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ARTICLES

The Federalization of the Duty of Loyalty Governing Charity Fiduciaries Under United States Tax Law

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INTRODUCTION

Charitable trusts and nonprofit corporations have long been governed by state law and overseen by state officials, such as state attorneys general.\footnote{2 See Terri Lynn Helge, Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board, 19 CORNELL J.L. & PUB. POL'Y 1, 13 (2009) ("The enforcement power of the state attorney general has been rooted in the common law for centuries."); Marion R. Fremont-Smith, The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change, 76 FORDHAM L. REV. 609, 610 (2007) ("Enforcement of state laws is the unique province of the attorneys general who have traditionally had exclusive jurisdiction to bring wrongdoing to the attention of state courts, with the courts empowered to apply a wide range of sanctions to assure compliance with the rules and remedy violations.").} Just as state law has regulated charitable entities in general, so has state law regulated fiduciaries\footnote{3 In broadly defined terms, a """fiduciary,"" is a person who ""acts on behalf of another . . . while exercising discretion with respect to a critical resource belonging to"" the one for whom the fiduciary acts. D. Gordon Smith, The Critical Resource Theory of Fiduciary Duty, 55 VAND. L. REV. 1399, 1402 (2002). A charity fiduciary is thus one who oversees or manages a charitable entity, and includes a trustee of a charitable trust, a director of a charitable corporation, and an officer of a charitable entity. See PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 300 cmt. a (Tentative Draft No. 1, 2007) [hereinafter PLNO].} of charitable entities. State law governs the conduct of charity fiduciaries in no small part by subjecting them to
fiduciary duties. Perhaps the most foundational of these is the duty of loyalty.

Notwithstanding the historically significant role of the states in regulating charities, the duty of loyalty owed by trustees of charitable trusts and directors of charitable corporations under state law is now largely eclipsed by federal tax laws that effectively regulate fiduciary behavior.

4 See Lloyd Hitoshi Mayer & Brendan M. Wilson, Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis, 85 Chi.-Kent L. Rev. 479, 491 (2010) ("With respect to current standards, there is general agreement that charity leaders owe their organizations two duties under state laws: care and loyalty," observing a duty of "obedience" is a duty some people recognize that may not be entirely distinct from the other two; see id. at 495 ("[S]tate attorneys general are vested with primary responsibility for regulating governance, but most state attorneys general offices lack the resources or the will to actively enforce state fiduciary standards.").

5 Cf. Restatement (Third) of Trusts ch. 15, intro. note (2007) (stating that the duty of loyalty is "often called the 'cardinal' principle of fiduciary relationships," but is "particularly strict in the law of trusts"); Unif. Trust Code § 802 cmt. (amended 2004) (characterizing the duty of loyalty as "perhaps the most fundamental duty of the trustee"); Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, Scott and Ascher on Trusts § 17.2 (5th ed. 2007) [hereinafter Scott and Ascher on Trusts] ("The most fundamental duty of a trustee is the duty of loyalty.").


7 Cf. Brody, The Limits, supra note 6, at 1414 ("Regulatory authority over nonprofit fiduciaries, particularly charity managers, has moved increasingly to the federal level through the income tax laws.").
This Article describes, analyzes, and evaluates this federalization of the duty of loyalty embodied in the federal tax regime.

Part I of this Article briefly summarizes the nature of the duty of loyalty under state law, particularly as it is articulated under modern reform proposals, model acts, and restatements of law. It discusses both the content of the duty of loyalty and the remedies for its breach.

Part II discusses the federalization of the duty of loyalty inherent in fundamental requirements for obtaining and maintaining exemption from federal income taxation as a charitable entity. This Part explains how the duty of loyalty lies at the heart of the general organizational and operational tests governing tax-exempt charities, the prohibition against excessive private benefit, and the absolute prohibition against private inurement of net earnings.

Next, Part III of this Article discusses the federalization of the duty of loyalty through the labyrinthine federal excise tax regime governing charities. After briefly discussing four major types of charitable entities or entity components (private foundations, unaffiliated public charities, supporting organizations, and donor-advised funds), the Article surveys the excise tax regime governing various transactions of each type of entity. Part III then observes that numerous disparate standards and rules pertaining to the duty of loyalty emerge from the federal excise tax regime—supra-trustee standards, trustee standards, and nonprofit-corporate-director standards (which include procedural fairness rules).

Part IV of this Article identifies and articulates important assumptions that appear to underlie the federalization of the duty of loyalty under United States tax law. These assumptions pertain to (1) the inadequacy of state law fiduciary standards and enforcement mechanisms; (2) the inadequacy of the fundamental income tax exemption requirements in ensuring adherence to the duty of loyalty; and (3) other assumptions, sometimes conflicting, that relate to the behavior of fiduciaries and large donors (and related persons) and appear to underlie the federal excise tax system governing charities.

Part V of this Article assesses the current federalized duty of loyalty. It first concludes that the governmental interest in federalizing the duty of loyalty is strong. Second, this Part concludes that the governmental interest in producing a rational uniformity of fiduciary loyalty standards is strong but unrealized. Third, this Part analyzes the interaction between the federalized duty of loyalty and state law loyalty standards and remedies for breach. It observes the effect of correspondence and variance between state and federal loyalty standards and discusses the nature and purpose of federal sanctions and their likely effect on state law remedies when the duty of loyalty has been breached.
I. THE DUTY OF LOYALTY UNDER STATE LAW

A. Overview of the Duty of Loyalty

Traditionally, the duty of loyalty owed by the governing board of a charitable entity has depended upon the organizational form of the entity. The directors of nonprofit corporations owe fiduciary duties articulated under state nonprofit corporation laws that mimic their for-profit counterparts, whereas the trustees of charitable trusts are generally held to the fiduciary standards crafted under the common law of trusts.

A director of a nonprofit charitable corporation typically must act in "good faith" and in accordance with what the director believes (or reasonably believes) to be in the "best interests of the corporation." Plainly, when a charity enters into a transaction with a director in which the latter may profit, the duty of loyalty compels her not to benefit at the charity’s expense. For example, a director would breach her duty of loyalty by intentionally charging a charity above-market interest on a loan. Disinterested directors may also breach their duty of loyalty by intentionally conferring a financial benefit on an interested director to the detriment of the charity. When presented with a situation in which the interests of a charitable nonprofit corporation conflict with the interests of directors and related persons, the duty of loyalty encourages directors to act in accordance with procedural safeguards.

Although some statutes prohibit loans to directors (and officers), generally there is no outright prohibition against transactions between a director and the nonprofit corporation that she oversees.

8 See, e.g., CAL. CORP. CODE § 5231(a) (West 2009) (requiring a director to act “in good faith, [and] in a manner that director believes to be in the best interests of the corporation”); MASS. GEN. LAWS ANN. ch. 180, § 6C (West 2005) (imposing a nearly identical standard); OHIO REV. CODE ANN. § 1702.30(B) (LexisNexis 2009) (stating that a director must act “in good faith, [and] in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation”); 15 PA. CONS. STAT. ANN. § 5712(a) (West 2010) (requiring a director to act “in good faith, [and] in a manner he reasonably believes to be in the best interests of the corporation”); TEX. BUS. ORGS. CODE ANN. § 22.221(a) (West 2010) (imposing a similar standard).

9 See, e.g., Spitzer v. Schussel, 792 N.Y.S.2d 798, 800-04 (Sup. Ct. 2005) (denying in part a motion to dismiss a claim against a former fiduciary who allegedly breached his duty of loyalty by charging a nonprofit organization excessive interest).

10 See, e.g., PLNO, supra note 3, §§ 365 cmt. c, illus. 1, 370 cmt. c(2), illus. 2.

11 See, e.g., MODEL NONPROFIT CORP. ACT § 8.60(a) (2008) [hereinafter MNCA, 2008] (stating that a conflict-of-interest transaction is not voidable if, in relevant part, the board is informed of material facts and a majority of disinterested directors approve the transaction); id. § 8.31 cmt., Note on Directors’ Liability (2) (stating that an interested director incurs no liability if one of the procedures of section 8.60 has been followed).

12 Loans between a director or officer and the corporation that she oversees or manages are forbidden in states that follow the 1987 REvised Model Nonprofit Corporation Act. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 8.32(a) (1987) [hereinafter RMNCA].
Trustees of charitable trusts historically have been subject to more rigid prohibitions against self-dealing than those applicable to corporate fiduciaries. Under the Restatement (Second) of Trusts, a trustee must act "solely in the interest of the beneficiary." Similarly, under the Restatement (Third) of Trusts, "[e]xcept as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely . . . in furtherance of its charitable purpose." Accordingly, under the latter, the duty of loyalty "strictly prohibit[s]" the trustee "from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests" except in "discrete circumstances." The duty of loyalty is breached even if "the action in question was taken in good faith," "the terms of the transaction were fair," and "no profit resulted to the trustee." A leading treatise summarizes the law as follows:

In a nutshell, the duty of loyalty ordinarily requires trustees to avoid all transactions that involve self-dealing, as well as those that involve or might create a conflict between the trustee's fiduciary and personal interests. Failure to comply with this duty opens the trustee to liability for breach of trust and subjects the trustee to the "no further inquiry rule." Under this rule, a trustee who has violated the duty of loyalty is liable without further inquiry into whether the breach has resulted in any actual benefit to the trustee, whether the trustee has acted in good faith, whether the transaction was fair, or even, in some cases, whether the breach has caused any actual harm to either the trust or its beneficiaries. In addition, the courts have often loaded the dice rhetorically, stating proudly that a trustee's duty not to engage in transactions that involve self-dealing or that involve or might create conflicts of interest is "strict" or "absolute." The "discrete circumstances" under which self-dealing is permitted include (among a few other grounds) court approval of the transaction.

optional provision in the more recent model act generally forbids such loans. See, e.g., MNCA, 2008, supra note 11, § 8.32(a).

13 See Restatement (Third) of Trusts § 78 cmt. a (2007) ("The duty of loyalty is, for trustees, particularly strict even by comparison to the standards of other fiduciary relationships.").

14 Restatement (Second) of Trusts § 170(1) (1959). For a critique of the traditional trust law formulation of the duty of loyalty, see John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (2005).

15 Restatement (Third) of Trusts § 78(1) (2007); see, e.g., In re The Taylor Orphan Asylum, 36 Wis. 534, 552 (1875).

16 Restatement (Third) of Trusts § 78(2) (2007).

17 Id. § 78 cmt. b.

18 Scott and Ascher on Trusts, supra note 5, §§ 17.2 (citations and footnote references omitted). The duty of loyalty, of course, governs trustees of charitable trusts and private trusts alike. See id. § 37.3.1.

19 See Restatement (Third) of Trusts § 78(2) cmt. c(1) (2007).
consent to the transaction by all beneficiaries, authorization of the transaction by the trust instrument, and the payment of reasonable compensation to the trustee. These exceptions, however, still subsume protections to ensure that a conflict-of-interest transaction is fair (in some meaningful sense) to the beneficiaries. For example, court approval of a self-dealing transaction requires a finding that the transaction is in the interest of the beneficiaries. When the trust instrument itself authorizes self-dealing, "a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly." Beneficiary consent to a self-dealing transaction is effective only if the trustee is dealing fairly and communicates material facts. Finally, trustee compensation must be "reasonable," and, under some formulations, "fair to the beneficiaries." 

20 Id. cmt. c(3).
21 Id. cmt. c(2) ("For example, the terms of a trust may permit the trustee personally to purchase trust property or borrow trust funds, or to sell or lend the trustee's own property or funds to the trust.").
22 Id. cmt. c(4) ("The strict prohibitions against transactions by trustees involving conflicts between their fiduciary duties and personal interests do not apply to the trustee's taking of reasonable compensation for services rendered as trustee."); see also id. § 38(1) ("A trustee is entitled to reasonable compensation out of the trust estate for services as trustee, unless the terms of the trust provide otherwise or the trustee agrees to forgo compensation."); Langbein, supra note 14, at 939-41 (contrasting the American rule, which allows trustee compensation, with the traditional English rule, which does not). See generally Restatement (Third) of Trusts § 78(2) cmts. c, c(1)-(8) (2007) (describing several exceptions to the general prohibition against self-dealing by trustees).
23 See id. § 78 cmt. c(1). However, section 802(b)(2) of the Uniform Trust Code does not, on its face, condition court approval of a self-dealing transaction on such a finding. Unif. Trust Code § 802(b)(2) (amended 2005).
24 See Restatement (Third) of Trusts § 78(2) cmt. c(2) (2007). However, "fair" is not synonymous with "at market value" in this context. Id. ("[T]he authorization may allow the trustee to purchase certain trust property at a stated or formula price that amounts to a beneficial ... option price. Such a purchase would not be 'unfair' even though for less than a fair-market consideration."). Interestingly, section 802(b)(1) of the Uniform Trust Code does not, on its face, condition trust instrument authorization of self-dealing on a showing of fairness by the trustee. Unif. Trust Code § 802(b)(1) (amended 2005). However, the terms of trust may never authorize a trustee to act other than in the interests of the beneficiaries. See id. § 105(b)(2).
25 See Restatement (Third) of Trusts § 78(3) cmt. g (2007); Langbein, supra note 14, at 964-65. Similarly, the Uniform Trust Code sets forth an exception to the general prohibition against self-dealing for a transaction to which the beneficiary consents, if the beneficiary is apprised of material facts and the trustee has not induced consent through "improper conduct." See Unif. Trust Code §§ 802(b)(4), 1009 (amended 2005). The comment to section 1009 of the Uniform Trust Code cites the traditional rule that the beneficiary's consent is binding "only if the transaction was fair and reasonable." Unif. Trust Code § 1009 cmt. (amended 2005) (citing Restatement (Second) of Trusts §§ 170(2), 216(3) & cmt. n (1959)).
27 Unif. Trust Code § 802(h)(2) (amended 2005) (stating that the duty of loyalty does not preclude paying the trustee reasonable compensation if "fair to the beneficiaries").
Some modern reform proposals seek to merge fiduciary standards regardless of the form of the charitable entity. Thus, under the American Law Institute's Principles of the Law of Nonprofit Organizations ("PLNO"), the duty of loyalty requires each director/trustee of any form of charity "to act in a manner that he or she reasonably believes to be in the best interests of the charity." When the interests of a charity do or might conflict with the interests of directors and related persons, PLNO encourages directors to act in accordance with procedural safeguards similar to those typically applicable under nonprofit corporation statutes.

**B. Remedies for Breach of the Duty of Loyalty**

A variety of approaches for redressing a trustee/director's breach of the duty of loyalty exist. PLNO offers a range of options and a good discussion of the propriety of each in various circumstances involving breach of fiduciary duty. PLNO initially places upon the governing board the duty to take "reasonable steps to correct" a failure to discharge fiduciary duties "and remedy the harm, if any, to the charity." If an individual member of the governing board becomes aware of another member's intentional breach of the duty of loyalty, the former must "take reasonable and appropriate action," and normally "need only seek to induce action by the board." The board may need to remove one of its members for breach of fiduciary Duty of Loyalty.

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28 See, e.g., PLNO, supra note 3, Reporter's Memorandum at xxxiii ("Chapter 3 tries ... to set forth a uniform set of rules of governance for both corporate charities and charitable trusts ... "); PLNO, supra note 3, ch. 3, topic 1, intro. note at 17 ("These Principles apply uniform legal standards of loyalty and care to fiduciaries of all types of charities ... "); PLNO, supra note 3, § 300, cmt. a on subsection (a) ("The term 'fiduciary' ... generally embraces a trustee of a charitable trust, a member of the board of directors of a corporate charity, and anyone else serving a similar role.").

29 PLNO, supra note 3, § 310(a).

30 See, e.g., id. §§ 310(b), 330 (setting forth procedures for approving conflict-of-interest transactions sufficient to avoid a shift in the burden of proving a transaction's fairness to a defendant).

31 Id. § 350(a).

32 Id. § 350(b). However, if a board member is unable to convince a majority of the board to remedy or prevent an act of self-dealing or other intentional breach of the duty of loyalty, she may have a duty to seek a judicial remedy. PLNO, supra note 3, § 350 cmt. b(3)-(4). This principle finds support both in the law of trusts, see, e.g., Restatement (Third) of Trusts § 39 cmt. a, illus. 1 (2003); id. § 81 cmt. e (stating that a trustee might reasonably decide not to sue to redress a breach of trust); Uniform Trust Code § 703(g) (amended 2005), and in the law of corporations. See, e.g., Francis v. United Jersey Bank, 432 A.2d 814, 822-29 (N.J. 1981) (discussing the duty of a director to employ various methods—including threatening to sue—to prevent breach of fiduciary duties by others); RMNCA, supra note 12, § 8.09(b) (authorizing a director to bring an action on behalf of the nonprofit corporation to remove a director for various types of malfeasance).
duty (if empowered to do so under the governing instrument) or even sue “for damages or injunctive relief against wayward fiduciaries.”

Moving beyond the actions required of a board, PLNO directs a “regulator or court” to “provide a remedy that is in the best interests of the charity.” This open-ended approach reflects the reality that state statutes “rarely specify remedies for breach of fiduciary duties,” thereby allowing state attorneys general and judges to craft remedies in their discretion. The following are available civil remedies for breach of a fiduciary duty: “an accounting, declaratory judgment, reprimand, specific performance, injunction, appointment of a receiver, restitution, . . . imposition of surcharge or damages, removal, and liquidation of the charity.” Non-monetary remedies include appointing new board members, removing board members, and implementing governance reforms. Liquidation is generally appropriate only when the court finds that an independent, properly functioning board to govern the charity is not likely to exist, in which case assets should be transferred to another charity organized for similar purposes.

Although damages are not generally imposed on directors of a nonprofit corporation, a breach of the duty of loyalty resulting in financial gain to the interested director may cause her to be monetarily liable to the charitable entity. This monetary liability could take the form of legal damages or restitution. The latter requires the disgorgement of profits, if they exceed legal damages. Importantly, if the governing board of a nonprofit corporation follows proper procedures when handling a transaction in which a director is financially interested, or if, in the alternative, the transaction is fair to the corporation when authorized by the board, then neither the interested director nor disinterested directors will be liable to the corporation, even if the interested director receives some benefit from the

34 PLNO, supra note 3, § 360.
35 Id. § 360 cmt. b(1).
36 Id.
37 Id. § 360 cmt. b(2).
38 See id.
39 See, e.g., MNCA, 2008, supra note 11, § 8.09(a); RMNCA, supra note 12, § 8.1(a).
40 See PLNO, supra note 3, § 360 cmt. b(2).
41 See id.
42 See, e.g., MNCA, 2008, supra note 11, § 8.31(a)(2)(v); PLNO, supra note 3, § 370.
43 See PLNO, supra note 3, § 360 cmt. b(2); MNCA, 2008, supra note 11, § 8.31 cmt., Note on Directors’ Liability (4), (5), and (6).
44 See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 43(1)(a), 2(a) (Tentative Draft No. 4, 2005).
transaction. 45 PLNO provides for a similar result in the case of all charitable entities, 46 although compliance with PLNO's procedures merely creates a "rebuttable presumption" 47 that the conflict-of-interest transaction was fair to the charity and in its best interests; one challenging the transaction bears the burden of proving that it was not. 48 One may conceptualize this framework as requiring "substantive fairness" and/or "procedural fairness" in the case of transactions between an interested fiduciary and her charity.

II. THE FEDERALIZATION OF THE DUTY OF LOYALTY THROUGH FUNDAMENTAL EXEMPTION REQUIREMENTS

This Part discusses the federalization of the duty of loyalty inherent in fundamental requirements for obtaining and maintaining exemption from federal income taxation as a charitable entity. The duty of loyalty lies at the heart of the general organizational and operational tests governing tax-exempt charities, the prohibition against excessive private benefit, and the absolute prohibition against private inurement of net earnings. 49 This Part explores this theme. 50

Section 501(a) of the Internal Revenue Code exempts from federal income taxation organizations described in section 501(c). Section 501(c)(3) describes the following organizations:

45 See MNCA, 2008, supra note 11, § 8.31 cmt., Note on Directors' Liability (2) (stating that an interested director incurs no liability if one of the procedures of section 8.60 has been followed); id. cmt. 1 ("[If . . . Section 8.60 shelters the director's conduct in connection with a conflicting interest transaction, there is no need to consider further the application of Section 8.31's standards of liability.").
46 See, e.g., PLNO, supra note 3, §§ 310(b), 330 (setting forth procedures for approving conflict-of-interest transactions sufficient to avoid a shift in the burden of proving a transaction's fairness to a defendant).
47 Id. § 330 cmt. a(2).
48 See id.
49 Cf. Symposium, What is Charity? Implications for Law and Policy, 39 CASE W. RES. L. REV. 807, 837 (1989). "We have turned to federal tax law to establish the fiduciary duties of officers and directors. It has been federal tax law by default because the state corporation statutes have been empty . . . . Section 501 therefore imposes the duties for most nonprofit institutions." Id. (quoting remarks made by Prof. Hansmann during discussion of his paper).
50 The approach of this section, which identifies commonalities in the state law duty of loyalty and fundamental exemption requirements, is similar to the approach set forth in a forthcoming article by Professor Dana Brakman Reiser. See Dana Brakman Reiser, Charity Law's Essentials, 86 NOTRE DAME L. REV. (forthcoming 2011) (analyzing state laws and the fundamental exemption requirements discussed in this paper as imposing an "other-regarding orientation" on charitable entities).
Corporations, and any community chest, fund, or foundation, [1] organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, [2] no part of the net earnings of which inures to the benefit of any private shareholder or individual, [3] no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and [4] which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.51

This Part explains how the first and second of the statutory requirements for qualification under section 501(c)(3)52 incorporate duty of loyalty concepts. For ease of discussion, this Article analyzes these statutory requirements by reference to their articulation under United States Treasury regulations and federal case law. The Treasury regulations interpret the first requirement as setting forth both an organizational test and an operational test.53 In addition, both the regulations and case law interpret the first statutory requirement as prohibiting an organization from conferring excessive private benefit.54 The second statutory requirement is simply known as the prohibition against private inurement of net earnings.55

A. Organizational and Operational Tests

Under the organizational test, an entity's charter must limit its purposes to one or more exempt purposes (i.e., the purposes described in section 501(c)(3) of the Internal Revenue Code),56 and generally must not expressly empower it to engage in activities that do not further exempt purposes.57 Under the operational test, an entity must engage "primarily in activities which accomplish" exempt purposes.58 An entity fails the test "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."59

52 The duty of loyalty is implicated by the requirements set forth in clauses [1] and [2] in the text of the preceding paragraph.
54 See id. § 1.501(c)(3)-1(d)(1)(ii).
55 Id. §1.501(c)(3)-1(c)(2).
56 See id. § 1.501(c)(3)-1(b)(1)(i)(A).
57 See id. § 1.501(c)(3)-1(b)(1)(i)(B).
58 Id. § 1.501(c)(3)-1(c)(1).
59 Id. In addition, the organization must not operate so as to violate the other statutory requirements for qualifying under section 501(c)(3). See id. § 1.501(c)(3)-1(c)(2), (3).
Of course, whether an organization satisfies the organizational and operational tests hinges in part on the existence of an "exempt purpose." The statute lists several exempt purposes, with no elaboration.\(^60\) The Treasury regulations provide more guidance.\(^61\) In addition to reiterating the statutorily designated exempt purposes, the regulations state that the term "charitable" in section 501(c)(3) retains "its generally accepted legal sense,"\(^62\) and is not "limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions."\(^63\) By embracing the judicially developed "broad outlines of charity," the regulations strongly indicate that common law concepts of charity are relevant in ascertaining the contours of exempt purposes.

The United States Supreme Court has not only affirmed this implication of the regulations, but also expanded the role of the common law beyond that which is implied in the regulations. In *Bob Jones University v. United States*, the Court held that an organization claiming exemption from federal income taxation under section 501(c)(3) of the Internal Revenue Code must not have a purpose that is illegal or that violates "established public policy."\(^64\) The Court grounded its analysis on the understanding that an organization's entitlement to federal income tax exemption under section 501(c)(3) depends upon whether it satisfies common law concepts of charity.\(^65\) The Court reasoned that section 501(c)(3) must be construed within the Code's "framework" and "against the background of the Congressional purposes."\(^66\) Identifying parallels between sections 501(c)(3) and 170(c)\(^67\) and observing that section 170 authorizes a deduction for "charitable contributions," the *Bob Jones* Court discerned a congressional intent to provide tax benefits to organizations serving charitable purposes.\(^68\) According to the Court, Congress exempted organizations described in section 501(c)(3) from income tax to promote "charitable" organizations because

\(^{60}\) See I.R.C. § 501(c)(3) (West Supp. 2010).

\(^{61}\) See Treas. Reg. § 1.501(c)(3)-1(d) (as amended in 2008).

\(^{62}\) Id. § 1.501(c)(3)-1(d)(2).

\(^{63}\) Id. (original emphasis omitted).

\(^{64}\) Bob Jones Univ. v. United States, 461 U.S. 574, 591, 595-96 (1983) (holding that two schools maintaining racially discriminatory policies as to students violated established public policy).

\(^{65}\) See id. at 586, 588-89.

\(^{66}\) Id. at 586.

\(^{67}\) United States Internal Revenue Code section 170(a)(1) authorizes a deduction for a "charitable contribution," which is defined in section 170(c). Under section 170(c)(2), a "charitable contribution" includes a gift to a "corporation, trust, or community chest, fund, or foundation" that satisfies certain requirements. Such requirements include those set forth in section 501(c)(3). See I.R.C. § 170(c)(2)(A)-(D) (West Supp. 2010).

\(^{68}\) Bob Jones, 461 U.S. at 586-88.
they serve a salutary public purpose.69 Consistent with the common law, Bob Jones concluded that “an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.”70

The organizational and operational tests, textured by Bob Jones University’s overlay of the common law of charity upon all section 501(c)(3) entities, may be understood, at a very basic level, to advance essentially the same goal that inheres in a charity board’s fiduciary duties, including the duty of loyalty. To require a charity to be formed and primarily operated for charitable purposes is to forbid it from advancing non-charitable purposes (other than, perhaps, those other purposes that are inevitably furthered concurrently with charitable purposes) to any significant degree. Like any other corporate entity or trust, a charity acts through people. Because a charity acts through agents who ultimately answer to the governing board,71 the operational test strongly encourages a governing board to ensure that the charity fulfills the charitable mission for which it is organized, rather than other purposes. The operational test thereby prods board members to do that which they are already required to do in exercising their fiduciary duties, including the duty of loyalty.

This point is readily discernable when one compares the operational test with the duty of loyalty articulated in PLNO. Section 310 of PLNO states, in relevant part, that the duty of loyalty requires each member of the charity’s governing board “to act in a manner that he or she reasonably believes to be in the best interests of the charity, in light of its stated purposes.”72 The initial comment to this section notes that the trustee of a charitable trust owes fiduciary duties “to the charitable purpose” of the trust.73 Indeed, under the Restatement (Third) of Trusts, the duty of loyalty generally requires a trustee of a charitable trust to administer it “solely in furtherance of its charitable purpose.”74 In the corporate context, a director owes duties to the entity itself.75 Consistent with these hornbook rules,

69 Id. at 587–88 (“Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind.”).
70 Id. at 586.
71 See PLNO, supra note 3, § 320(a) (“All powers of the charity are exercised by or under the authority of its governing board, and the activities and affairs of the charity are managed by, or under the direction and subject to the oversight of, the governing board . . . .”); id. § 320(b)(1) (stating that the governing board is responsible for monitoring implementation of the charity’s purposes); id. § 320(b)(3) (stating that the governing board is responsible for monitoring the chief executive’s performance).
72 Id. § 310 cmt. a(1).
73 Id. § 310 cmt. a(1).
75 PLNO, supra note 3, § 310 cmt. a(1).
the comments to section 310 of PLNO state that its formulation of the duty of loyalty “combines the trust and corporate language to declare an affirmative obligation of the fiduciaries to govern for charitable purposes.”76 Requiring a charity’s board to govern for the entity’s charitable purposes is, of course, to require the board to govern the charity in a manner that satisfies the operational test of the Treasury regulations. In other words, the operational test of the Treasury regulations may be viewed as an effort to condition tax exemption upon the realization of charitable outcomes that are expected when a charity’s governing board faithfully discharges its fiduciary duties generally, and the duty of loyalty particularly.

Admittedly, directors’ compliance with the duty of loyalty does not guarantee satisfaction of the operational test. It is possible that an entity will fail the operational test, notwithstanding that the governing board has discharged its duty of loyalty, because the board failed to exercise its duty of care.77 It is also possible that the board could properly discharge all of its fiduciary duties, but, through neglect or fraud, the officers or employees of the entity cause it to violate the operational test. Further, it is possible that an entity could comply with the operational test even if a member of its governing board breaches her duty of loyalty.78 Nonetheless, the substance

76 Id. (emphasis added).

77 PLNO describes the duty of care as follows: “The duty of care requires each governing-board member—(a) to become appropriately informed about issues requiring consideration, and to devote appropriate attention to oversight; and (b) to act with the care that an ordinarily prudent person would reasonably exercise in a like position and under similar circumstances.” PLNO, supra note 3, § 315. For state statutory expressions of the duty of care, see, e.g., CAL. CORP. CODE § 5231(a) (West Supp. 2010) (requiring a director to act “with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances”); MASS. ANN. LAWS ch. 180, § 6C (LexisNexis 2005) (requiring a director to act “with such care as an ordinarily prudent person in a like position with respect to a similar corporation organized under this chapter would use under similar circumstances”); MICH. COMP. LAWS ANN. § 450.2541 (West Supp. 2010) (stating that a director must discharge her duties “with the degree of diligence, care, and skill that an ordinarily prudent person would exercise under similar circumstances in a like position”); N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (McKinney 2005) (imposing an essentially similar standard); OHIO REV. CODE ANN. § 1702.30(B) (LexisNexis 2009) (stating that a director must act “with the care that an ordinarily prudent person in a like position would use under similar circumstances”); 15 PA. CONS. STAT. ANN. § 5712(a) (West 1995) (requiring a director to exercise “reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances”); TEx. BUS. ORGS. CODE ANN. § 22.221(a) (West 2009) (requiring a director to act “with ordinary care”).

78 For example, a director might vote in favor of several program initiatives recommended by the charity’s chief executive officer because the director wants to receive some benefit from the executive in return for her vote, notwithstanding that the director believes the program initiatives will not advance the charity’s mission. If, contrary to the belief of the director, the program initiatives actually appropriately carry out the charity’s exempt purposes, the charity would not fail the operational test. Although these and other examples can be imagined, the general correspondence between the effective discharge of the duty of loyalty by directors and the satisfaction of the operational test remains.
of the operational test is the end sought to be realized through fulfillment of the duty of loyalty. Moreover, a charity with a board that fulfills its duty of loyalty is far more likely to operate in accordance with its exempt purposes than one governed by a board that does not. At a minimum, the operational test may be understood as a federalization of the goal sought to be achieved through the law's imposition of a duty of loyalty on charity fiduciaries and an effort to incentivize the discharge of fiduciary duties by those who govern tax-exempt charities. Under this view, the most fundamental requirement of tax exemption for charities complements, and reinforces the primacy of, a charity fiduciary's duty of loyalty.

B. Prohibition Against Excessive Private Benefit

Under the Treasury regulations, an organization fails to satisfy the organizational and operational tests unless it serves a public rather than a private interest. This means that the entity must "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests." The language of the regulations has produced a doctrine related to, but theoretically distinct from, the private inurement prohibition discussed infra. The doctrine is the prohibition against unlawful private benefit, or the "private benefit doctrine." Applying this doctrine, the United States Tax Court has held that an organization fails to qualify for income tax exemption when it benefits private interests more than insubstantially, relative to the general public benefits conferred thereby. For obvious reasons, a judge cannot apply the test entirely objectively. Even more subjective is the approach of the IRS, which considers a private benefit "incidental" only if it is incidental both quantitatively and qualitatively. According to the IRS, a private benefit is

80 Id.
81 See BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 599-601 (9th ed. 2007) (original emphasis omitted) (discussing the private benefit doctrine and observing that the doctrine is distinct from, yet to some extent subsumes, the private inurement doctrine).
82 See Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1067-79 (1989) (holding that an organization that trained people for careers in political campaigning substantially benefited private interests (the Republican party and its candidates) and therefore failed to qualify as a tax-exempt educational organization).
83 See I.R.S. Gen. Couns. Mem. 37,789 (Dec. 18, 1978). In this General Counsel Memorandum, the IRS opined that the leasing of land by a hospital to members of its medical staff for $1.00 per year would give rise to more than incidental private benefit when the land could have been leased to the doctors at fair market value, and the benefit to the doctors was almost as great as the benefit to the public. Similarly, in General Counsel Memoranda 39,498, discussed infra note 84, the IRS concluded that a salary income guarantee may fail scrutiny under the private benefit doctrine. I.R.S. Gen. Couns. Mem. 39,498 (Apr. 24, 1986).
quantiﬁcationally incidental only if it is not substantial in view of the overall public beneﬁt conferred by the activity. A beneﬁt is quantitatively incidental only if the beneﬁt is a necessary concomitant of the activity beneﬁtting the public (i.e., the public can beneﬁt only if certain private individuals also beneﬁt).  

Thus, an organization that advances plainly charitable purposes may forfeit federal income tax exemption by conferring certain beneﬁts upon private parties. Under the private beneﬁt doctrine, a charitable organization will sacriﬁce its exemption if it confers a beneﬁt upon any private party (even someone who lacks an ongoing relationship with the charity) that, relative to the overall public beneﬁts provided by the charity, is not merely incidental. 

Like the operational test, the private beneﬁt doctrine also compels a result demanded by the duty of loyalty governing charity ﬁduciaries. To require a ﬁduciary to act in the best interests of a charity is obviously to forbid her from seeking to advance the best interests of others. In language strikingly similar to the language of the Treasury regulations cited above, the comments to PLNO section 310 state that the duty of loyalty not only requires ﬁduciaries “to govern for charitable purposes,” but also requires them not to govern “for the beneﬁt of board members, executives, donors, or other private parties.” In other words, the duty of loyalty requires charity ﬁduciaries to govern their charities so as not to violate the content of the private beneﬁt doctrine under federal income tax law. Once again, as in the case of the operational test, the private beneﬁt doctrine of federal income tax law embraces the end to which the duty of loyalty aims and incentivizes the discharge of the duty of loyalty by those who govern tax-exempt charities. Hence, the private beneﬁt doctrine, like the operational test in general, complements, and reinforces the primacy of, a charity ﬁduciary’s duty of loyalty.

C. Prohibition Against Private Inurement of Net Earnings

An organization is not described in section 501(c)(3) if its net earnings “inure in whole or in part to the beneﬁt of private shareholders or

In applying the “qualitative” test of incidental private beneﬁt, the IRS lacked sufﬁcient facts to determine whether an income guarantee was the sole means that a hospital could use to recruit a physician practicing in a ﬁeld of medical specialization in order to enable the hospital to provide excellent health care services. Further, because the subsidies to the recruited physician were not capped (except by a total income guarantee), the contemplated ﬁnancial incentives may not have been quantitatively incidental to the hospital’s attempt to further exempt purposes. Id.

85 See supra note 80 and accompanying text.
86 PLNO, supra note 3, § 310 cmt. a(1).
87 The phrase “net earnings” is misleading, for private inurement may be found even
This prohibition against the use of a charity's earnings for private gain is known as the private inurement doctrine, and it is distinct from the private benefit doctrine in at least two respects. First, the private inurement prohibition is triggered only when certain private persons receive benefits from a charity. Under Treasury Regulation 1.501(a)-1(c), a "private shareholder or individual" is someone "having a personal and private interest in the activities of the organization." Case law supports the conclusion that a person generally has such an interest only if she can exert control over the charity's operations, although whether such control must be formal is not a settled issue. Under this approach, the class of people who may receive benefits from a charity in violation of the private inurement doctrine is, to some degree, limited because the number of persons able to control the operations of a charitable organization is finite. Consequently, the prohibition against private inurement of net earnings is not implicated in many transactions that bestow benefits upon persons unaffiliated with a charity.

The second distinction between the prohibition against private inurement and the private benefit doctrine is that the former applies when any portion of "net earnings" inures to the benefit of an insider. There is no de minimis safe harbor under the statute. By contrast, the bestowal of an "incidental" private benefit does not disqualify an organization from section 501(c)(3) under the private benefit doctrine.

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89 See Hopkins, supra note 81, at 559-63 (discussing the private inurement doctrine).
90 Treas. Reg. § 1.501(a)-1(c) (as amended in 1982) (emphasis omitted).
91 Compare United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1178-79 (7th Cir. 1999) (finding no private inurement when a professional fundraising firm that dominated a charitable entity could not formally control it), with Variety Club Tent No. 6 Charities, Inc. v. Comm'r, 74 T.C.M. (CCH) 1485 (1997) (finding that a person had the requisite private interest in a charity when he had a significant voice in its operations and formal and informal control over much of its income). The IRS's concept of the degree of "control" necessary to render a person a "private shareholder or individual" with respect to a charity appears to have evolved somewhat in recent years. To illustrate, in 1986 the IRS opined that physicians have a personal and private interest in the activities of a hospital (i.e., that physicians constitute "private shareholders or individuals") if they are employees of the hospital or have a close working relationship with the hospital (such as staff physicians). I.R.S. Gen. Couns. Mem. 39,498 (Apr. 14, 1986). But the IRS now appears to recognize that a staff physician is not necessarily a "private shareholder or individual" with respect to an exempt hospital if she does not have substantial influence over its affairs. See Rev. Rul. 97-21, 1997-1 C.B. 121. See generally Hopkins, supra note 81, at 564-69 (discussing who qualifies as an "insider" for purposes of the prohibition against private inurement).
To an even greater degree than the operational test and the private benefit doctrine, the prohibition against private inurement corresponds to the duty of loyalty governing charity fiduciaries. First, the prohibition against private inurement extends to those who have some degree of control over a charity's operations. Plainly, a charity's governing board falls within the class of controllers; indeed, it, along with senior officers, probably presents the clearest case of those with a "personal and private interest" in the charity. Second, the prohibition against private inurement forbids conferring a financial benefit upon an insider, such as a director or trustee, to the detriment of a charity. Case law is replete with examples of private inurement involving transactions in which a charity receives inadequate consideration for whatever benefit it provides. The procedural safeguards that board members are encouraged to follow by modern statutes in order to ensure compliance with the duty of loyalty are designed to prevent the very type of financial exploitation of charities that would violate the prohibition against private inurement. If these procedural safeguards are not followed, the interested director of a nonprofit corporation must establish the fairness of the transaction to the charity.

PLNO would extend the same rule to all governing charity fiduciaries, even trustees of charitable trusts. Requiring that the transaction be fair to a charity and in its best interest, of course, is tantamount to requiring that the transaction not result in private inurement of the charity's net earnings.

Thus, the prohibition against private inurement in important respects largely subsumes the duty of loyalty. When a charity violates the prohibition against private inurement, the violation will often be explained by a breach of the duty of loyalty. Certainly, one can imagine situations when private inurement results from the breach of the duty of care, rather than the breach of the duty of loyalty. However, in many contexts a breach of the duty of loyalty will best explain why private inurement has occurred.

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92 See, e.g., Mabee Petroleum Corp. v. United States, 203 F.2d 872, 875-77 (5th Cir. 1953) (payment of excessive compensation to insider); Founding Church of Scientology v. United States, 412 F.2d 1197, 1202 (Cl. Cl. 1969), cert. denied, 397 U.S. 1009 (1970) (payment of excessive rent to insider). See Hopkins, supra note 81, at 562 ("[T]he private inurement doctrine requires that these transactions [between a charity and insiders] be tested against a standard of reasonableness.").

93 See, e.g., MNCA, 2008, supra note 11, § 8.60(a).

94 See, e.g., 805 ILL. Comp. STAT. ANN. 105/108.60(a) (West 2010) (stating that a self-dealing transaction is not voidable if it is "fair" to the corporation); N.Y. NOT-FOR-PROFIT CORP. LAW § 715(b) (McKinney 2005) (same if "fair and reasonable"); OHIO REV. CODE ANN. § 1702.301(A) (1)(c) (LexisNexis 2009) (same if "fair"); 15 PA. CONS. STAT. ANN. § 5728(a)(3) (West 1995) (same); TEX. BUS. ORGS. CODE ANN. § 22.230(b)(2) (West 2010) (same); VA. CODE ANN. § 13.1-871A.3 (Supp. 2010) (same); MNCA, 2008, supra note 11, § 8.60(a)(3) (same).

95 See PLNO, supra note 3, § 375(b).

96 For example, the board could negligently approve the sale of charitable assets for a below-market price to an insider who is not a fiduciary, such as a founder who does not serve as a director or officer but who nonetheless has great influence over the board.
By requiring the charity to receive a “fair deal” in transactions with insiders, the prohibition against private inurement all but commands charity fiduciaries to properly exercise their duty of loyalty.

III. THE FEDERALIZATION OF THE DUTY OF LOYALTY THROUGH THE FEDERAL EXCISE TAX REGIME

This Part of the Article discusses the federalization of the duty of loyalty through the labyrinthine federal excise tax regime governing charities. After briefly discussing four major types of charitable entities or entity components (private foundations, unaffiliated public charities, supporting organizations, and donor-advised funds), the Article surveys the excise tax regime governing various conflict-of-interest transactions involving each type of entity. Part III then observes that numerous disparate standards and rules pertaining to the duty of loyalty emerge from the excise tax regime—supra-trustee standards, trustee standards, and nonprofit-corporate-director standards, including procedural fairness rules.

A. General Classification of Charitable Entities

Section 509 classifies charitable entities according to their sources of support, their affiliation with other charities, and, in a few cases, the nature of their operations. A charity is classified as a private foundation if one of the subsections of section 509(a) does not describe it. The following discussion briefly describes the major types of charities.

97 I am not the first to recognize that the federal excise tax regime establishes fiduciary standards for charity managers. Over two decades ago, Henry Hansmann spoke of the “extensive corporation statute for private foundations under the private foundation provisions” of the Code, and opined that “the tax code's private foundation rules are a bad model upon which to base corporate-law fiduciary duties.” Symposium, supra note 49, at 838 (quoting remarks made by Prof. Hansmann during discussion of his paper). Similarly, Marion Freemont-Smith has written that the private foundation excise tax regime incorporates in the Code “standards of behavior for fiduciaries developed under the common law to assure loyalty and prevent recklessness in the handling of charitable assets.” MARION R. FREEMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 114 (2004); see also Helge, supra note 2, at 19 (referring to the “development of the IRS as federal regulator of the fiduciary duties of managers of charitable organizations”).


1. Unaffiliated Public Charities.—A tax-exempt charity described in section 509(a)(1) or 509(a)(2) is fairly described as an "unaffiliated public charity." These organizations include several familiar types. They first include traditional public charities—churches, primary and secondary schools, colleges, universities, hospitals, and certain medical research organizations affiliated with hospitals—which derive their non-private foundation status by virtue of their operations, rather than their sources of funding. Other types of charities qualify as unaffiliated public charities because of their sources of funding. One type includes any organization that normally receives a substantial portion of its total support—exclusive of income received in performing its tax-exempt function—from a governmental unit or from direct or indirect contributions from a broad segment of the general public. Another type of unaffiliated public charity is one that does not normally receive more than one-third of its total support from unrelated business activities and investments and normally receives more than one-third of its total support from any combination of gifts, grants, membership fees, and income from performing an exempt function.

2. Supporting Organizations.—Another type of charity classified as other than a private foundation is a supporting organization ("SO"). An SO maintains a formal relationship with another charity, akin to a subsidiary/parent or brother/sister relationship between for-profit corporations. An SO must satisfy three requirements. First, the SO must be organized and operated solely "for the benefit of, to perform the functions of, or to carry out the purposes of" a section 509(a)(1) or 509(a)(2) entity (hereinafter referred to as a "supported organization"). Second, the SO must satisfy one of three alternative statutory requirements ensuring that the supported organization controls the SO, or that the two entities share common

100 Although an entity described in paragraph (1) or (2) of section 509(a) may in fact have a formal affiliation with another charity, that affiliation is not essential to the entity's classification as other than a private foundation. Hence, the term "unaffiliated public charity" in this Article refers to any organization described in section 509(a)(1) or (2), regardless of its relationship to another charity. See I.R.C. § 509(a)(1)-(2) (West Supp. 2010).


102 See id. §§ 170(b)(1)(A)(vi), 509(a)(1); Treas. Reg. § 1.170A-9(c) (as amended in 2008) (setting forth two alternative tests for qualifying as a publicly supported organization).

103 See I.R.C. § 509(a)(2) (West Supp. 2010). For these purposes, qualifying support does not include receipts from certain insiders of the charity or from non-publicly supported charities. See id. § 509(a)(2)(A).


supervision or complementary operations. These requirements give rise to the classification of an SO as a “Type I,” “Type II,” or “Type III” SO in common nomenclature. Finally, designated insiders, including large donors and their family members, must not control the SO.

3. Private Foundations.—A tax-exempt entity described in section 501(c)(3) that is neither an SO nor one of the various types of unaffiliated public charities discussed in Part III.A.1 is classified as a private foundation. Typically, a single large donor or small group of donors (such as an individual, couple, family, or corporation) primarily or exclusively funds a private foundation.

4. Donor Advised Funds.—A donor-advised fund (“DAF”) is, strictly speaking, a component of a charity, rather than a distinct legal entity organized for charitable purposes. However, transactions involving a DAF are subject to special excise tax rules that practically require analysis of a DAF as though it were a charitable entity for some purposes of federal tax law. Subject to narrow exceptions, a DAF is a fund or account that meets the following four requirements. First, the charity that sponsors the fund must separately identify it “by reference to contributions of a donor or donors.” Second, the sponsoring charity must own and control the fund. Third, by reason of her status as a donor, the donor of the fund, or her designee, must have advisory privileges with respect to the distribution or investment of fund assets. Finally, the charity sponsoring the DAF must not be a private foundation.

108 See id. § 509(a) (West Supp. 2010).
110 See I.R.C. § 4966(d)(2)(B)(i)-(iii) (West Supp. 2010) (excepting from the definition of a DAF those funds that distribute money only to a single entity and those from which money may be distributed only for certain education-related grants upon the recommendation of a committee appointed by the sponsoring organization).
111 Id. § 4966(d)(2)(A)(i).
112 Id. § 4966(d)(2)(A)(ii).
113 Id. § 4966(d)(2)(A)(iii).
114 Id. § 4966(d)(1)(B) (defining “sponsoring organization” to exclude a private foundation). The definitional requirements of a DAF do not imply that a private foundation is prohibited from soliciting funds and holding them in separate accounts. Rather, any such account would simply not meet the definition of a DAF.
B. How the Federal Excise Tax Regime Regulates Common Conflict-of-Interest Transactions Involving the Four Types of Charitable Entities

1. Compensation of Insiders.—

   a. Private Foundations

   A federal self-dealing excise tax effectively prohibits most transactions between a private foundation and a “disqualified person” with respect to the foundation. A disqualified person includes an officer or director of the private foundation, any substantial contributor to the foundation, a member of the family of the foregoing, and entities in which any of the foregoing hold an ownership interest exceeding thirty-five percent. A “substantial contributor” to a private foundation is, in general, someone who has given more than $5,000 to the foundation, if her cumulative gifts exceed two percent of total gifts received by the foundation through the close of the year in which the contributor has made gifts to the foundation. Thus, fiduciaries, large donors, and their family members are all subject to the private foundation excise tax on acts of self-dealing.

   The payment to a disqualified person of compensation for “non-personal” services, like most conflict-of-interest transactions involving a private foundation, is taxable as an act of self-dealing. Similarly, the payment of excessive compensation to a disqualified person for any type of service is an act of self-dealing. However, a private foundation’s payment of non-excessive compensation to a disqualified person for personal services which are reasonable and necessary to carry out the foundation’s exempt purposes is not taxable. The category of “personal services” has been defined as services of a “professional and managerial” nature.

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115 See id. § 4941(d)(1).
117 Id. § 4946(a)(1)(A) (2006). A disqualified person also includes one whose ownership interest in a substantial contributor exceeds twenty percent, id. § 4946(a)(1)(C), and a member of the family of any such owner. I.R.C. § 4946(a)(1)(D).
118 I.R.C. § 4946(a)(1)(D).
119 Id. § 4946(a)(1)(E)-(G).
120 Id. §§ 507(d)(2)(A), 4946(a)(2).
121 See id. § 4941(d)(1)(D) (West Supp. 2010).
122 See id.
123 See id. § 4941(d)(2)(E).
124 Madden v. Comm’r, 74 T.C.M. (CCH) 440, 449 (1997); see also Rev. Rul. 74-591, 1974-2 C.B. 385 (ruling that the payment of a pension to a disqualified person was not an act of self-dealing when his personal services consisted of general administration, bookkeeping, investment counseling, disbursing funds, and managing real estate).
They include brokerage, legal, investment counseling, and general banking services. Moreover, members of the governing board of a private foundation may receive reasonable compensation for attending board meetings.

If the payment of compensation is an act of self-dealing under these rules, a tax is generally imposed both on the self-dealer (i.e., the compensated disqualified person) and any foundation manager (including a board member) who knowingly participated in the decision to pay the compensation. No tax is imposed on the private foundation itself. A disqualified person who receives compensation in an act of self-dealing cannot avoid taxation by proving her good faith or her reasonable belief that the transaction is entirely fair to the foundation. In contrast, a foundation manager is liable for paying the excise tax imposed on management if her participation in the decision to cause the foundation to engage in the act of self-dealing involves “knowing” that a self-dealing transaction exists, unless her participation “is not willful and is due to reasonable cause.”

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126 Id. § 53.4941(d)-3(c)(2) ex. 1.
127 Id. § 53.4941(d)-3(c)(2) ex. 2.
128 Id. § 53.4941(d)-2(c)(4), (d)-3(c)(2) ex. 3.
131 Id. § 4941(a)(2), (b)(2).
132 See Madden v. Comm’r, 74 T.C.M. (CCH) 440, 449 (1997) (imposing an excise tax on a disqualified person notwithstanding that the compensation for its services was at the market price).
133 United States Treasury regulations provide the following definition of “knowing”:

For purposes of section 4941, a person shall be considered to have participated in a transaction “knowing” that it is an act of self-dealing only if:

(i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing,

(ii) He is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing, and

(iii) He negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act.

134 I.R.C. § 4941(a)(2) (West Supp. 2010). The Treasury regulations appear to alter the statutory test slightly. Under the regulations, a foundation manager who knows that an act is an act of self-dealing is liable for payment of the tax on management only if her participation in the transaction “is willful and is due to reasonable cause.” Treas. Reg. § 53.4941(a)-1(b)
A manager generally escapes liability if her conclusion that no self-dealing occurred was based upon a reasoned, written opinion provided by competent legal counsel, or if she otherwise exercised ordinary business care in determining that a transaction is not taxable self-dealing.

b. Unaffiliated Public Charities

No federal excise tax applies to an unaffiliated public charity's payment of reasonable compensation to a disqualified person such as a member of its board of directors or anyone else who can exercise substantial influence over the charity's operations. Thus, in the case of an unaffiliated public charity, no distinction between "personal" and "non-personal" services is of import. If a public charity pays excessive compensation to a disqualified person, the amount exceeding reasonable compensation is subject to section 4958's excess benefit transactions excise tax, or "EBTET". A tax is generally imposed both on the disqualified person who receives the excess benefit and any manager (e.g., a director or officer) who participates in the decision to cause the charity to enter into the excess benefit transaction.

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(1)(iii) (as amended in 1973).
136 Id. § 53.4941(a)-1(b)(5).
137 Reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises under like circumstances. Id. § 53.4958-4(b)(1)(ii)(A) (2002). Standards for determining reasonableness (in the context of taxable trades and businesses) under section 162 apply for these purposes. Id.
138 In the context of an unaffiliated public charity, the term "disqualified person" means any person who, within the five years preceding the transaction at issue, was "in a position to exercise substantial influence over the affairs of the organization," as well as members of his family and certain affiliated entities. I.R.C. § 4958(f)(1) (West Supp. 2010).
139 A voting member of the board of directors is deemed to exercise substantial influence over the affairs of the charity, and therefore is a "disqualified person." See Treas. Reg. § 53.4958-3(c)(1) (2002).
140 An "excess benefit transaction" is any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.
141 A first-tier tax equal to 25% of the excess benefit is first imposed on the disqualified person. Id. § 4958(a)(1). A second-tier tax equal to 200% of the excess benefit is imposed on the disqualified person if the excess benefit is not corrected within a certain time period. Id. § 4958(b).
142 The tax on management equals ten percent of the excess benefit. Id. § 4958(a)(2). This tax is limited to a maximum of $20,000. Id. § 4958(d)(2). Congress enacted the EBTET
Although section 4958 does not relieve an over-compensated disqualified person from excise tax liability merely because she acted in good faith or with the reasonable belief that her compensation is entirely fair, both an interested disqualified person and disinterested directors may benefit from a rebuttable presumption that the compensatory arrangement is reasonable if certain procedures are followed. By Treasury regulation, payments of compensation are presumed to be reasonable under the following three conditions:

1. An authorized body comprised entirely of disinterested fiduciaries of the charity approved the compensation arrangement in advance of payment;
2. The body of fiduciaries obtained and relied upon appropriate comparability data before deciding upon the compensatory arrangement; and
3. In deciding upon the compensatory arrangement, the body of fiduciaries adequately and concurrently documented the basis for its decision.

When these three conditions are satisfied, the IRS can rebut the presumption of reasonableness only by developing contrary evidence based on facts existing on the effective date of the compensatory arrangement.

Additional protections are available to disinterested fiduciaries who approve conflict-of-interest transactions. Disinterested managers are subject to excise tax only when they participate in an excess benefit transaction while “knowing that it is such,” and they escape liability when their participation “is not willful and is due to reasonable cause.”

“Knowing” participation in an excess benefit transaction ordinarily does primarily to enable the IRS to penalize a charity’s insiders for violating the statutory prohibition against private inurement of a charitable organization’s net earnings without revoking the entity’s federal income tax exemption. See Jill S. Manny, Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?, 26 FORDHAM L. REV. 735, 750-52 (2007). Of course, a transaction subject to the EBTET also generally results in private inurement of a charity’s net earnings, and therefore generally constitutes grounds for revocation of federal income tax exemption.

The Treasury Department has recently published regulations listing factors that the IRS will consider in determining whether to revoke an entity’s tax exemption when it has engaged in an excess benefit transaction. Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii) (as amended in 2008).


143 Treas. Reg. § 53.4958-6(a) (2002). The regulations set forth detailed rules expounding upon these three requirements. See id. § 53.4958-6(c). Similar rules apply in establishing a rebuttable presumption of reasonableness involving a “transfer of property, or the right to use property.” Id. § 53.4958-6(a). The House Ways and Means Committee recommended the rebuttable presumption of reasonableness in its report accompanying the enactment of the EBTET. See H.R. REP. No. 104-506, at 56-57 (1996).

144 Treas. Reg. § 53.4958-6(b) (2002). In the case of non-fixed payments, additional facts existing up to the date of payment are also relevant. Id.

not exist if, after full disclosure to an appropriate professional, the manager relies on a reasoned written opinion of the professional in approving the compensatory arrangement.\(^{146}\) Additionally, if the governing body of the charity in question has acted in a manner sufficient to invoke the rebuttable presumption of reasonableness, a board member ordinarily does not participate "knowingly" in an excess benefit transaction.\(^{147}\) Moreover, a manager who does not know that a compensatory arrangement is an excess benefit transaction does not act "willfully,"\(^{148}\) and her participation is due to "reasonable cause," if she has acted with ordinary business care and prudence.\(^{149}\)

c. SOs

SOs are subject to the EBTET regime,\(^{150}\) which in some respects applies to them just as it applies to unaffiliated public charities. However, a few features of the regime, added by the Pension Protection Act of 2006 (the "PPA"),\(^{151}\) apply to SOs but not unaffiliated charities. Under the PPA, an excess benefit transaction includes certain transactions between an SO and particular insiders regardless of whether the transactions are fairly priced. For example, an excess benefit transaction includes any compensation provided by an SO to a "substantial contributor"\(^{152}\) or to certain persons or entities related thereto.\(^{153}\) The entire amount of this compensation is treated as an excess benefit.\(^{154}\) The EBTET is generally imposed both on the disqualified person\(^{155}\) who receives the excess benefit

\(^{146}\) Treas. Reg. § 53.4958-1(d)(4)(iii) (2002). Reliance on a professional is appropriate only if the professional is opining on a matter within her expertise. Id. Appropriate professionals include legal counsel, certified public accountants, and qualified compensation consultants. Id.

\(^{147}\) See id. § 53.4958-1(d)(4)(iv).

\(^{148}\) Id. § 53.4958-1(d)(5).

\(^{149}\) Id. § 53.4958-1(d)(6).

\(^{150}\) Like any organization described in section 501(c)(3) or (c)(4) but not classified as a private foundation, an SO is an "applicable tax-exempt organization" subject to the EBTET regime. See I.R.C. § 4958(e) (West Supp. 2010) (defining "applicable tax-exempt organization").


\(^{152}\) A substantial contributor is generally defined as someone who has given more than $5,000 to the organization, if her cumulative gifts exceed two percent of total gifts received by the organization through the close of the year in which the person in question has made gifts to the organization. I.R.C. § 4958(c)(3)(C)(i) (West Supp. 2010).

\(^{153}\) See id. § 4958(c)(3)(A)(i)(I), (B)(i)-(iii). Somewhat simplified, the related persons include members of the substantial contributor's family and business entities in which the substantial contributor's ownership interest exceeds thirty-five percent. Id. § 4958(c)(3)(B) (ii), (iii).

\(^{154}\) Id. § 4958(c)(3)(A)(ii).

\(^{155}\) Id. § 4958(a)(1), (b).
and on any manager (e.g., a director or officer of the SO) who participates in the decision to cause the SO to enter into the excess benefit transaction. 156

d. DAFs

The PPA generally subjects a DAF to the EBTET regime in the case of transactions involving the DAF and "disqualified persons" with respect to the fund. 157 These disqualified persons, referred to herein as "DAF insiders," include (1) any fund donor who has advisory privileges with respect to fund distributions or investments by virtue of her status as a donor; 158 (2) the designee of any such donor; 159 (3) a member of the family of any such donor or designee; 160 and (4) any business entity in which the ownership interest of the foregoing exceeds thirty-five percent. 161

Although some transactions between a DAF and a DAF insider are taxed like transactions between a disqualified person and an unaffiliated public charity, 162 the PPA created a special DAF rule akin to a provision applicable to SOs. Under this rule, an excess benefit transaction includes certain transactions between the DAF and DAF insiders regardless of whether the transactions are fairly priced. Specifically, an "excess benefit transaction" includes any grant, loan, compensation, or other similar payment" provided by a DAF to a DAF insider. 163 The entire amount of this compensation is treated as an excess benefit. 164 If compensation is paid to a DAF insider, the tax under section 4958 is apparently imposed on both the DAF insider and any director or officer of the sponsoring organization who participates in the decision to cause the DAF to pay the compensation.

2. Grants to Insiders.—

a. Private Foundations

A grant to a disqualified person quite literally falls within the definition of taxable self-dealing because it is a "transfer" of a private foundation's assets to a disqualified person. 165 A grant that constitutes an act of self-
dealing results in imposition of excise tax on both the self-dealer (i.e., the disqualified person receiving the grant) and any foundation manager (including a board member) who knowingly participated in the decision to make the grant.

As with the case of receiving excessive compensation, a disqualified person who receives a grant in a taxable self-dealing transaction cannot avoid excise tax liability by proving her good faith or her reasonable belief that the transaction is not an act of self-dealing. On the other hand, the same grounds for avoiding liability for excise taxes that are available to foundation managers in the case of a decision to pay prohibited compensation are likewise available with respect to disinterested management's decision to make a grant that constitutes an act of self-dealing.

b. Unaffiliated Public Charities

At first glance, a grant by a public charity to a disqualified person seems to satisfy the statutory definition of an "excess benefit transaction," for it confers an economic benefit upon a disqualified person without securing any direct consideration from the disqualified person for the public charity. However, by Treasury regulation, an economic benefit is disregarded if it is "provided to a person solely because the person is a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose." Thus, for example, the making of a scholarship grant by a public charity with educational purposes to a disqualified person (such as the child of a member of the charity's governing board) may not constitute an excess benefit transaction.

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4945(g)(3). That a grant is not a "taxable expenditure" does not insulate it from qualifying as an act of self-dealing.

166 Id. § 4941(a)(1), (b)(1). There is no excise tax imposed on the private foundation itself.

167 Id. § 4941(a)(2), (b)(2).

168 See supra notes 133–36 and accompanying text. Of course, the application of the rules limiting management's liability for excise taxes differs somewhat when managers have decided to approve a self-dealing transaction when the "reasonableness" of the terms of the transaction are irrelevant. For example, whereas managers would be entitled to rely on competent compensation consultants in determining the amount of compensation to pay the foundation's president, relying on an outside consultant's opinion as to the "reasonableness" of the amount of a grant to a disqualified person would not shield management from excise tax liability.


If the grant does not fall under the special rule discussed immediately above, a tax is generally imposed both on the disqualified person who receives the excess benefit and any exempt organization manager who participates in the decision to cause the charity to make the grant. The governing statutory provisions are those applicable to the payment of excessive compensation, discussed supra.\textsuperscript{171} As is the case with respect to its treatment of excessive compensation, section 4958 does not absolve a disqualified person who receives a taxable grant from excise tax liability merely because he acted in good faith or with the reasonable belief that the transaction was entirely fair to the public charity. Disinterested managers who participate in the decision to make a taxable grant are subject to excise tax under the same circumstances in which they incur a tax for authorizing the payment of excessive compensation.\textsuperscript{172}

c. SOs

The application of the EBTET to SOs in the case of grants is generally the same as its application to unaffiliated public charities. However, under a special rule, an excess benefit transaction includes any grant provided by an SO to a substantial contributor or to certain persons or entities related to a substantial contributor.\textsuperscript{173} The entire amount of the grant is treated as an excess benefit.\textsuperscript{174}

d. DAFs

Unlike the excise tax provisions governing any other type of charitable entity, the Code generally prohibits grants from a DAF to an individual—whether or not that individual is an insider with respect to the DAF.\textsuperscript{175} Moreover, and entirely separate from the provision that taxes grants in general from a DAF (section 4966), a special provision in section 4958 now defines an excess benefit transaction to include "any grant, loan, compensation, or other similar payment" provided by a DAF to a DAF insider.\textsuperscript{176} For purposes of the EBTET imposed by section 4958, the entire

\textsuperscript{171} See supra Part III.B.1.b.
\textsuperscript{172} I.R.C. § 4958(a)(2) (West Supp. 2010). The defenses of relying on an appropriate professional and acting with ordinary care, discussed in supra notes 145–49 and accompanying text, should apply similarly in the case of grants.
\textsuperscript{173} I.R.C. § 4958(c)(3)(A)(i), (B)(i)–(iii) (West Supp. 2010).
\textsuperscript{174} Id. § 4958(c)(3)(A)(ii).
\textsuperscript{175} See id. § 4966(c)(1)(A) (defining a taxable distribution generally to include any distribution to a natural person). There are a few exceptions to this general rule. See, e.g., id. § 4966(d)(2)(B)(ii), (C); I.R.S. Notice 66-109, 2006-2 C.B. 1121.
\textsuperscript{176} I.R.C. § 4958(c)(2)(A) (West Supp. 2010) (emphasis added).
amount of the grant is treated as an excess benefit.\textsuperscript{177} Section 4966 contains no “abdication” provision removing from its application any transaction resulting in tax under the EBTET of section 4958. Thus, it appears that a grant to a DAF insider triggers tax under both sections 4958 and 4966.

A section 4966 tax on a taxable distribution from a DAF is imposed on both the sponsoring organization\textsuperscript{178} and on a fund manager who agreed to the distribution while knowing that it is a taxable distribution.\textsuperscript{179} Insofar as a grant from a DAF to a DAF insider is a de jure excess benefit transaction under section 4958, both the sponsoring organization’s managers\textsuperscript{180} and the DAF insider\textsuperscript{181} apparently are liable for the EBTET, as well.

3. \textit{Loans to Insiders}.

a. Private Foundations

A loan from a private foundation to a disqualified person constitutes an act of self-dealing.\textsuperscript{182} In contrast, the lending of money by a disqualified person to a private foundation is not an act of self-dealing if the loan is without interest or other charge, and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3).\textsuperscript{183}

As in the case of other self-dealing transactions, a loan that constitutes self-dealing results in no imposition of excise tax on the private foundation itself. However, a tax is generally imposed both on the self-dealer\textsuperscript{184} (i.e., the disqualified person receiving the loan) and any foundation manager (including a board member) who knowingly participated in the decision to make the loan.\textsuperscript{185} The grounds (if any) for avoiding liability for the self-dealing excise tax discussed previously\textsuperscript{186} apply in the case of loans.

b. Unaffiliated Public Charities

A loan between an unaffiliated public charity and a disqualified person does not necessarily result in excise tax. The terms of the loan must be such that the disqualified person does not receive an excess benefit from

\textsuperscript{177} \textit{Id.} § 4958(c)(2)(B).
\textsuperscript{178} \textit{Id.} § 4966(a)(1).
\textsuperscript{179} \textit{Id.} § 4966(a)(2).
\textsuperscript{180} \textit{Id.} § 4958(a)(2).
\textsuperscript{181} \textit{Id.} § 4958(a)(1), (b).
\textsuperscript{182} \textit{Id.} § 4941(d)(1)(B).
\textsuperscript{183} \textit{Id.} § 4941(d)(2)(B).
\textsuperscript{184} \textit{Id.} § 4941(a)(1), (b)(1).
\textsuperscript{185} \textit{Id.} § 4941(a)(2), (b)(2).
\textsuperscript{186} See supra notes 132–36 and accompanying text.
the lending transaction. The general rules of the EBTET regime apply to loans, as in the case of other conflict-of-interest transactions.

c. SOs

The application of the EBTET regime to SOs in the case of loans differs greatly from its application to unaffiliated public charities. Two special rules are extremely important. First, an excess benefit transaction includes any loan provided by an SO to a substantial contributor or to certain persons or entities related to a substantial contributor.187 Second, an excess benefit transaction includes any loan provided by an SO to any disqualified person (unless, in general, the disqualified person is a publicly supported charity).188 In each case, the entire amount of the loan is treated as an excess benefit.189 The incidence of taxation in the case of loans, and the grounds for avoiding tax (if any), are the same as in other types of excess benefit transactions.

d. DAFs

An excess benefit transaction includes any loan provided by a DAF to a DAF insider.190 For purposes of the EBTET, the entire amount of the loan is treated as an excess benefit.191 If a loan is made to a DAF insider, apparently the tax under section 4958 is imposed on both the DAF insider and any manager of the sponsoring organization (i.e., a director or officer) who participates in the decision to cause the DAF to make the loan.

4. Other Conflict of Interest Transactions.—

a. Private Foundations

Most transactions between a private foundation and a "disqualified person" with respect to the foundation, including sales and exchanges of property,192 leases,193 and other forms of furnishing goods, services, and facilities,194 are effectively prohibited by the federal self-dealing excise

188 See id. § 4958(c)(3)(A)(i)(II).
189 Id. § 4958(e)(3)(A)(ii).
190 Id. § 4958(e)(3)(A)(i).
191 Id. § 4958(e)(2)(A).
192 Id. § 4941(d)(1)(A).
193 Id.
194 Id. § 4941(d)(1)(C).
tax. 195 Indeed, any “transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation” is an act of self-dealing.196 Whether the transactions are “fair” to the private foundation is generally irrelevant. If the self-dealing excise tax applies in the case of these other conflict-of-interest transactions, the incidence of tax and ability (or inability) to avoid excise tax liability are determined under the same rules discussed previously.197

b. Unaffiliated Public Charities

Other conflict-of-interest transactions involving an unaffiliated public charity and a disqualified person present no novel issues. The transactions must not confer upon a disqualified person any excess benefit from a related charity. The general rules of the EBTET regime apply to these conflict-of-interest transactions.198

c. SOs

Conflict-of-interest transactions between an SO and a disqualified person that have not been discussed previously in this paper are generally subject to the EBTET regime. Thus, except in the case of loans to disqualified persons, grants to substantial contributors and related parties, and payments of compensation to substantial contributors and related parties, the general rules of the EBTET regime apply to most transactions between SOs and disqualified persons. Examples of such transactions include sales of property, exchanges of property, and leases. Such transactions should not trigger excise tax if they convey no excess benefit on disqualified persons.

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195 Exceptions to the general rule apply in limited circumstances. See, e.g., id. § 4941(d)(2)(C) (“The furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3).”); id. § 4941(d)(2)(D) (“The furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public.”); id. § 4941(d)(2)(F) (“Any transaction between a private foundation and an incorporated disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization is not self-dealing “if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.””).
196 Id. § 4941(d)(1)(E).
197 See supra notes 130-36 and accompanying text.
198 Moreover, rules similar to those applicable to compensation arrangements apply in establishing a rebuttable presumption of reasonableness involving a “transfer of property, or the right to use property.” Treas. Reg. § 53.4958-6(a)(1)-(3) (2002).
However, under a special rule, an excess benefit transaction includes "any grant, loan, compensation, or other similar payment" provided by an SO to a substantial contributor or to certain persons or entities related to a substantial contributor. The legislative history of the PPA indicates that a "similar payment" includes an expense reimbursement. The entire amount of the payment is treated as an excess benefit. The incidence of taxation in the case of such payments, and the grounds for avoiding tax (if any), are the same as in other types of excess benefit transactions.

d. DAFs

There are three types of conflict-of-interest transactions between a DAF and a DAF insider which have not yet been discussed in this paper that must be identified and analyzed. First, and similar to the rule governing SOs and substantial contributors, an excess benefit transaction includes "any grant, loan, compensation, or other similar payment" provided by a DAF to a DAF insider. The legislative history of the PPA indicates that "similar payments" include an expense reimbursement. For purposes of the EBTET, the entire amount of the other similar payment is treated as an excess benefit.

A second class of other conflict-of-interest transactions between a DAF and a DAF insider consists of those which must be analyzed under the normal section 4958 rules. These rules, which essentially impose an objective fair dealing test, apply to transactions between a DAF and a DAF insider other than a loan to the DAF insider, a grant to the DAF insider, the payment of compensation to the DAF insider, or a similar payment to a DAF insider. An example is the purchase of a security held by the DAF by a DAF insider.

A third class of transactions consists of those governed by section 4967—a provision that applies apart from the EBTET regime. Under section 4967, a tax is imposed if, upon the advice of a DAF insider, a distribution from the DAF is made so as to result in that person or any other DAF insider "receiving, directly or indirectly, a more than incidental benefit as

202 Id. § 4958(c)(2)(A) (emphasis added).
205 See id. § 4958(f)(1)(E).
a result of such distribution." 206 A tax under section 4967 is imposed on any DAF insider who advised as to the distribution, 207 any DAF insider who received a benefit as a result of the distribution, 208 and on any fund manager who agreed to the making of a distribution, knowing that the distribution would confer the benefit. 209 However, the tax is coordinated with the EBTET regime; no tax is imposed under section 4967 with respect to any distribution if a tax has been imposed with respect to such distribution under section 4958. 210

C. Fiduciary Rules and Standards that Inhere in the Excise Tax Regime Governing Charities

One may discern three types of standards that characterize the federal excise tax regime's regulation of various conflict-of-interest transactions involving charity fiduciaries: (1) supra-trustee standards; (2) trustee standards; and (3) nonprofit-corporate-director standards. This sub-part explains the meaning of each type and then categorizes the excise tax rules according to their type.

"Supra-trustee" standards, as used herein, are those subsumed under various excise tax provisions that regulate fiduciaries more stringently than does the fiduciary duty of loyalty governing trustees of trusts. As discussed above, under the law of trusts, the "no further inquiry rule" does not apply in various situations. For example, a trustee is entitled to receive reasonable compensation for services performed in administering the trust. Hence, an excise tax provision effectively prohibiting the payment of reasonable compensation for necessary services provided by a trustee is a supra-trustee standard. Likewise, the trust law duty of loyalty does not subject transactions between a settlor and a trust that he created to the "no further inquiry rule" as long as the settlor does not also serve as trustee. Such transactions do not necessarily present a "conflict of interest" under the common law of trusts. Hence, a tax rule that effectively prohibits a fiduciary from dealing (on behalf of the charitable entity) with a major contributor can be conceptualized as a supra-trustee standard. 211

206 Id. § 4967(a)(1).
207 Id.
208 Id.
209 Id. § 4967(a)(2).
210 Id. § 4967(b).
211 Actually, insofar as the law of trusts permits a settlor to alter the no-further-inquiry rule by the terms of trust, any excise tax provision that categorically prohibits a transaction between a charitable organization and its governing fiduciaries is in some sense a supra-trustee standard. However, because no excise tax provision analyzed in this Part can be avoided entirely by authorizing the transaction giving rise to tax in the organization's governing instrument, this Article will ignore the fact that all of these transactions in some sense apply supra-trustee standards. If this Article did not ignore this fact, it would be impossible to distinguish
“Trustee standards,” as used herein, are those subsumed under various excise tax provisions that regulate fiduciaries essentially in the same way that the fiduciary duty of loyalty governs trustees of trusts. Similarly, “nonprofit-corporate-director standards” are those subsumed under various excise tax provisions that regulate fiduciaries essentially in the same way that the duty of loyalty governs directors of nonprofit charitable corporations.

1. Supra-Trustee Standards.—Fiduciaries presented with certain transactions are essentially subjected to supra-trustee standards under the federal excise tax regime. Consider the payment of compensation from a private foundation to a disqualified person for “non-personal services.” Although the duty of loyalty governing trustees of trusts does not appear to bar compensation for “non-managerial” services provided in the course of trust administration, such compensation has been held to constitute self-dealing. Because a fiduciary’s decision to pay herself for these services subjects her to excise taxation, she is effectively prohibited from receiving compensation for them. Another supra-trustee standard is that implicit in the general imposition of self-dealing excise tax on private foundation managers who participate in a decision to cause the foundation to enter into a sales, leasing, or lending transaction with a “disqualified person” who is not a foundation manager or related person. Most notably, the self-dealing excise tax applies to these transactions between a private foundation and a “substantial contributor” (a major donor), even one who is not an officer or director of the foundation. In contrast, the duty of loyalty does not categorically prohibit a trustee from engaging in such transactions with the settlor of a trust if the settlor is not the trustee or a person related to the trustee.

These supra-trustee standards are not confined to the private foundation context. Similar supra-trustee standards apply in the case of the following: (1) grants, loans, compensation, and “similar payments” from an SO to a

the differing fiduciary standards that the excise tax regime applies to various types of conflict-of-interest transactions examined herein.

214 Indeed, in the case of a member of the governing board of a private foundation who participates in the decision to pay another disqualified person—including a fellow member of the board—such compensation would generally be subject to the excise tax on organization management, notwithstanding that the member does not personally benefit from the transaction. See I.R.C. § 4941(a)(2), (b)(2) (West Supp. 2010).
215 Id. § 4941(a)(2), (b)(2).
216 Id. § 4941(d)(1)(A).
217 Id.
218 Id. § 4941(d)(1)(B).
substantial contributor to the SO;\textsuperscript{220} (2) grants, loans, compensation, and “similar payments” from a DAF to a DAF insider;\textsuperscript{221} and (3) donor-advised distributions from a DAF that result in any DAF insider receiving, directly or indirectly, more than an incidental benefit as a result of the distribution.\textsuperscript{222}

In each of these cases, an organization manager who participates in the decision to cause the charitable entity to make the described payments is generally liable for excise tax,\textsuperscript{223} no matter how “fair” or “reasonable” the terms of the transactions may be.

2. Trustee Standards.—The federal excise tax regime essentially subjects charity directors/trustees to a trustee standard in another class of transactions.\textsuperscript{224} The duty of loyalty governing trustees of trusts prohibits most types of self-dealing between fiduciaries and the trusts that they administer. This trustee standard generally applies in the case of the following: (1) sales,\textsuperscript{225} leasing,\textsuperscript{226} and lending\textsuperscript{227} transactions between a private foundation and its directors and officers,\textsuperscript{228} and (2) loans from an SO to a trustee/director of the SO.\textsuperscript{229} Of course, as discussed previously,\textsuperscript{230} the duty of loyalty permits a trustee to receive reasonable compensation for her services. Thus, one may rightly glean an implicit trustee standard in the exception to the private foundation self-dealing excise tax for payments.

\textsuperscript{220} See id. § 4958(c)(3)(A)(i)(I), (B)(i)-(iii) (West Supp. 2010). I have included the payment of taxable “grants” in the class of transactions subjecting fiduciaries to supra-trustee standards because grant recipients could, in theory, be members of the charitable class served by the charitable entity and be unrelated to trustees/directors. Such grants would not be prohibited by the fiduciary duty of loyalty. The same is true of grants from a private foundation to disqualified persons who are not trustees/directors or related persons; grants to such unrelated disqualified persons are still presumably subject to the excise tax on acts of self-dealing, notwithstanding that they do not necessarily imply breach of the duty of loyalty.

\textsuperscript{221} See id. § 4958(c)(2)(A). I classify the excise taxation of these transactions as implicitly imposing supra-trustee standards because DAF insiders have only advisory privileges, and hence are not, strictly speaking, “fiduciaries” of their funds. Thus, transactions between them and the sponsoring organization would not be prohibited by the duty of loyalty, as long as the donor-advisor is not also a director of the sponsoring organization. That the fiduciaries of a sponsoring organization are nonetheless subject to tax for approving these transactions implies that they are subject to supra-trustee standards.

\textsuperscript{222} See id. § 4958(c)(2)(A). I classify the excise taxation of these transactions as implicitly imposing supra-trustee standards because DAF insiders have only advisory privileges, and hence are not, strictly speaking, “fiduciaries” of their funds. Thus, transactions between them and the sponsoring organization would not be prohibited by the duty of loyalty, as long as the donor-advisor is not also a director of the sponsoring organization. That the fiduciaries of a sponsoring organization are nonetheless subject to tax for approving these transactions implies that they are subject to supra-trustee standards.

\textsuperscript{223} See id. § 4958(a)(2).

\textsuperscript{224} See Brody, The Limits, supra note 6, at 1435.

\textsuperscript{225} I.R.C. § 4944(d)(1)(A) (West Supp. 2010).

\textsuperscript{226} Id.

\textsuperscript{227} Id. § 4944(d)(1)(B).

\textsuperscript{228} See id. § 4946(a)(1)(B), (b)(1) (2006).

\textsuperscript{229} See id. § 4958(c)(3)(A)(i)(II) (imposing an excise tax on loans from an SO to a disqualified person).

\textsuperscript{230} See supra note 22 and accompanying text.
of reasonable compensation to a director/trustee who provides necessary "personal" services to the private foundation.231

3. Nonprofit-Corporate-Director Standards.—The federal excise tax regime essentially subjects charity directors/trustees to a modified nonprofit corporate-director standard in a third class of transactions. Most conflict-of-interest transactions are generally proper under nonprofit corporate law if they meet either a procedural or a substantive test of fairness.232 Substantive fairness is essentially the nominal standard that governs the following transactions under the federal excise tax regime: (1) all transactions between a trustee/director and an unaffiliated public charity, which are subject to the general EBTET regime;233 (2) the payment of reasonable compensation by a private foundation to a director/trustee for necessary personal services234 (which payment is also consistent with the trustee standard);235 and (3) transactions—other than a loan—between an SO and any trustee/director who is not a substantial contributor to the SO, which are subject to the general EBTET regime.236

Moreover, the test of procedural fairness governing transactions involving a nonprofit corporate director is approximated by the rebuttable presumption of reasonableness under the Treasury regulations interpreting

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232 See supra notes 8–12 and accompanying text.
233 See I.R.C. § 4958(c)(1)(A), (B) (West Supp. 2010). In a transaction between a charity and an interested director/trustee, the EBTET requires the charity to receive value equal to the benefit conveyed. Thus, the Code can be viewed as imposing a nominal fairness requirement in conflict of interest transactions.

One qualification of this point is in order, however. Disinterested directors can escape liability for the excise tax on management without ultimately establishing the fairness of the transaction to the charity. As previously observed, a manager of an unaffiliated public charity ordinarily is not subject to the excise tax on management under the EBTET regime if, after full disclosure to an appropriate professional, she relies on the professional’s reasoned written opinion as to the propriety of the elements of the transaction. Treas. Reg. § 53.4958-1(d)(4)(iii) (2002). Reliance on a professional is appropriate only if the professional is opining on a matter within her expertise. Id. Moreover, a manager who does not know that a compensatory arrangement is an excess benefit transaction escapes liability if she has acted with ordinary business care and prudence. Id. § 53.4958-1(d)(6). Accordingly, one would expect that a director who fulfills her state law duty of care in approving a conflict-of-interest transaction between an unaffiliated public charity and another disqualified person generally would not be liable for the EBTET on management. Stated another way, the general approach of the EBTET is to assume that the state law duty of care usually establishes the appropriate standard for evaluating the actions of disinterested directors of an unaffiliated public charity in deciding the reasonableness of transactions between the charity and other insiders.

A similar analysis applies to those transactions in which the Code subjects directors of private foundations and supporting organizations to nonprofit-corporate-director standards.

235 See supra note 22 and accompanying text.
the EBTET. These procedural rules, which establish a semi-safe harbor under the EBTET, apply to transactions involving “a compensation arrangement[,] . . . transfer of property, or the right to use property.” Of course, the rebuttable presumption technically applies only to transactions between disqualified persons and unaffiliated public charities and to those transactions between disqualified persons and SOs and DAFs which are not associated with supra-trustee and trustee standards.

IV. APPARENT ASSUMPTIONS UNDERLYING THE FEDERALIZED DUTY OF LOYALTY

This Part identifies important assumptions that appear to underlie the federalization of the duty of loyalty under federal tax law. These assumptions pertain to (1) the inadequacy of state law fiduciary standards and enforcement mechanisms; (2) the inadequacy of the fundamental income tax exemption requirements in ensuring adherence to the duty of loyalty; and (3) other assumptions, sometimes conflicting, that relate to the behavior of fiduciaries and large donors (and related persons) and appear to underlie the federal excise tax system governing charities.

As a preliminary matter, I must preface my remarks with the caveat that this Part merely sketches the assumptions that appear to underlie the federalization of the duty of loyalty owed by charity fiduciaries under federal tax law. Elsewhere, I have examined in detail the fiduciary assumptions that appear to underlie the federal excise tax regime governing compensation paid by charities. Thoroughly exploring these assumptions alone was no small undertaking, and offering the same approach with respect to all types of conflict-of-interest transactions is beyond the scope of this Article. Although a comprehensive analysis of the fiduciary assumptions underlying the federalization of the duty of loyalty must await another day, a preliminary overview of these assumptions nicely serves the purposes of this paper.

The most obvious assumption of the fundamental income tax exemption requirements, as well as the federal excise tax regime, is that regulating fiduciary behavior through the enforcement of state law fiduciary duties is insufficient to encourage fiduciaries of all types of charities to behave responsibly. Otherwise, there would be little need for federal tax rules that supplement state law; a charitable trust or corporation that is recognized as such under state law could simply be exempt from federal income tax. Precisely why state law is assumed to be inadequate is open

237 See supra notes 143-44 and accompanying text.
238 Treas. Reg. § 53.4958-6(a) (2002).
239 See supra Part III.C.1-2.
240 See Buckles, Fiduciary Assumptions, supra note 99, at 64-107.
241 See id. at 102-03.
to debate. Perhaps Congress believes that state attorneys general, who oversee the operations of charitable entities, cannot adequately monitor charity fiduciaries effectively. Although this “enforcement rationale” finds considerable support,\(^{242}\) it has limited explanatory force. Were the enforcement rationale sufficient, Congress could simply require, under penalty of taxation, that fiduciaries exercise their state law fiduciary duties or federal standards that correspond to the pattern of fiduciary duties under state law. However, the multiple standards inherent in the current legal framework—particularly those that inhere in the excise tax regime—obviously do not perfectly track state law. Thus, although the federalized duty of loyalty may assume that state law enforcement of fiduciary duties is inadequate, it surely also assumes that state law standards implicit in the duty of loyalty are inadequate, at least as they are currently applied.

Another assumption of the federalization of the duty of loyalty is that the penalty of losing federal income taxation for an entity’s failure to satisfy the fundamental exemption requirements is insufficient to ensure that charity fiduciaries will act as they should. Otherwise, the complex excise tax regime, which penalizes fiduciaries for approving or engaging in various conflict-of-interest transactions, would be unnecessary. The assumption is logically premised on the lack of complete alignment between a fiduciary’s personal interests and the interests of the charity that she governs. A fiduciary who desires to exploit a charity for private gain may care little that the penalty for her breach of the duty of loyalty is the loss of the entity’s federal income tax exemption. On the other hand, she may care greatly about incurring a hefty excise tax liability if she is caught exploiting the charity. This observation highlights the reality that, although the fundamental exemption requirements reinforce and to some degree subsume the duty of loyalty, they alone present weak enforcement mechanisms for ensuring adherence to the duty of loyalty by fiduciaries.\(^{243}\)

Another assumption of the federalized duty of loyalty is that multiple standards of fiduciary conduct should apply in different contexts. As explained previously, the excise regime employs three basic standards for discharging the duty of loyalty: supra-trustee standards, trustee standards, and nonprofit-corporate-director standards. Interestingly, only one of these standards applies consistently to any single type of charity; the nonprofit-corporate-director standard essentially applies to all conflict-of-interest


\(^{243}\) Cf. Reiser, supra note 50 (observing that the EBTET statute and regulations “better align available remedies with the aim of maintaining charities’ other-regarding orientation” than loss of federal income tax exemption because the EBTET penalizes fiduciaries directly).
transactions involving an unaffiliated public charity. In no other case are
the fiduciaries of one entity type subject to a single fiduciary standard.
Fiduciaries of private foundations are generally subject to supra-trustee
standards and trustee standards. Fiduciaries of SOs are subject to all three
standards in various circumstances. The members of the governing board
of an organization sponsoring DAFs are subject to supra-trustee standards
in the case of certain transactions between DAFs and DAF insiders; in
certain other transactions with DAF insiders, a “fairness” test applies.

Perhaps even more fascinating is that not one of the fiduciary standards
employed by the federal excise tax regime applies consistently to any single
type of conflict-of-interest transaction. The payment of compensation
can subject fiduciaries to supra-trustee standards, as well as trustee and
nonprofit-corporate-director standards. The same is true of loans, sales,
leases, and outright grants.

The inconsistent application of fiduciary standards appears to reflect
conflicting assumptions about fiduciary behavior. A recurring theme
concerns assumptions about whether the risk of exploitation of charities
by insiders is sufficiently high to tolerate conflict-of-interest transactions
ostensibly entered into on terms that are fair to the charity. The private
foundation self-dealing excise tax regime, which largely subsumes supra-
trustee and trustee standards, generally assumes that directors cannot be
trusted to exercise their duty of loyalty. The regime apparently assumes
that any risk that value-enhancing transactions will be provided at a sub-

244 See supra Part III.C.1-2. As noted previously, the payment of reasonable compensa-
tion for necessary services is consistent with both a trustee standard and a nonprofit corpo-
rate-director standard.

245 See supra Part III.C.1-3.

246 See supra Part III.C.3.

247 Except in the case of loans, grants, compensation, and similar payments from a DAF
to a DAF insider, transactions between a DAF and DAF insiders are subject to the general
that the charity receive a benefit equal in value to that which it conveyed, one could view the
statutory test as one of fairness, at least nominally. On the other hand, as previously observed,
a manager of a charity ordinarily is not subject to the excise tax on management under the
EBTET regime if, after full disclosure to an appropriate professional, she relies on the profes-
sional’s reasoned written opinion in approving a disqualified person’s transaction. Treas. Reg.
§ 53.4958-1(d)(4)(iii) (2002). Moreover, a manager who does not know that a transaction is an
excess benefit transaction escapes liability if she has acted with ordinary business care and
prudence. Id. § 53.4958-1(d)(6). A director who fulfills her state law duty of care in approving
the terms of a transaction between the charity and a major donor would therefore usually not
be liable for the EBTET on management. Establishing “ordinary prudence” would seem to
be a lesser burden than establishing fairness.

248 See supra notes 213-14, 231, and 233-35 and accompanying text.

249 For a discussion of these inconsistent assumptions underlying the excise taxation of
compensation, see Buckles, Fiduciary Assumptions, supra note 99, at 104-07. That discussion is
selectively summarized herein, and modified as necessary to examine numerous conflict-of-
interest transactions, not just compensation of fiduciaries.
optimal level under current law is outweighed by the risk that, if interested
directors and major donors are generally permitted to transact business
with a private foundation, they will exploit it.250

In contrast, the rule permitting payment of reasonable compensation for
personal services provided by a disqualified person to a private foundation
assumes quite the opposite. The EBTET, as applied to unaffiliated public
charities, also assumes the opposite, for it implements a standard (fairness,
based on market value) to govern all transactions with a disqualified person.
However, the excise taxes imposed on certain transactions between an SO
and a major donor—namely, those involving grants, loans, compensation,
and similar payments—apply even when the terms of the transaction
are fair to the charity. Hence, the tax as applied to SOs assumes that, if
major donors and related persons were permitted to enter certain kinds of
transactions with an SO, the expected loss from exploitation of the charity
would exceed the expected loss from the under-performance of services
that may obtain under current law. The excise tax applied to DAF insiders
assumes essentially the same with respect to the same class of transactions.
Counter-intuitively, however, other transactions between an SO and a major
donor, or between a DAF and a DAF insider, are apparently assumed not to
present the same risks. Sales of assets between these parties, for example,
are subject to the general standard of the EBTET regime (fairness, based
on fair market value).

Certain supra-trustee standards reflect assumptions that merit special
comment. Most supra-trustee standards expand the class of transactions
effectively subject to the “no further inquiry rule” to include certain
transactions between the charitable entity and major donors. These
standards appear to rest on the assumption that fiduciaries are just as inclined
to further the financial interests of major donors as they are to further their
own financial interests; therefore, the rationale for a categorical prohibition
against transactions with interested fiduciaries applies equally to certain
transactions with major donors. The basis for this assumption is unclear,
and exploring it invites numerous questions. Why should the law assume
that fiduciaries are inclined to further the financial interests of major donors
who are unrelated to the fiduciaries? Is the prospect of future donations
from these same donors relevant to this inquiry? If this assumption about
fiduciaries applies to some transactions with major donors, why does it not
apply to all transactions with them? If the assumption is reasonable with
respect to fiduciaries of private foundations, SOs, and DAFs, why is it not
reasonable with respect to fiduciaries of unaffiliated public charities with

250 The implicit cost-benefit analysis that seems to underlie the general private founda-
tion self-dealing excise tax is similar to that underlying the “no further inquiry” rule of trust
law. For a discussion of this analysis, see Langbein, supra note 14, at 951-52; Robert H. Sitkoff,
major donors? To what extent is the expected monitoring of charities by the general public relevant to this inquiry?

Clearly, this section raises as many questions as it answers. At a minimum, the discussion demonstrates that a thorough analysis of the assumptions underlying the excise taxation of conflict-of-interest transactions across charitable entity types is due.

V. ASSESSMENT OF THE FEDERALIZED DUTY OF LOYALTY

A. The Governmental Interest in Federalizing the Duty of Loyalty

For a number of reasons, the governmental interest in federalizing the duty of loyalty is strong. The governmental interest in requiring substantive fairness in conflict-of-interest transactions is very strong, and its interest in promoting procedural fairness is reasonable. Let us first examine the governmental interest in ensuring substantive fairness.

As explained previously, three fundamental requirements for obtaining and maintaining exemption as a tax-exempt charity may be understood as a federalization of the goal sought to be achieved through the law's imposition of a duty of loyalty on charity fiduciaries—that the charity's operations advance its exempt purposes, rather than other purposes (including the private interests of fiduciaries and other persons). The governmental interest in ensuring that a charity operates as intended is perfectly legitimate. After all, the government refrains from taxing charitable entities precisely because they perform a function that the government has deemed to justify exemption from taxation. Advancing purely private, personal interests does not, generally speaking, merit tax exemption. Ensuring that fiduciaries not exploit charities for private gain—a chief purpose of the duty of loyalty—through imposition of substantive fairness tests that inhere in the tax regime is therefore justifiable. Hence, the federalization of the duty of loyalty, subsumed within the fundamental exemption requirements, appears entirely legitimate.

The federalization of the duty of loyalty subsumed in certain excise tax provisions is likewise justified. Most obviously, fiduciary loyalty standards implicit in the general EBTET regime applicable to unaffiliated public charities, and to SOs and DAFs in the case of some transactions, reinforce the governmental interest furthered by the fundamental exemption requirements discussed above, especially the prohibition against private inurement of net earnings. Insofar as many excess benefit transactions give rise to private inurement, the EBTET discourages private inurement, thereby furthering a significant government interest. One narrow feature of the private foundation excise tax on acts of self-dealing functions similarly—reserving the taxation of compensation paid for necessary personal services performed by a fiduciary to instances in which this compensation
is excessive.251 Each of these excise tax provisions essentially imposes a substantive fairness test to further governmental interests in ensuring that charitable entities are indeed “charitable.”

In situations where substantive fairness tests are insufficient to deter fiduciary abuse, the government theoretically can also justify imposition of trustee standards, and even supra-trustee standards. The government has sought to do just that in certain contexts through the federal excise tax regime.252 Such standards appear justifiable if they are the most feasible way to ensure that a charity’s operations further exempt purposes. Of course, this observation ultimately begs the question of whether, and in what circumstances, substantive fairness tests are indeed insufficient to check fiduciary abuse. Unfortunately, as suggested by Part IV, it is at least questionable whether the current excise tax regime governing charities is based on a cogent analysis of the circumstances in which substantive fairness tests are insufficient to check fiduciary abuse.

The government’s interest in promoting procedural fairness is also defensible. Long relied upon in the context of conflict-of-interest transactions between fiduciaries and nonprofit corporations, procedural fairness rules encourage fiduciary behavior that is likely to produce a “fair deal” for the charity. Thus, the procedures necessary to invoke the rebuttable presumption of reasonableness under section 4958 are sensible. They both increase the probability that a charity will not engage in an excess benefit transaction and promote compliance with the prohibition against private inurement of net earnings. However, as I have argued elsewhere,253 it is questionable whether the rebuttable presumption should apply to interested fiduciaries themselves (as opposed to disinterested fiduciaries who rely on the presumption to avoid the section 4958 excise tax on management). The virtue of eliminating the presumption of reasonableness as applied to financially interested disqualified persons is that doing so would encourage them to provide services at a market discount in order to make it obvious that no excess benefit transaction has occurred.254

B. The Governmental Interest in Promoting Rational Uniformity of Fiduciary Loyalty Standards

One may posit a presumptive case for the governmental interest in promoting rational uniformity of fiduciary loyalty standards through the federal tax system. As used herein, “rational uniformity” does not require that only one set of loyalty standards govern fiduciaries through the Code.

252 See supra Part III.C.1.
253 Buckles, Fiduciary Assumptions, supra note 99, at 110-12.
254 Id.
Rather, rational uniformity requires that the tax regime subject fiduciaries who engage in conflict-of-interest transactions presenting the same risk of charity exploitation, and the same propensity to benefit charity, to the same standards of loyalty. Rational uniformity (1) promotes efficient transactions between fiduciaries and charities, and discourages those that are highly likely to be inefficient; (2) tends to promote enforcement and compliance with the Code, insofar as rules that appear to “make sense” are easier to understand and apply; and (3) tends to promote equity, insofar as fiduciaries who engage in similar behavior are taxed (or not taxed) similarly.

It is almost certain that rational uniformity of fiduciary loyalty standards throughout the federal tax regime has not been realized. The current tax regime creates and enforces fiduciary loyalty standards that vary widely across entity types, and even across types of transactions engaged in by the same entity. As discussed supra, only in the case of conflict-of-interest transactions involving unaffiliated public charities are fiduciaries subject to a consistent standard of loyalty. Further, no single fiduciary standard employed by the federal excise tax regime applies consistently to any single type of conflict-of-interest transaction. This state of affairs probably has arisen because the excise tax provisions that embrace various standards of loyalty are based on underlying assumptions that often conflict. A previous article has identified inconsistencies in the apparent assumptions underlying the federal excise tax regime in its treatment of compensation paid to charity insiders. Because many other conflict-of-interest transactions are subject to the same excise tax rules that apply to compensation, similar inconsistencies in assumptions probably explain current law’s excise tax system as applied to conflict-of-interest transactions in general. The presence of numerous conflicting assumptions suggests that the excise tax regime has not yet achieved rational uniformity.

C. Interaction Between the Federalized Duty of Loyalty and State Law Loyalty Standards and Remedies for Breach

1. In General.—In some respects, federal tax law complements and reinforces state law enforcement of the duty of loyalty. For example, the fundamental exemption requirements to some degree incentivize the discharge of state law fiduciary duties by those who govern tax-exempt charities. Fiduciaries who discharge their duties of loyalty (and their duties of care) reduce the likelihood that their charities will violate fundamental exemption requirements. Indirectly, the imposition of the fundamental

255 See supra Part IV.
256 See supra Part IV.
257 See Buckles, Fiduciary Assumptions, supra note 99, at 104-07.
258 As discussed previously, a complete exploration of these issues must await another day—in another article.
exemption requirements tends to heighten awareness among fiduciaries of the standards of loyalty to which they are subject. Moreover, the fundamental exemption requirements raise the stakes of breaching the duty of loyalty. By monitoring compliance with fundamental exemption requirements, the IRS essentially stands alongside state attorneys general in scrutinizing conflict-of-interest transactions. Breaches of the duty of loyalty that result in violation of the fundamental exemption requirements are therefore more likely to be discovered. Finally, in some cases the federal excise tax regime imposes standards on fiduciaries that correspond to those established under state law, and therefore tends to reinforce state law in some sense. Excise tax provisions imposing a trustee standard tend to complement state law in its regulation of charitable trusts, just as excise tax provisions imposing a nonprofit-corporate-director standard tend to complement state law in its regulation of nonprofit charitable corporations.

However, federal law is not entirely complementary of state fiduciary duties. The federalization of the duty of loyalty practically pre-empts several features of state fiduciary law, and this practical pre-emption may well impose costs on society. First, some transactions are effectively precluded by federal law, notwithstanding that they are permissible under state law and may add value to the charity. Consider, for example, the sale of assets from a director of an incorporated private foundation to the entity for a price clearly below market value. Because the below-market sales price confers a benefit on the charity, the sale would be permissible under the general loyalty standards under state law, but the private foundation self-dealing excise tax effectively forbids it as a general rule. The same tax also forbids the entity from lending to a director—even if the note bears above-market interest—and leasing assets to a director—even if the foundation can extract above-market rental payments. The rule effectively prohibiting an SO from entering into certain transactions with a major donor or parties related thereto also conflicts with typical state law and similarly forecloses some value-enhancing transactions.

Second, disparate federal/state fiduciary standards tend to decrease administrative efficiencies that would likely more fully obtain were

259 Cf. Brody, The Limits, supra note 6, at 1429 ("Per se prohibitions sweep too broadly, and void too many transactions that would benefit the charity and thus benefit the public.").

260 Of course, some state statutes now mimic the private foundation excise tax rules by deeming private foundations to have governing instruments that forbid transactions giving rise to federal excise tax. See, e.g., Tex. Bus. & Orgs. Code Ann. § 2.107 (West 2009); Tex. Prop. Code Ann. § 112.055 (West 2007). These statutes are presumably designed to prevent inadvertent violations of the federal excise tax regime, rather than to embrace the fiduciary standards that inhere in the excise tax regime as reflective of general state policy.


262 Id. § 4941(d)(1)(B).

263 Id. § 4941(d)(1)(A).

264 See id. § 4958(c)(3)(A)(ii)-(iii).
governmental enforcement interests better aligned. When the federalized duty of loyalty implicit in a federal tax provision corresponds to the duty of loyalty under state law, one would expect state and federal government enforcement efforts to improve. When one level of government discovers a breach or possible breach, it can so inform the other level of government.\(^{265}\) Conversely, disparate standards of loyalty lessen the effectiveness of this type of communication, at least to some degree. To illustrate, that an incorporated private foundation has engaged in an act of self-dealing under section 4941 by buying equity securities from a director says nothing about whether the transaction is appropriate under state law. Should the IRS inform a state attorney general of the act of self-dealing, the state would still need to devote resources to investigate fully the reasonableness of the terms of the transaction. Nonetheless, informing the state attorney general that an act of self-dealing has occurred would direct her attention to the transaction for further evaluation, thereby enhancing the overall monitoring function of the state. Thus, the disparate standards still may generate efficiency gains for the state, relative to a world in which the duty of loyalty had not been federalized to any degree.


Another relevant question is whether the sanctions imposed by federal law for violating the federal tax regime's fiduciary standards interact well with remedies available under state law when a fiduciary breaches her duty of loyalty. The federal tax regime essentially is designed to (1) deter fiduciary misconduct, as well as exploitation of charities by major donors and persons related to them; (2) provide restitution to the government for unpaid taxes when fiduciaries fail to operate the charity in accordance with tax exemption requirements; (3) promote restitution to charities when their fiduciaries breach a federalized duty of loyalty; and (4) penalize certain charities when their fiduciaries breach a federalized duty of loyalty. The tax regime deters fiduciary misconduct and donor exploitation of charities primarily through the various excise taxes imposed on disinterested managers\(^{266}\) and financially interested insiders.\(^{267}\) Though the provisions imposing excise taxes are penal, they obviously are intended to deter the types of transactions that give rise to tax. They do so not only

\(^{265}\) Under current law, the IRS does notify state governments of determinations of this nature. Treas. Reg. § 301.6104(c)-1 (as amended in 1981).


\(^{267}\) See, e.g., id. §§ 4941(a)(1), (b)(1), 4958(a)(1), (b), 4967(a)(1).
by moderately taxing disinterested fiduciaries for complicity, but also by heavily taxing interested insiders—thereby dramatically decreasing the financial incentive to enter into disfavored transactions.

The tax regime provides restitution to the federal government primarily by taxing the income of charities that have failed to satisfy the requirements for exemption (even retroactively to the date on which the charity initially failed the operational test). The tax regime promotes restitution to charities, albeit imperfectly, by imposing draconian second-tier excise taxes upon disqualified persons and/or charity managers who fail to "correct" a transaction with respect to which a breach of a federalized duty of loyalty has occurred. In general, "correction" requires "undoing" the transaction (or the unlawful benefit conferred thereby on the disqualified person) so as to place the charity in a position "not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." Insofar as second-tier excise taxes can be avoided only through "correction" of the transaction in question, the tax regime tends to promote restitution to charities, or at least recompense.

Under the EBTET, correction essentially requires the disqualified person to pay damages and interest. Under the private foundation self-dealing excise tax regime, correction generally requires the disqualified person to rescind the transaction, and make certain that the private foundation also receives (1) net profits realized by the disqualified from the consideration supplied by the foundation in the self-dealing transaction; and (2) the benefit of any post-self-dealing transaction fluctuation in the market value of property involved in the act of self-dealing. Thus, "correction" in the case of private foundation self-dealing transactions more closely tracks restitution principles than in the case of excess benefit transactions subject to the EBTET.

Finally, some provisions of the Code penalize a charity itself when its fiduciaries fall short of a federalized fiduciary standard. Most notable

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270 See, e.g., id. § 4941(b)(2) (50% tax).

271 Id. § 4958(f)(6) ("The terms 'correction' and 'correct' mean, with respect to any excess benefit transaction, undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."); id. § 4941(e)(3) ("The terms 'correction' and 'correct' mean, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.").

272 See Treas. Reg. § 53.4958-7(b)(1), (c) (2002).

is section 507, which generally imposes a “termination tax” on a private foundation for “willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax” under the private foundation excise tax regime.274 The tax equals the lesser of (1) the substantiated amount of “the aggregate tax benefit” attributable to the foundation’s section 501(c)(3) status, or (2) the value of the foundation’s net assets.275

b. Effect of Federal Sanctions on State Law Remedies

Although the excise tax penalties surely do deter breaches of the federalized duty of loyalty, they may to some degree curtail the effectiveness or availability of state law remedies that an attorney general can pursue when deterrence fails. For example, the initial tax imposed on a disqualified person for engaging in an excess benefit transaction is twenty-five percent of the excess benefit.276 Should the state attorney general desire, on behalf of the charity, to collect damages or restitution from the disqualified person for breach of the duty of loyalty, doing so may be more difficult when the disqualified person must also pay the federal government twenty-five percent of the damages.277

On the other hand, the second-tier excise taxes imposed under the private foundation excise tax regime and under the EBTET regime appear to encourage complete or partial restitution to charity, for “correction” is what enables insiders to avoid these exceptionally steep taxes. Because “correction” under the private foundation self-dealing excise tax regime closely parallels restitution under state law, the regime appears to bolster state law enforcement efforts, at least when the state attorney general deems restitution available and desirable.278 The same is true, to a lesser degree, of “correction” under the EBTET regime. “Correction” under the EBTET does not necessarily make the charity as whole as true restitution, but neither does it foreclose a state attorney general from pursuing additional remedies when there has been a breach of the duty of loyalty. Insofar as

275 Id. § 507(c)(1), (2).
276 Id. § 4958(a)(1) (West Supp. 2010).
277 Another problem involves the effect that imposition of dual (i.e., state and federal) monetary penalties on fiduciaries could have on prospective board members. Those who are contemplating board service may refuse to serve if they perceive that the penalties for breach of fiduciary duties for actions taken in good faith are excessive. Cf. Brody, The Limits, supra note 6, at 1413 (“[T]he fear of potentially high monetary liability discourages good directors from serving.”).
278 Of course, in some cases “correction” of a self-dealing transaction under section 4941 will exceed the monetary remedy required by restitution under state law, insofar as not all self-dealing transactions are breaches of the state law duty of loyalty.
“correction” under the EBTET regime results in partial restitution, it, too, appears to augment state law enforcement efforts.

More problematic, however, are penalties imposed upon charitable organizations themselves when their fiduciaries fall short of a federalized duty of loyalty. Consider the private foundation termination tax. It is triggered, and payable by the entity, when there have been repeated, willful acts of self-dealing. This is so even when the acts of self-dealing do not constitute breaches of the state law duty of loyalty.279 Thus, in this instance, federal law essentially forces the transfer of assets from a charitable entity to the federal government, notwithstanding that charity fiduciaries may have satisfied general state law standards of loyalty. In such circumstances, it is difficult to see how a state’s interest in overseeing charitable funds has been furthered. Granted, the IRS has the authority to abate the termination tax if the private foundation distributes all of its net assets to established public charities,280 or if a state officer notifies the IRS that court-approved corrective action has been taken to ensure that “the assets of such private foundation are preserved for . . . charitable or other purposes specified in section 501(c)(3).”281 But these grounds provide little solace for a charity when its fiduciaries have done nothing to harm it, notwithstanding their involvement in self-dealing transactions under section 4941. In situations in which no insider has misappropriated charitable assets, it is even questionable whether a state attorney general with limited resources would seek judicial approval of a course of action to ensure that “the assets of such private foundation are preserved” for charitable purposes. And even if she did so—perhaps because she desires to protect the assets of a respected regional private foundation from what amounts to confiscation by the federal government—federal law would have essentially forced her to expend limited resources that, in the absence of the federal law, she would have considered better spent elsewhere. Thus, the private foundation termination tax may well interfere with efficient state law enforcement of fiduciary duties, at least in some instances.

The sanction of revoking federal income tax exemption for a breach of the federalized duty of loyalty that culminates in private inurement may also interfere with the remedy a state attorney general would prefer. Consider a charity governed by a board that causes its earnings to inure to the benefit of an insider. The IRS has the power to revoke the entity’s federal income tax exemption, even if the consequent income tax liability

279 Technically, all acts of self-dealing are improper under state law, for (1) a fiduciary is generally required to obey the terms of the charity’s governing instrument; and (2) federal law requires a tax-exempt private foundation’s governing instrument to prohibit it from engaging in acts of self-dealing. See I.R.C. § 508(e)(1)(B) (West Supp. 2010).
280 See id. § 507(g)(1).
281 Id.
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is vastly greater than the amount of private inurement involved. The state attorney general may prefer to petition a court for equitable relief, such as ordering the appointment of a new governing board and the adoption of good governance practices, with the result that the charity will continue as a tax-exempt entity owning most of its assets. The IRS may prefer to subject the entity to federal income taxation, thereby depleting the assets that can be used for charitable purposes. Because the IRS has great discretion in revoking an entity's tax exemption when it has failed to satisfy a fundamental requirement of exemption under federal tax law, the IRS ultimately decides whether the state attorney general can effectively pursue her preferred remedial course of action. Perhaps the IRS properly wields this discretion, insofar as all entities operate with plain notice of the requirements for maintaining exempt status. On the other hand, one could argue that the discretion of the IRS should be sharply curtailed when the charity has taken remedial action, under the supervision of a state attorney general, to correct breaches of the duty of loyalty and to prevent future ones from occurring.

CONCLUSION

Federal tax law dominates the fiduciary standards of loyalty governing charity fiduciaries. It does so through the fundamental requirements that charities must satisfy to obtain and maintain exemption from federal income tax, and through the increasingly complex excise tax regime governing charity fiduciaries and major donors. Current law effectively imposes at least three fiduciary loyalty standards that apply across various types of charitable entities and conflict-of-interest transactions. Although the law may rightly impose these different standards, there are good reasons to doubt that the current system is based on consistent, rational assumptions. Moreover, the current federal tax regime may well complement state enforcement of fiduciary standards in some contexts, but probably interferes with such enforcement in others.

Where do we go from here? The problems identified in this Article suggest a need for (1) conducting a more detailed analysis of the assumptions apparently underlying the federal excise tax regime's treatment of conflict-of-interest transactions; (2) developing a better framework for evaluating (a) precisely what fiduciary standards should govern each type of charitable entity, and (b) whether the answer to the preceding inquiry is contingent on (i) the type of conflict-of-interest transaction in question or (ii) other factors not currently accounted for under the excise tax regime; and (3) reconsidering the federal sanctions that should apply to breaches of a

\footnote{For a list of factors that the IRS considers in determining whether a charity's participation in transactions subject to the EBTET will result in revocation of the charity's federal income tax exemption, see Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii) (as amended in 2008).}
federalized duty of loyalty, in view of their likely effect on remedial efforts by the states.