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# The Federalization of Nonprofit and Charity Law

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# Foreword: The Federalization of Nonprofit and Charity Law

*Dana Brakman Reiser*[1]

TRADITIONALLY, state law governs the internal operations of nonprofit organizations.[2] The influence of federal law is rooted in its role in determining who will receive the highly enticing carrots of tax-exemption and qualification to receive tax-deductible contributions.[3] In recent years, through various mechanisms, federal law has come to wield greater influence.[4] This move is not without controversy,[5] and this issue offers four articles examining different aspects of this federalization of nonprofit law and its consequences.

Benjamin Leff examines the impact of federal law on the complexion of nonprofit boards, particularly their use of "independent" directors.[6] He begins by reviewing IRS governance initiatives on director independence to date, canvassing an array of statements by IRS officials lauding independent directors, form changes requesting disclosures regarding board composition and conflict of interest policies, and IRS training materials for determination and examination specialists focusing on independence.[7] In addition, Leff examines the IRS "in action," reviewing recent adverse IRS determinations of eligibility for exemption that focus on board composition.[8] He concludes that the IRS is after something different than state attorneys

1 Professor of Law, Brooklyn Law School.

2 *See* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 53-55, 377 (2004).

3 *See* I.R.C. § 501(c)(3) (2006) (setting for criteria for exemption from taxation for "[c]orporations . . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, . . . educational [or a few other similar] purposes"); *see also id.* § 170(c) (defining a very similar group of organizations as qualifying to receive tax-deductible charitable contributions). The federalization of nonprofit law is not exclusively a recent trend and has antecedents decades ago. *See* FREMONT-SMITH, *supra* note 2, at 377.

4 *See* James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, pt. IV (2010); Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 480-81 (2010); Marcus Owens, *Charities and Governance: Is the IRS Subject to Challenge?*, TAX ANALYSTS 2008-9664, at 1-4.

5 *See, e.g.*, Fishman, *supra* note 4, at pt. V(C); Owens, *supra* note 4, at 7.

6 Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Third-Party Stakeholders as a "Middle Path,"* 99 KY. L.J. 731 (2011).

7 *See id.* at 736-43.

8 *See id.* at 754-59.

general policing board independence to protect donors and the public from abusive self-dealing transactions. The IRS is concerned when a board is dominated by founders, for fear the organization will pursue private over exempt purposes (whether or not those private purposes are financial).[9] The determination letters Leff examines show the IRS does not refuse exemption anytime an organization lacks an independent board; it denies exemption when organizations without independent boards present a risk that private interests would dominate and where the organization does not have other empowered parties likely to counter that risk.[10]

Leff argues this focus can be defended as appropriate to the IRS's role in guarding exempt purposes and preventing exempt organizations from pursuing private purposes.[11] Importantly, he does not suggest the IRS has persuasively made this argument, rather only that such an argument could be used to support its actions.[12] To make the IRS's board independence inquiries defensible though, Leff believes a limiting principle is required.[13] He argues the IRS should only require independent boards for organizations at risk to pursue private purposes, without meaningful third-party stakeholders, and who will not be governed by the already restrictive private foundation regime.[14] Meaningful third-party stakeholders include a class of individuals like donors, volunteers, and members, who have "an interest in an organization's activities."[15] In organizations at risk for pursuing private purposes, and without the additional regulation of the private foundation regime, demanding independent board members enlists them to serve as needed meaningful third-party stakeholders, incentivized and empowered to combat this risk.[16]

Finally, in Leff's view, if this limiting principle is applied, federal efforts to regulate nonprofit board composition can be appropriately cabined to their proper sphere.[17] The lack of meaningful third-party stakeholders, he argues, makes an organization a particular threat to federal interests in maintaining the fisc because it means "the federal government has no allies" to combat inappropriate self-dealing.[18] Furthermore, he argues, organizations without meaningful third-party stakeholders are unlikely to arouse much attention from state regulators, responsive to whistleblowers,

9 *See id.* at 752-55, 764-65.

10 *See id.* at 765.

11 *See id.* at 747.

12 *See id.* at 765.

13 *See id.* at 747, 765.

14 *See id.* at 777.

15 *Id.* at 765-66.

16 *See id.* at 771.

17 *See id.* at 777-80.

18 *Id.* at 779.

disgruntled volunteers, and donors who feel duped.[19] Thus, Leff argues his limiting principle may produce a division of labor beneficial to the overall nonprofit regulatory environment. It offers a net gain by focusing the energies of federal regulators on precisely those problematic nonprofits overburdened or uninterested state attorneys general may fail to police.

Johnny Rex Buckles considers a different context where federal regulation has made forays into the heartland of traditional state nonprofit regulation, that of the duty of loyalty.[20] He argues the duty of loyalty has long been federalized in at least three ways: the application of the standard organizational and operational tests for exemption, the private benefit doctrine, and the prohibition on inurement.[21] The organizational and operational tests for exemption require qualifying organizations to be formed to pursue *exempt* purposes and to engage in *exempt* activities.[22] Disqualifying non-exempt purposes and activities include, prominently, loyalty breaches like pursuing the personal gain for organizational fiduciaries or engaging in activities that would enrich these fiduciaries at the expense of the exempt entities. Likewise, he views the prohibitions on excessive private benefit and on any inurement to insiders to condition an organization's eligibility for exemption on being free from loyalty breaches.[23]

In addition to loyalty requirements imposed by the fundamental requirements for exemption, Buckles argues that federal excise taxes on exempt nonprofits further federalize loyalty.[24] His extremely thorough review of the excise tax regime, including those under I.R.C. § 4958 and the private foundation, supporting organization, and donor-advised fund rules, identifies three different federal loyalty standards.[25] At times, the excise tax regime requires fiduciaries of exempt organizations to meet loyalty standards greater than that state loyalty requirements of either trust or nonprofit corporate law would impose. He refers to these as "supra-trustee standards."[26] In other situations, the federal standard imposed is equivalent to either the trust law or the nonprofit corporate law standard.[27]

Unfortunately, current law does not help us to discern why some contexts require supra-trustee standards, while others merit more lenient nonprofit corporate director-type treatment, and still others traditional

19 *See id.* at 778-79.

20 Johnny Rex Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries Under United States Tax Law*, 99 KY. L.J. 645 (2011).

21 *Id.* at 653.

22 *See id.* at 654-58.

23 *Id.* at 658-62.

24 *Id.* at 662.

25 *Id.* at 665-76.

26 *Id.* at 678-79.

27 *Id.* at 679-81.

trust law standards.[28] The standards imposing loyalty obligations vary by organization and transaction involved, without a clear rationale.[29] Thus, Buckles decries the federal excise tax regime's duty of loyalty concept as internally inconsistent, if not incoherent. Yet, he does not challenge the strong interest of federal law enforcement of loyalty. His point is quite the contrary. State enforcement in the nonprofit context is legendarily inadequate.[30] Revoking exemption for breaches of loyalty, even if possible under the organizational and operational tests or private benefit and inurement doctrines, is practically flawed.[31] This ultimate sanction will be imposed in the rarest of circumstances, and when it is, the victimized organization, rather the disloyal fiduciary, will often be harmed.[32]

In Buckles's view, federal law has important reasons to pursue loyalty from exempt organization fiduciaries, but it must do so more thoughtfully and consistently.[33] Buckles argues that consistency might be achieved by harmonizing the standards or by articulating cogent reasons for the differing approaches, but achieving it is paramount.[34] Although some elements of a federalized duty of loyalty reinforce state fiduciary law, it can also undermine state law remedies, by applying revenue-depleting excise taxes and revoking exemptions.[35] Therefore, he argues, reconciling the impacts of a federalized duty of loyalty on state law remedies is also vital.[36]

Nicole Dandridge reminds us that even clear and consistent federal efforts to regulate nonprofits may differentially and detrimentally impact smaller organizations.[37] Her article examines new federal filing requirements focused on improving governance and transparency, which Dandridge argues will impose significant costs on small nonprofits without generating corresponding benefits.[38] The revised Form 1023 encourages all applicants for exemption to adopt relatively stringent and procedurally complex governance standards like conflict of interest policies, which she argues are inappropriate for small and local community service organizations.[39] The new Form 990-N, despite its small size and limited information requests,

28 *See id.* at 686-87.

29 *See id.*

30 *See id.* at 681-82.

31 *See id.* at 682.

32 *See id.*

33 *See id.* 693-94.

34 *See id.*

35 *See id.* 687-93.

36 *See id.* 693-94.

37 Nicole S. Dandridge, *Choking Out Local Community Service Organizations: Recent Upsurge in Federal Regulation Impacting Small Nonprofit Entities and Reasonable Enforcement*, 99 KY. L.J. 695 (2011).

38 *See id.* 696.

39 *See id.* 708-11.

puts these small nonprofits on an annual reporting schedule and penalizes noncompliance with revocation of exemption.[40] Once revoked, exemption may only be regained through reapplication using the very form her analysis harshly critiques, the new Form 1023.[41]

Dandridge reminds us of the heterogeneity of the nonprofit sector and its ties to local communities, attributes that may be overlooked in the desire to obtain the uniformity and resources of federal enforcement. She argues the IRS should instead heed the lessons of "responsive regulation" and "new governance."[42] Responsive regulation theory instructs regulators to take seriously the context within which regulated entities operate and proceed from "restorative" to more "punitive" enforcement efforts in a stepwise fashion.[43] The new governance school of thought encourages greater collaboration between regulators and the regulated industry, championing careful attention to the context in which regulated entities operate and the goals of the regulation.[44]

According to Dandridge, mass revocations for Form 990-N nonfilers skip several steps along the responsive regulatory path, proceeding too quickly to dire regulatory consequences for the small, unsophisticated entities being regulated.[45] Before moving to revocation, she argues the IRS should pursue greater efforts at education and training for nonprofit leaders, as well as notice.[46] Notice might helpfully be made more effective by obtaining the assistance of state regulators.[47] Moreover, even when notice is to no avail, she argues exemptions should be revoked subject to reinstatement on filing a proper Form 990-N, and should not require full reapplication through the revised Form 1023 process.[48] If Congress and the IRS followed the precepts of new governance and involved small nonprofits more in the decision-making process leading to the Form 1023 and 990-N changes, Dandridge suggests the same form revisions and non-filing remedies might not have been put in place.[49] Although the IRS did extend Form 990-N filing deadlines in response to concerns that small nonprofits were unaware or unable to meet the initial ones,[50] Dandridge argues greater flexibility was warranted.

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40 *See id.* at 712-13. The Form 990-N was promulgated to comply with demands for filing by small nonprofits included in the Pension Protection Act of 2006. *See id.* at 711-12.

41 *Id.* at 713.

42 *See id.* at 721-22.

43 *Id.* at 723-24.

44 *See id.* at 724-25.

45 *See id.* at 725-26.

46 *Id.* at 725-28.

47 *Id.* at 727-28.

48 *Id.* at 725-26.

49 *Id.* at 724.

50 *Id.* at 719-20.

In the final article, Mark Sidel considers the links between federalization and another recent trend in nonprofit law: self-regulation.[51] In fact, Sidel frames his view of the federalization trend to include greater self-regulation.[52] He notes, for example, an influential staff report of the Senate Finance Committee in 2004 that recommended funds be authorized to contract with accreditation organizations, which would serve as certifiers of eligibility to obtain charitable exemption and receive deductible contributions under federal tax law.[53] Of course, this staff report and the efforts of the Senate Finance Committee and its then-Chairman Senator Charles Grassley spurred one of the most prominent and comprehensive self-regulatory efforts in recent years, that of the Panel on the Nonprofit Sector by Independent Sector,[54] which was convened at Senator Grassley's behest.[55] It is beyond any doubt that the Panel's efforts occurred in the shadow of possible federal regulation, had Senator Grassley and his colleagues not been satisfied with its self-regulatory efforts.

At the moment, federal and self-regulatory efforts appear to recommend similar best practices and have been thus far "mutually reinforcing."[56] This will not necessarily always be the case. Sidel recognizes that federal regulation and self-regulation can also be in tension and raises important issues to monitor here.[57] If federal regulation begins to make more demands on exempt nonprofits, will self-regulatory efforts be displaced? Or, will other, more complicated dynamics ensue if and when nopnrofits are forced to respond to conflicting recommendations from these multiple sources of regulation? What about conflicts between the demands of competing self-regulators? In the U.S. nonprofit sector, these trends are in their early stages and these questions cannot yet be answered.[58]

Instead, Sidel offers insights drawn from the experience of other

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51 Mark Sidel, *The "Federalization" Problem and Nonprofit Self-Regulation: Some Initial Thoughts*, 99 KY. L.J. 783 (2011).

52 *See id.* at 785.

53 *Id.* at 785-87.

54 *Id.* at 784.

55 Letter from Senator Chuck Grassley, Chairman, Senate Fin. Comm., to Diana Aviv, President and CEO, Independent Sector (Sept. 22, 2004), *available at* http://www.nonprofitpanel.org/about/SFCltr.pdf (requesting that Independent Sector "convene an independent national panel on the non-profit sector to consider and recommend actions that will strengthen good governance"); Letter from Diana Aviv, President and CEO, Independent Sector, to Senator Chuck Grassley, Chairman, Senate Fin. Comm., and Senator Max Baucus, Ranking Member, Senate Fin. Comm., (Oct. 12, 2004), *available at* http://www.nonprofitpanel.org/about/acceptance_html.html (accepting the request to convene a panel and describing its efforts to proceed).

56 *Id.* at 788.

57 *See id.* at 787-88.

58 *See id.* at 788.

regulated industries domestically and of nonprofits abroad.[59] Canvassing fields as diverse as securities and organic food certification, Sidel reviews how federal agencies have delegated regulatory tasks like data-gathering and compliance review to self-regulatory authorities, often but not always retaining enforcement power in the agency itself.[60] Looking beyond our borders, Sidel relates the experience of self-regulation in the Philippines. There, the government ultimately delegated responsibility for determining eligibility for certain tax benefits to a self-regulatory body, the Philippine Council for NGO Certification (PCNC).[61] The PCNC, though, is not the only active self-regulatory body for nonprofits in the Philippines. Other self-regulatory bodies also function, offering codes of ethics and best practices for particular subsectors.[62] In addition to delegating government regulatory authority to the PCNC (a process which has not been uniformly smooth),[63] Sidel reports that significant progress has been made toward resolving conflicts amongst various self-regulators.[64] Both experiences can offer lessons for the U.S. nonprofit context. Managing conflicts among standards set by multiple self-regulatory bodies or between self-regulatory and government standards is a growing domestic problem. Sidel reports on one state's efforts to harmonize them[65] and suggests these efforts will be required more often going forward.

The relationship of state and federal nonprofit regulation evokes great interest and creates significant tensions. On the one hand, federalization may be a boon, adding enforcement resources that strapped state regulators need to successfully regulate the nonprofit sector. On the other hand, federalization could impinge on state authority, undermine state regulation, nonprofit autonomy and viability, as well as valuable self-regulation. It could also be executed in an inconsistent or destructive fashion. The articles collected here offer us valuable insights and critiques of this dynamic process as it moves toward an uncertain future.

59 *Id.* at 788-97.
60 *See id.* at 788-91.
61 *Id.* at 791-96.
62 *Id.* at 794-95.
63 *See id.* at 795.
64 *See id.* at 794-96.
65 *Id.* at 796-97.