UNREGULATED CHARITY

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Abstract: The vast majority of charities in the United States operate in a regulatory blind spot: they are neither meaningfully evaluated when they apply for charitable status nor substantively monitored after they receive charitable status. Driven by severe budget constraints, the IRS decided to essentially ignore any charity that claims it will realize less than $50,000 in annual gross receipts. From a practical perspective, the IRS's decision makes sense. To the extent smaller charities are less likely to cause harm, it is reasonable (perhaps even preferable) to subject them to less scrutiny. This type of prioritization, known as risk-based regulation, has become increasingly popular as regulatory budgets have continued to shrink. But however intuitive, reasonable, or widespread risk-based regulation may seem, the fact remains that the IRS has effectively absolved itself of its duty to oversee the majority of charities.

This Article explores, on both a micro- and macro-level, the negative consequences of the IRS's decision to leave smaller charities unregulated. On the micro-level, the lack of regulation impacts virtually every person who interacts with the charitable sector, including donors, beneficiaries of charities, and private actors in the market. On the macro-level, as an increasing number of charities operate without proper regulation, the public will lose faith in the charitable sector and the "halo effect" enjoyed by all charitable organizations will erode.

This Article is the first to identify and discuss the harms associated with the IRS's failure to apply either front-end or back-end scrutiny to smaller charities. To address this regulatory failure, this Article argues that the IRS should require a more robust retrospective regulatory tool for all charities, regardless of size. This solution represents a cost-effective means for the IRS to meet its regulatory burden in a manner that will help restore public faith in the charitable sector.

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INTRODUCTION

In the not-too-distant past, an aspiring charity[1] would be forced to wait an unbearably long time for the Internal Revenue Service (IRS) to process its tax-exempt application.[2] Due to a series of increasingly severe budget cuts, the IRS was unable to review applications in a timely manner.[3] Wait times as long as ten months,[4] eighteen months,[5] and even

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1. Throughout this Article, "charity" and "charitable status" will refer to public charities described in § 501(c)(3) of the Internal Revenue Code of 1986, as amended.

2. 1 NAT'L TAXPAYER ADVOCATE, 2015 ANNUAL REPORT TO CONGRESS 39 (2015) [hereinafter 2015 TAXPAYER ADVOCATE REPORT] ("By 2012, the volume of [the IRS's] open inventory was 36,034 cases, applications requiring little or no development were taking four months to close, and applications requiring assignment to a reviewer were taking nine months just to be assigned.").

3. George K. Yin, *The IRS's Misuse of Scarce EO Compliance Resources*, 146 TAX NOTES 267, 268 (2015) ("The IRS has accumulated a massive backlog of applications, causing unacceptable delays in their processing, and it is now under severe budgetary constraints, with no relief in sight.").

4. Kelly P. Erb, *IRS Announces Shorter, Faster Application For Some Tax Exempt Organizations*, FORBES (July 1, 2014, 9:21 PM), www.forbes.com/sites/kellyphillipserb/2014/07/01/irs-announces-

two years[6] were so common that the IRS began to post the average age of pending tax-exempt applications on a website called *Where's My Exemption Application?* to address the public's frequent questions about pending tax-exempt applications.[7] For nonprofit professionals, attorneys representing charities, and anxious leaders of nonprofits awaiting their tax-exempt determination letter, a visit to this website was a weekly ritual.[8]

The *Where's My Exemption Application?* website posted the average age of pending applications—a minimal, but precious, piece of information. For example, a visitor in July 2014 would see the following notice: "The average age of our pending application inventory now is October 2013,"[9] meaning that applications submitted ten months prior to visiting the site were still waiting for IRS review.[10] This ten-month delay was only an average, meaning there were likely some applications that were submitted much earlier than October 2013.[11] Most frustratingly, the website did not provide specific information about any individual application. But however meager or dispiriting, the *Where's My Exemption Application?* website was the only way for applicants to get an idea of when they might learn the outcome of their tax-exempt application.

Today, the process is much different. A visitor to the new *Where's My Exemption Application?* website is informed that they should hear back from the IRS within either 90 or 180 days, depending on which application they submitted.[12] Indeed, tax-exempt applications are routinely approved in as little as two weeks.[13] This newfound efficiency,

shorter-faster-application-for-some-tax-exempt-organizations/ [http://perma.cc/ZV2P-YVYA] ("Yes, that does mean that ten months—or about 300 days—after an initial application, organizations are still waiting to hear about tax-exempt status. That kind of wait time is ridiculous not only for tax exempt organizations but for individuals who wish to support them.").

5. 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 39 ("By 2013, the application inventory backlog stood at about 66,000 cases, and applications requiring review took a *year and a half* to be assigned.") (emphasis added).

6. As anecdotal evidence, one of my clients waited for over two years before receiving the IRS determination letter on a tax-exempt application.

7. Steve Vick, *Where is My IRS Tax Exempt Application?*, NONPROFITALLY (Mar. 3, 2014), https://nonprofitally.com/where-is-my-irs-tax-exempt-application/ [https://perma.cc/2XD8-EKFF].

8. As an attorney who represented a number of nonprofit professionals and leaders, I can attest that this website was relied upon heavily to track the status of applications. Unfortunately for the client discussed in footnote 6, *supra*, the weekly ritual lasted for over two years.

9. *See* Erb, *supra* note 4.

10. *Id.*

11. *See supra* notes 4–6.

12. *Where's My Exemption Application?*, IRS, www.irs.gov/charities-non-profits/charitable-organizations/wheres-my-application [http://perma.cc/67BM-PEVB].

13. *See* The Director, *Reform It Now Receives IRS Determination*, REFORM IT NOW (Aug. 15, 2014), https://www.reformitnow.org/news/reform-now-receives-irs-determination/

although laudable, comes at a great cost. To expedite application review, the IRS decided to simply ignore the majority of applicants by adopting a streamlined application for smaller charities. This application, the Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, or Form 1023-EZ (the "Streamlined Application"), was crafted under the assumption that it was inefficient to subject all charities to the "same lengthy application process" regardless of whether the charity was "a small soccer or gardening club or a major research organization."[14] Designed specifically for organizations that have less than $250,000 in assets and reasonably expect to have less than $50,000 of gross receipts in any of the subsequent three years ("Smaller Charities"),[15] the Streamlined Application requires almost no disclosures and bestows charitable status with virtually no investigation into the applicant's worthiness.[16]

The justification for this change was simple: the IRS believed that Smaller Charities represented lower risk and did not require the same level of scrutiny that larger charities demanded.[17] As a result, the IRS crafted an application designed to process applications in a more efficient manner. But with what must have been a myopic focus on the application backlog, the IRS crafted an inadequate screening process. Indeed, the Streamlined Application is virtually devoid of rigor and provides no means for meaningful investigation.[18]

This is troubling for a number of reasons, but this Article is primarily concerned with the fact that the charitable sector relies, largely, upon the good will associated with the charitable designation (for instance, the 501(c)(3) status bestowed by the IRS). In 2017, charities received $410.02 billion in charitable contributions from the public.[19] Although a cynic might assume that this giving was inspired by a desire to take

[http://perma.cc/7UA6-CHM4] ("Literally . . . we were able to file for 501(c)(3) status on August 1st, and received the detemination [sic] letter on August 14th. The IRS processed the application in 8 calendar days.").

14. *New 1023-EZ Form Makes Applying for 501(c)(3) Tax-Exempt Status Easier; Most Charities Qualify IR-2014-77*, IRS (July 1, 2014), www.irs.gov/uac/Newsroom/New-1023-EZ-Form-Makes-Applying-for-501c3Tax-Exempt-Status-Easier-Most-Charities-Qualify [http://perma.cc/VV9Y-H7J4] [hereinafter IRS Press Release].

15. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., CAT. NO. 66268Y, INSTRUCTIONS FOR FORM 1023-EZ (2018), www.irs.gov/pub/irs-pdf/i1023ez.pdf [https://perma.cc/U3VN-3V52].

16. *See infra* sections I.A.2, I.A.3.

17. *See* IRS Press Release, *supra* note 14.

18. Yin, *supra* note 3 ("[T]here is essentially no information obtained about applicants upfront . . . .").

19. Brice McKeever, *The Nonprofit Sector in Brief 2018*, NAT'L CTR. FOR CHARITABLE STAT. (Dec. 13, 2018), https://nccs.urban.org/publication/nonprofit-sector-brief-2018#giving [https://perma.cc/AF86-KH89].

advantage of the tax-deductibility of donations to charities, the fact remains that most donors do not itemize their deductions.[20] Rather, most donors give to charities because they either believe in the goals of the charitable organizations, or they feel like better people when they give to worthy organizations. Although the latter reason, also known as the "warm glow" effect, appears to be less substantive than a tax-deduction or support of a cause one believes in, it should not be ignored. Indeed, many scholars argue that the search for "warm glow" explains why many donors choose to give. Thus, the failure to adequately screen charities represents a potential existential threat to the charitable sector—if people no longer can trust that a charity has been properly vetted to ensure that the organization is organized for charitable purposes, there would be a diminished warm glow gleaned from any giving, and it would be rational for donors to stop or reduce their giving.

It is perhaps for this reason that the decision to implement the Streamlined Application was widely criticized.[21] The National Taxpayer Advocate bemoaned that the "the IRS relinquished its power to effectively determine whether applicants qualify as [charitable] organizations,"[22] and the President of the National Council of Nonprofits, a network of charitable groups, contemptuously noted that "it takes more to get a library card than it takes to get this new exempt status."[23] As hyperbolic as they seem, such criticisms are not overstatements: one can comfortably argue that the Streamlined Application allows a Smaller Charity to opt-in to the tax-exempt realm without any inquiry into its worthiness.[24] Thus, in the name of efficiency, the IRS adopted a woefully ineffective screening mechanism.

Defenders of the IRS might argue that the Streamlined Application is a rational response of an underfunded agency in the face of an untenable

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20. *See Briefing Book*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/what-are-itemized-deductions-and-who-claims-them [https://perma.cc/YF9Z-469R] ("In recent years about 30 percent of taxpayers, mostly high income, have chosen to itemize, but increases in the standard deduction and limits to itemized deductions starting in 2018 will greatly reduce the number of itemizers.").

21. Patricia Cohen, *I.R.S. Shortcut to Tax-Exempt Status is Under Fire*, N.Y. TIMES (Apr. 8, 2015), https://www.nytimes.com/2015/04/09/business/irs-shortcut-to-tax-exempt-status-is-under-fire.html [https://perma.cc/Z6TJ-TH6R]; *see also* Manoj Viswanathan, Essay, *Form 1023-EZ and the Streamlined Process for the Federal Income Tax Exemption: Is the IRS Slashing Red Tape or Opening Pandora's Box?*, 163 U. PA. L. REV. ONLINE 89 (2014–2015); Yin, *supra* note 3.

22. *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 44.

23. *See* Cohen, *supra* note 21.

24. *See* Yin *supra* note 3, at 268 (suggesting, perhaps sarcastically, that "the IRS should consider an even simpler form: a one-line version that merely asks applicants to attest (by checking a single box) that they qualify for (c)(3) status"); *infra* section I.A.C.3.

regulatory burden.[25] Indeed, given limited regulatory resources, there is an intuitive appeal to focusing on the population that presents the greatest risk. This choice, shifting regulatory resources, attention, and energy to the population that presents the greatest potential harm, is known as "risk-based regulation."[26] But the logical consequence of risk-based regulation is that, although high-risk populations receive the attention they deserve, low-risk populations necessarily receive lower levels of regulatory scrutiny.[27] This is the cost of risk-based regulation, and such cost is reasonable as long as the potential harms caused by the low-risk population are acceptably low.[28] Following this logic, a regulatory agency might justifiably lessen the scrutiny of low-risk populations by, for example, fashioning a simplified screening mechanism or requiring less annual reporting. However, while risk-based regulation theories might permit such actions, even the most generous reading of risk-based regulation theory does not condone completely ignoring low-risk populations.[29]

Perhaps in anticipation of this criticism, the IRS promised to put more resources into monitoring charities.[30] In the press release announcing the Streamlined Application, the IRS Commissioner John Koskinen said, "[r]ather than using large amounts of IRS resources up front reviewing complex applications during a lengthy process, we believe the [Streamlined Application] will allow us to devote more compliance activity on the back end to ensure groups are actually doing the charitable work they apply to do."[31] In this manner, the IRS argued that if any bad actors were to obtain tax-exempt status through the Streamlined Application, a more robust monitoring system would catch them.[32] In other words, the lack of any front-end scrutiny should not give rise to criticism so long as there is ongoing review and inspection.

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25. Joe Davidson, *IRS Chief Departs, Blasting Congress for Budget Cuts Threatening Tax Agency*, WASH. POST (Nov. 7, 2017), https://www.washingtonpost.com/news/powerpost/wp/2017/11/07/irs-chief-departs-blasting-congress-for-budget-cuts-threatening-tax-agency/ [https://perma.cc/ZNQ9-7K76].

26. Julia Black & Robert Baldwin, *When Risk-Based Regulation Aims Low: Approaches and Challenges*, 6 REG. & GOVERNANCE 2, 2 (2012).

27. *Id.* at 3–4.

28. Robert Baldwin, Julia Black & Gerard O'Leary, *Regulating Low Risks: Innovative Strategies and Implementation* 2 (Law, Soc'y & Econ. Working Papers, Working Paper No. 9/2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2258976 [https://perma.cc/ED9W-XMG9].

29. *See* Black & Baldwin, *supra* note 26, at 2 ("The bulk of regulated sites and operations, however, tend to present lower levels of risk and most regulators need to deal with lower risks in some way or other. Such risks have some capacity to produce both significant harms and political contention, and in many cases the law will demand that lower risks be attended to.").

30. *See* IRS Press Release, supra note 14.

31. *Id.*

32. *Id.*

Unfortunately, the monitoring mechanisms for Smaller Charities are, like the Streamlined Application itself, wholly inadequate. Smaller Charities are required to submit only the e-Postcard, an annual information return that contains virtually no information about the organization's activities[33] and elicits data so scant as to leave virtually no opportunity for scrutiny.[34]

Similar to the way poor screening threatens to curb the warm glow of giving, the failure to monitor charities presents another potential blow to the charitable sector. Indeed, the failure to monitor might be more damaging than the failure to screen. Although poor screening might allow unworthy organizations to call themselves "charities," a robust monitoring mechanism would be able to identify those charities acting in an inappropriate manner. For example, imagine that a charity promised to work to solve the homelessness crisis in Seattle. This is a laudable goal that deserves charitable status. But now imagine that this charity spends all donations on lavish dinners for the founders and fails to spend any resources on homelessness prevention or amelioration. A more robust screening process would not identify this activity; after all, the charity looked legitimate at the application stage. This example demonstrates the need for a system that periodically checks in on charities to ensure that they are not only formed to engage in charitable activities, but that they actually engage in the charities they were formed to do. Unfortunately, the current regulatory regime fails to implement either adequate front-end scrutiny or back-end scrutiny for Smaller Charities, resulting in a reality in which Smaller Charities are vetted neither prospectively nor retrospectively.

This Article argues that this regulatory blind spot is unacceptable. A few legal scholars have joined the chorus of critics[35] to denounce the insufficiency of the Streamlined Application,[36] but this Article is the first to consider the shortcomings of the Streamlined Application in conjunction with the inadequate monitoring regime for Smaller Charities. This is also the first article to recognize the fact that the IRS, as currently funded, is incapable of properly vetting all applications for

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33. *See Annual Electronic Filing Requirement for Small Exempt Organizations — Form 990-N (e-Postcard)*, IRS, https://www.irs.gov/charities-non-profits/annual-electronic-filing-requirement-for-small-exempt-organizations-form-990-n-e-postcard [https://perma.cc/CQH9-2YAZ] [hereinafter *Filing Requirements for Form 990-N*].

34. *See infra* Section I.B.2.

35. *See, e.g.*, 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 44 (highlighting the failure of the Form 1023-EZ to properly assess the worthiness of tax-exempt applications); Cohen, *supra* note 21 (noting the "unlikely coalition of tax lawyers, state enforcement agents and even many nonprofits" speaking up against the adoption of the Form 1023-EZ).

36. *See* Viswanathan, *supra* note 21; Yin, *supra* note 3.

charitable status in a satisfactory manner, which makes any suggested changes to the Streamlined Application infeasible. Rather than focus on fixing the flaws of the Streamlined Application, this Article suggests revising and imposing a more robust monitoring mechanism. This solution addresses the regulatory failure and recognizes the IRS's crippling funding shortage by both providing the IRS with enough data to properly monitor Smaller Charities and fostering the transparency necessary to empower the public to police the activities of Smaller Charities.

Part I of this Article discusses the IRS's tools for screening and monitoring charities, including a detailed discussion of tax-exempt applications and annual reporting requirements. This discussion will highlight the failure of the existing regulatory regime for Smaller Charities. Part II discusses the potential harms of ignoring Smaller Charities, exploring both the micro-level harms incurred when individual charities engage in impermissible activities and the macro-level harms of persistent and widespread violations in the charitable sector. Part III of this Article discusses risk-based regulation generally and explores the specific challenges posed by regulating low-risk populations.[37] This Part will set forth Julia Black and Robert Baldwin's recommended framework for choosing appropriate regulatory tools for low-risk populations and apply it to Smaller Charities. This Part makes it clear that the IRS's chosen regulatory strategy fails to provide the minimum regulatory scrutiny of low-risk populations. To remedy this failure, Part IV argues that the IRS ought to implement a more rigorous annual reporting requirement to properly monitor the activities of Smaller Charities.

I. THE REGULATORY TOOLS OF THE CHARITABLE REGIME

The IRS is responsible for both assessing the worthiness of organizations vying for charitable status and reviewing the activities of existing charities to ensure continued compliance with the law. This Article will refer to these two responsibilities as, respectively, the screening function and the monitoring function. Although other federal agencies might have a hand in monitoring charitable contributions[38] and many state actors have a role in the oversight of charities,[39] the IRS is

37. *See* Julia Black & Robert Baldwin, *When Risk-Based Regulation Aims Low: A Strategic Framework*, 6 REG. & GOVERNANCE 131 (2012); *supra* notes 26, 28.

38. *See, e.g.*, The Crimes Against Charitable Americans Act of 2001, USA Patriot Act § 1011, 15 U.S.C. §§ 6102, 6106 (2012) (giving the Federal Trade Commission the authority to regulate for-profit third parties that solicit charitable contributions on behalf of charities).

39. Secretaries of state, for example, regulate the formation of charities at the state level and state

the agency in charge of determining whether a particular organization qualifies as a tax-exempt charity[40] and imposing reporting requirements to ensure charities continue to act in accordance with regulations.[41] It may seem a bit odd that the agency in charge of collecting taxes is tasked with determining the worthiness of charities,[42] but however counterintuitive, the IRS has embraced its regulatory role and has developed both screening tools for aspiring charities and monitoring tools for established charities. These tools—the tax-exempt application process and the annual information returns—are discussed in detail in the following sections.

A. The Screening Tool: The Tax-Exempt Application Process

Entities recognized by the IRS as charities enjoy a number of benefits.[43] As tax-exempt entities, they are, of course, exempt from paying federal taxes on income.[44] Perhaps more importantly, individuals who donate money to charities may take a deduction on their personal taxes.[45] The deductibility of donations is one of the more remarkable benefits of becoming a charitable organization. The justification for the charitable deduction is that incentivizing private donations might promote more charitable activity. The fact that individuals can deduct donations from their personal taxes suggests something of an equivalence between paying taxes and contributing to charities.[46]

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attorneys general have the authority to prosecute fraud committed by charities. *See, e.g.*, Danny Hakim, *New York Attorney General Sues Trump Foundation After 2-Year Investigation*, N.Y. TIMES (June 14, 2018), www.nytimes.com/2018/06/14/nyregion/trump-foundation-lawsuit-attorney-general.html [https://perma.cc/WZM7-8BUV] (discussing the New York State attorney general's lawsuit against the Trump Foundation).

40. *See generally* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., Pub. 557, TAX EXEMPT STATUS FOR YOUR ORGANIZATION (2008) [hereinafter IRS Pub. 557], www.irs.gov/pub/irs-pdf/p557.pdf [https://perma.cc/9THQ-ZZW4] (describing the IRS's procedures for entities applying for tax-exempt status).

41. *Id.*

42. Lloyd H. Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 498 (2010) ("[I]t is generally recognized that Congress . . . did not intend for the IRS to become a national regulator of the charitable sector.").

43. *See generally* Roger Colinvaux & Harvey Dale, *The Charitable Contributions Deduction: Federal Tax Rules*, 68 TAX LAW. 331 (2015).

44. I.R.C. § 501(c)(3) (2012).

45. I.R.C. § 170(b)(1)(vii) (2012). The amount of the deduction is limited to a percentage of the donor's adjusted gross income and dependent on whether the tax-exempt entity is a public charity or a private foundation.

46. *See* Eric F. Amarante, *Why Don't Some White Supremacist Groups Pay Taxes*, 67 EMORY L.J. ONLINE 2045, 2051 (2018) ("By allowing [the] tax deduction, we imply an equivalence between donating to tax-exempt organizations and paying taxes. For most tax-exempt entities, this makes

Further, many states piggyback on the IRS's tax-exempt determination to provide analogous benefits in the form of exemptions from state income and sales taxes.[47] Given these benefits, it is important to ensure that the mechanism for approving charitable status is as effective as possible. This mechanism, the tax-exempt application process, requires organizations to complete one of two forms: the Form 1023 (the traditional application) or the recently implemented Streamlined Application.[48]

1. The Form 1023: The Traditional Screening Tool

Until recently, almost all organizations that hoped to obtain charitable status were required to complete the same application: the Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, more commonly known as the Form 1023.[49] There are a few exceptions to this requirement,[50] but the vast majority of aspiring charities were, until 2014, required to complete the Form 1023. The first thing most people notice about the Form 1023 is its length. The application is twenty-six pages long with thirty-eight pages of accompanying instructions.[51] The application requires a number of attachments and exhibits, including the organization's formation document[52] and bylaws;[53] the names, addresses, and biographies of the

sense. Organizations that provide shelter to the homeless, for example, provide a service that many believe the government should provide. Thus, perhaps payments to such organizations should be treated as if they were payments to the government (i.e., taxes)."); Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983) ("When the Government . . . allows deductions all taxpayers are affected; the very fact of the . . . deduction for the donor means that other taxpayers can be said to be indirect and vicarious 'donors.'").

47. *See, e.g.*, Tenn. Code Ann. § 67-6-322 (West 2010) (exempting charities from the Tennessee state sales tax).

48. *See Public Charity – Tax Exemption Application*, IRS, https://www.irs.gov/charities-non-profits/charitable-organizations/public-charity-exemption-application [https://perma.cc/4GEF-A663].

49. U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB No. 1545-0056, FORM 1023: APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE (2017) [hereinafter *Form 1023*], https://www.irs.gov/pub/irs-pdf/f1023.pdf [https://perma.cc/2SQV-5BGU].

50. Some notable exceptions to the application requirement include churches and very small organizations (those that anticipate less than $5,000 in gross receipts). *See Organizations Not Required to File Form 1023*, IRS, www.irs.gov/charities-non-profits/charitable-organizations/organizations-not-required-to-file-form-1023 [http://perma.cc/HX4U-HG3M].

51. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV, CAT. NO. 17132Z, INSTRUCTIONS FOR FORM 1023, APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE (2017) [hereinafter *Instructions for Form 1023*], https://www.irs.gov/pub/irs-pdf/i1023.pdf [https://perma.cc/9CH8-3RDG].

52. In most states, formation documents are called the articles of incorporation. *See Form 1023*, *supra* note 49 at 2, pt. II, l. 1 ("Organizational Structure.").

board of directors;[54] the salaries of the five highest paid employees and five highest paid independent contractors;[55] and several years' worth of pro forma financial statements.[56] These requests, however, represent a relatively small percentage of most completed applications.

The bulk of most submissions is generally the response to Part IV of the Form 1023, which requires a narrative description of the organization's "past, present, and planned activities" (the "Narrative").[57] The Narrative is the opportunity for the applicant to "fully describe all of the activities in which it expects to engage, including standards, criteria, procedures, or other means adopted or planned for carrying out the [charitable] activities."[58] In other words, this is where the applicant makes the case that its activities are deserving of tax-exempt status.[59] The IRS reserves the right to deny tax-exempt status if the applicant does not present a "meaningful explanation of [the applicant's] activities," or if the applicant "provides only general information, lacks sufficient detail, does not fully describe the organization's programs . . . , [or] is otherwise vague."[60] In short, the Narrative is an opportunity for applicants to convince the IRS that the organization's activities justify tax-exemption.[61]

Once completed, the twenty-six-page form, the required attachments, and the Narrative all combine to create an impressive document. According to a private group that provides guidance on completing the Form 1023, "a typical application package is between 50–100 pages of material."[62] All told, this application provides the IRS with a relatively complete picture of what the organization hopes to accomplish,[63] how the organization plans to meet those goals,[64] how much money it hopes

53. *See id.* at 2, pt. II, l. 5 ("Organizational Structure").

54. *See id.* at 2, pt. V, l. 3a ("Compensation and Other Financial Arrangements with Your Officers, Directors, Trustees, Employees, and Independent Contractors").

55. *See id.* at 2, pt. V, l. 1b ("Compensation and Other Financial Arrangements with Your Officers, Directors, Trustees, Employees, and Independent Contractors").

56. *See id.* at 10, pt. IX ("Financial Data"). Note that the form requires applicants to provide either three or four years' worth of financial information, depending on the age of the applicant.

57. *See Instructions for Form 1023*, *supra* note 51, at 8.

58. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 798 (11th ed. 2015).

59. *Id.*

60. *Id.* at 799 (quotations omitted).

61. *See id.*

62. *See How Long Does It Take to Complete Form 1023*, FOUND. GROUP, www.501c3.org/frequently-asked-questions/how-long-does-it-take-to-complete-form-1023/ [http://perma.cc/TTR3-YRAQ].

63. *See Form 1023*, *supra* note 49, at 2, pt. IV ("Narrative Description of Your Activities").

64. *Id.*

to raise,[65] how much it plans to spend in salaries,[66] and why the organization believes it deserves tax-exempt status.[67] At this point, it should be noted that the IRS approves the vast majority of tax-exempt applications. For example, the IRS approved 94% of all tax-exempt applications in 2014, which suggests an application process that is less than rigorous.[68] However, this generous approval rate is not the fault of the Form 1023, but rather the IRS's inability to adequately review all the information provided by Form 1023s. In sum, the Form 1023 provides a fair amount of information for the IRS to determine if the organization is worthy of charitable status. Unfortunately, one could not in good conscience say the same about the Streamlined Application.

2. *The Form 1023-EZ: "A radical change to a decades-old process"*[69]

Introduced in 2014, the Streamlined Application represents a dramatically different approach to assessing applicants.[70] Indeed, it is difficult to imagine how the Streamlined Application could be more dissimilar from the Form 1023. In place of the traditional form's rather intimidating twenty-six-page length, the Streamlined Application is only three pages long.[71] And as the balance of this Section illustrates, describing the form as "three pages" might overstate its substance.

The Streamlined Application consists primarily of benign informational requests and clumsilyworded questions and attestations. Given its brevity, rather than describe the Streamlined Application, it might be more illuminating to point out what is missing. For example, unlike the Form 1023, the applicant is not required to provide its formation document or bylaws.[72] Thus, the IRS is unable to discern if

65. *See id.* at 10, pt. IX ("Financial Data").

66. *See id.* at 2, pt. V ("Compensation and Other Financial Arrangements With Your Officers, Directors, Trustees, Employees, and Independent Contractors").

67. *See id.* at 2, pt. IV ("Narrative Description of Your Activities").

68. *See* 1 NAT'L TAXPAYER ADVOCATE, OBJECTIVES REPORT TO CONGRESS: FISCAL YEAR 2016, at 71 (2016), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2016-JRC/Volume_1.pdf [https://perma.cc/RA7A-J2WX].

69. Viswanathan, *supra* note 21, at 89.

70. *See* IRS Press Release, *supra* note 14.

71. U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO.1545-0056, FORM 1023-EZ, STREAMLINED APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE (2014) [hereinafter *Form 1023-EZ*], www.irs.gov/pub/irs-pdf/f1023ez.pdf [https://perma.cc/KQS2-VRCE].

72. *Compare id. with Form 1023*, *supra* note 49. The absence of an organization's formation document and bylaws startled many nonprofit professionals because it made it so the IRS had no opportunity to ensure the applicant organization's formation documents contain the provisions required fulfilled the organizational test. *See* Letter from Alissa H. Gardenswartz, President, Nat'l

the applicant has the required provisions that prohibit substantial noncharitable activity, private inurement, and substantial private benefit, or the provision that dedicates assets to charitable purposes upon dissolution.[73] Rather than require an applicant to provide the actual provisions, the Streamlined Application merely requires an attestation that its organizing documents contain the appropriate provisions.[74]

In addition to the Streamlined Application's refusal to require organizational documents, the questions designed to discover the organization's planned activities, salaries, and legislative activities are poorly crafted. Rather than permitted narrative answers, this section of the Streamlined Application requires the applicant to answer eight "yes" or "no" questions.[75] These questions cover the entity's plans to influence legislation, pay salaries to insiders, pay funds to individuals, work with foreign organizations, engage in insider transactions, incur unrelated business income in excess of $1,000, engage in gaming activities, or provide disaster relief.[76] Setting aside, for the moment, the insufficiency of "yes" or "no" questions regarding such foundational aspects of organizational activity, many of these "yes" or "no" questions are misleading. For example, question six of Part III asks if the organization plans to "donate funds to or pay expenses for individual(s)."[77] The applicant may only check "yes" or "no" and there is no opportunity for clarification or explanation.[78] Although it may be folly to guess at the IRS's justification for any individual prompt, it appears that this question is attempting to determine if the applicant plans to engage in an impermissible amount of private benefit. A charity is supposed to serve a public, rather than private, interest.[79] Thus, any funds or expenses donated to an individual might be considered a benefit to that person, and not the public. If a charity engages in a substantial amount of such private benefit, it may have its tax-exemption revoked.[80] For this reason,

Ass'n of State Charity Officials, to Sunita Lough, Comm'r, Tax Exempt & Gov't Entities Div. (May 23, 2014) [hereinafter Letter], www.nasconet.org/wp-content/uploads/2018/03/May-23-letter-to-IRS-re-1023EZ.pdf [https://perma.cc/CBZ8-MWLR].

73. *See Organizational Test – Internal Revenue Code Section 501(c)(3)*, IRS, www.irs.gov/charities-non-profits/charitable-organizations/organizational-test-internal-revenue-code-section-501c3 [http://perma.cc/66FN-VAT3] [hereinafter Organizational Test].

74. *See Form 1023-EZ*, *supra* note 71.

75. *Id.*

76. *Id.* at 3, pt. III, ls. 4–11.

77. *Id.* at 3, pt. III, l. 6.

78. *Id.*

79. 26 C.F.R. § 1.501(c)(3)–1(d)(1)(ii) (2019).

80. *See* Better Bus. Bureau of Wash., D.C., Inc. v. United States, 326 U.S. 279 (1945); U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., 1990 EO CPE, C. OVERVIEW OF INUREMENT/PRIVATE BENEFIT ISSUES IN IRC 501(C)(3) (1990), www.irs.gov/pub/irs-

a charity cannot simply collect donations and donate the money to a person in need. Despite the fact that this activity is, undoubtedly, charitable, it benefits only a single individual and not the public. But private benefit incidental to the accomplishment of charitable purposes, even if substantial, is permissible.[81] For example, if a charity formed by lakefront property owners is dedicated to ensuring the lake, which includes public facilities, has clean water. Although the charity will clearly benefit the property owners, this benefit is merely a byproduct of providing a benefit to the public.[82] Thus, the call of the question and the limited available answers suggest the clarity of black and white, when in fact the law is decidedly gray. There are similar concerns with respect to the questions regarding influencing legislation,[83] engaging in financial transactions with insiders,[84] or realizing more than $1,000 in unrelated business income.[85]

The Streamlined Application ends with an opportunity for the applicant to declare its intent to operate as either a public charity or a private foundation.[86] Depending on the applicant's selection, the Streamlined Application requires an appropriate attestation. For example, if the organization claims to qualify as a public charity under Sections 509(a)(1) and 170(b)(1)(A)(vi), it must attest that it either receives at least one-third of its support from contributions from the general public or meets the 10% facts and circumstances test.

The Streamlined Application is completed entirely online in a matter of minutes.[87] Indeed, it is so slight that it is reasonable to conclude that the form was designed not to properly screen applicants, but to create a process that would quickly and efficiently address the IRS's charitable application backlog.[88]

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tege/eotopicc90.pdf [https://perma.cc/7PLJ-E9NP].

81. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., 1990 EO CPE, C. OVERVIEW OF INUREMENT/PRIVATE BENEFIT ISSUES IN IRC 501(C)(3) (1990), www.irs.gov/pub/irs-tege/eotopicc90.pdf [https://perma.cc/7PLJ-E9NP].

82. Rev. Rul. 70-186, 1970-1 C.B. 128.

83. *See Form 1023-EZ*, *supra* note 71, at 2, pt. III, l. 4.

84. *Id.* at 2, pt. III, l. 8.

85. *Id.* at 2, pt. III, l. 9.

86. *Id.* at 2, pt. IV, l. 1a.

87. Anecdotally, my clients are able to complete the form in about half an hour, after a few meetings explaining the import of the questions; *see also* Yin, *supra* note 3.

88. *See* Yin, *supra* note 3; Letter, *supra* note 72 (noting that the Streamlined Application "fails to obtain the minimum amount of information necessary to identify organizations that should not be approved or should be monitored closely in back-end compliance").

3. *Comparing the Two Screening Tools*

As the previous sections make clear, the differences between the Form 1023 and the Streamlined Application are substantial. One form demands a significant amount of information and requires the applicant to prove its worthiness of tax exemption while the other form largely allows the applicant to attest to its worthiness. The ultimate result of the Streamlined Application is a lighter burden on the applicant (and, not coincidentally, the IRS). According to IRS estimates, applicants should expect to spend about 19 hours to learn about the law and complete the Streamlined Application,[89] compared to 105 hours to complete the Form 1023.[90] The chart below illustrates the major differences between the two applications:

Table 1

Requirement	***Form 1023***	***Form 1023-EZ***
Organizational documents must limit activities to charitable purposes	Requires copies of the organizational documents (the articles of incorporation and bylaws) and an indication of the location of such provision[91]	Requires attestation[92]
Organizational documents must not	Requires copy of organizational documents	Requires attestation[94]

89. *See Instructions for Form 1023-EZ*, *supra* note 15, at 10. *But see* Letter from Tim Delaney, Nat'l Council of Nonprofits to the Office of Info. and Regulatory Affairs 3 (Apr. 30, 2014) [hereinafter Nat'l Council of Nonprofits Letter], https://www.ctphilanthropy.org/sites/default/files/resources/National%20Council%20of%20Nonprofits%20Comments%20About%20IRS%20Proposed%20Form%201023-EZ.pdf [https://perma.cc/X3WB-DZQ7] (noting that completion could take "as little as an hour or so—not because they deliberately intend to skirt the law, but because they simply don't know or understand what they are required to certify").

90. *See Instructions for Form 1023*, *supra* note 15.

91. *Form 1023*, *supra* note 49, at 2, pt. III, l. 1.

92. *Form 1023-EZ*, *supra* note 71, at 1, pt. II, l. 5.

94. *Form 1023-EZ*, *supra* note 71, at 1, pt. II, l. 6.

permit engagement in substantial non-exempt activities	and an indication of the location of such provision[93]	
Organizational document must have appropriate dissolution provision	Requires copy of organizational documents and an indication of the location of such provision[95]	Requires attestation[96]
Compensation disclosures	Requires list of five highest paid officers, directors, trustees, employees, and independent contractors and the amount of compensation for each[97]	Asks a yes or no question regarding compensation for officers, directors, and trustees (not employees or independent contractors)[98]
Description of organizational activities	Narrative required[99]	No narrative required; attestation as to charitable activities[100]

93. *Form 1023*, *supra* note 49, at 2, pt. III, l. 1.

95. *Form 1023*, *supra* note 49, at 2, pt. III, l. 2.

96. *Form 1023-EZ*, *supra* note 71, at 1, pt. II, l. 7.

97. Please note that the applicant does not need to list this information for employees and independent contractors if the salary is less than $50,000 per year. *See Form 1023*, *supra* note 49, at 3, pt. V.

98. *Form 1023-EZ*, *supra* note 71, at 2, pt. III, l. 5.

99. *Form 1023*, *supra* note 49, at 2, pt. IV.

100. *Form 1023-EZ*, *supra* note 71, at 1, pt. II, ls. 5–6.

Conflicts of interest	Disclosure of related parties and potential conflicts of interest required. A conflicts of interest policy, if in place, must be submitted. If organization has any contracts or arrangements with an insider, it must be disclosed[101]	Requires attestation[102]
Close connection with other organizations	If a close connection with another organization exists, the applicant must explain the relationship[103]	No disclosure required[104]
Financial Data	Requires disclosure of basic financial information for each year in existence and as many as four years of estimated finances[105]	No disclosure required[106]

Unsurprisingly, many commentators find the substance of the Streamlined Application lacking.[107] The Streamlined Application eschews substantial disclosures that have traditionally been required of charities. For example, the Streamlined Application omits not only the Narrative—the opportunity for the would-be charity to outline its case that it deserves tax-exempt status—but also fails to elicit any financial data other than an attestation that the applicant meets the financial thresholds to qualify as a Smaller Charity.[108] This stands in stark contrast to the Form 1023, which requires not only then-current financial information, but also projected financial statements for as many as three

101. *Form 1023*, *supra* note 49, at 2–3, pt. V.

102. *Form 1023-EZ*, *supra* note 71, at 2, pt. III, l. 8.

103. *Form 1023*, *supra* note 49, at 5–7, pt. VIII, l. 15.

104. *See Form 1023-EZ*, *supra* note 71.

105. *Form 1023*, *supra* note 49, at 9–10, Pt. IX.

106. *See Form 1023-EZ*, *supra* note 71.

107. *See, e.g.*, Yin, *supra* note 3, at 271 (arguing that the Form 1023-EZ "makes the entire (c)(3) application process, intended by Congress to give the IRS sufficient information about the 'nature, purposes, and activities' of the applicants, a sham" (citation omitted)).

108. That is, that the applicant projects that its annual gross receipts will not exceed $50,000 in any of the next three years and it has total assets less than $250,000. *See Instructions for Form 1023-EZ*, *supra* note 15. There are a number of non-financial requirements that are less relevant to this discussion, including whether the organization is a foreign entity, successor organization, church, school, or hospital. *See generally id.*

years.[109]

The lack of financial information is troubling, but the most galling omission is the Streamlined Application's failure to require any actual copies of the applicant's organizational documents. Without these documents, the applicant does not prove to the IRS (or to any individual who might request a copy of the Streamlined Application) that the organization is formed for permissible charitable purposes.[110] There is an attestation, but no actual proof of compliance with the statutory requirement that an organization is formed exclusively for charitable purposes.[111] For example, the law requires charities to have an organizational restriction against engaging in transactions that amount to private benefit or inurement.[112] The Streamlined Application fulfills this requirement with a mere attestation and no requirement of providing proof of such prohibition, while the Form 1023 requires copies of the applicant's organizational documents and specific references to the required provisions.[113] Finally, to ensure that charity leaders are not able to raise money and simply dissolve the charity before pocketing the donations, the law requires a promise to distribute any funds upon dissolution in accordance with charitable laws.[114] Without a requirement to submit organizational documents, there is no way to prove compliance with these legal requirements.

For those that practice outside of the nonprofit field, these complaints might seem unduly pedantic—but these restrictions represent the core requirements for obtaining charitable status: the organizational and operational tests. The organizational test is designed to ensure that charitable applicants have provisions in their formation documents that ensure continued charitable activity and restrict improper or discouraged activity.[115] To meet this test, the applicant's organizational documents "must limit the organization's purposes to one or more of those [certain enumerated charitable purposes][116] and mustn't expressly empower it to

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109. *See Form 1023*, *supra* note 49, at 10, pt. IX ("Financial Data").

110. This is a core requirement of charities. *See Organizational Test*, *supra* note 73.

111. *See Form 1023-EZ*, *supra* note 71.

112. *See* IRS Pub. 557, *supra* note 40.

113. *See Form 1023-EZ*, *supra* note 71.

114. *See* IRS Pub. 557, *supra* note 40.

115. *See Organizational Test*, *supra* note 73. As Professor Hopkins explains, "[a]n organization is organized exclusively for one or more tax-exempt, charitable purposes only if its articles of organization limit its purposes to one or more exempt purposes and do not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes." Hopkins, *supra* note 58, at 67–68.

116. These purposes are religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition, and the prevention of cruelty to children or animals. *See* I.R.S. Pub. 557, *supra* note 40, at 21.

engage, other than as an insubstantial part of its activities, in activities that don't further one or more of those purposes."[117] To the extent that the organizational test represents a bulwark against improper activities by nonprofits, one can easily see the objections to the Streamlined Application's failure to require submission of organizational documents.

The other major test for charities, the operational test, represents the IRS's requirement that charities operate in a manner consistent with nonprofit law.[118] Obviously, the application phase, which is concerned with the organization's then-current fitness to be a charity and is rarely forward-looking, is a poor tool to determine whether or not an applicant meets the operational test.[119] Indeed, to the extent the application phase considers anticipated activities, the reviewers are necessarily limited by the conjectural nature of the answers.[120] Thus, the IRS does not rely upon the tax-exempt application to determine a particular organization's fulfillment of the operational test. Rather, the IRS uses annual reports, which are monitoring tools more suited to measuring an organization's ongoing activities. These tools are discussed in more detail in the following sections.

B. The Monitoring Tool: The Annual Reporting Requirement

Clearly, any reasonably rigorous regulatory regime charged with oversight of charities cannot end at the application phase. After all, the application process can only provide information about the organization's then-current operations and any information related to future activities will be based upon best intentions.[121] Further complicating matters, unlike taxable entities, charities are not required to submit annual tax returns which could conceivably provide financial information necessary for IRS scrutiny.

To bridge this gap and to ensure that tax-exempt organizations operate in accordance with charitable laws—in other words, to ensure that the operational test is met—the IRS requires annual information

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117. *See id.* at 24.

118. *See Operational Test – Internal Revenue Code Section 501(c)(3)*, IRS, https://www.irs.gov/charities-non-profits/charitable-organizations/operational-test-internal-revenue-code-section-501c3 [https://perma.cc/J3FH-3YLZ].

119. *But see Form 1023*, *supra* note 49, at 2, pt. IV (requiring the applicant to describe activities that may occur in the future).

120. *See id.*

121. *See* Matthew Rossman, *Evaluating Trickle Down Charity*, 79 BROOK. L. REV. 1455, 1495 (2014) ("There is no formal mechanism by which the organization must periodically reestablish the basis for its exempt status. Thus, most organizations are granted tax-exempt status on the basis of largely aspirational and non-specific projections about their programming and never again separately questioned about it.").

returns.[122] In conjunction with the tax-exempt application, these returns permit the IRS to regulate charities not only at the inception of the entity's tax-exempt lifecycle with the Form 1023 or the Streamlined Application, but also on an annual basis thereafter. There are three annual information returns relevant to this discussion. The first two, which this Article dubs the "Traditional Monitoring Tools," are known as the Form 990[123] and Form 990-EZ,[124] while the third is the Form 990-N.[125] The Traditional Monitoring Tools elicit a fairly robust amount of data, providing regulators some information that might help to determine if a charity is compliant with charitable laws. In this manner, these forms are roughly analogous to the Form 1023. The Form 990-N, on the other hand, is analogous to the Streamlined Application, in that it requires precious little disclosure and leaves the IRS with virtually no means of evaluating a charity's activities. The three monitoring tools are discussed in more detail in the following sections.

1. The Traditional Monitoring Tools

The information required by an annual information return varies depending on the size of the charity. Generally speaking, the more money involved, the more disclosure and information will be required. For example, entities that have annual gross receipts over $200,000 or assets greater than or equal to $500,000 are required to submit a Form 990, the most robust of the annual information returns, while Smaller Charities are permitted to submit less rigorous annual information returns.[126]

The Form 990 provides "a realistic picture of the [charity] and its operations," with the ultimate goal of "promoting compliance with the federal tax law."[127] More specifically, the Form 990 requires a fairly detailed account of the charity's financial condition, including disclosure of gross income, expenses, disbursements, a balance sheet, total contributions received (including the names and address of certain contributors), and salaries paid.[128] In addition to this financial

122. I.R.C. § 6033 (2012).

123. U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-0047, FORM 990: RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX (2018) [hereinafter *Form 990*], www.irs.gov/pub/irs-pdf/f990.pdf [https://perma.cc/N3VR-TYHK].

124. U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., OMB NO. 1545-1150, FORM 990-EZ: SHORT FORM RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX (2018) [hereinafter *Form 990-EZ*], https://www.irs.gov/pub/irs-pdf/f990ez.pdf [https://perma.cc/M4KW-EB54].

125. *See Filing Requirements for Form 990-N*, *supra* note 33.

126. *See Form 990*, *supra* note 123.

127. Hopkins, *supra* note 58, at 882.

128. *See Form 990*, *supra* note 123.

information, a charity filing a Form 990 is required to submit narrative descriptions of its "three largest program services,"[129] which must provide "specific measurements such as clients served, days of care provided, number of sessions or events held, or publications issued."[130] Finally, and perhaps most importantly, the IRS is not the only audience for Form 990s. In addition to submission to the IRS, charities are required to make their Form 990s publicly available for inspection and copying.[131] Thus, the IRS and the general public have the opportunity to scrutinize the activities of charities on an annual basis.

One should expect to spend approximately eighty-five hours to complete the Form 990.[132] Recognizing this burden, the IRS does not require all entities to complete the Form 990. Charities that have annual gross receipts between $50,000 and $200,000 and assets under $500,000—that is, slightly smaller charities—are required to complete a less rigorous annual information return, the Form 990-EZ.

In comparison to the Form 990, the Form 990-EZ is significantly streamlined. It still requires the basic financial information and narrative descriptions required by the Form 990,[133] but in the interest of saving time for smaller organizations, the Form 990-EZ does not elicit the Form 990's level of detail.[134] As a result, the IRS estimates that it should take about eleven-and-a-half hours to learn about the law and fourteen-and-a-half hours to prepare the form,[135] less than half the estimated time it takes for charities filing the Form 990.

Thus, the annual information returns for large- and mid-sized charities (the Form 990 and Form 990-EZ, respectively) each require charities to provide some financial information and a narrative description of the charity's activities for the previous year. And like the Form 990, charities that file the Form 990-EZ must make the information available

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129. *See Form 990*, *supra* note 123, at 2, pt. III, l. 4.

130. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., CAT. NO. 11283J, INSTRUCTIONS FOR FORM 990 RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX 11 (2019) [hereinafter *Instructions for Form 990*], www.irs.gov/pub/irs-pdf/i990.pdf [https://perma.cc/N4GD-Z63F].

131. *See Public Disclosure and Availability of Exempt Organizations Returns and Applications: Documents Subject to Public Disclosure*, IRS, www.irs.gov/charities-non-profits/public-disclosure-and-availability-of-exempt-organizations-returns-and-applications-documents-subject-to-public-disclosure [http://perma.cc/5759-EZRE].

132. Per the Paperwork Reduction Act. *See Instructions for Form 990 Return of Organization Exempt from Income Tax*, IRS (2018), https://www.irs.gov/instructions/i990/ar02.html [https://perma.cc/DG68-W2PW].

133. *See Form 990-EZ*, *supra* note 125.

134. *See generally id.*

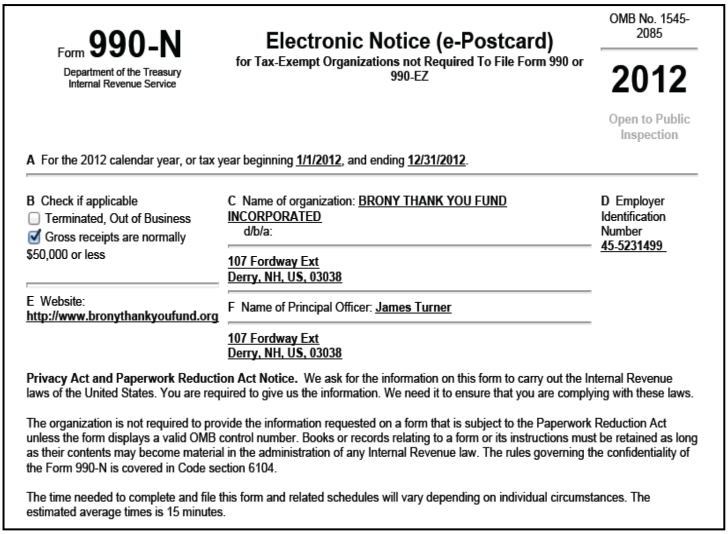
135. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., CAT. NO. 64888C, INSTRUCTIONS FOR FORM 990-EZ (2019) [hereinafter INSTRUCTIONS FOR FORM 990-EZ], https://www.irs.gov/pub/irs-pdf/i990ez.pdf [https://perma.cc/SQ9B-5YRT].

to the general public, providing some level of transparency. For Smaller Charities, however, the annual reporting requirement is, to say the least, quite different.

2. The Form 990-N

The IRS does not require Smaller Charities to file either the Form 990 or the Form 990-EZ, but instead requires the Form 990-N, or e-Postcard.[136] The information elicited by the e-Postcard is minimal. The form requires no detailed financial information, and there is no requirement for a narrative description of the activities of the charity. In fact, other than the aforementioned attestation, there is no information other than the charity's name, address, website, and employer identification number, along with the name and address of a principal officer. Below is an example of a completed Form 990-N[137]:

Figure 1:



Form **990-N**
Department of the Treasury
Internal Revenue Service

Electronic Notice (e-Postcard)
for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ

OMB No. 1545-2085
2012
Open to Public Inspection

A For the 2012 calendar year, or tax year beginning 1/1/2012, and ending 12/31/2012.

B Check if applicable
☐ Terminated, Out of Business
☑ Gross receipts are normally $50,000 or less

C Name of organization: BRONY THANK YOU FUND INCORPORATED
d/b/a:
107 Fordway Ext
Derry, NH, US, 03038

D Employer Identification Number
45-5231499

E Website:
http://www.bronythankyoufund.org

F Name of Principal Officer: James Turner
107 Fordway Ext
Derry, NH, US, 03038

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws.

The organization is not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. The rules governing the confidentiality of the Form 990-N is covered in Code section 6104.

The time needed to complete and file this form and related schedules will vary depending on individual circumstances. The estimated average times is 15 minutes.

The utility of such a disclosure is questionable. Indeed, to even categorize the e-Postcard as "disclosure" is to stretch the meaning of the word. Other than contact information, the IRS cannot deduce anything

136. The alternative name for this form is quite descriptive, as the information is provided only online (charities may not submit physical versions) and the information elicited is minimal. *See* Hopkins, *supra* note 58.

137. *See* THE BRONY THANK YOU FUND, http://www.bronythankyoufund.org/ [http://perma.cc/6LMP-A33M]. Please note that the reference to "related schedules" at the bottom of the form is a bit of a mystery, as the e-Postcard does not require any schedules. *Id.*

about the organization's activities. To the extent it was designed to serve an ongoing monitoring function akin to the Traditional Monitoring Tools, one can only conclude that it failed.

C. A Failure to Regulate

The criticisms of the e-Postcard were easy to predict. As discussed in more detail at the end of this section, the e-Postcard's lack of meaningful information renders the form virtually useless. Similarly, the criticisms of the Streamlined Application were equally unsurprising. The information gleaned by the Streamlined Application pales in comparison to the breadth of information culled by the Form 1023. This section will describe the crux of the criticisms of both the Streamlined Application and the e-Postcard, by first discussing the Streamlined Application's failure to educate applicants before shifting to its inability to collect adequate information. The section will close with a (fittingly) brief discussion of the e-Postcard's failure to monitor the activities of charities.

1. A Failure to Educate

Many of the criticisms of the Streamlined Application highlight that the Form 1023 played a significant role in educating applicants on the proper activities and conduct of charitable organizations.[138] For example, by requiring an applicant to engage in the laborious process of completing the Narrative, the applicant is forced to consider the organization's past, present, and planned activities in a critical manner.[139] The applicant is not merely permitted to provide a rote description of the organization's activities, but it must explain how each of the activities furthers a charitable purpose.[140] In theory, this requires a critical evaluation of each of the applicant's planned activities in light of permissible charitable purposes. In addition to the Narrative, the Form 1023 also asks organizations to provide current and projected financial information, which requires a thoughtful applicant to consider how much projects will cost and how the organization will raise such funds.[141] Collectively, this amounts to a relatively strenuous process.

Professor Bruce Hopkins argues that this difficult process is intentional.[142] According to Hopkins, the prompts were drafted to spur

138. *See, e.g.*, Nat'l Council of Nonprofits Letter, *supra* note 89, at 2–3 (noting a nonprofit leader's concern that the Form 1023-EZ lacks sufficient rigor to prepare a charity to succeed).

139. *See Form 1023*, *supra* 49, at 2, pt. IV.

140. *See Instructions for Form 1023*, *supra* note 51, at 8.

141. See *Form 1023*, *supra* 49, at 9–10, pt. IX.

142. Hopkins, *supra* note 58, at 802.

reflection and inspire thoughtful responses, because the Form 1023:

> involves far more than merely responding to the questions on a government form. It is a process not unlike the preparation of a prospectus for a business in conformity with securities law requirements. Every statement made in the application should be carefully considered . . . . Organizations that are entitled to tax-exempt status have been denied recognition of exemption by the IRS, or at least have caused the process of gaining the recognition to be more protracted, because of unartful phraseologies in the application that motivated the agency to muster a case that the organization did not qualify for exemption.[143]

In other words, the rigor of the Form 1023 serves an educational role. By challenging applicants to make the case that their charitable activities are worthy of tax-exemption, the Form 1023 weeds out applicants that are less-prepared. Applicants with little more than "half-baked plans and ideas" may be discouraged by the Form 1023.[144] As one critic of the Streamlined Application noted, "[h]aving gone through the [Form 1023] application process with a museum I helped start, we were put through the ringer by the IRS which to some extent forced us to think through our plans (mission, vision, intent, how we would operate, etc.) ultimately, I believe, making us stronger."[145] Professor George Yin illustrates the educational deficit of the Streamlined Application by describing a "sincere but not well advised" hypothetical group of applicants.[146] Yin imagines such applicants as they "pore over the few sentences in the instructions summarizing the private inurement and benefit doctrines and other familiar parts of the law."[147] Highlighting the inadequacy of the instructions, Yin rhetorically asks, "[h]ow are they, working on their own, going to complete their required attestations?"[148]

One might plausibly argue that an uneducated pool of charities is acceptable if the IRS is vigilant in ensuring that only appropriate applicants ultimately receive tax-exempt status. But as discussed in the next section, the IRS is simply incapable of serving in this capacity because the Streamlined Application fails to elicit sufficient information

143. *Id.*

144. *See* Nat'l Council of Nonprofits Letter, supra note 89, at 2–3. ("The [Form 1023] is overwhelming and is discouraging to some, but also a deterrent to those with only half-baked plans and ideas.").

145. *Id.* at 3. The concerns set forth in the National Council for Nonprofit's letter were addressed point by point by Professor Manoj Viswanathan. *See* Viswanathan, *supra* note 21 at 96–99.

146. Yin, *supra* note 3, at 268.

147. *Id.*

148. *Id.*

to make such a determination.[149]

2. *A Failure to Assess*

Although the lack of an educational component represents a common theme of many criticisms, the direst warnings relate to the Streamlined Application's failure to elicit sufficient information for the IRS to make an informed decision on an applicant's merits.[150] This aspect of the Streamlined Application has been derisively referred to as the charitable application's equivalent of "don't ask, don't tell."[151] Critics expressed concern that this failure paves the way for the IRS to award charitable status to entities that should not qualify.[152]

The critics' fears may be well-founded. At least one study supports the notion that the Streamlined Application may result in the IRS awarding charitable status to unfit entities.[153] Nina Olson, the National Taxpayer Advocate,[154] engaged a study in conjunction with the IRS to assess the success of the Streamlined Application.[155] The study required additional disclosures for over 400 organizations that submitted a Streamlined Application.[156] The additional requested information included "the organizing document with language required to meet the organizational test; a detailed description of past, present, and future activities; revenues and expenses; and a detailed description of any transactions with donors or related entities."[157] In other words, these organizations were asked to provide much of the information they would have been required to submit under the traditional Form 1023.

The results of the study are disheartening. As Jill MacNabb, an advisor to the National Taxpayer Advocate, noted, "there is a significant difference in the approval rate of a [Streamlined Application] just as it is

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149. *Id.*

150. *Id.*

151. *See* Cohen, *supra* note 21.

152. *See* Nat'l Council of Nonprofits Letter, *supra* note 89.

153. *See* NAT'L TAXPAYER ADVOCATE, 2015 ANNUAL REPORT TO CONGRESS 1–32 (2015), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2015ARC/ARC15_Volume2.pdf [https://perma.cc/46RG-9HZC] ("Study of Taxpayers That Obtained Recognition As IRC § 501(c)(3) Organizations on the Basis of Form 1023-EZ.").

154. The National Taxpayer Advocate is an independent organization within the IRS that serves as an advocate for taxpayers who are experiencing delays or are suffering economic harm. *See generally* TAXPAYER ADVOCATE SERV., https://taxpayeradvocate.irs.gov/ [https://perma.cc/9X86-PB9X].

155. *See* NAT'L TAXPAYER ADVOCATE, 2016 OBJECTIVES REPORT TO CONGRESS, *supra* note 68, at 70–76.

156. *Id.*

157. *See id.* at 73.

and the approval rate when you ask for some very basic information."[158] Although 95% of all Streamlined Application filers are ultimately approved, only 73% of the applications in the study were ultimately granted charitable status.[159] Although based upon a small sample size, the rational conclusion is that the IRS is providing charitable status to entities that would not have qualified had they been required to submit the Form 1023.[160] Or, in the words of the National Taxpayer Advocate, the IRS granted tax-exemption for "applications it would have rejected had the applications been subject to the slightest scrutiny."

Another study by the National Taxpayer Advocate provides additional reason for concern. This study set out to review the organizational documents of Streamlined Application filers to determine if the documents complied with IRS's organizational test—in other words, if the charter and bylaws: (1) limited the organization's activities to one or more exempt purpose; (2) did not expressly empower the organization to engage (other than insubstantially) activities which are not in furtherance of such purpose(s); and (3) ensured that assets are properly distributed upon dissolution.[161] Because the Streamlined Application does not require submission of organizational documents, the IRS relies upon attestations of the existence of such provisions.[162] Of the 408 Streamlined Application filers in this study, all of which received charitable status,[163] 37% failed to comply with the organizational test.[164] In other words, these applicants obtained charitable status despite the fact that a brief review of their organizational documents would have

158. Fred Stokeld, *Taxpayer Advocate Official Concerned About EO Short Form*, TAX NOTES, Oct. 5, 2015, at 39.

159. *Id.*

160. This author is in the process of conducting a more robust study of Streamlined Application Filers to determine the veracity of this conclusion.

161. *See* ORGANIZATIONAL TEST – INTERNAL REVENUE CODE SECTION 501(C)(3), https://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Organizational-Test-Internal-Revenue-Code-Section-501(c)(3) [https://perma.cc/66FN-VAT3]. Note that organizations in some states can meet the dissolution requirement without a specific provision. The study took this factor into account.

162. See FORM 1023-EZ, *supra* note 66. Under the Form 1023, the applicants must not only provide copies of the organizational documents, but also indicate precisely where the provisions appear in such documents. *See* FORM 1023, *supra* note 49, at 2, pt. III.

163. The small number of applicants reviewed is because the inquiry was limited to those states that provide copies of organizational documents free of charge. *See also supra* note 160 regarding the author's plan to conduct a more robust study.

164. *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 37. The National Taxpayer Advocate, Nina Olson, concludes that "there were organizations that have been approved that if we had just simply asked four questions we would not have approved them today." *See* David van den Berg, *Olson: Exemption Applicants Are Being Wrongly Approved*, TAX NOTES, Apr. 27, 2015, at 396.

revealed their obvious deficiency.[165] Even in such a small sample size, this is particularly worrisome and gives credence to claims that the Streamlined Application is not properly vetting applicants.[166]

By way of example, the articles of incorporation of one of the entities in the study contained the following charitable purpose:

> My father . . . sufferred [sic] a spinal cord injury in February 2013, which left him a quadriplegic [sic]. His physicians and physical therapists say he is capable of recovering and walking again but his insurance . . . will not cover the expense, so we are hosting fundraisers/benefits to try to raise money on our own to pay for his therapy out of pocket.[167]

Of course, one has sympathy for any person trying to raise money for an injured family member. But however sympathetic, this purpose is not a sufficient mission for a charity.[168] Charitable organizations are required to have a *public*, as opposed to a *private*, charitable purpose.[169] Raising money for an individual, regardless of the need, does not meet this standard.[170]

Another example provides more alarming proof of the IRS's inability to properly vet Streamlined Application filers. One organization received charitable status despite having a grossly insufficient dissolution provision.[171] The provision read as follows: "[a]ssets will be distributed to [the founder] if this nonprofit dissolves."[172] In other words, the organizational documents permitted the incorporator to solicit tax-deductible contributions, engage in no charitable work, dissolve the organization, and pocket any funds raised. This clearly violates the requirement that organizations dedicate all assets to a charitable purpose,[173] and would hopefully give rise to scrutiny by state authorities and the IRS. However, even if authorities were able to catch this

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165. *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 37.

166. *Id.*

167. *Id.* at 38 (alterations in original).

168. Andrew Megosh et al., 2001 EO CPE, H. PRIVATE BENEFIT UNDER IRC 501(C)(3) 135 (2001), https://www.irs.gov/pub/irs-tege/eotopich01.pdf [https://perma.cc/2J45-PGYQ] (noting that "an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest").

169. *Id.*

170. *Id.*

171. *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 2.

172. *Id.*

173. Elizabeth Ardoin, ORGANIZATIONAL TEST – IRC 501(C)(3) *in* 2004 EO CPE TEXT 10 (2004), https://www.irs.gov/pub/irs-tege/eotopicd04.pdf [https://perma.cc/JAU8-HM5D] ("An organization will not qualify for exemption unless its creating document contains a dissolution provision that permanently dedicates its assets to an exempt purpose.").

activity, the fact that the Streamlined Application does not permit the IRS to review organizational documents casts serious doubt on this tool's ability to properly assess applicants.

Thus, there is convincing evidence to conclude that the Streamlined Application does not elicit enough information to allow the IRS to adequately review applications. However, some critics go further, suggesting that the Streamlined Application is not merely providing inadequate information for assessment, but that the IRS is engaging in virtually no assessment.[174] Citing a "high-ranking agency official," Yin proffers that, with the Streamlined Application, "the IRS has effectively created a self-certification process to obtain (c)(3) status."[175] Yin does not simply argue that the information elicited by the Streamlined Application is inadequate; rather he argues that the information is nonexistent.[176] Yin questions whether the Streamlined Application's "series of completely opaque attestations" provides the IRS with anything to "screen and analyze."[177]

Perhaps we might find some comfort in the belief that the applicants cited above were unintentionally filing noncompliant organizational documents. One might reasonably assume that most people starting charities aspire to follow the law, and they would not intentionally leave out a required provision in its charter documents in order to either engage in non-charitable activity or distribute assets in contravention of 501(c)(3) requirements upon dissolution. However, critics maintain that the Streamlined Application may open the door to more insidious actors.[178] Such critics are concerned that the lack of rigor in the Streamlined Application will make "it easier for 'scam' charities to obtain tax-exempt status," and that it shifts "IRS oversight obligations onto the public, the funding community, and state charity regulators."[179] Although recognizing the notion that the "long-established Form 1023 and application process need review and streamlining,"[180] the National

174. *See* Yin, *supra* note 3, at 267.

175. *Id.* at 267–68 (citing Fred Stokeld et. al., *IRS Hearing on EO Guidance Expected in Spring*, TAX NOTES, Mar. 10, 2014, at 1078).

176. *Id.*

177. *Id.* at 269.

178. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-164, TAX-EXEMPT ORGANIZATIONS: BETTER COMPLIANCE INDICATORS AND DATA, AND MORE COLLABORATION WITH STATE REGULATORS WOULD STRENGTHEN OVERSIGHT OF CHARITABLE ORGANIZATIONS 32 (2014) (noting that by "decreasing the quality of information the IRS needs to make informed decisions about granting tax-exempt status" the Form 1023-EZ is "making it easier for 'scam' charities to obtain tax-exempt status").

179. *Id.*

180. Nat'l Council of Nonprofits Letter, *supra* note 89, at 1.

Council of Nonprofits[181] also expressed "serious concerns" about the Streamlined Application, warning that potential "bad actors will . . . opt to use the [Streamlined Application's] express-lane approval process to avoid the transparency mandate that is integral to the current Form 1023 application process."[182]

In sum, if the inaccurate attestations were intentional, then the Streamlined Application's lack of rigor invites fraud. If the inaccurate attestations were unintentional, then the Streamlined Application is failing to properly educate applicants. In either case, the criticism that the IRS is not adequately assessing applicants carries considerable weight.[183] As noted by the National Taxpayer Advocate, with the adoption of the Streamlined Application, "the IRS effectively abdicated its responsibility to determine whether an organization is organized and operated for an exempt purpose."[184]

3. No Monitoring of Smaller Charities

The IRS argues that any perceived insufficiency of the application process is irrelevant because the IRS hopes to implement rigorous and effective monitoring procedures.[185] This argument makes sense. If limited resources make it impossible to both adequately screen and monitor charities, then perhaps a shift of resources to the back end is justified. However, this argument loses all credibility when one examines the back-end monitoring tool for Smaller Charities, the e-Postcard.[186] As noted above, the e-Postcard provides virtually no financial information other than an opaque attestation that the organization's "[g]ross receipts are normally $50,000 or less,"[187] and it demands absolutely no description of the charity's activities. Beyond providing contact information, the document is virtually useless.

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181. The National Council of Nonprofits represents the "largest network of nonprofits in the country." Viswanathan, *supra* note 21, at 95.

182. Nat'l Council of Nonprofits Letter, *supra* note 89, at 7. "Likewise, the Taxpayer Advocate also raised concerns about the streamlined 1023-EZ form, including a lack of empirical data demonstrating that organizations anticipating less than $50,000 in gross annual receipts pose low risks to compliance, a failure to conduct a comprehensive evaluation of downstream consequences of the streamlined application, and a post-implementation plan . . . to correct potential compliance problems." GAO-15-164, *supra* note 178, at 32.

183. *See id.*

184. *See* 2015 TAXPAYER ADVOCATE REPORT, *supra* note 2, at 36.

185. IRS Press Release, *supra* note 14.

186. See Rossman, *supra* note 121, at 1494 (2014) ("IRS scrutiny of 501(c)(3) organizations is heavily front-loaded.").

187. *See supra* note 137 and accompanying text (showing an example of a completed Form 990-N).

Thus, if an organization attests that its gross receipts will not exceed $50,000, it will operate in a regulatory blind spot. At the outset of the organization's charitable existence, the IRS requests the scant information required by the Streamlined Application. Thereafter, the IRS annually requests the meager information required by the e-Postcard. Considering the Streamlined Application and the e-Postcard together, the IRS has effectively given up either prospective or retrospective review of Smaller Charities.

II. THE HARMS OF UNREGULATED CHARITY

The only defensible argument for the IRS's failure to screen or monitor Smaller Charities is that they present no appreciable risk of harm.[188] The argument must hold that, by dint of the organization's size, the potential harms are similarly small. This appears to be the position of the IRS,[189] but the argument does not stand to reason. In fact, the potential for Smaller Charities to engage in widespread noncompliance presents a series of harms. From the micro-level perspective, individual Smaller Charities may engage in a number of prohibited or disfavored activities that harm donors, market participants, and charitable beneficiaries.[190] On a macro-level, any widespread impermissible activities by Smaller Charities might inspire a collective distrust of the charitable sector, ultimately undercutting the nonprofit sector's effectiveness.

A. Driven by the Bottom Line

Although the plain language of the Internal Revenue Code appears to prohibit charitable organizations from engaging in any activities other than those specifically enumerated in the statute, the reality is quite different. The Internal Revenue Code states, in facially uncompromising language, that "to be exempt as an organization described in 501(c)(3), an organization must be both organized and operated *exclusively* for one or more purposes specified in such section."[191] Such enumerated

188. *See* Yin, *supra* note 3 at 4 ("Implicit in [Commissioner Koskinen's] claim about small organizations appears to be the sense that their exemption costs the fisc very little, and thus the effect of any mistaken determinations will be de minimis.").

189. *See* IRS Press Release, *supra* note 14, at 1 (quotation omitted).

190. Lloyd H. Mayer, *The "Independent" Sector: Fee-for-Service Charity and the Limits of Autonomy*, 65 VAND. L. REV. 49, 85 (2012) ("The term 'beneficiaries' in the charity context refers to those who benefit gratuitously from a charity's activities, as distinguished from consumers who pay full fair market value for the goods or services they receive from a charity . . . .").

191. Organizations Organized and Operated for Religious, Charitable, Scientific, Testing for Public Safety, Literary, or Educational Purposes, or for the Prevention of Cruelty to Children or

purposes are religious, charitable, scientific, testing for public safety, literary, educational, or preventing cruelty to children or animals.[192] A reasonable interpretation of this edict would conclude that charities are not permitted to engage in any activity, however insignificant in amount or character, that fails to fall within the activities contemplated by the enumerated purposes.[193] Such is the plain meaning of "exclusively."[194] However, the regulatory regime takes a permissible stance on a number of activities that seem, for lack of a better word, uncharitable. In this manner, charities may engage in a range of activities outside the scope of the enumerated charitable purposes.

By permitting charities to engage in such activities, the regulatory regime runs the risk of condoning behavior that may, to some, appear antithetical to any reasonable definition of charity.[195] More to the point, without running afoul of the regulatory regime, charity leaders often earn handsome salaries,[196] some of our most cherished public charities are major participants in the private market,[197] and many charities charge fees for the charitable services they provide.[198] Such activities are not, on their face, offensive, but they are also certainly not necessarily "religious, charitable, scientific, [related to] testing for public safety, literary, educational, or prevention of cruelty to children or animals."[199]

Because an excess of such activities would be unacceptable, the regulatory regime developed limits on the amount and character of such activities. These limits suggest a regulatory aversion to such activities, recognizing that unreasonably lavish salaries, excessive commercial activity, and prohibitively high fees for charitable services would transform an organization's activities from selfless to self-serving, lessening the justification for favorable tax treatment.[200] Too much of

Animals, 26 C.F.R. § 1.501(c)(3)-1(a)(1) (2019) (emphasis added).

192. *Id.*

193. John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 496 (2002).

194. *See generally id.*

195. Dean Baker, *End Bloated Salaries in the Nonprofit Sector*, STAN. SOC. INNOVATION REV., Spring 2019, at 58 ("The federal government is providing enormous subsidies to the bloated pay of top executives at nonprofits. This is simply not a good use of federal dollars, and it is hardly in keeping with the idea that nonprofits should be serving a public purpose.").

196. *See id.*; Andrea Fuller, *Charity Officials are Increasingly Receiving Million-Dollar Paydays*, WALL STREET J. (Mar. 6, 2017), https://www.wsj.com/articles/charity-officials-are-increasingly-receiving-million-dollar-paydays-1488754532 [https://perma.cc/G8SF-SJAL].

197. *See generally* Colombo, *supra* note 193.

198. *See generally* Lloyd H. Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 480 (2010).

199. 26 C.F.R. § 1.501(c)(3)-1(d)(1)(i) (2019).

200. *Cf.* Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH L. REV. 999,

any such activities will result in excise taxes or even revocation of tax-exempt status.[201] Given that the regulatory regime places limitations on paying salaries, engaging in commerce, and charging fees for charitable services, this Article will refer to them as "Disfavored Activities."

This section will start by discussing a Disfavored Activity for which the regulatory regime has fashioned a partial monitoring tool: the commercial activity of charities. In short, charities are required to disclose "unrelated business income" of more than $1,000 in any given year.[202] Income is "unrelated" if it is derived from a regularly carried on trade or business that is not substantially related to furthering the charity's exempt purpose.[203] Such income is subject to taxes and reporting. By requiring disclosure of such unrelated business income, regardless of an entity's size, the regime capably monitors unacceptable amounts and types of this particular commercial activity. However, as described in more detail below, the existing regime does not monitor *related* commercial activity in an acceptable manner.[204] Since related commercial activity may also undercut public faith in the charitable sector, the inability of the regulatory regime to monitor related commercial activity represents a regulatory failure.

After discussing the commercial activity of charities, the remainder of this section discusses two Disfavored Activities for which the regulatory regime has yet to fashion an acceptable monitoring tool: paying salaries and charging fees for charitable services. As this section will argue, the monitoring mechanisms in place to measure such activities are woefully inadequate for Smaller Charities.

1. The Market and Charities: Limited Commercial Activity

It might come as a surprise to those unfamiliar with the charitable sector to learn that charities may, and often do, engage in commerce.[205] This surprise is no doubt due to the fact that an act of commerce, a *quid pro quo* exchange, may very well be the antithesis of what most people

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1021 n.51 (1982) ("It has also been said that the core feature of charity is that it is not 'self-regarding,' but 'other-regarding.'").

201. *See* PUB 557, *supra* note 40.

202. *See infra* notes 216–219.

203. *See Unrelated Business Income Tax*, IRS, https://www.irs.gov/charities-non-profits/unrelated-business-income-tax [perma.cc/H5ZN-3DYD] (last updated Mar. 26, 2019). For example, if a church takes advantage of its proximity to a college football stadium by charging for parking space on Saturdays, the church is realizing income that is completely unrelated to its faith-based mission.

204. *See infra* notes 216–219.

205. *See* Colombo, *supra* note 193, at 489–90.

think of when they think of charities.[206] Visions of soup kitchens and homeless shelters echo widely accepted definitions of charitable organizations as those "set up to provide help and raise money for those in need," or entities dedicated to "the voluntary giving of help, typically in the form of money, to those in need."[207] If the very definition of charity is "voluntary giving," then a commercial transaction in which one party exchanges money for the services or goods of another certainly does not qualify.[208] Indeed, if one is giving something in exchange for something else, one wonders if anything is "given" at all.

The instinct that charities should not engage in commercial activity finds some support in the Internal Revenue Code.[209] As noted above, the Internal Revenue Code purports to limit activities of charities "exclusively" to certain enumerated purposes. Professor John Colombo argues that a plain reading of this provision would prohibit any amount of commercial activity "in no uncertain terms."[210] However, as Colombo concedes, this language "has almost never been interpreted literally"[211] and that, with respect to commercial activity, the definition of "exclusively" has been held to mean something akin to "mostly."[212] Ultimately, the regulatory regime has concluded that so long as "no[t] more than an insubstantial part" of a particular charity's activity is engaged in something other than one of the enumerated charitable purposes, the charity is deemed to be operated "exclusively" for charitable purposes.[213] This generous interpretation permits commercial activity. Indeed, it is becoming increasingly common for charities to engage in such activity.[214]

The amount and degree of commerciality that is permissible for charities has been crafted for over nearly a century by courts and the IRS, resulting in a number of tests.[215] For commercial activity that is related to the charity's mission, charities may engage in *unlimited*

206. Rob Atkinson, *Tax Favors for Philanthropy: Should Our Republic Underwrite de Tocqueville's Democracy?*, 6 WM. & MARY POL'Y REV. 1 (2014).

207. *Charity*, OXFORD DICTIONARIES, http://www.oxforddictionaries.com/us/definition/american_english/charity [https://perma.cc/R5LQ-W8XR].

208. *Id.*

209. I.R.C. § 501(c)(3) (2012).

210. Colombo, *supra* note 193, at 496.

211. *Id.*

212. Hopkins, *supra* note 58.

213. *Id.* at 228.

214. *See* Colombo, *supra* note 193, at 489 ("[I]t is now common to find charities engaged in numerous economic activities through a variety of business arrangements . . . .").

215. For a complete discussion of the history of commercial activity by 501(c)(3) organizations, see generally *id*.

amounts of commercial activity.[216] A charity may also engage in a certain amount of commercial activity that is unrelated to its charitable purpose so long as the charity pays taxes on any revenues generated through such activities. This taxable revenue is known as unrelated business income, and if a charity incurs too much, then the charity jeopardizes its 501(c)(3) status. However, the test for what, precisely, constitutes an amount of unrelated business income that would jeopardize an organization's tax-exempt status is not entirely clear. And like many of the restrictions on tax-exempt entities, the justification for the imposition of tax on unrelated business income is a bit muddled. Take, for example, Goodwill Industries.[217] Goodwill's mission is "to enhance people's dignity and quality of life by strengthening communities, eliminating barriers to opportunity, and helping them reach their full potential through learning and the power of work."[218] Because providing jobs is inherent in the mission of Goodwill, the income realized through the operation of used clothing stores is *related*. The justification for permitting such activity is based in pragmatism. If commercial activity is the byproduct of charitable activity, then any regulatory limit on such commercial activity might stifle the organization's ability to meet its desired charitable activity.

However, if a commercial activity is *not* related to the organization's charitable purpose, then it is permissible only to the extent the activity does not constitute a substantial part of the organization's activities.[219] Again, this regulatory leniency is driven by pragmatism. If one combines the inherent difficulty of raising money in the nonprofit sector by traditional means with the pervasiveness of commerciality in our culture, it would be unreasonable to place an absolute limit on commercial activity by nonprofits.[220] To do so might limit the ability of nonprofits to flourish, with the concomitant reduction in positive charitable activity.[221]

216. I.R.C. § 513(a) (2012) ("[T]he term 'unrelated trade or business' [means] . . . any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . .").

217. GOODWILL, https://www.goodwill.org [perma.cc/6NKX-2S5P].

218. *About Us*, GOODWILL, https://www.goodwill.org/about-us/ [perma.cc/JQ2V-3UZP].

219. Organizations Organized and Operated for Religious, Charitable, Scientific, Testing for Public Safety, Literary, or Educational Purposes, or for the Prevention of Cruelty to Children or Animals, 26 C.F.R. § 1.501(c)(3)-1(b)(iii) (2019); *see also*, Rev. Rul. 69-279, 1969-1 C.B. 152; Rev. Rul. 69-256, 1969-1 C.B. 151.

220. *See* Henry B. Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 877 (1980) ("Because nonprofits are unable to sell equity shares, they must rely largely upon donations, retained earnings, and debt for capital financing.").

221. *See id.* at 877 (noting that "while some institutions have accumulated endowments in excess of their needs, many others are sorely strapped for the capital funds necessary to meet the

The limitation on unrelated commercial activity has been crafted through decades of court decisions and IRS private letter rulings, resulting in complex and unclear guidance. One can imagine the difficulty of determining how a particular commercial activity is "related" to a particular charitable purpose. Is, for example, selling cookies (a clear commercial activity) related to the charitable purpose of the Girl Scouts? How is Goodwill's sales of used clothing different from any other thrift store? Similarly, it is difficult to determine if a particular commercial activity makes up a "substantial" portion of an organization's operations. The Supreme Court noted that a single non-exempt purpose, if substantial, is impermissible.[222] In this manner, a nonprofit organization that planned to promote community organizing in a coffee shop was deemed non-charitable because the organization's "primary activity consists of operating a commercial coffeehouse."[223] But where is the line? If the Girl Scouts realize hundreds of millions of dollars in revenue for selling cookies, how much other activity must it engage in to render this amount "insubstantial?"[224] What percentage of such activity qualifies as substantial?[225]

It is important to appreciate the policy considerations that undergird the limitation of commercial activities by charities because these considerations lay bare the danger of the poor screening and monitoring mechanisms for charities.[226] In other words, the policy considerations illustrate the potential harms of a regulatory regime that fails to identify impermissible amounts of commercial activity. While there are a number of concerns, including a commercial activity's tendency to divert attention from charitable activities,[227] the potential to create market

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burgeoning demand for their services").

222. *See* Better Bus. Bureau of Wash., D.C., Inc. v. United States, 326 U.S. 279, 283 (1945) ("In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes.").

223. I.R.S. Priv. Ltr. Rul. 2019-34-008 (Nov. 17, 2017), https://www.irs.gov/pub/irs-wd/201934008.pdf [https://perma.cc/3ZC3-U3NH].

224. This is a trick question. Because Girl Scout Cookie sales are characterized as related activity, the organization may engage in unlimited amounts of such sales.

225. *See* Rossman, *supra* note 121, at 90. In discussing the difficulty of discerning the limits and reach of the private benefit doctrine, which also uses the "substantial" limitations, Rossman notes, "[t]here is no fixed percentage for what constitutes insubstantiality." *Id.*

226. For a detailed discussion about commercial activity, see John Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 849 (1993).

227. *See* Colombo, *supra* note 193, at 534. Colombo calls this the "diversion problem," and explains that "[t]his argument views commercial activity by nonprofits as inherently bad because it diverts the attention of managers and resources away from the core charitable mission and core

inefficiencies,[228] and charitable assets being subject to liabilities of the commercial activity,[229] this Article will restrict the discussion to those concerns with the potential to have the greatest negative impact on the charitable sector. Colombo calls these considerations the "traditional" policy concerns: the twin fears of unfair competition and the erosion of the corporate tax base.[230]

The unfair competition policy consideration has two prongs: predatory pricing and subsidized market expansion.[231] The first consideration is obvious: tax-exempt organizations that engage in commercial activity might have an unfair competitive advantage over for-profit actors because charities do not have to pay taxes.[232] The concern is that charities may leverage their tax savings to engage in predatory pricing.[233] After all, once a charity is relieved of the burden of paying taxes on a commercial activity, it may use those savings to price its goods or services lower than for-profit entities, thereby engaging in unfair competition.[234] The second consideration, subsidized market expansion, reflects "the possibility that an exempt organization will unfairly expand market share by using its tax savings to reinvest in its commercial activity."[235] When a charity engages in subsidized market expansion, rather than using tax-savings to cut prices of services or goods, a charity might employ the savings to expand its commercial activity.[236] Thus, charities have access to a source of money (the money that would have been spent on taxes) that is unavailable to for-profit competitors.[237] Although many commentators have noted that there is no evidence that charities engage in either predatory pricing or subsidized

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charitable outputs." *Id.*

228. *See id.* at 538 ("[T]hese issues revolve around whether an exempt charity's operation of a commercial activity creates inefficiencies in the capital markets or the distribution of goods and services that would not result from competition by for-profits only or if nonprofits concentrated their resources solely on production of charitable outputs.").

229. *Id.* at 545 ("There certainly is a legitimate public interest in ensuring that charitable assets, the creation of which has been at least partially subsidized by tax-exemption, are not squandered in the operation of noncharitable businesses.").

230. *Id.*

231. *Id.*

232. *Id*. at 530 ("An example would be a sort of 'predatory pricing' in which an exempt organization prices its product below its competitors because it does not have to recoup the costs of taxation." (citing Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 610 (1989))).

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.*

market expansion,[238] the fear of unfair competition remains one of the core reasons for the imposition of limits on the commercial activity of charities.[239]

The other traditional policy consideration is the effect on the tax base. Stated plainly, critics are worried that the United States is foregoing potential revenue by failing to tax the activities of charities.[240] This concern has intuitive appeal, and "it is not overly cynical to suggest that some members of Congress would be willing to cede parts of the formerly exempt nonprofit sector to for-profit firms in return for the tribute of additional tax revenue."[241] Perhaps this is because the nonprofit sector makes up a significant portion of the American economy, reporting $2.26 trillion in gross revenues and $5.17 trillion in assets in 2013.[242] The U.S. Government Accountability Office estimates that this amounted to approximately 5% of America's gross domestic product.[243] Although these numbers are impressive, one should exercise caution in using them to try to calculate income that might be taxed under a hypothetical regime that taxed charities. This is because tax-

238. *Id.* ("In fact, legal academics and economists who have examined the issue have reached an almost remarkable consensus that unfair competition in the form of predatory pricing or predatory market expansion simply is not a serious policy concern." (citing Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 318–25 (1976); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 613 (1989); William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61–68 (1972); Susan Rose-Ackermann, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1036–39 (1982); Richard Steinberg, *"Unfair" Competition by Nonprofits and Tax Policy*, 44 NAT'L TAX J. 351, 354–55 (1991))).

239. *See* Colombo, *supra* note 193, at 530 (concluding that "even though unfair competition was the primary rationale for enacting the UBIT, it in fact may not be a very serious policy concern in practice").

240. *See* J. Bennett & G. Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, TAX NOTES 1095–98 (Sept. 14, 1987) (arguing, in part, that organizations that receive more than 50% of their revenue from commercial activity should not be deemed tax-exempt). Interestingly, for the purposes of this Article, Bennett and Rudney also argue that any commercial activity which is priced significantly below cost to targeted individuals should not be considered commercial. *Id.*; *see also*, Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991) (arguing that contributions should make up one third of the gross revenue of charities).

241. *See* Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 507–08 (1990).

242. This number represents reporting nonprofits, and only accounts for 35% of the nonprofit organizations registered with the IRS. BRICE S. MCKEEVER, URBAN INST., THE NONPROFIT SECTOR IN BRIEF 2018: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING, http://nccs.urban.org/publication/nonprofit-sector-brief-2018#the-nonprofit-sector-in-brief-2018-public-charities-giving-and-volunteering [perma.cc/NY5Q-HCL3]. Importantly, note that this number does not include Smaller Charities since the reporting requirements are to scant as to render such data impossible to deduce. *Id.*

243. *See* GAO-15-164, *supra* note 178, at 1.

exempt entities have no incentive to engage in tax planning, and the cumulative revenue and assets of charities would no doubt look very different if they were subject to taxes.[244] Regardless of the actual impact, policymakers have expressed concern that our country is foregoing substantial revenues by bestowing tax-exemption on charities.[245]

This concern led to the imposition of a tax on income derived from certain commercial activities of charities.[246] As noted above, charities are permitted to engage in an insubstantial amount of commercial activity that is unrelated to the entity's charitable purpose.[247] However, such income is subject to taxation, known as the unrelated business income tax.[248] To the extent a charity engages in "a trade or business" that is "regularly carried on" and "is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption," the charity must pay taxes on that activity.[249] In this manner, the regulatory regime limits the amount of permissible commercial activity of a charity that is not related to its charitable purpose.

But such limitations would be irrelevant if there were no means to monitor the commercial activities of charities. If neither the public nor the regulatory agency knows the amount and character of a charity's commercial activity, the restrictions on unrelated commercial activity would be meaningless. Fortunately, the regulatory regime has developed a mechanism for charities to self-report unrelated business income: the Exempt Organization Business Income Tax Return, or the Form 990-T.[250] This form is required to be filed by any charity with gross income of $1,000 or more from a regularly conducted unrelated trade or business.[251] Note that there is no gross receipts limitation, so all charities, even Smaller Charities, are required to file the Form 990-T if they have more than $1,000 of unrelated business income.[252] And just

244. For example, if tax-exempt entities were subject to federal taxes, a rational charity would use mechanisms like tax shelters to lower its tax burden. *See generally* Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, 17 TAX POL'Y ECON. 169 (2003) (discussing the use of tax shelters, a mechanism some corporations use to lower their tax burden).

245. Colombo, *supra* note 193, at 532 (noting that "tax base protection was [a] major concern of Congress" when it opted to tax certain commercial activity of nonprofits).

246. *Id.*

247. *See* IRS Pub. 557, *supra* note 40.

248. *See Unrelated Business Income Tax*, IRS (Mar. 26, 2019), https://www.irs.gov/charities-non-profits/unrelated-business-income-tax [perma.cc/H5ZN-3DYD].

249. *Id.*

250. *See* EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN, FORM 990-T, www.irs.gov/pub/irs-pdf/f990t.pdf [https://perma.cc/FC8L-E92P].

251. Treas. Reg. § 1.6012-2(e) (2019).

252. *See* FORM 990-T, *supra* note 250.

like the Forms 990 and 990-EZ, the Form 990-T is a public document, allowing both the IRS and the general public to scrutinize the unrelated commercial activities of charities.[253]

The Form 990-T is not used to record *related* commercial activity. If an organization is required to file a Form 990 or 990-EZ, it must provide an accounting of its "program service revenue," which would include revenue derived from related commercial activity.[254] The IRS and the general public, therefore, have the means of scrutinizing the related commercial activity of mid-sized and larger charities. This is simply not the case with Smaller Charities, which are required only to file the e-Postcard. Thus, IRS does not adequately monitor related commercial activity for Smaller Charities, which allows Smaller Charities to hide any related commercial activity behind a cloak of regulatory indifference. It is true that unrelated business income is captured through the requirement of the Form 990-T, so to the extent unrelated business income is at issue, an entity claiming unfair competition has the tools to identify the bad actors, and the IRS has the means to identify and address unfair competition by taxing the activity.[255] But if the threat lies in a Smaller Charity's related commercial activity, there is no means of tracking such activity by harmed parties or the IRS. This is, therefore, an example of a Disfavored Activity for which the regulatory regime has developed a partial monitoring mechanism: the regime measures unrelated commercial activity but fails to adequately monitor related commercial activity. For Smaller Charities, this is the only Disfavored Activity discussed in this Article for which the regime has developed any monitoring tools.

2. The Price of Charity: Reasonable Salaries

In 2010, Congress withheld over $400 million in federal grants from the Boys & Girls Clubs of America.[256] The rejection was not due to some scandal, a change in grantmaking priorities, or any illegality on the part of the charity. Rather, a number of senators blanched when they learned that the organization paid their CEO almost a million dollars a year.[257] The fact that the CEO received a salary was not the sticking point for the lawmakers, but it struck many as unseemly for the salary to

253. *Id.*

254. *See* FORM 990, *supra* note 123, at pt. I, l.2.

255. *See* FORM 990-T, *supra* note 250.

256. Stephanie Strom, *Lawmakers Seeking Cuts Look at Nonprofit Salaries*, N.Y. TIMES (July 26, 2010), https://www.nytimes.com/2010/07/27/us/27nonprofit.html [perma.cc/YPA2-HJD8].

257. *Id.*

be so high.[258] Ken Berger, the president of Charity Navigator, argued that it defied "common sense" that "those working for the benefit of the neediest people in our society should make millions and multimillions like corporate leaders."[259] The message from Congress was clear: a charity may pay a salary, but it has to be reasonable. As succinctly stated by Senator Tom Coburn, "A nearly $1 million salary . . . for a nonprofit executive is not only questionable on its face but also raises questions about how the organization manages its finances in other areas."[260]

To some, the fact that the charities can pay salaries at all is surprising,[261] let alone the fact that many charity executives enjoy handsome compensation packages that rival salaries paid in the for-profit realm.[262] Such surprise might be justified by a plain reading of the statutory private inurement prohibition, which requires charities to ensure that no part of the "net earnings inure in whole or in part to the benefit of private shareholders or individuals."[263] A reasonable interpretation of this language would prohibit any compensation. Indeed, it is hard to conceive of a salary as anything other than giving a portion of the "net earnings" of a charity to "private . . . individuals."[264] However, the plain meaning of the Internal Revenue Code is not controlling, and charities may pay salaries to employees to the extent that the salaries are reasonable.[265] Reasonableness is determined by examining both the assets of the organization and the absolute amount of the salary, as compared to salaries paid by similar organizations.[266]

The justification for permitting reasonable salaries, similar to the approach to commercial activity by charities, appears to be pragmatic. In terms of legislative history, lawmakers noted that those working for charities "need not necessarily accept reduced compensation merely

258. *Id.*

259. *Id.*

260. *Id.*

261. *See* DARRYL K. JONES ET AL., THE TAX LAW OF CHARITIES AND OTHER EXEMPT ORGANIZATIONS 257 (3d ed., 2014) ("Perhaps the one assumption most associated with tax exemption, by laypersons and scholars alike, is that those who conduct charitable activities are not in it for the money.").

262. *See* Fuller, *supra* note 196.

263. Organizations Organized and Operated for Religious, Charitable, Scientific, Testing for Public Safety, Literary, or Educational Purposes, or for the Prevention of Cruelty to Children or Animals, 26 C.F.R. § 1.501(c)(3) (2019).

264. *Id.*

265. Hopkins, *supra* note 58, at 513 ("A tax-exempt organization . . . can, of course, make ordinary and necessary expenditures in furtherance of its operations without forfeiting its exempt status. This includes the payment of compensation for services rendered, whether to an employee or to a vendor, consultant, or other independent contractor.").

266. *Id.* at 514–15.

because he or she renders services to a tax-exempt, as opposed to a taxable, organization."[267] Equating salaries paid to employees of charities to those of for-profit entities recognizes the reality that the labor pool is not artificially divided between the profit-seeking sector and the charitable sector. The clear implication is that nonprofits might have difficulty attracting quality employees if they were not permitted to pay comparable salaries. This legislative concern is echoed in case law, with one court noting that the law "places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."[268]

One should, however, be careful not to draw too many conclusions from these statements because the ability of charities to pay salaries and the requirement that such salaries be "reasonable" was enshrined into law with little debate.[269] With respect to the private inurement prohibition—itself an "elusive, elastic, and evolving theory rather than a safely articulated standard"[270]—the fact that charities may pay salaries stands as an anomalous exception. Further, although legislative history[271] and some courts[272] suggest that salaries for charities' employees ought to receive no extra scrutiny, the fact remains that salaries paid by charities are not unrestricted. This is in sharp contrast to salaries paid by for-profit organizations, which are under no such limitations.[273]

Regardless of its genesis, the rule is fairly well-settled: salaries paid by charities must be reasonable in light of what comparable charities pay and with an eye toward the assets of the organization. In some ways, one might think of this rule as using reasonableness to measure the organization's commitment to charitable work *vis-á-vis* self-interest. The justification for this limitation lies in the belief that excessive salaries strongly suggest that the organization is focused less on its charitable

267. H.R. REP. NO. 104-506, note 5 (1996).

268. World Family Corp. v. Comm'r, 81 T.C. 958, 969 (1983).

269. Many of the rules governing charitable organizations have little theoretical foundation—most were simply adopted from ancient English law without much comment or criticism. *See* Amarante, *supra* note 46.

270. *See* Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 581 (2000).

271. H.R. REP. NO. 104-506, n.5 (1996).

272. *See World Family Corp.*, 81 T.C. at 969.

273. Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1184–85 (2011) ("Currently, corporate law as it relates to executive compensation provides essentially no limits. Within the common law on the subject, all the cases point in one direction: more pay and on any terms to which managers can get boards to agree.").

mission and more on enriching insiders.[274] Thus, while the regulatory regime will permit some salaries, they must not get out of hand. So long as they are reasonable, the regime will assume the organization has acceptable priorities.

Given the limitations on salaries, it stands to reason that the IRS's monitoring tools must include some means for the agency to scrutinize and analyze the salaries paid by charities. As noted above, the Forms 990 and 990-EZ require public disclosure of the salaries.[275] These forms require "total salaries and wages paid to all officers and employees and payments made to directors and trustees," including "all . . . forms of income and benefits received from the organization."[276] In this manner, any charity that is required to file a Form 990 or Form 990-EZ is forced to provide the raw data necessary for the IRS and the public to determine the reasonableness of the salaries. In other words, the monitoring tools for charities required to file such forms are sufficient to, in the very least, identify charities enriching their insiders. But if an organization is not required to file such forms, the only way the IRS can measure the reasonableness of salaries would be a direct audit, and the public has no way to determine salary levels. Thus, Smaller Charities, permitted to file the e-Postcard and relieved of the obligation to file either a Form 990 or 990-EZ, operate outside of any regulatory tool capable of measuring the reasonableness of salaries.

The resultant harms of this regulatory failure are obvious. A Smaller Charity, complying with every required disclosure, could take all organizational revenue and use it to pay salaries. Donors to the charity would have no means of discovering the fact that their donations did nothing other than enrich an insider. If the donor is driven by nothing other than the potential tax-deduction of the contribution, then the harm is only psychic, as the donor received the benefit of the donation (a lower personal tax burden). But what of the donors who give, but do not take a tax-deduction?[277] In these cases, the donors cannot rely on the implicit promise of the charitable regime: if you give to a 501(c)(3)

274. Dean Baker, *End Bloated Salaries in the Nonprofit Sector*, STAN. SOC. INNOVATION REV. 57, 57–58 (2019) ("As fans of arithmetic know, the more money that goes to the CEO and other top executives, the less money is available to pay people lower on the ladder. This means less pay for both midlevel workers and the lower-level workers who clean the bathrooms and serve the food. And in the case of nonprofits, it also means less money for the beneficiaries of the charity in question.").

275. *See supra* section I.B.1.

276. *See* INSTRUCTIONS FOR FORM 990-EZ, *supra* note 135, at 15.

277. Joseph Rosenburg et. al., *The New Debate over a Charitable Deduction for Nonitemizers*, URBAN INST., 5 (Oct. 2016), *available at* https://www.taxpolicycenter.org/sites/default/files/publication/135446/the-new-ebate-over-a-charitable-deduction-fornonitemizers.pdf [https://perma.cc/2KZM-MWJ9]. The authors note that nonitemizers make up approximately 74% of total taxpayers and accounted for an estimated 18% of the total charitable giving. *Id.*

organization, the government will ensure that your donation is used to promote charitable activity.[278] Therefore, to the extent a donor contributes to a charity to either support the charity's mission or to enjoy the warm glow of being a generous person, the donor cannot rely upon a regulatory regime that does not adequately monitor potentially excessive salaries.

3. Charging for Charity: Fees for Service

As noted in the previous section, charities are permitted to engage in unlimited commercial activity that is related to the charity's exempt purpose.[279] Thus, the Girl Scouts may sell hundreds of millions of dollars' worth of cookies[280] under the justification that the cookie sales are related to its mission of "build[ing] girls of courage, confidence, and character."[281] Similarly, Harvard may charge each student tens of thousands of dollars for tuition without jeopardizing its tax-exempt status.[282] However, while selling cookies may be the best way to build the character of young women, Harvard provides diplomas *only* to those willing and able to pay a handsome fee. Regardless of our comfort level with allowing commercial activity by charities, there is something especially troubling with charities charging fees in exchange for their charitable services. How can an activity constitute charity if the recipient pays for it?

Although the IRS has carved out some exceptions, the general rule allows charities to charge reasonable fees for charitable services provided.[283] In fact, the IRS is relatively dismissive of the concern, noting that the mere existence of fees for services "will be relevant in very few cases" and "when the community clearly benefits from an organization's activities, a reasonable charge will usually not negate this benefit."[284] There does not appear to be a statutory basis for this approach.[285] Rather, the IRS bases this approach on common law, citing

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278. Although beyond the scope of this Article, one could also make a convincing argument that the purported charitable beneficiaries are also harmed. Given that all the assets of the organization are being spent on salaries, one may assume that the charity would have less impact, robbing potential beneficiaries of the full-promise of the organization's charitable activity.

279. *See* IRS Pub. 557 *supra* note 40.

280. *See All About Cookies, FAQs*, GIRL SCOUTS, https://www.girlscouts.org/en/cookies/all-about-cookies/FAQs.html [perma.cc/WFA7-2Q8K].

281. *See* GIRL SCOUTS, https://www.girlscouts.org/ [perma.cc/DG3Y-7CD9].

282. *See* Colombo, *supra* note 193.

283. IRS Gen. Couns. Mem. 37,257 (Sept. 15, 1977).

284. *Id.*

285. Hopkins, *supra* note 58, at 642 ("An organization was denied recognition of exemption as a charitable and educational entity because it charged 'substantial fees,' even though the federal tax

the Restatement (Second) of Trusts, which states that an organization is charitable even if it charges the beneficiaries for its services "if the income so derived is to be used only to maintain the institution or for some other charitable purpose."[286] This is true even if the charity realizes a profit, "provided that the profits are to be applied only to charitable purposes."[287] The IRS emphasizes that the determinative factor is not the fee, but the benefit to the community. As noted by the IRS:

> In most cases in which an organization is directly serving the community, the fact that it charges a reasonable fee for goods or services should not preclude its exemption. For example, if a community swimming pool is of sufficient benefit to the community to warrant recognition as a legal charity . . . the fact that the organization charges admission fees sufficient to cover its cost of operation should not be important. On the other hand, if an organization's activities are not sufficiently beneficial to the community, it would not be exempt even if it charged a reduced fee, or no fee at all. *The determinative factor is how the organization's activities serve the community rather than whether a fee is charged.*[288]

The memorandum goes on to note that the IRS reserves the right to determine that a fee may be so high as to limit access to a small group.[289] In such cases, the organization would cease to provide a public benefit, and would no longer qualify as a charity.[290] Further complicating matters is the fact that the regulatory regime singles out fees paid for services that are "inherently charitable," such as education, health care, child care, and elder care, for special treatment.[291] In such cases, charities may charge "fair-market-value fees" without running afoul of regulations.[292] For activities that fall outside of these specified areas, fees that are not "substantially-below-cost" may constitute unrelated business income and may jeopardize the charity's tax exemption.[293]

Setting aside the complexity of the rules, the justification for permitting this practice is refreshingly practical, with the IRS noting that

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law does not preclude exemption on that basis.").

286. RESTATEMENT (SECOND) OF TRUSTS § 376 (1959).

287. *Id.*

288. IRS Gen. Couns. Mem. 37,257, *supra* note 283, at 7 (emphasis added).

289. *Id.* ("[T]he fact that a fee makes it impossible for some people in the community to receive the service is acceptable, but a fee so large that it would exclude most of the community would not be acceptable.").

290. *Id.*

291. *See* Mayer, *supra* note 190, at 101.

292. *Id.* at 101–02.

293. *Id.* at 102.

"the existence of [charitable] organizations may depend upon their ability to charge for the services that they provide."[294] Further, the ability for charities to charge fees is consistent with the relatively liberal policy permitting commercial activity by charities. As long as the fees collected are related to the organization's charitable purpose and not unreasonably high, the activity will not jeopardize the organization's charitable status.[295]

Given this complexity, it is perhaps not surprising that the IRS has failed to establish clear guidelines for determining precisely when fees become impermissibly high.[296] While the IRS provides some guidance—charities ought to levy fees substantially below the cost of operation, charities should not compete with commercial providers, and sales should be more than incidental to the charitable purpose[297]—the resulting case-by-case regime is predictably inconsistent.[298] The best one might confidently say is that the IRS views fees for charitable services with some suspicion, and there is some undefined point at which fees become unreasonably high.

If the restriction against unreasonably high fees is to have any meaning, the IRS must have monitoring tools in place that examine the amount and character of any fees charged. Unfortunately, the monitoring mechanisms in place are inadequate. For example, if an organization does not qualify as a Smaller Charity, it must report fees as part of its program service revenue on the Forms 990 and 990-EZ.[299] Although this disclosure is a good start, neither of the forms require the organization to separately disclose fees from other program service revenue, so it is impossible for the IRS (or for that matter, the general public) to determine the reasonableness of fees. Perhaps suspiciously high program service revenue would inspire further inquiries, but this reporting procedure is inadequate if the goal is to determine reasonableness of fees for charitable services. But however inadequate the Forms 990 and 990-EZ may be with respect to measuring the reasonableness of fees, they are a far cry better than the e-Postcard, which provides absolutely no financial information of Smaller Charities. Thus, if program service revenue were suspiciously high for a Smaller Charity, there would be no

294. IRS Gen. Couns. Mem. 37,257, *supra* note 283, at 7.

295. Hopkins, *supra* note 58, at 641 ("Many tax-exempt organizations charge fees for the services they provide; where the business generating this revenue is a related one, the receipts are characterized as *exempt function revenue*.").

296. Colombo, *supra* note 226, at 849. As Colombo notes, "no clear guidance exists for when an activity crosses the line from exempt to 'commercial.'" *Id.*

297. IRS Gen. Couns. Mem. 37,257, *supra* note 283, at 9.

298. Hopkins, *supr*a note 58, at 642 ("Frequently, the agency will take the position that the charging of fees is evidence of substantial commercial activity or purpose . . . .").

299. *See* INSTRUCTIONS FOR FORM 990-EZ, *supra* note 135, at 11.

means of discovering it and neither the IRS nor the general public would have the capability of deducing anything about program service revenue other than the fact that the charity avers that it is under $50,000.

Thus, although the IRS has exhibited discomfort with charities charging fees for service, there is no adequate means to discover the character and amount of such fees. Similar to the concerns regarding paying excessive salaries, donors might be upset to learn that a charity is charging fees for the charitable services provided. A donor might reasonably ask: if the charity is charging fees to cover its charitable activities, what is my donation for? The current regulatory regime has no acceptable answer.

In sum, the regulatory regime permits a number of Disfavored Activities so long as they are reasonable (e.g., salaries), related to charity (e.g., commercial activity), or not egregious (e.g., fees for services). There are certainly good arguments to permit such activities; perhaps charities must pay salaries to entice qualified individuals to leave the promised riches of the private market, or maybe a charity's commercial activities and fees for services serve to bolster the limited assets necessary to engage in good works. Regardless of the justifications, there are limits on Disfavored Activities, and when these limits are exceeded, the regulatory regime imposes excise taxes[300] and threatens the loss of tax-exempt status.[301] But without an adequate means of monitoring these activities, any purported limits are meaningless.

B. A Tarnished Halo

As the previous section illustrated, the failure to screen or monitor Smaller Charities results in a number of micro-level harms. That is to say, the current regulatory regime fails to identify and stop charities from charging excessive fees for their charitable services, paying insiders unreasonably high salaries, or engaging in substantial amounts of commercial activity. This Article refers to these harms as "micro" because they largely affect the individual donors to the charity, who cannot assume that donations will be spent in a charitable manner, and for-profit entities that compete with charities and might fall prey to unfair competition. There is, however, a larger, more macro-level harm that results from the widespread failure to police charities: the fading of an ineffable good known as a "warm glow."[302] The warm glow is "a

300. *Id.*

301. *Id.*

302. Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1222 (2010) ("Warm glow can derive from moral satisfaction, social approbation, or simply the status signal of being able to spend generously." (citing B. Douglas Bernheim & Antonio Rangel, *Behavioral Public Economics:*

specific kind of utility that comes from giving."[303] As described by Professor Usha Rodrigues,

> a local nonprofit food cooperative is selling more than the free-range eggs or organic strawberries that Whole Foods and other for-profits market so effectively. The co-op offers community participation and an investment in local farms, a distinctive ethos that is incompatible with the profit motive and closely connected to the construction of an individual's social identity.[304]

The warm glow is a powerful enough incentive to suggest that charities rich in warm glow may not need the tax-benefits of charitable status to survive.[305] As Rodrigues argues, "[e]ven in a tax-neutral world, at least some nonprofits would continue to flourish because they offer a special kind of warm glow that for-profits cannot provide, the warm glow of participating in a nonprofit organization."[306] It is for this reason that any threat to the warm glow of the charitable sector gives rise to concern, as the lack of a warm glow could be devastating to many charities. Imagine, for example, that the public can no longer trust Rodrigues's hypothetical co-op to contribute to one's social identity—if, for example, the co-op began to aggressively focus on cutting overhead to the extent that it preferred commercial farms over local farms—the value of shopping at the co-op is significantly lessened. A rational consumer would likely start to reconsider their patronage and maybe opt to frequent an alternative, such as Whole Foods. If, after all, the only thing purchased is organic produce (without any warm glow), there are a multitude of options for most consumers.[307]

Scholars who have studied the warm glow of charities often point to the ever-increasing incidents of scandals in the charitable sector.[308] Through these scandals, the regulation of charities (or lack thereof) periodically draws the attention of the general public.[309] The general

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Welfare and Policy Analysis with Nonstandard Decision-Makers, *in* BEHAVIORAL ECONOMICS AND ITS APPLICATIONS 7, 62–65 (Peter Diamond & Hannu Vartiainen eds., 2007); Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LIT. 701, 712–13 (1996)).

303. Usha Rodrigues, *The Power of Warm Glow*, 88 TEX. L. REV. 149, 151 (2009) [hereinafter Rodrigues, *The Power of Warm Glow*].

304. *Id.* at 152–53.

305. *Id*. at 153.

306. *Id.*

307. *Id*.

308. *See* Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 18 (2011).

309. *See id.* at 3 ("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;

pattern is that a sufficiently scandalous activity draws the attention of the media,[310] which in turn sparks debate and consternation from lawmakers.[311] The very existence of the scandals and their discussion in popular media is relevant not necessarily because it highlights a problem endemic in the charitable sector, but because "the scandals, and the legislative solutions they prompted, suggest that our current system of rules and oversight is not sufficient."[312] In other words, the press coverage of scandals could be seen as a leading indicator of the public's growing loss of faith in the charitable sector.[313]

Although the connection between press coverage and public faith may not be conclusive, there is good reason to believe that scandals erode the public's support of the charitable sector. The very nature of the charitable sector relies upon the continued blessing of the general public. After all, the public is essentially footing the bill of all charitable activity, since the tax-exemption of charities effectively serves as a subsidy of the charitable sector.[314] And if the charity "leverage[es] its tax-exempt status for the sake of a few extra dollars" the "cost (revenue lost to the government) [is] ultimately borne by all taxpayers."[315] Further, even if a scandal is not the causal element of a taxpayer loss, the perception of widespread charitable ill-deeds might have a wide-ranging negative effect on the charitable sector as a whole.

Without proper enforcement, the loss of faith and the related dimming of the warm glow is inevitable. This concern is evident in a letter bemoaning the widespread legal noncompliance of the charitable sector by Internal Revenue Commissioner Mark W. Everson.[316] Everson notes that a failure to address the sector's noncompliance risks "the loss of the faith and support that the public has always given to this sector."[317] In other words, the positive public perception of charities—a vital

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.").

310. *See id.* at 19.

311. *See id.* at 8. Such scandals, according to Colinvaux, "seriously eroded the 'halo' effect of charitable organizations and enabled passage of reform legislation, but also illustrated the consequences of unchecked growth." *Id.*

312. *See id.* at 20.

313. *See id.*

314. *See* Hansmann, *supra* note 232, at 621.

315. *See* Colinvaux, *supra* note 308, at 27.

316. Albert B. Crenshaw, *Tax Abuse Rampant in Nonprofits, IRS Says*, WASH. POST (Apr. 5, 2005), https://www.washingtonpost.com/archive/business/2005/04/05/tax-abuse-rampant-in-nonprofits-irs-says/db3fff8d-3206-4493-961f-ddd24c224c91/ [https://perma.cc/Q4X3-SMCC].

317. *See id.*

component of a charity's value—is endangered by a lax regulatory system.[318]

Unregulated Disfavored Activities present a direct threat to the charitable sector's continued enjoyment of warm glow. Unreasonable salaries, for example, are seen as particularly galling to the general public.[319] As Colinvaux notes, charitable payment of excessive compensation directly contradicts "the general public's perception of charity and what it means to do charity."[320] There is also an argument, however counterintuitive, that the preference for low salaries is not limited to donors, as employees view warm glow as a component of their compensation.[321] Rodrigues argues that "[i]f [a charity] were to begin doling out large salaries or lavish perquisites, while an employee's monetary income might rise, the identity value derived from being part of a nonprofit would fall."[322] Further, the practice of relying upon fees for service to support charitable activities has often come under scrutiny, primarily in the realm of nonprofit hospitals.[323] In this manner, widespread and unchecked Disfavored Activities might "create reputational externalities for the whole sector."[324]

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318. Brian Galle, *Keeping Charity Charitable*, 88 TEX. L. REV. 1213, 1214 (2010) ("[T]he fact that society perceives an organization as charitable is a critical element of the entity's success." (emphasis omitted)); *see also* Rossman, *supra* note 121, at 101 ("[T]he chief function of the IRS as it relates to the charitable sector is to monitor who qualifies for 501(c)(3) status to assure the public and donors that the charitable subsidy is utilized for legitimate charitable purposes as the law has defined them.").

319. *See* Colinvaux, *supra* note 308, at 37 ("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.").

320. *See id.*

321. *See* Galle, *supra* note 318, at 1223 ("In effect, the employees are making donations of the difference between their salary and the market salary for someone of their talents and realizing the psychic rewards from the gift.").

322. Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1259, 1284 (2011).

323. *See, e.g.*, Letter from Senator Charles Grassley to Charles Rettig, Commissioner of the IRS, (Feb. 19, 2019), https://www.grassley.senate.gov/sites/default/files/20190219%20CEG%20to%20IRS%20%28Nonprofit%20hospital%20compliance%29.pdf [https://perma.cc/8EXD-2ZHS] ("[I]t appears that at least some of these tax-exempt hospitals have cut charity care, despite increased revenue, calling into question their compliance with the standards set by Congress."); TOP 82 U.S. NON-PROFIT HOSPITALS, QUANTIFYING GOVERNMENT PAYMENTS AND FINANCIAL ASSETS, OPEN THE BOOKS 4–11 (2019), *available at* https://issuu.com/openthebooks/docs/top_82_largest_u.s._non-profit_hosp (last visited Oct. 17, 2019) (noting that the revenues of 82 large nonprofit hospitals totaled $296,557,776,914); Wendi C. Thomas, *The Nonprofit Hospital That Makes Millions, Owns a Collection Agency and Relentlessly Sues the Poor*, PROPUBLICA (June 27, 2019), https://www.propublica.org/article/methodist-le-bonheur-healthcare-sues-poor-medical-debt [https://perma.cc/9GZS-9R32] (criticizing a Memphis-based nonprofit hospital for aggressive collection lawsuits).

324. *See* Galle, *supra* note 318, at 1232. Galle's quote referred specifically to "self-dealing" by

To the extent donors can no longer trust charities to be faithful stewards of their contributions, they will, quite reasonably, stop donating.[325] This is especially true because charities are not the only means of obtaining the warm glow.[326] Rodrigues notes that "[a]nimal lovers, for example, can feed stray dogs or adopt them. If interested in more systemic solutions, they can pay to spay or neuter individual dogs they encounter."[327] Of course, even the most fervent animal lover would not likely take to the streets and administer piecemeal birth control, because it is much more efficient to find an appropriate organization for a donation.[328] But to the extent the animal lover has no faith that a donation will be used in a charitable manner, they might be forced to engage in such inefficient activities to obtain the specifically sought-after warm glow. Regardless of the example's absurdity, the point is salient: the charitable sector does not have a warm glow monopoly and a collective loss of faith that diminishes the warm glow could prove fatal to the charitable regime. It is in this manner that the failure of the regulatory regime to adequately screen and monitor charities not only results in micro-level harms (excessive salaries, commercial activity, and fees for services), but also the potentially devastating macro-level harm of the charitable sector losing the warm glow.

III. RISK-BASED REGULATION

At this point, the IRS might reasonably cry foul. How is an agency that is consistently underfunded expected to keep pace with a regulated population that continues to grow in number and complexity? Indeed, in many ways, the IRS's decision to ignore Smaller Charities might be deemed both intuitive and rational.[329] Given the IRS's crippling budget restrictions, regulatory sacrifices must be made, and it is reasonable to focus resources and attention on the regulated population that represents a greater risk.[330] If Smaller Charities represent less risk, then moving

managers, but the point stands that one charity's activity reflects on the entire sector. *Id.*

325. *See* Rodrigues, *supra* note 303, at 152 ("Knowledge of the economics of the transaction, the ultimate profit motive of the for-profit charity entrepreneur, the risk of contract failure, and the inability to measure desired outputs combine inexorably to produce the suspicion that the donor is really just a sucker.").

326. *See* Rodrigues, *The Power of Warm Glow*, *supra* note 303, at 1275.

327. *See id.*

328. *See id.*

329. ROBERT BALDWIN ET AL., UNDERSTANDING REGULATION, THEORY, STRATEGY, AND PRACTICE 282 (2012) ("Risk-based regulation was originally used as a way to justify regulatory efforts with reference to a rational calculus.").

330. *See* Black & Baldwin, *supra* note 26, at 2.

regulatory resources to higher-risk populations is theoretically justifiable. This approach is known as risk-based regulation,[331] and it argues not only that a focus on the regulated population which presents the highest risks should be encouraged, but also that the related reduction in resources dedicated to lower risk populations is not necessarily a regulatory failure.[332]

Risk-based regulation allows a resource-strapped regulatory body to leverage its precious resources in a manner that results in the greatest impact.[333] Again, this is intuitive. Take, for example, an agency charged with enforcing anti-pollution regulations to maintain clean waterways. It would not make sense to spend the bulk of the agency's time and effort chasing small, occasional sources of pollution if a single paper factory causes 90% of the pollution in the waterways. This intuitive appeal is evident in the fact that risk-based regulation "has exploded in popularity in a host of sectors across the world."[334]

However, the popularity of risk-based regulation should not obscure its challenges. This approach is not neutral, and choices made by regulatory bodies have consequences on the effectiveness of regulations and the activities of the regulated population.[335] First, a regulatory body must determine how to not only measure the risk, but how to define it.[336] Further, the obvious consequence of this regulatory choice is that populations identified as "low-risk" will receive less scrutiny.[337] Ideally, the regulatory agency makes this decision deliberately, and not merely as the thoughtless byproduct of limited regulatory resources.[338] In addition, the challenges inherent in risk-based regulation require regulators to consider how to both implement the risk-based regulatory

331. *See* BALDWIN ET AL., *supra* note 329, at 281. Risk-based regulation "is the prioritizing of regulatory actions in accordance with an assessment of the risks that parties will present to the regulatory body's achieving objectives." *Id.*

332. *See* Black & Baldwin, *supra* note 26, at 1. In risk-based regulation, "the tendency is for regulators' gaze to be drawn to their highest risks and for regulators to be encouraged to pull back resources from lower risks." *Id.*

333. *See id*.

334. BALDWIN ET AL., *supra* note 329, at 281; *see also* Julia Black & Robert Baldwin, *Really Responsive Risk-Based Regulation*, 32 LAW & POL'Y 181, 182 (2010) (noting that "regulators have been developing risk-based frameworks of supervision in a wide range of countries, particularly in the areas of environment, food safety, occupational health and safety, financial services, and pension regulation").

335. BALDWIN ET AL., *supra* note 329, at 283.

336. *See id*. ("Each aspect of a risk-based framework involves a complex set of choices and evaluations on such matters as the risk to be focused on and how such risks are to be defined.").

337. *See id*. ("Risk-based regimes also demand that the regulator makes decisions on the risks that it will not prioritize.").

338. *See id*.

strategy and build flexibility into the risk-based regime to ensure continued effectiveness.[339]

Compounding the difficulty of implementation are the peculiar issues presented by the population that has been identified (rightly or wrongly) as "low-risk." After all, the recognition of a population as low-risk should not relieve the regulator of its duty to regulate such population. Indeed, low-risk populations generally make up the majority of the regulated population,[340] and low-risk populations may present risks with the capacity to evolve, grow, and spread.[341] In other words, if in the rare occasion that the low-risk population produces harms that are always small and acceptable, then there is no problem with the lack of regulation of low-risk populations. But when low-risk populations present the capability of generating great harm, the risk-based regulatory calculus must be adjusted.[342]

In a series of seminal articles, Professors Julia Black and Robert Baldwin discuss the specific challenges of risk-based regulation of low-risk populations[343] and they are the only scholars to propose an analytical framework for regulators to consider when designing regimes to regulate low-risk actors.[344] Black and Baldwin's work follows a rich history of scholarship dedicated to theories of regulatory enforcement, from Ian Ayres and John Braithwhite's responsive regulation[345] to Malcom K. Sparrow's challenge to "pick important problems and fix them,"[346] and represents the first serious treatment of regulating low-risk populations. Black and Baldwin's framework is not a magic bullet, in that it describes in fairly general terms what a successful risk-based regulatory system might look like, while simultaneously leaving the details to individual regulators. This is because Black and Baldwin's work focuses on regulation without specific reference to any industry, and the authors hope the framework might work equally well for an environmental regulator as it would for the IRS.[347] These shortcomings

339. *See generally id.* at 283–94.

340. *See* Black & Baldwin, *supra* note 26, at 2 ("The bulk of regulated sites and operations, however, tend to present lower levels of risk and most regulators need to deal with lower risks in some way or other.").

341. *Id.* (noting that low-risk populations "have some capacity to produce both significant harms and political contention, and in many cases the law will demand that lower risks be attended to").

342. *See id.*

343. *See id.*

344. *See* Black & Baldwin, *supra* note 37, at 133.

345. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION (1992).

346. MALCOLM K. SPARROW, THE REGULATORY CRAFT: CONTROLLING RISKS, SOLVING PROBLEMS, AND MANAGING COMPLIANCE 154 (2000).

347. For example, the framework assumes that regulators engage in some minimal amount of

aside, it is a useful framework for agencies interested in critically assessing its regulatory priorities.

At the outset, Black and Baldwin emphasize that the challenges of any risk-based regulation begin with the unavoidable conclusion that when "resources are moved to . . . higher risks, they are necessarily withdrawn from somewhere else."[348] While this observation may seem a bit obvious, the consequences are significant. Black and Baldwin discuss a number of potential problems with defining certain groups as "low-risk."[349] For example, the regulated population may blanch at the agency's perceived indifference to harms produced by low-risk populations, especially "[w]hen harm occurs at a low-risk site" and the regulator is forced not only to defend "why that site was a low priority for action" but also that the site "will continue to be a low priority."[350] Using the previous polluting paper factory hypothetical, if the regulatory agency adequately stems the pollution from the paper factory, but fails to stop an individual's persistent (but small scale) dumping, the neighbor of the individual polluter may not appreciate the lack of current or future policing. Further, the regulator must contend with the fact that risks are dynamic.[351] The determination by regulators to impose lower scrutiny on a particular population "is not so much a characterization of the risk itself as a statement of a risk's relative significance to the regulatory organization."[352] In other words, defining a population as low-risk is simply an indication of priority, and, because of the dynamism of low risk populations, regulators must stay vigilant to recognize those "low net risks [that] mutate to higher risks."[353]

There are therefore multiple challenges inherent in risk-based regulation. The regulatory agency must properly assess the risk, devise appropriate regulatory tools, and periodically reassess the regulatory regime to ensure effectiveness. Each of these challenges is discussed briefly below,[354] but Black and Baldwin note that "[i]n its idealized

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regulatory activity for the entire regulated population. This assumption, although quite reasonable, does not hold true for the IRS's regulation of smaller charities.

348. Black & Baldwin, *supra* note 26, at 6.

349. *Id*.

350. *Id*. at 7 ("[A] regulator's giving a risk a low priority may be contested by consumers, local residents, politicians, NGOs, and industry.").

351. *Id*.

352. *Id*. at 4.

353. *Id*. at 7.

354. Commentators have identified other challenges, including how the regulatory body plans to defend low-risk regulation when a harm occurs. "When harm occurs at a low-risk site, it may be difficult to explain why that site was a low priority for action, and will continue to be a low priority." Black & Baldwin, *supra* note 26, at 7. This article is less interested in the political consequences of the regulatory decisions, but Professor Yin suggests that the IRS's recent

form, risk-based regulation offers an evidence-based means of targeting the use of resources and of prioritizing attention to the highest risks in accordance with a transparent, systematic, and defensible framework."[355] As the following sections illustrate, although the IRS's chosen regulatory regime is both transparent and systematic, it is far from defensible.

A. The First Challenge: Assessing the Risk

Naturally, the first challenge for risk-based regulation is to properly assess the risks presented by the regulated population.[356] As Black and Baldwin note, risk-based regulatory frameworks all "vary considerably in their complexity," but

> have a common starting point, which is a focus on risks not rules. Risk-based frameworks require regulators to begin by identifying the risks they are seeking to manage, not the rules they have to enforce. Regulators are usually overburdened by rules. They cannot enforce every one of these rules in every firm at every point in time. Selections have to be made.[357]

While it makes sense to ask a regulatory body to focus its resources on the populations that pose the greatest risk, the process of determining where the greatest risk lies is not a straightforward endeavor. This determination is a judgment call, rife with potential for both mistake and arbitrariness.[358] Given the fact that risk-based regulation is ultimately a determination of regulatory capacity, risk-assessment must also weigh the costs of imposing variable regulatory intensity on different portions of the regulated population.[359] But a myopic focus on costs and limited resources would be disastrous, as the resultant lighter regulatory pressure on a large swath of the regulated population also has consequences.[360]

Black and Baldwin identify five "common core elements" of agencies that successfully assess risk in risk-based regulatory frameworks. First,

regulatory decisions evidence the IRS's intent to avoid criticism. Noting the Streamlined Application's utter lack of rigor, Yin notes that "[i]f there is nothing for the IRS to do, and the agency in fact doesn't do anything, it would seem there will be no basis for criticism of the agency." Yin, *supra* note 3, at 268.

355. *See* Black & Baldwin, *supra* note 37, at 181.

356. *Id.* at 184.

357. *Id.*

358. BALDWIN ET AL., *supra* note 329, at 283 ("This process is, however, not mechanical, since it demands that judgments be made on a number of matters.").

359. *Id.* at 284 ("The difficulty here is that the costs of influencing regulatees may vary according, inter alia to the regulatees' dispositions, cultures, and capacities.").

360. *Id.* ("[I]f regulators pay the closest attention to those firms that present the greatest risks, this inevitably means that some firms will 'fly under the radar' to a lesser or greater degree because they do not meet the risk threshold for such priority of attention.").

the regulatory body clearly articulates their objectives.[361] Second, it identifies its own risk tolerance, with an eye toward political risk.[362] Third, the regulator must assess the potential harm and its probability.[363] Fourth, the regulator must rank the regulated population in terms of the potential harms and their probability.[364] And fifth, the regulatory body must shift resources to reflect the risk assessment.[365]

In the matter at hand, the IRS appears to have completely skipped or glossed over elements one, three, and four, and instead focused on the second and fifth elements. For the first element—clearly articulating an objective—the IRS's objective appeared to be little more than eliminating the tax-exempt application backlog.[366] As noted in the press release announcing the Streamlined Application, "[t]he [Streamlined Application] will allow the IRS to speed the approval process for smaller groups and free up resources to review applications from larger, more complex organizations *while reducing the application backlog*."[367] Rather than focusing on screening and monitoring charities, the IRS's actions suggest that there were few concerns that trumped administrative efficiency. For the third element—assessing harm and its probability—the IRS identified charities that regularly expect to realize no more than $50,000 in gross annual receipts as the low-risk population without providing any argument for why the threshold is appropriate. In announcing the launch of the Form 1023EZ, Commissioner Koskinen conclusively stated that "many small organizations will be able to complete this form without creating major compliance risks."[368] Neither Koskinen nor the IRS cited any study or research suggesting the lower risk presented by Smaller Charities, nor did they identify any reasoning or methodology for selecting the threshold. This reinforces the suspicion held by many observers that the IRS adopted the Streamlined Application because the agency had "accumulated a massive backlog of applications, causing unacceptable delays in their processing, and it is

361. *See* Black & Baldwin, *supra* note 37, at 184 ("First, they require a determination by the organization of its objectives—of the risks 'to what' that it is concerned to control.").

362. *Id.* ("Secondly, they require a determination of the regulator's own risk appetite—what type of risks is it prepared to tolerate and at what level. This can be an extremely challenging task for a regulator. In practice, a regulator's risk tolerance is often ultimately driven by political considerations.").

363. *Id.* ("Thirdly, risk-based frameworks involve an assessment of the hazard or adverse event and the likelihood of it occurring.").

364. *Id.* at 185.

365. *Id.*

366. *See, e.g.*, Viswanathan, *supra* note 21, at 91; Yin, *supra* note 3, at 268.

367. *See* IRS Press Release, *supra* note 14 (emphasis added).

368. *See id.*

now under severe budgetary constraints, with no relief in sight."[369] There is no evidence that the IRS was driven by anything other than a desire to address the regulatory burden, and the adoption of the Streamlined Application had nothing to do with any belief that Smaller Charities caused, or had the potential to cause, lower risk.

As noted above, the IRS did not completely ignore all of the "common core elements" of successful risk-based regulatory frameworks, and it appears that the IRS focused on the second and fourth elements. Indeed, the second element—identifying the agency's risk tolerance, with attention paid to political risk—there is evidence that the decision to implement the Streamlined Application was almost entirely driven by the agency's risk-tolerance. The lack of screening procedures combined with the IRS's statement that "small soccer or gardening club[s]" received the same scrutiny as "major research organization[s]," make it clear that the IRS's risk-tolerance for charitable malfeasance by Smaller Charities is quite high, while its tolerance for suffering accusations of inefficiency is much lower.[370] For the fourth element—ranking the regulated population—the IRS simply created a threshold and deemed all actors below $50,000 in gross receipts as low-risk.[371] No inquiry was made into the activities of such actors or the various risks presented by different types of charities that happen to fall under the gross receipts threshold. The IRS ably tackled the fifth element—shifting resources to the population identified as high-risk—by crafting the Streamlined Application and shifting regulatory focus on charities that filed the Form 1023. Thus, based upon the five elements of successful low-risk regulation identified by Black and Baldwin, the IRS's risk-based regulatory scheme does not inspire much confidence that the risks were appropriately assessed.

B. The Second Challenge: Finding the Right Tool

The second major challenge of risk-based regulation is how the regulator implements the regulation in light of the risk evaluations.[372] Assuming the regulator has successfully identified a high-risk population, the question is how, precisely, the regulator ought to reduce those risks. The choices are obvious: the regulator may develop a more intense regulatory regime for higher risk populations, it may implement less intense procedures for low-risk populations, or both. In our

369. Yin, *supra* note 3, at 268.

370. *See* IRS Press Release, *supra* note 14.

371. *Id.*

372. BALDWIN ET AL., *supra* note 329, at 285.

hypothetical water pollution agency, the regulator may, for example, engage in monthly on-site inspections of the high polluting paper plant to ensure compliance with the relevant rules. For the smaller polluters, the agency might engage in less frequent on-site visits, correspondence audits, or self-reporting. Although the lower scrutiny gives rise to a higher probability that the smaller polluters will be noncompliant, the potential damage is low if the regulator properly identified the level of potential risk.

For tax-exempt applications, the IRS decided not to develop a different regulatory tool for high-risk applicants. Instead, the IRS decided to continue to use the regulatory tools already in place—that is, the full Form 1023 and the annual reporting requirements—rather than implement new regulatory tools. Thus, rather than impose higher scrutiny on high-risk populations, the IRS decided to implement less scrutiny on low-risk populations. The underlying assumption, one of doubtful veracity, is that the existing regulatory tools were sufficient to monitor high-risk applicants.[373] More damningly, as the next sections illustrate, the IRS's chosen regulatory tools for the low-risk population were poorly crafted.

1. The GRID and Regulating Low-Risk Populations

Black and Baldwin have crafted the only methodology for determining the appropriate regulatory tools for low-risk populations: the Good Regulatory Intervention Design ("GRID").[374] The first step in implementing the GRID is to categorize the nature of the activity through Black and Baldwin's typology of low-risk, with categories ranging from a stable activity with inherent low risk to an instable activity with a net low risk.[375] To do so, Black and Baldwin suggest the following categories:

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373. Lloyd H. Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI-KENT L. REV. 479, 480 (2010) ("For more than fifty years scholars have expressed concerns that while there is a general consensus regarding the legal duties of nonprofit, and particularly charity, officers, directors, and trustees, enforcement of those duties has been spotty and haphazard at best.").

374. *See* Black & Baldwin, *supra* note 37, at 136.

375. *Id.* at 136–37.

Table 2:

Category 1	Inherent low risk – stable	The activity is not capable of producing intolerable harms/impacts and operations are not likely to change in the periods between regulators' strategy reviews.
Category 2	Net low risk – stable	The activity is capable of producing intolerable harms/impacts in the periods between regulators' strategy reviews but risks are reduced by good management.
Category 3	Inherent low risk, but may change or accumulate	The activity is not capable (as presently organized) of producing intolerable harms/impacts in the periods between regulators' strategy reviews but operations . . . may change or there may be numbers of such risks being created that create a cumulative problem.
Category 4	Net low risk but may change or accumulate	The activity is capable of producing intolerable harms/impacts in the periods between regulators' strategy reviews but, at present, risks are reduced by good management. That good management may, however, change or there may be numbers of such risks being created that create a cumulative problem.

Once the activity is categorized, the regulator must categorize the nature of the regulated population, measuring both the regulatees' motivation and capacity to comply.[376] After these determinations are made, the GRID matrix, set forth below, helps regulators determine the proper regulatory tools.[377]

376. *Id.*

377. *Id.* at 137. Please note that the matrix that appears below has been slightly edited for clarity. More specifically, the matrix set forth below only indicates the regulatory intensity and omits the lists of categories of regulatory activities (screening tools, monitoring tools, and engagement and

Table 3:

Nature of regulatee	Nature of the low-risk activity			
	Category 1	Category 2	Category 3	Category 4
Regulatees are well-motivated with high capacity to comply[378]	Low regulatory intensity	Low regulatory intensity	Low regulatory intensity	Low regulatory intensity
Regulatees are well-motivated with low capacity to comply[379]	Low regulatory intensity	Low regulatory intensity	Medium-Low regulatory intensity	Medium-Low regulatory intensity
Regulatees are less motivated with high capacity to comply[380]	Medium regulatory intensity	Medium regulatory intensity	Medium regulatory intensity	High regulatory intensity
Regulatees are less motivated with low capacity to comply[381]	Medium regulatory intensity	Medium regulatory intensity	High regulatory intensity	High regulatory intensity

According to Black and Baldwin, "[t]he aim of the GRID is to provide a framework for deciding systematically which strategies should be used for which type of risk and which type of regulatee."[382] As the GRID makes clear, Black and Baldwin suggest differing levels of intensity (from low to high) depending on how the regulator categorizes each of the risk and the regulated population. The GRID therefore

incentive mechanisms).

378. *Id.* at 136 ("Regulatees are willing to comply (judged on their records and/or officers' estimations) and are sufficiently well-informed, resourced, and organized to allow compliance.").

379. *Id.*

380. *Id.* ("Regulatees are less willing to comply but they are sufficiently well informed, resourced, and organized to allow compliance if their motivation is improved.").

381. *Id.* ("Regulatees are less willing to comply and are not sufficiently well informed, resourced, and organized to foster compliance even if their motivation is improved.").

382. *Id.*

provides a mechanism for regulators to properly assess risk and craft appropriate regulatory tools for the low-risk population. However, as attractive as the GRID may appear, the authors are quick to note that

> [a] "best practice" framework cannot neatly reconcile public expectations of universal protection with the regulatory reality of prioritization and rationing. It can, however, help regulators to identify those intervention tools that are likely to have the most potential in relation to different risks and contexts.[383]

The theory behind the GRID is simple: impose higher intensity of intervention based upon both the nature of the risk (moving horizontally from left to right) and nature of the regulated population (moving vertically from top to bottom). Thus, the population and risk that deserves the lowest intensity of intervention is at the upper left-hand corner of the GRID (for instance, the regulated population that is well-motivated with capacity to comply and also boasts an inherent low risk that is stable).[384] The next sections will apply the GRID matrix to the regulation of Smaller Charities.

2. *The First Step: The Nature of the Activity*

As noted above, the first step is to categorize the nature of the regulated activity with respect to the level of risk and stability.[385] In other words, the task is to determine the GRID column in which the regulated population belongs. Taking the issue at hand, we can use the process of elimination to determine which category applies to Smaller Charities. If one assumes that the harm or impact possible with less than $50,000 in gross receipts is acceptable, then one could conceivably argue that, given their size, Smaller Charities do not present the possibility of intolerable harms. This may place the population in Category 1 (*inherent low risk—stable*). However, this argument ignores the fact that without meaningful policing of charitable activity, there is no mechanism that ensures the charities remain small.[386] When a charity completes the Streamlined Application, for example, it certifies that it reasonably believes it will make no more than $50,000 in any of the next three years.[387] It does not, however, promise to remain under this threshold and, to the extent that gross revenues serve as a proxy for risk (an arguable claim, but this argument reflects the apparent logic of the

383. *Id*.

384. *Id*. at 141.

385. *Id.* at 136.

386. *Id.*

387. *See Form 1023-EZ*, supra note 71.

IRS), it would not be accurate to label the risk Smaller Charities pose as "stable" given the potential for gross receipts to grow. To put a fine point on it, Smaller Charities may not remain small. Further, to the extent the abuse of salaries, commercial activity, and fees for service represent a risk, we cannot safely conclude that Smaller Charities have an "inherent" low risk because Smaller Charities, just like larger charities, have the ability to engage in Disfavored Activities. Thus, Smaller Charities do not belong in the first category.

For similar reasons, Category 3 (*inherent low risk but may change or accumulate*) also fails. Although Category 3 is a better fit than Category 1, due to its recognition that Smaller Charities might grow (thereby remedying the incorrect assumption about a Smaller Charity's "stability"), it fails to properly assess the risk. It is not possible to characterize the risk posed by Smaller Charities as "inherently low" unless the regulatory body has some means of monitoring and limiting the risks. Smaller Charities may not only engage in activities that cause the organization to realize more than $50,000 in gross receipts, but they may also engage in unacceptable levels of commercial activity, pay unreasonably high salaries, and charge unconscionably high fees for their charitable services. Just as Category 1 failed due to the mischaracterization of the potential risk, Category 3 is inappropriate.

Category 2 (*net low risk—stable*) is an equally poor fit for Smaller Charities. While this category permits the possibility that Smaller Charities might produce intolerable harms, thereby addressing the poor fit in Categories 1 and 3, it requires controlling the risks through good management. Good management relies upon properly educated managers who are aware of the limits placed upon charities. The failure of the Streamlined Application to properly educate would-be charities suggests that this level of education should not be assumed. And as previous sections showed, the IRS has virtually no mechanism to manage this risk at either the application stage or through on-going monitoring for Smaller Charities.[388] Thus, Category 2 is not appropriate.

The only category that appears to describe the regulated population at hand is Category 4 (*net low risk but may change or accumulate*). As described above, although the potential risks posed by Smaller Charities may be low, they cannot honestly be described as "stable."[389] Thus,

388. It very well may be the case that the IRS is relying upon state attorneys general to monitor the management of charities. If this is the case, however, this trust is misplaced. *See* Mayer & Wilson, *supra* note 42, at 494 ("The widespread criticism of the current system is that while attorneys general have this authority in theory they rarely exercise it in fact, and when they do exercise it, they do so in flawed ways.").

389. *See* Black & Baldwin, *supra* note 37, at 136.

Category 4's recognition that the risks are "capable of producing intolerable harms/impacts" is apt because it recognizes the ability for Smaller Charities to grow and evolve into larger charities.[390] Further, although "good management" might reduce such risks, there is no indication that the application process establishes the education necessary to establish such managerial oversight.[391] Finally, and most relevant to this discussion, this category recognizes the fact that if a large number of Smaller Charities engaged in excessive amounts of Disfavored Activities, the cumulative impact would undermine the public's faith in the entire charitable sector. In other words, this population represents a risk that may accumulate. Thus, of the four categories, Category 4 most suitably describes the risks presented by Smaller Charities, and we therefore find ourselves on the right side of the GRID, with regulatory intensity ranging from low to high, depending on the nature of the regulated entity.

3. The Second Step: The Nature of the Regulated Population

Once the regulatory body has properly categorized the nature of the risk, the next step is to identify the nature of the regulated population.[392] To do so, Black and Baldwin ask the regulator to consider two factors: motivation to comply and capacity to comply.[393]

The motivation of Smaller Charities to comply is difficult to measure. Black and Baldwin do not provide a definition of "motivation," so we are left with the commonly understood meaning of the word. Although a number of dictionary definitions exist, the Oxford English Dictionary's definition might be the most useful, because it defines "motivation" as "the general desire or willingness of someone to do something; drive; enthusiasm."[394] This definition forces the regulator to consider the desire, or level of enthusiasm, inherent in the regulated population, which is directly related to the level of risk that the population presents. In other words, a population that is highly motivated to comply with regulations (for instance, a population that has an enthusiasm to comply) will require lower levels of regulatory scrutiny. The task is, therefore, to identify the level of enthusiasm of Smaller Charities to comply with

390. Black & Baldwin, *supra* note 26, at 7 tbl. 1.

391. *Id.* ("The activity is capable of producing intolerable harms/impacts in the periods between regulators' strategy reviews but risks are reduced by good management.")

392. Black & Baldwin, *supra* note 37, at 136.

393. *Id.*

394. Motivation, Oxford English Dictionary, https://oed.com/view/Entry/122708?redirectedFrom=motivation#eid (last visited Nov. 30, 2019).

regulatory requirements. Given the breadth of potential charities that might fall below the $50,000 gross annual receipts threshold—a category that includes any number of different types of organizations with different levels of management—it might not be possible to label the population either "well motivated" or "less motivated." Further, there is no reason to assume that the size of an organization has any bearing on such organization's level of motivation to comply. One can easily imagine small organizations that have high motivation to comply with regulations, perhaps because they routinely partner with larger organizations that require such compliance. Similarly, one can imagine a smaller organization that is under no such third-party pressure to comply, making it less motivated. The population is simply too diverse to impose a single assumption about motivation levels. Thus, we must turn to the second factor, capacity, to determine where Smaller Charities should fall vertically on the GRID.

With respect to capacity, Black and Baldwin refer to organizations that are "well informed, resourced, and organized to foster compliance" as those with high capacity for compliance.[395] In terms of whether Smaller Charities are well-informed, we are once again faced with the problem of the breadth and diversity of the class. There is a chance that some Smaller Charities are quite well-informed about the regulatory requirements imposed upon tax-exempt entities. Such a charity might, for example, have a nonprofit lawyer on its board of directors. But the relative lack of resources available to many Smaller Charities suggests the opposite. The combination of the general lack of access to low-cost legal advice in most parts of the country with the low resources of the regulated population results in the probability of a large number of organizations that do not have the capacity to engage qualified advisors. Further, as noted earlier, the Streamlined Application fails to adequately educate applicants on the proper means of operating a charity. This is evident not only in the insufficiency of the instructions to the application, but also to the fact that studies show a high incidence of noncompliance of Streamlined Application filers with respect to the organizational requirements of tax-exemption.[396] Thus, the combination of low resources and poor education leaves Streamlined Application filers poorly informed.

For the second component of capacity—the level of resources of the regulated population—we do not need to speculate. By definition, Streamlined Application filers have few assets and reasonably expect

395. *See* Black & Baldwin, *supra* note 37, at 136.

396. *See* 2015 TAXPAYER ADVOCATE REPORT TO CONGRESS, *supra* note 2.

low levels of gross receipts.[397] In other words, the fact that these organizations reasonably believe they will make no more than $50,000 in gross receipts per year[398] likely means that these organizations, by definition, are not "well resourced."[399] It is also reasonable to assume that most Smaller Charities spend the majority of their gross receipts on programming and have little remaining funds for compliance.[400] Indeed, many nonprofits with revenues greater than $100,000 report severe shortcomings in computers and training.[401] It is not a stretch to assume organizations with half the revenues will be even less well-resourced. And although there are certainly some Streamlined Application filers who may have competent representation or counselors, they are likely to represent the minority of applicants.

The last characteristic of compliance capacity—the level of organization—is difficult to generalize for Smaller Charities. Such an organization might be run by a lean group of dedicated professionals, with well-defined roles and laudable levels of organization. But just as likely (indeed, perhaps more likely) is a charity run by founders with a level of dedication to the charity's mission that might not match the level of commitment to organizational operations and regulatory requirements. Although this characteristic is difficult to predict for Smaller Charities, the other two characteristics—whether the charity is well-resourced and well-informed—may be easier to deduce. In sum, these three factors strongly suggest that Smaller Charities are more likely than not to have a low capacity to comply. Therefore, it seems reasonable to assume that while charities that opt to use the Streamlined Application may vary in terms of their level of motivation, they will likely have a low capacity to comply. Thus, keeping in mind that we have already placed Smaller Charities in Category 4, the GRID suggests either medium to low regulatory intensity or high regulatory intensity, depending on the level of motivation.

4. *The Third Step: Selecting the Appropriate Intervention*

Once the nature of the low-risk activity and the nature of the regulatee have been identified, Black and Baldwin suggest applying the identified

397. *See Instructions for Form 1023-EZ*, *supra* note 15.

398. *Id.*

399. *See* Black & Baldwin, *supra* note 26, at 19.

400. *See* NONPROFIT OVERHEAD COST PROJECT, CTR. ON NONPROFITS & PHILANTHROPY, URBAN INST. & CTR. ON PHILANTHROPY, INDIANA UNIV. (Aug. 2004), https://philanthropy.iupui.edu/files/research/nonprofit_overhead_brief_3.pdf [https://perma.cc/DV3T-P3XJ].

401. *Id.*

intensity to appropriate tools.[402] However, choosing the right tools is not self-evident. Black and Baldwin suggest the following list of "intervention tools that have the major potential for use with low-risk" regulated populations[403]:

Table 4:
Potential Tools for Low-Risk Sites/Activities

Screening and rule-based strategies 1. Exemptions without notification or registration 2. Exemptions with notification or registration 3. Registration plus conditions/rules; permit and licensing systems 4. Application of general binding rules without notification/registration
Inspection/monitoring and proxy strategies *Inspection and/or monitoring by an agency* 5. Frequency-adjusted inspections or monitoring 6. Regulatory audits 7. Themed inspections or monitoring 8. Random inspections or monitoring 9. Advice and assistance visits 10. Reactive investigations, responding to complaints, whistle-blowing or post-incident investigations 11. Surveillance *Proxy measures* 12. Benchmarking or "yardsticking" strategies 13. Measuring indirect/proxy outcomes *Firm-based measures* 14. Self-monitoring and self-certification by regulated firms 15. Management-based strategies including mandatory performance disclosure by regulated firms *Using third-party monitors* 16. Third-party monitoring 17. Information and inspection-sharing regimes
Engagement and incentive strategies 18. Information campaigns, generic advice, and recommendations (including codes and guidance) 19. Dialogue with interested parties 20. Industry or NGO/interested party-led solutions 21. Multi-agency approaches 22. Incentive strategies

402. Black & Baldwin, *supra* note 26, at 21.

403. *Id.*

Just as the GRID is not an equation in which regulators may input a regulatory puzzle in order to receive a perfect regulatory solution, the tools suggested in the table above are fact-specific. Black and Baldwin stress that each tool has its "strengths and weaknesses," and suggest that the tools "can be used in combination."[404] Regulators are encouraged to weigh each tool in light of the regulatory goals and the limits of the controlling legislation.[405] By way of example, third-party monitoring (number 16 in the chart above) "requires close supervision of the third-party monitors," which suggests a resource-intensive endeavor.[406] Thus, resource-strapped agencies might not be able to rely upon this tool. Further, depending on "how the scheme is designed and implemented," a third-party monitoring tool "may or may not be done transparently, and may or may not be able to respond to change."[407] Therefore, if transparency and flexibility are highly valued by the agency, this tool may not be appropriate.

The IRS's current regime appears to consist of a combination of the following tools: (2) Exemptions with notification or registration (e.g., the Streamlined Application), (6) Regulatory audits (e.g., spot audits conducted by the IRS), and (14) Self-monitoring and self-certification by regulated firms (for instance, submission of annual information reports). But if the previous sections were convincing, two of the three tools are insufficient; the Streamlined Application fails the screening function—negating tool 2—and the e-Postcard effectively exempts Smaller Charities from the monitoring function of tool 14. Given the paucity of information on the e-Postcard, that leaves audits (tool 6) as the only back-end regulatory tool available to the IRS.

If audits are the only remaining tool for regulating Smaller Charities, then the regime is inadequate. Although regulatory agencies increasingly rely on audits to ensure compliance with the law, the effectiveness of audits is hindered by inadequate funding. This is because effective audits require significant investment, including funding to recruit and retain qualified auditors, implement rigorous standards for audits, and ensure the absence of conflicts between the auditor and the regulated population.[408] However, even if an agency has the financial capability to

404. *Id.* at 17–18.

405. *Id.*

406. *Id.* at 18.

407. *Id.*

408. Sasha Courville, Christine Parker & Helen Watchirs, *Introduction: Auditing in Regulatory Perspective,* 25 LAW & POL'Y 179, 180 (2003) ("An audit might promise to compensate for lack of

implement a meaningful audit program, the very nature of audits—an individual investigator digging deep into an individual organization—is an inefficient and "labor-intensive approach."[409] For this reason, the National Taxpayer Advocate said that "[w]hile audits serve a role in furthering taxpayer compliance, they are no substitute for preventative, front-end efforts to avoid compliance issues in the first place."[410] Further, even a well-designed and well-funded audit regime is expensive and "diverts tax dollars" to enforcement and squanders "taxpayer donations" on compliance.[411] Thus, commentators view audits as a valuable complement to a robust regulatory regime, but they cannot serve as a substitute for more holistic regulation.

Further, the discussion of the effectiveness of audits is a bit beside the point, because the limited budget of the IRS renders frequent audits virtually impossible.[412] To illustrate this impossibility, note that in 2011, Colinvaux bemoaned the fact that the despite "[s]ignificant growth" in the charitable sector, the IRS boasted an audit rate of "about one-third of one percent" of all charities.[413] Proffered as proof of a failure to regulate, this audit rate is practically astronomical compared to the current audit rate of charities.[414] For fiscal year 2017, the IRS received 1,528,487 annual information returns.[415] Of these returns, the IRS reviewed a total

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government regulatory oversight and to provide accountability for organizational behavior. Yet the capacity of an audit to do so depends on the answers to a number of questions: Who are the auditors? What is their expertise? How are they regulated or accredited? What is their relationship to the auditee? What methods do the auditors use to collect data or evidence? How, if at all, do they sample the data to be checked? To what extent do they use fieldwork, rely on expert opinions, rely on checks of internal controls and systems? How widely do they consult and to what extent do they rely on consultations? How authentic is the participation of any stakeholders? How do the auditors form an opinion on the data or evidence? Who sets the parameters of the opinion that the auditor is to form? To what extent are the audit findings negotiated with the auditee before being published? What is the response of the auditees to the audit? Is it possible to measure the impact of the audit process? In what intended and/or unintended ways does the prospect or reality of audit change the behavior of the auditee? Is there evidence of 'creative compliance' to maintain autonomy while appearing to comply? Is there evidence of dysfunctional side-effects or conflicts between the consequences of audit and effectiveness or performance?").

409. *See* 2015 TAXPAYER ADVOCATE REPORT TO CONGRESS, *supra* note 2, at 37.

410. *Id.*

411. *Id.*

412. *See* Rossman, *supra* note 121, at 97 ("Due to limited staffing, the IRS Tax Exempt Division typically reviews less than two percent of the 990s it receives and audits returns at a rate of one-third of one percent.").

413. Colinvaux, *supra* note 308, at 17 ("For the 2007-2008 filing year, the IRS received 888,412 information returns. To review all these returns, the IRS assigned 461 employees, with the result that 2,946 returns were examined . . . .").

414. INTERNAL REVENUE SERVICE DATA BOOK 6 (2017). This number includes Forms 990, 990-EZ, 990-N, 990-PF, and 990-T.

415. *Id.*

of 2,677 returns.[416] This works out to an audit rate of 0.175%, or about half of what Colinvaux deemed unacceptably low in 2011.[417] This represents approximately one audit for every 570 annual information returns submitted. Given these numbers, it is little surprise that critics argue that a reliance upon audits "invites noncompliance."[418] Once a regulated population learns that audits are unlikely, it is reasonable to assume the regulated population may feel free to engage in more risky behavior.

Thus, even assuming the sufficiency of the three tools implemented by the IRS—applications, audits, and reporting—the fact that Smaller Charities are exempted from two of the tools (a rigorous application and meaningful reporting) and the remaining tool (audits) is expensive and underused, renders the tools for regulating Smaller Charities virtually nonexistent. This regime fails to rise to Black and Baldwin's challenge to recognize that "as risk types move east on the GRID and firm types move south, it is likely to be appropriate to apply enforcement strategies with increasing regulatory intensity."[419] This failure makes reassessment and flexibility, the next challenge, all the more vital, so agencies can recognize regulatory failures and adjust the regime accordingly. Unfortunately, as the next section makes clear, the IRS has exhibited either an inability or unwillingness to reassess, and any professed flexibility is meaningless without honest assessment of the current regulatory failure.

C. *The Third Challenge: Reassessment and Flexibility*

The third challenge inherent in risk-based regulation is the need to reassess regulatory tools and maintain flexibility to properly address risk.[420] This challenge addresses the danger of an agency ignoring changing circumstances that demand new regulatory tools or a reconsideration of the risk assessment. If new risks emerge or if the environment changes such that the regulatory regime is no longer responsive to likely risks, a lack of flexibility will doom regulatory effectiveness.[421] Further, political realities often conspire to ossify

416. *Id.* at 34. Depressingly, this number likely represents a slightly inflated audit rate, as the reviewed annual information returns include forms not reflected in the 1,528,487 returns, as it includes Forms 1041-A, 1120-POL, and 5227.

417. Colinvaux, *supra* note 308, at 17.

418. *See* 2015 TAXPAYER ADVOCATE REPORT TO CONGRESS, *supra* note 2, at 37.

419. Black & Baldwin, *supra* note 37, at 141.

420. *Id.*

421. BALDWIN ET AL., *supra* note 329, at 288 (Regulators "become unresponsive to changing circumstances so that they fail to detect and deal with new risks and changes in risk profiles.").

regulatory measures into "institutionalized process[es]," resulting in a regulator that is resistant to change.[422] Applied to the water pollution hypothetical, imagine that the agency applies higher scrutiny to the high polluting paper mill and imposes low-intensity regulations on smaller polluters. This regulatory approach is successful only if the number and intensity of the smaller polluters remain static. If the number of smaller polluters grows dramatically, the pollution will also grow. Thus, a regulatory approach that refuses to adapt will fail.

With respect to adaptability, the IRS did not completely ignore the criticisms of the Streamlined Application, and it implemented changes in 2018.[423] The willingness to amend the screening tool reflects an encouraging potential to have the requisite ability to reassess and remain flexible. However, the changes do not inspire confidence. Although besieged by a number of criticisms and facing evidence that Smaller Charities do not meet organizational requirements of tax-exempt entities,[424] the amendments to the Streamlined Application were quite modest. Indeed, the totality of the changes amount to little more than a requirement of a mission statement and an attestation as to the estimated annual gross receipts and total assets of the applicant.[425] The revisions failed to address the issues presented by the two studies conducted by the Taxpayer Advocate[426] by, for example, requiring copies of organizational documents to ensure proper compliance with the organizational requirement. Indeed, one wonders what inspired the changes. Regardless, after the IRS was confronted with four years of data and strong evidence of regulatory failure, it failed to either properly assess the Streamlined Application's failure, adequately revise the form to respond to the criticisms, or exhibit requisite flexibility to react to proven and well-documented regulatory failure.

IV. FOCUS ON MONITORING

Despite its general inaction, the IRS is aware of the shortcomings of

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422. *Id*.

423. *See January 19, 2018 Exempt Organizations Update: E-News for Charities and Nonprofits*, IRS, https://www.irs.gov/charities-non-profits/current-edition-of-exempt-organizations-update [https://perma.cc/28T7-PGJC].

424. *See* 2015 TAXPAYER ADVOCATE REPORT TO CONGRESS, *supra* note 2, at 42.

425. *See Form 1023-EZ Revisions*, IRS, www.irs.gov/charities-non-profits/form-1023-ez-revisions [https://perma.cc/6LMP-A33M]. The revision also addresses organizations that had their tax-exempt status automatically revoked for failure to submit three consecutive annual information returns, requiring any application for reinstatement to be for the "same foundation classification [the applicant] had at the time of the automatic revocation." *Id.*

426. *See* 2015 TAXPAYER ADVOCATE REPORT TO CONGRESS, *supra* note 2, at 36.

the Streamlined Application. Recognizing the public's desire to discern between filers of the Form 1023 and the Streamlined Application, the IRS began to publish lists of Streamlined Application filers.[427] The IRS justified this decision by arguing that the publication would "allow taxpayers to more easily research information on tax-exempt organizations."[428] This is a curious statement, and it betrays a lingering distrust of Streamlined Application filers. After all, taxpayers were able to search the IRS list of exempt organizations to learn the tax-exempt status of any given charity,[429] and once a taxpayer found the charity on this list, the taxpayer knew the tax treatment of any potential donation.[430] Given this, what precisely is gained by publishing a list of Streamlined Application filers unless there is something inherently suspicious about such organizations? The strong implication is that charities which opted to use the Streamlined Application are less trustworthy than charities that filed Form 1023s. One could argue that the publication of Streamlined Application filers is an admission by the IRS that the Streamlined Application fails to properly vet applicants. In the very least, it implies that the IRS is more cautious about Streamlined Application filers. After all, if the process were fulfilling its role, there would be no need to distinguish between filers of different applications.

Perhaps the focus on the shortcomings of the Streamlined Application is misplaced. Given that limited resources have strangled the IRS's ability to properly screen applicants, continued tweaks to the Streamlined Application are not likely to address the problem because the simple fact remains that a rigorous and searching application would not help if the IRS's budget constraints persist. Thus, critics of the Streamlined Application might be fighting a losing battle. Rather than calling for an abolishment of the Streamlined Application,[431] critics might find more traction in focusing on back-end regulation. As

427. *IRS Makes Approved Form 1023-EZ Data Available Online*, IRS (Feb. 22, 2017), https://www.irs.gov/newsroom/irs-makes-approved-form-1023ez-data-available-online [https://perma.cc/EP9J-9DTG].

428. *Id*.

429. *See Tax Exempt Organization Search*, IRS, https://apps.irs.gov/app/eos/ [perma.cc/VR78-SFHH].

430. For example, the website listed whether the organization was public charity or private foundation. If the organization was not listed, then the taxpayer knew that a donation would not be tax deductible.

431. *See, e.g.*, Letter from David Thompson, Vice President, Nat'l Council of Nonprofits, to Lynn Jenkins and John Lewis, U.S. House Representatives (Apr. 6, 2018) ("By any measure, the problems with the express-lane approach to tax exemption continue and, indeed, are increasing . . . . And the IRS' primary obligation of preventing ineligible organizations and perhaps bad actors from receiving and exploiting tax-exempt status for personal gain is being shirked with every application processed. [The Streamlined Application] should be withdrawn immediately.").

evidenced by the IRS's decision to publish lists of Streamlined Application filers, the agency is willing to provide as much data as possible to allow the general public to make informed decisions concerning charities. The reason for this willingness may be driven by resource scarcity—after all, publishing a list of filers is a relatively inexpensive way to address inadequate regulatory measures—but only a cynic would ignore the potential that low-cost disclosure might have in addressing the faults of the application process.

Following this line of thinking, critics of the current regime should not focus on further tweaks and amendments to the Streamlined Application. Any meaningful revisions would require more front-end resources that are simply unavailable. However, there is an obvious low-cost alternative: implement a more rigorous monitoring tool for Smaller Charities. More precisely, rather than an absence of both front-end and back-end regulation, the IRS could bolster the monitoring tool for any charities that may have benefitted from less scrutiny on the front-end. In other words, the IRS should abolish the e-Postcard and require all Smaller Charities to file the Form 990-EZ.

A. Form 990-EZs for All

As noted above, the e-Postcard is utterly useless.[432] It produces no financial data, no reporting on salaries, and no disclosure of activities. It is, in effect, little more than an assurance that someone related to the organization is willing to spend fifteen minutes a year to let the IRS know it exists.[433] But if the IRS were to require Smaller Charities to file the Form 990-EZ, many of the concerns about Disfavored Activities would be addressed. For example, part IV of the Form 990-EZ requires charities to list "each person who was an officer, director, trustee, or key employee[434] . . . of the organization at any time during the organization's tax year."[435] For each such person, the charity must disclose reportable compensation,[436] deferred compensation,[437] and

432. *See supra* section I.C.3.

433. *See supra* note 137 and accompanying text (showing an example of a completed Form 990-N).

434. "Key employee" is defined as, "any person having responsibilities or powers similar to those of officers, directors, or trustees." INSTRUCTIONS FOR FORM 990-EZ, *supra* note 135, at 17 ("The term includes the chief management and administrative officials of an organization (such as an executive director or chancellor). A chief financial officer and the officer in charge of the administration or program operations are both key employees if they have the authority to control the organization's activities, its finances, or both.").

435. *Id.*

436. *See* Form 990-EZ, *supra* note 124, at pt. IV, l.c.

437. *Id.* at pt. IV, l.d.

fringe benefits.[438] This disclosure would help address concerns about unreasonable or excessive salaries. Further, the Form 990-EZ requires some detail on commercial activity and fees charged for charitable services, as applicants are required to disclose the "total program service revenue (exempt function income)" of the charity.[439] Such a disclosure would partially address the concerns regarding excessive commercial activity or unreasonably high fees for services.

Perhaps most attractive to the IRS, there is little cost associated with implementing this solution because the Form 990-EZ is already in place. Further, the public nature of Form 990-EZs means that the IRS can, in effect, share the burden of monitoring with the public.[440] Unlike the vetting process, which is necessarily limited to agency action, monitoring responsibilities might be shared.[441] If all organizations, including Smaller Charities, were required to file more robust annual information returns, a charity engaging in impermissible commercial activity or paying unreasonable salaries to insiders would make such data available for any interested party. This includes, of course, the IRS, but it also will be available to state regulators, potential victims of unfair competition, and potential donors.[442]

B. Require a More Searching Form 990-EZ

Requiring the Form 990-EZ for all charities is an elegant and virtually cost-free solution, but it is not a cure-all. As noted above, the Form 990-EZ fails to differentiate among the different types of commercial activity. All "program service revenue" is disclosed in a single total amount that includes fees for service, program-related investment income, unrelated business income, and income derived from government fees and contracts.[443] Thus, if the goal is to disclose the specific data necessary to identify high fees for service or commercial activity that unfairly competes with for-profit entities, the form will need to be amended to require more specific details.

Such an amendment has some precedent. As recently as 2008, the Form 990 was redesigned to be more responsive to current needs.[444]

438. *Id.* at pt. IV, l.e.

439. *See Instructions for Form 990-EZ*, *supra* note 135, at 11.

440. Andrew Elmore, *Collaborative Enforcement*, 10 NE. U. L. REV. 72, 76 (2017).

441. *Id.*

442. *Id.*

443. *See Instructions for Form 990-EZ*, *supra* note 135, at 11–12.

444. Form 990 Redesign for Tax Year 2008 (Filed in 2009), Frequently Asked Questions, IRS.gov (Aug. 22, 2011), https://www.irs.gov/pub/irs-tege/990r_faqs.pdf [https://perma.cc/2ME4-V7U9].

According to the IRS, the previous version "failed to reflect the changes in the law and the increasing size, diversity, and complexity of the tax-exempt sector" which resulted in a failure to meet "the Service's tax compliance interests or . . . the transparency and accountability needs of the states, the general public, and communities served by the organizations."[445] The same might be said of the annual information reports used today.[446] The adoption of the Streamlined Application certainly qualifies as one of the "changes in the law" that would demand adjustments to reporting requirements, especially if one considers the widespread use of the e-Postcard. Maybe more importantly, the required change would be minimal. Rather than permitting Form 990-EZ filers to provide a single total amount of all program service revenue, the form would be amended to require filers to disclose unrelated business income, related business income, and income derived from fees for service (and how those fees are determined) as separate line items. Admittedly, it is unlikely that the IRS would find regulatory resources necessary to review this additional information, but the public would, in the very least, have the data necessary to make informed decisions about which charities to support, and state regulators would have access to data that may inspire more policing.

CONCLUSION

Many areas of the law fail to meet the expectations of the general public, and charity law is no exception. While the general public's conception of charity does not likely include paying salaries, engaging in commercial activity, or charging fees for service, the fact remains that charities frequently engage in these activities. Although the plain meaning of many of the laws governing charities suggests more restriction, over a century of case law and agency actions have combined to result in a more lenient regime. Compounding the problem, the IRS is overburdened and underfunded. We therefore face a regulatory failure. So long as the regulatory failure remains unaddressed, these activities by charities will continue. This will ultimately result in harming the

445. *See* IRS, SUMMARY OF FORM 990 REDESIGN PROCESS, (Aug. 2008), https://www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf [https://perma.cc/UHB2-5CEG].

446. I am not the first commentator to call for a more robust disclosure regime. *See, e.g.*, Rossman, *supra* note 121, at 107 ("The IRS could revise the Form 990 to elicit more specific information from economic development organizations about their activities, including the names, types, and locations of businesses they assist; the forms of aid they provide; the number and types of jobs this aid creates; and other information relevant to understanding the relative public and private benefit generated by the organization's activities.").

reputation of the entire charitable sector. To the extent potential donors cannot ensure that their donations will be spent in a charitable manner, they will have less incentive to give, and the warm glow enjoyed by charities will fade.

This does not have to be the case. Although the IRS's decision to create a virtual self-certification process for aspiring charities drew sharp criticism, one might conclude that it was a reasonable response by an agency facing a budgetary shortfall. But the IRS went too far, and the paucity of effective screening or monitoring mechanisms is unacceptable. In a perfect world, the IRS would have the funding to more strictly assess and regulate charities, but this is not realistic. Thus, the most direct means of remedy the situation is to impose more robust reporting requirements on Smaller Charities. In doing so, we would give the public the ability to monitor Smaller Charities, and hopefully stem the erosion of the public's faith in the charitable sector.