham L. Rev.* 735, 736 (2007) (noting that “[u]ltimately, the intermediate sanctions provisions are all about process, not substance” and examining whether the scope of the sanctions should be widened to cover non-insider transactions).

In addition, one consequence of the breadth of the charitable designation is that once the IRS grants charitable tax exemption, the presumption of charitability is extended indefinitely or until the IRS makes a determination that revocation of charitable status is appropriate. That is, loss of charitable status will occur at the earlier of: the organization's termination or conversion to another tax status, or an affirmative act by the IRS to revoke. In the meantime (which for most organizations is a long time), there is little that the IRS can do by way of sanction. Accordingly, one would expect over time to see a charitable sector that expands, especially as the definition of charity evolves. And that is, of course, what we have seen.²³¹ In short, given the growth of the charitable sector, the scandals raised the issue of additional enforcement tools (and resources). And perhaps most importantly, considering that resources are finite and not ever likely to be up to the task of regulating such a large and diverse sector, more effective enforcement might well depend on a new legislative approach to charity: brighter lines and, perhaps, positive requirements.

There is evidence that the legislative policy is beginning to shift in this direction. Precise standards imposed on credit counseling organizations and the modified intermediate sanctions rules that apply to donor advised funds and supporting organizations are each modest confessions that additional enforcement tools are needed to police certain abuses. In addition, these provisions show a preference for brighter lines in enforcement over the prevailing facts and circumstances or value-based standards for imposition of sanctions.

Even stronger evidence of a shift is found in a new and prohibitive rule designed to stop participation by tax-exempt organizations in tax shelter transactions. The provision, enacted as part of TIPRA,²³² imposed a 100 percent excise tax on proceeds attributable to knowing participation by a tax-exempt organization in a "prohibited tax shelter transaction," which is a transaction identified by the Treasury Department as such (technically, as a "listed transaction").²³³ Notably, the tax applies even absent knowing conduct, though the rate is reduced in such cases to 35 percent. Further, if the transaction becomes a prohibited transaction *after* the exempt organization enters into it, an excise tax of 35 percent applies to proceeds attributable to

231. See JCT Historical Development, *supra* note 5, at 18-26 (charting the growth of the charitable sector from 1975 to 2005).

232. Pub. L. No. 109-222, 120 Stat. 345; IRC § 4965. See *supra* note 128.

233. See, e.g., Notice 2009-59, 2009-31 I.R.B. 170 ("Transactions that are the same as or substantially similar to one of the types of transactions described in the list . . . have been determined by the Service to be tax avoidance transactions. . . . As a result, taxpayers may need to disclose their participation in these listed transactions . . . and material advisors may need to disclose these transactions. . . . Taxpayers [and material advisors] who fail to disclose may be subject to penalties. . .").

the transaction and allocable to the period after the transaction became a prohibited transaction.²³⁴

In enacting this provision, more than any of the other reform provisions, Congress changed the ground rules for tax-exempt status. As a policy matter, the provision stands for the proposition that it is fundamentally inconsistent with tax-exempt status to engage in conduct that enables tax evasion. True to form, it is a negative restriction, but unlike some of the other broad negative restrictions (no substantial lobbying, no political intervention), it was written with a strong deterrent that does not require revocation of tax-exempt status.²³⁵ And consistent with the anti-abuse approaches taken with respect to donor advised funds and supporting organizations (following the private foundation approach), the rule in effect stops the transaction, without allowance for much in the way of facts and circumstances ambivalence. In short, the rule provides the IRS with a strong, previously lacking, enforcement tool.²³⁶

234. IRC § 4965.

235. Similar to the unrelated business income tax rules, the provision tolerates transgressions to tax exempt status (i.e., exemption is not revoked); but unlike the UBIT, in the case of tax shelter transactions, any income knowingly derived therefrom must be confiscated. IRC § 4965(a)(1)(B). In general, if the conduct was not knowing, the tax rate is identical to the UBIT rate. IRC § 4965(a)(1)(A). The tax is an excise tax, not an income tax, and so fundamentally is about deterrence. With the UBIT, deterrence is not the underlying rationale, except that unrelated business activity may not become an organization's primary activity.

236. By providing the IRS with broad authority to define which transactions will trigger the tax, the provision may be criticized because it introduces considerable uncertainty for exempt organizations. This is because the tax applies to transactions that were not announced by the IRS as prohibited at the time the organization entered into the transaction. But arguably, without so providing, this uncertainty is precisely what the provision was aimed at: exempt organizations will, or should, think twice before entering into a transaction that promises atypical returns, or that asks of little or no investment from the organization apart from the act of their participation (i.e., apart from contributing their tax exempt status). See H.R. Conf. Rep. No. 109-455, at 129-132 (2005). Importantly, although the tax applies to transactions that were not "listed" at the time entered into but subsequently become listed, only income attributable to the post-listing period is subject to tax. Accordingly, the organization has a choice: it can unwind from the listed transaction or pay tax on income attributable to it from the time of listing. There is a risk of course that the IRS will abuse its discretion by listing transactions that are not abusive and so chill legitimate investment decisions. However, such a risk is low, and anyway beside the point. The conduct targeted by the TIPRA provision is investment conduct that seems or should seem too good to be true; and to encourage due diligence. An exempt organization now should check current lists of suspect transactions, and in addition, factor in possible future taxes on proceeds as part of the return on investment before deciding whether to participate in suspect transactions.

Going forward, the question is the extent to which this trend will continue. Although bright lines can have inequitable outcomes, their administrative appeal is manifest. As the public charity-private foundation distinction breaks down and the charitable sector continues to grow, there will be increasing pressure for more certainty in tax enforcement through imposition of bright-line rules.²³⁷

PART V. CONCLUSION: A DAMAGED CHARITABLE FORM AND FRAMEWORK

This Article has been an effort to take a bird's eye view of the charitable designation in federal tax law. In general, over the course of a century, notwithstanding years of experience with charitable organizations and dramatic change in the scope and diversity of the charitable sector, and so of the aggregate value of the tax benefits, most legal change has been in the form of negative requirements or process-oriented positive requirements and not in the imposition of substantive positive obligations. Although the initial charitable designation of 1913 has been significantly restricted in many ways, key fundamental traits have remained relatively untouched: the broad purpose-based approach to qualification as charitable, the all-or-nothing approach to enforcement for public charities, and the policy of linking multiple tax benefits to a determination of charitable under section 501(c)(3). The result has been a large, growing, and diverse charitable sector. And, as described in this Article, the result also has been a sector, especially with respect to public charities, that is proving increasingly difficult to oversee.

237. It is interesting to compare the Congressional response to the tax shelter problem with the response to another attack on the charitable form—abusive charitable contributions of noncash property. For noncash contributions, the legislative response was targeted and not comprehensive. Presented with an option of eliminating the deduction for many noncash contributions, instead special rules were adopted for each type of property in question: something akin to whack-a-mole. Thus, there are now separate rules of contributions of vehicles, intellectual property, façade easements, fractional contributions, clothing and household items, and taxidermy. The probable outcome, as in whack-a-mole, will be that moles will keep popping out of new holes. Indeed, shortly after passage of the PPA, a new scheme involving contribution of noncash property arose, prompting the IRS to list the transaction as a “transaction of interest.” See Notice 2007-72, 2007-2 C.B. 544 (involving “transaction...in which a taxpayer directly or indirectly acquires certain rights in real property or in an entity that directly or indirectly holds real property, transfers the rights more than one year after the acquisition to an organization described in § 170(c) of the Internal Revenue Code, and claims a charitable contribution deduction under § 170 that is significantly higher than the amount that the taxpayer paid to acquire the rights”).

The evidence is all around us. The reported scandals of early this century surveyed in Part III of this Article are symptoms of a charitable form that is under stress. More importantly, the resulting reform legislation, analyzed in Part IV, shows that the law is wrestling with the remaining legacies of the initial charitable designation. The clear trends that emerge from the reform legislation are frustration with the breadth of the standard under section 501(c)(3) and with the all-or-nothing, facts and circumstances-based means of enforcement. The result is piecemeal reform: a fragmentation of the charitable sector based on purpose (but an unwillingness or inability to measure the purpose), and a gradual but selective blending of the public charity-private foundation distinction. This piecemeal reform approach has some predictive capacity. As new scandals are reported, the law will continue to shift in the direction now cast—following the lead of credit counseling organizations and hospitals, and further disaggregating the sector. And the law likely will continue to borrow anti-abuse measures from the private foundation regime and selectively apply them to public charities on a case-by-case basis.

Such piecemeal reform, certain to have detractors, nevertheless should be viewed as a consequence of Congress's reluctance to impose substantive positive obligations on charitable organizations. In the absence of a positive standard for charity and a growing charitable sector, when it comes to oversight, there is little choice but to draw additional lines; and these lines, if based on form and not substance, will place greater emphasis on functional categories and process: such as process-oriented exemption standards, governance initiatives, greater disclosure and transparency,—and brighter enforcement lines to police abuses. And this is what we are seeing.

While we may continue on this path, it is also time to begin developing a clearer idea of the type of organization that should be supported by the tax system, and, critically, to what extent. One barrier to such an inquiry, however, is one of the remaining, largely unquestioned historical characteristics of the charitable designation: placing the basis for multiple tax benefits under one section, that of section 501(c)(3). Because the tax benefits are packaged together, the all-or-nothing approach to exemption becomes yet more problematic: an organization stands to lose not only tax exemption, but also eligibility to receive deductible contributions, access to tax-exempt financing, and likely other federal regulatory benefits and other substantial benefits under state law. For enforcement purposes, with so much residing on the determination of whether an organization may remain "charitable," it is that much harder to reach an adverse conclusion. Further, the bundling of the tax benefits also may contribute to a reluctance to impose substantive positive requirements. On its terms, section 501(c)(3) is a test for tax exemption only, i.e., application for charitable status is not per se an application for eligibility for the charitable deduction, or access to other federal and state tax and nontax benefits. So to a certain extent, we may

require less in the way of positive requirements to achieve “charitable” status because the facial question is “what standard should apply for purposes of tax exemption.” If instead we asked the question “what standard should apply for purposes of being eligible to receive deductible contributions,” we might get a different answer, and perhaps impose more positive requirements, depending on the public benefit of the organization’s activity. Accordingly, one modest step in the direction of making more sense of the relationship between the tax system and charitable organizations would be to unpackage, or delink, the tax benefits. This might also lead the way toward a more deliberate sense of the public benefit to be provided in exchange for one or more tax preferences.

Ultimately, one lesson from the scandals and the resulting legislation is that we are trying to make one standard, that of tax exemption, do too much. The reason we care about the charitable designation is not because of tax exemption. Many non-charitable organizations are exempt from federal income tax, and exemption probably is not, standing alone, an exceptional tax benefit for these organizations. Rather, the principal reasons we care about the charitable designation are because of the many benefits, in addition to income tax exemption, associated with it, and because of the expectation that the public should derive a benefit from an organization designated as charitable. And this points to a principal weakness of current law, whether the standard for tax exemption, as articulated in section 501(c)(3) of the Code, can continue to support the many tax and other benefits it engenders. Chances are that until there is more comprehensive change to the way in which charitable organizations are regulated, the scandals of the 2000s will be repeated in form if not substance.

