NONPROFIT INTERJURISDICTIONALITY

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INTRODUCTION

Two stories from the troubling side of nonprofit organizations led me to consider the problem I now discuss.

Several years ago the Citizenship Education Fund, a nonprofit corporation headquartered in Illinois and led by Reverend Jesse Jackson, received unwelcome attention upon the revelation that a key employee had quietly departed with very generous severance benefits after having given birth to Reverend Jackson's child.[1] The employee's salary was not listed, as it should have been, among the five highest paid employees on the nonprofit's annual Form 990 tax returns.[2] The Illinois state Attorney General allowed the Coalition retroactively to amend its state charities report, and then his office closed its investigation.[3]

On cable television, Bill O'Reilly, a vocal conservative critic of Reverend Jackson, asserted that political calculations colored the Attorney General's "go lightly" approach—particularly because the Attorney General was seeking the governorship at the time. O'Reilly demanded to know why a full "audit" had not been done by the Attorney General.[4] The Attorney General defended his actions, in another venue, by stating that he was adhering to the normal practices of his office and referring interested parties to the possibility of other enforcement activity by the Internal Revenue Service.[5]

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1. Tim Novak & Chuck Neubauer, *Jackson Charity Adds Donors to Tax Filing*, CHI. SUN-TIMES, Apr. 27, 2001, at 12; Jerry Seper, *Illinois Won't Investigate Jackson's Rainbow Group*, WASH. TIMES, Mar. 29, 2001, at A3.

2. *See* Novak & Neubauer, *supra* note 1, at 12.

3. *Id.*

4. Mr. O'Reilly apparently confused "auditing," an ordinary function of Internal Revenue examiners, with "investigation," an ordinary activity for a state Attorney General to authorize. *The O'Reilly Factor* (Fox News Network television broadcast, Apr. 2, 2001) (transcript no. 040201cb.256); *The O'Reilly Factor* (Fox News Network television broadcast, Mar. 28, 2001) (transcript no. 032801cb.256).

5. *See* Seper, *supra* note 1, at A3.

The American Conservative Union, a conservative taxpayer organization, formally requested that the IRS launch proceedings that could have led to the revocation of the Coalition's exempt status; but the IRS declined to pursue the matter.[6] A former IRS Commissioner observed that the IRS had fewer resources than ever before with which to monitor nonprofit returns.[7]

* * * *

At about the same time, the Enron Corporation, led by Kenneth Lay, collapsed in a scandal of legendary proportions. Allegations of wrongdoing included fraudulent accounting reports, tax evasion, phony commodities trading, offshore debt concealment, pension manipulation, and the misappropriation of funds by executives at the highest levels of the corporation.[8] As Enron's trouble became progressively more evident, its stock price declined from a high near $83.00 a share in January of 2001.[9] It sputtered downward for the rest of the year and fell through the floor, declining below 67 cents in January 2002.[10] The value of the assets held by the private Kenneth and Linda Lay Family Foundation moved in a correspondingly catastrophic fashion because the Foundation's portfolio consisted predominantly of Enron stock, which had been donated by the Lay family.[11]

In the flush times, the Lays had reduced their personal tax liability by donating to their foundation shares of Enron, which they had obtained on favorable terms. Personal tax returns are not public, and the matter cannot be determined with certainty, but it is possible that Mr. Lay and his wife Linda deducted millions of dollars in a single year to reduce their personal tax liability. The amount of their charitable deductions could have been valued at the appreciated fair market value ($48,186,482) of the Enron gift, rather than at the cost to Mr. Lay of the stock he donated ($4,160,861).[12]

6. *The O'Reilly Factor* (Fox News Network television broadcast, Apr. 29, 2002) (transcript no. 042904cb.256).

7. *The O'Reilly Factor* (Fox News Network television broadcast, Mar. 9, 2001) (transcript no. 030902cb.256); *The O'Reilly Factor* (Fox News Network television broadcast, Feb. 2, 2001) (transcript no. 020202cb.256).

8. *See* Wikipedia, *Enron Corporation*, *at* http://en.wikipedia.org/wiki/Enron_Corporation (last visited Mar. 1, 2005).

9. Eric Berger, *NYSE Blocks Further Trades of Enron Stock*, HOUS. CHRON., Jan. 16, 2002, at B1.

10. *Id.*

11. Sandra J. Champion, *Leaving a Lasting Legacy*, SENIOR CONSULTANT, Apr. 2003, at 2 (stating that 90% of the foundations $52 million portfolio consisted of Enron stock), *at* http://www.srconsultant.com/ Articles/2003-04-Champion-Lasting-Legacy.pdf.

12. In 2000 Kenneth Lay's compensation exceeded $140 million and may have exceeded $168 million. *See* PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON GOV'T AFFS., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 52 (2002); Steve Schifferes, *Enron's Trail of Deception*, BBC NEWS, Feb. 13, 2003, *at* http://news.bbc.co.uk/1/hi/business

As Enron stock prices collapsed, the directors of the Lay Family Foundation—virtually all of them Lay family members and some of whom were also employees of Enron—confronted a potential conflict between their duties to the Family Foundation and their loyalty to Enron Corporation.[13] The foundation directors could have rationalized a delay in selling Enron stock by equating Enron's fortunes with the fortunes of the Foundation, since they held so many shares; but this must have become an increasingly difficult illusion to sustain. Or, the Securities and Exchange Commission regulations or the Lays themselves may have imposed a restriction on the ability to sell the stock.[14] A timely decision during 2001 by the family dominated board to sell off the Foundation's Enron stock would have helped conserve the market value of the Foundation's charitable as-

/2759613.stm; *see also* Form 990-PF returns of the Kenneth L. and Linda P. Lay Family Foundation, 2000, 2001, 2002, *at* www.Guidestar.com, http://www.guidestar.org/search/report/docs.jsp [hereinafter Lay Foundation Forms 990]. *See generally* Kim Cobb, *The Fall of Enron/ Ripple Effect: Oregon Subsidiary Feels Energy Giant's Bankruptcy*, HOUS. CHRON., Feb. 3, 2002, at A16.

13. The eight-person board of directors in 2001 included Linda Lay, president (wife of Kenneth); Kenneth Lay, vice president; Robyn Herrold Lay Vermeil (daughter of Kenneth); Mark K. Lay (son and an Enron contract employee); Elizabeth Ayers Lay Vermeil, as well as other Lay relatives. Only the secretary of the Foundation, Holly Korman, appears unrelated to Kenneth and Linda Lay.

14. Rule 144 of the Securities and Exchange Commission imposes holding periods applicable to donees or purchasers of unregistered stock from insiders, which could have affected the rate at which the foundation could divest itself of Enron stock. 17 C.F.R. § 230.144 (2004). Willful disregard of Rule 144 would have exposed directors to significant penalties, possibly including criminal sanctions. Timing restrictions placed by donors on the sale of donated securities are enforceable, furthermore—although such restrictions would detrimentally effect deductibility and the enforceability of such restrictions has its limits. *See* Carol J. Sulcoski, *Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5*, 88 MICH. L. REV. 604 (1989). *See generally* Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400 (1998). Directors also should have considered section 53.4944-1(a)(2)(i) of the Internal Revenue Service's Foundation and Similar Excise Tax Regulations, which states that:

> an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

26 C.F.R. § 53.4944-1 (2004). With respect to donor-imposed restrictions, if any, directors could have weighed their common law and statutory duties to preserve the assets of their collapsing foundation against the costs attached to an intentional breach of restrictions—which in this case would have been low or unquantifiable.

There are also regulations which require Foundations to diversify their portfolios, but those sections would not, in all likelihood, have compelled action. Section 4943(c) of the United States Code provides that a private foundation has excess business holdings in a corporation if its holdings exceed its "permitted holdings," generally limited to twenty percent of the corporation's voting stock. 26 U.S.C. § 4943(c) (2000). The Lay family holdings, even taken together with the holdings of the other foundation board members are not likely to have approached this level. The foundation itself only held .5% of Enron's outstanding stock. In his personal capacity Kenneth Lay owned fluctuating amounts of stock in Enron—but apparently not at or near the 20% level—between 1999–2002. *See* Tim Francis-Wright, *The Lay Family Charity Began at Work*, *at* http://www.bear-left.com/original/2002/0210layfamily.html (last visited Mar. 2, 2005). *See generally* Gary M. Brown, *Investigating Enron: Life After Enron and Sarbanes-Oxley*, VAND. MAG., Summer 2003, at 29.

sets. For a Foundation officer to recommend holding onto it might have been imprudent behavior.

But such a sell-off would not have been in the personal best interest of the Foundation's president, Linda Lay, who was married to the Foundation's vice president, Kenneth, who was Enron's president. For an Enron officer to recommend selling Enron stock might have been a disloyal act. Selling, furthermore, might have prompted accusations of insider trading. Also, a sell-off might further have depressed share values and eroded confidence in the company if the news of such a transaction became public. In fact, however, the Foundation did not divest itself quickly enough to avoid gigantic market losses.[15]

The Lays received large personal tax benefits as a reward for their donations to their family charity, but operating charities in Texas and elsewhere, many of which received substantial long-term gift commitments from the Foundation, were hugely distressed by the collapse of the Lay Foundation's asset base.[16] The vast bulk of its charitable assets disappeared before pledges could be honored and mission-oriented expenditures undertaken. The tax benefits the Lays received exceeded, by an order of magnitude, what the Foundation had left to give away to operating charities.[17]

At a moment of public interest in Enron's affairs—during the critical period in 2001 when the value in Enron stock in the Foundation's portfolio was collapsing—neither state nor federal regulators were anywhere to be seen. If the Texas Attorney General's office or federal regulators closely monitored the activities of this private Foundation at that time, there is no public evidence of the fact. Timely action by either regulator might have

15. The 2001 return of the Foundation declared a fair market asset value of $2,415,130, and the 2002 return a fair market asset value of $1,452,877. The net value of noncharitable-use assets declined from $40,091,829 in 2000 to $26,945,796 in 2001. *See* Lay Foundation Forms 990, *supra* note 12. Prior to 2001 the largest holding, by far, was stock in Enron. *See id.* The 2001 form contained an explanatory footnote stating that the market value of the foundation's assets "declined significantly in 2001 due to reduction in the market value of public securities owned. As of December 31, 2001, the amounts approved for future payment exceed the value of the Foundation's assets." *See* Lay Foundation Form 990 (2001), § XV, line 3b, *at* http://www.guidestar.org/Documents/2001/760/454/2001-760454168-1-F.pdf; *see also* Bill Murphy, *Dwindling Lay Foundation Can't Fulfill Year's Pledges*, HOUS. CHRON., Dec. 7, 2002, at A35; Francis-Wright, *supra* note 14 (tracing giving patterns and suggesting that it served Enron's purposes); NYSSCPA.org, *Lay Family Foundation Can't Meet Pledges* (Dec. 9, 2002) (reporting that the Foundation was unable to meet its pledges), *at* http://www.nysscpa.org/home/2002/1202/2week/article5.htm.

16. *See* Rick Cohen, *Corporate Giving: De-Cloaking Stealth Philanthropy*, NONPROFIT Q., Fall 2002, *at* http://www.plannedlegacy.com/newsletter/10_02/corporate_giving.html (last visited Mar. 2, 2005).

17. *See generally id.*

hastened diversification of the Foundation's equities accounts, or hastened the sale of Enron stock, and served the public interest.[18]

Adding salt to the wound, the Foundation was permitted by state and federal regulators to delay filing its 2001 state and federal nonprofit reports. Timely public filings could have drawn public attention to the board's decision making and provoked enforcement activity by regulators. Instead, the Foundation received an automatic three-month extension, and then another three-month discretionary extension; and so rather than being filed in May of 2002, the return of the Kenneth and Linda Lay Foundation was filed in November of 2002.[19] It appears that during the critical year when the Enron stock declined, neither the Attorney General of Texas nor the Internal Revenue Service asked the Foundation to render an interim accounting of its affairs.[20]

Reporters who inquired about the conduct of the Kenneth and Linda Lay Family Foundation's business at that time received little assistance from the Foundation. Those who contacted the Texas Office of the Attorney General were referred to the filing extension that had been granted by the IRS. Did the Attorney General, or the IRS, have the authority to find out what the Foundation was doing with its Enron shares? Neither, apparently, opted to assume responsibility for carrying that particular ball.[21]

As the Jackson and Enron episodes unfolded, they revealed questionable conduct by nonprofit officers and hesitation by regulators. Even discounting for the political motivations of critics of the organizations involved, they direct our attention to the reluctance of nonprofit regulatory authorities to move in an aggressive and timely fashion when to do so might be politically difficult—despite abundant grounds for concern about damage to the public interest.

At a more provocative level than political ax-grinding, these stories expose a pattern and practice in nonprofit law enforcement today. Principal nonprofit enforcement agencies appear to pass responsibility for enforcement from one to the other when they deem it convenient, and sometimes the passes are never completed. They correspondingly illustrate a confusion

18. *See generally supra* note 14.

19. Extension requests are published together with copies of the returns. *See* Lay Foundation Forms 990, *supra* note 12.

20. Although private foundations in Texas are not required to submit copies of their 990 returns, Texas law permits the Attorney General to "inspect, examine, and make copies of the books, records, and other documents the attorney general considers necessary and may investigate the association to determine if a violation of any law of this state has occurred." TEX. BUS. ORGS. CODE ANN. § 252.010(b) (Vernon 2004).

21. After the debacle, neither the IRS nor the Texas Attorney General took public action with respect to the Foundation.

in several quarters—among the media, the public, the directors and officers of nonprofits, practicing attorneys, and perhaps the agencies themselves—about where the primary responsibility for enforcement of many of the most basic nonprofit governance rules rests. The question deserves to be asked: Does the existence of overlapping jurisdictions work to diminish the effectiveness of the response to signs of irregularity and misconduct, or to increase it?

For many years it was something of a cliché among those who discussed nonprofit law to remark that its enforcement operated at two levels—state and federal—where different agencies addressed distinctly different conduct. Those who worked in the area of tax-exempt entities could then rely on the IRS to focus on issues directly connected with taxation, while those who dealt with fiduciary duties and governance principles could rely on Attorneys General to devote their efforts at charities regulation to monitoring the mission and programmatic activities of the states.[22]

Over the past thirty-five years, however, legislative and case law developments have obliterated many of these distinctions.[23] Today there is, in substance, considerable overlapping enforcement responsibility of the principal state and federal actors, namely the Attorneys General and the Internal Revenue Service. Furthermore, Congressional proposals, which have surfaced in recent years in connection with hearings on nonprofit oversight, propose not merely greater "coordination" of state and federal activities, but also suggest the extension of federal supervision into areas of fiduciary responsibility for which the states have been principally responsible and the expansion of state authority to take up federal claims.[24]

22. It was possible, in fact, for practitioner's guides to tax matters written prior to 1969 to disregard issues of nonprofit governance entirely. *See, e.g.*, UNITED STATES MASTER TAX GUIDE § 438 (1968) (indicating five "prohibited transactions" which could destroy a contribution deduction for a trust and might also apply to nonprofit corporations); *see also* James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 265–68 (2003).

23. *See* NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR (2001); Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999).

24. The CARE Act of 2003, as reported to the floor of the other House of Representatives, contains provisions that would amend the Internal Revenue Code of 1986, as amended, to authorize disclosure by the Internal Revenue Service to state charity regulators of information about organizations that have applied for, received, or been denied exemption from federal income tax or which have been the subject of adverse action by the Internal Revenue Service. *See Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before the Sen. Comm. on Finance*, 108th Cong. (2004) (statement of William Josephson), *available at* http://finance.senate.gov/hearings/95482.pdf; see also the discussion draft circulated by the staff of the Senate Finance Committee (Sen. Grassley, Chair) in connection with hearings held on the subject of nonprofit supervision in June 2004, STAFF OF SENATE COMM. ON FIN., 108TH CONG., STAFF DISCUSSION DRAFT, *at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf [hereinafter Staff Discussion Draft].

Does the greater interjurisdictional overlap produce "better" results? There are a number of policy advantages—but there are also significant difficulties. What follows is an attempt to explore the implications of overlap for the quality of an enforcement response.

I. NONPROFIT MISCONDUCT: AN OVERVIEW

Cataloging the variety of ways in which contemporary nonprofit laws may be abused requires a book of many volumes, especially since the contours of the problems with the "dark side of philanthropy" have hardly gone unnoticed. In testimony before the Senate Finance Committee, for example, William Josephson, in charge of charities law enforcement in New York, provided thirty-two different recent examples of abuse and referred congresspersons to the multiyear series of investigative articles in the *Boston Globe*, to make the point that abuses of the nonprofit law occur in countless permutations.[25] The creativity of those who are determined to enrich themselves at the expense of the public and to the detriment of charity seems boundless; the negligent behavior that has led many nonprofits into ruin is disheartening.[26]

On the other hand, the general types of misconduct which the laws penalize can be painted in broad strokes without too much difficulty. Building on the work of Professor Fremont-Smith,[27] and sacrificing much detail in the process, List 1[28] presents a generalized compilation of improper activities which have been addressed by nonprofit law enforcement agencies. It does not include regular offenses which affect nonprofits and for-profits alike—therefore making no claim to be exhaustive—but it does capture, in broad terms, the major violations and breaches.

LIST 1 Generic Nonprofit Wrongdoing

Violation/Breach of Duty
Improper or inadequate ***a***ccounting or reporting practices.
Negligent supervision of operations; poor ***b***usiness judgment.
Unlawful political ***c***ampaigning.

25. Statement of William Josephson, *supra* note 24; *see also* SILBER, *supra* note 23, at 3.

26. *See, e.g.*, MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004) [hereinafter GOVERNING NONPROFIT ORGANIZATIONS]; Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002*, 42 EXEMPT ORG. TAX REV. 25 (2003).

27. GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at 476–511.

28. *See generally* Michele Estrin Gilman, *"Charitable Choice" and the Accountability Challenge: Reconciling the Need for Regulation with the First Amendment Religion Clauses*, 55 VAND. L. REV. 799 (2002); *see also* Peter Sword, *Ethics of Charities* (ALI-ABA Course of Study, Dec. 5–6, 1996), available on Westlaw, SB30 ALI-ABA 201 (1996).

Excessive ***c***ompensation or benefits

Unfair ***c***ompetition.

Conflicts of interest; usurpation of business opportunities.

Improper ***c***onversion from nonprofit to a for-profit business form.

Discrimination against or harassment of personnel.

Discriminatory programmatic activities.

Dissipation of nonprofit assets or investments.

Improper ***d***issolution or termination of nonprofit entity.

Excessive or improper ***l***obbying activities.

Violations of client, volunteer, employee, or ***m***embership rights.

Failure diligently to pursue a charitable ***m***ission.

Deviations from lawful ***m***ission.

Underpayment or ***n***onpayment of taxes.

Unlawful invasions of ***p***rivacy.

Deceptive charitable ***s***olicitations.

Terrorist and subversive activities and support.

The listed violations are not mutually exclusive. Failure to diligently pursue a charitable mission, for example, may also involve negligent supervision. It also happens that nonprofit groups, and those who act improperly within them, seldom commit a single violation when they go wrong—there will normally be multiple violations if there is one.

II. AN INVENTORY OF STATE ENFORCEMENT ACTIVITIES

The traditional state role in licensing corporations, authorizing trusts, and even regulating unincorporated associations sets the course for contemporary practices. Today's statutes typically authorize secretaries of state to administer the formation and operational activities of nonprofits, with additional administrative or judicial assistance. The historical assignment to attorneys general of the responsibility for protecting assets belonging to the public (*parens patriae)* typically empowers them to investigate operations and prosecute wrongdoing on behalf of the public.[29] Most attorneys general also have the authority to stand in the shoes of injured parties and to sue on their behalf when doing so is in the public interest.[30]

State corporation laws specify the governing instruments that are required to be filed in order to operate in the nonprofit corporate form; they

29. GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at 476–511. S*ee generally* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004).

30. *Id.*

mandate procedural regularities and proscribe director misconduct. Judicial decisions elaborate and sometimes originate positive law to address other kinds of nonprofit wrongdoing. Every state has statutes applicable to charitable trusts that define fiduciary responsibilities for trustees of charities, and everywhere case law interprets them in its own tradition.[31]

Except for federal tax law violations, few types of nonprofit wrongdoing have escaped the purview of an Attorney General's authority to investigate, and, if warranted, to prosecute miscreants. Even the suppression of subversive and terrorist activity, which is often thought of as a federal function, has state nonprofit law analogs. For example, when the Nazi Party attempted to obtain a charter to operate its Bund as a nonprofit corporation prior to the Second World War, a justice of the New York Supreme Court rejected the charter as unsuitable pursuant to the state's incorporation laws.[32]

With the powers legislatively granted to attorneys general, there are many sources of law to be invoked. Professor Brody enumerated some of these sources in her testimony before the Senate Finance Committee staff in July 2004:

> Much of the common law of charity, property, and wills and trusts has found its way into State statutes. We find State laws on nonprofit corporations; Federal and State tax laws; and State (and sometimes local) laws on charitable solicitations. Like businesses, many nonprofits worry about laws (sometimes with special rules for nonprofits) on contracting, labor and employment, torts and insurance, employee benefits, antitrust, bankruptcy, and political activity, as well as laws that govern specific industries such as hospitals and day care. Of additional importance are several sources which are not themselves law but which influence legal development, including uniform laws adopted by the National Conference of Commissioners on Uniform State Laws; model acts adopted by the American Bar Association; and restatements and principles of the law issued by the American Law Institute.[33]

31. *See* GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at chs. 4, 6.

32. *See* SILBER, *supra* note 23, at ch. 2. *But see* the comments of the Charities Bureau of the New York State Department of Law in response to the March 12, 2002, Advisory of the Committee on Ways and Means Subcommittee on Oversight:

> In 1999 the New York Attorney General launched an investigation of the Holyland Foundation. It was hampered by our failure to enlist the cooperation of the Internal Revenue Service (to which the proposed amendment of Code sections 6103 and 6104 [to permit greater sharing of information] . . . is relevant), although ultimately we were able to document Holyland's transfer of thousands of dollars to foreign bank accounts and organizations. We have been unable to proceed further, since we lack any overseas investigative capability, and no federal authority has come to our aid, although we have surely asked.

William Josephson, *Comments on Taxpayer Rights Proposal* (Mar. 26, 2003), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=306.

33. Evelyn Brody, *White Paper for Roundtable on Exempt-Organization Reforms*, TAX NOTES TODAY, July 26, 2004, 2004 TNT 143–92 (Lexis), *at* http://services.taxanalysts.com/taxbase/tnt3.nsf/.

Although some of the laws Professor Brody refers to above are federal in nature, the state law matrix populates most of the legal landscape.

Chart 1 presents a general summary of actions against nonprofit misconduct that are available to state attorneys general and administrators. The actions indicated here do not have statutory or common law underpinnings in every jurisdiction, and many of the states that do provide legal authority for prosecution by charities regulators give them minimal enforcement resources with which to do so.[34] For this reason, Chart 1 should not be understood as an accurate picture of ongoing enforcement activities. "Despite their broad authority over charitable assets and fiduciaries," the president of the National Association of Charities Officials has reported, "many states lack the resources to effectively regulate the charitable organizations operating within their jurisdictions. Of our fifty states . . . most do not have personnel dedicated to the exclusive regulation of charities."[35]

And yet the erratic qualities of state regulation should not be overstated. The actions listed on the chart are available in most states with large populations and active charities enforcement—including California, Illinois, New York, Pennsylvania, Missouri, and a number of others. These are areas where national nonprofit organizations—and those intending to become national—need to operate. By so doing, they open themselves to effective monitoring by multiple state jurisdictions.

CHART 1 State Enforcement Actions[36]

Violation/Breach of Duty	**Attorney General/Other State Enforcement Action**
Improper or inadequate ***a***ccounting or reporting practices.	Statutory penalties for false state charities statements or for filing untimely or inaccurate reports; state tort law; state consumer protection law; state tax law; whistleblower protections; violation of nonprofit accounting principles.
Negligent supervision of operations; poor ***b***usiness judgment.	Violation of governance and management principles derived from case law, statute, and professional standards, including transgression of prudent person and business judgment rules; duty of care violations; breach by trustees of fiduciary standard of care; charter and bylaw violations, etc.
Unlawful political ***c***ampaigning.	State election campaign laws; state anticorruption statutes.
Excessive ***c***ompensation or benefits.	Breach of noninurement and nondistributional constraints established in charters and bylaws pursuant to state law; breach of statutes imposing reasonable compensation and reimbursement limitations, etc.
Unfair ***c***ompetition.	State incorporation requirements; state antitrust regulations.
Conflicts of interest; usurpation of business opportunities.	Common law duty of loyalty violations; state corporate governance requirements, including disclosure statutes; common law and

34. *See* GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at 476–511.

35. Mark Pacella, *NASCO Makes Recommendations for Charitable Regulation Reforms*, TAX NOTES TODAY, June 23, 2004, 2004 TNT 121–37 (Lexis).

36. *See* GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at 476–511.

	statutory procedural standards; state contract bid rules; common law contractual and equitable claims; breach of bylaw and charter obligations; contract and indemnification claims by Attorney General based on subordination and subrogation powers, etc.
Improper ***c***onversion from nonprofit to a for-profit business form.	Attorney General's consent authority; state nonprofit conversion laws (principally healthcare).
Discrimination against or harassment of personnel.	Claims of violation of state constitutional rights; violation of state employment and human rights statutes, civil rights, or criminal laws; whistleblower provisions.
Discriminatory programmatic activities.	State civil rights laws; public accommodation laws.
Dissipation of nonprofit assets or investments.	Common law and statutory violations of trust and corporate investment management rules; assertion of *parens patriae* power; trustee fiduciary malfeasance; prosecution of federal jeopardizing investment statutes under § 508(e) authority; violation of charter and bylaw constraints; claims based on subrogation powers, etc.
Improper ***d***issolution or termination of nonprofit entity.	Attorney General's authority to judicial consent requirements; state statutory dissolution requirements; conversion laws.
Excessive or improper ***l***obbying activities.	State and municipal lobbying restrictions; common law *ultra vires* actions.
Violations of client, volunteer, employee, or ***m***embership rights.	Private actions under state nonprofit membership rights provisions; claims of state constitutional violations; common law contractual claims; common law and statutory employment law violations; voting rights and membership rights, derivative actions, etc.
Failure diligently to pursue a charitable ***m***ission.	Action, *parens patriae*, or on behalf of members or officers or directors, to revoke a charter; action to reclassify the status of an organization; action to revoke specific tax benefits, including property tax benefits, for failure to qualify therefore; action to revoke an administrative consent or state license to operate; action to compel a name change or impose a bond pursuant to statutory authority, etc.
Deviations from lawful ***m***ission.	Statutory and common law actions claiming *ultra vires* conduct and breach of duty of obedience; breach of charter and bylaw restrictions; breach of state judicial and bureaucratic approval and consent requirements, etc.
Underpayment or ***n***onpayment of taxes.	State and local tax law violations, especially state real property tax exemption law; employment tax violations; municipal tax requirements; service fees, etc.
Unlawful invasions of ***p***rivacy.	State tort law claims; legislative consumer privacy statutes; statutory and common law membership list protections, etc.
Deceptive charitable ***s***olicitations	Violations of state charitable solicitation statutes; common law misrepresentation claims; statutory consumer protection actions based upon topical regulation of business practices, marketing techniques, and similar statutes;[37] deceptive acts and practices statutes; contract, tort, and fraud law; violations of state payment system regulations.
Terrorist and subversive activities and support.	State antiterrorist legislation prohibiting financial support for terrorist activity (in some states); criminal statutes.

37. *See* Ill. v. Telemarketing Assocs., Inc., 538 U.S. 600 (2003). The complaint filed by the Illinois Attorney General "asserted [Illinois] common-law and statutory claims for fraud and breach of fiduciary duty." *Id.* at 607.

III. THE EXPANSION OF IRS JURISDICTIONAL AUTHORITY

Next door to the more conventional tax collecting operations of the Internal Revenue Service, the Exempt and Government Entities Division of the Internal Revenue Service today supervises 1.6 million tax-exempt organizations that hold $2.4 trillion in assets.[38] Many of the tasks connected with examining the financial statements of 501(c)(3) and other organizations are also routine, but evaluating the quality of nonprofit governance does not always sit easily within the Service. Nevertheless, the supervision of governance has become an expanding part of its work.

For many years the regulatory actions of the Service centered on functions consistent with the fisc-protecting role: determining whether applications to be excused from payment of tax through exemption should be granted or revoked; placing nonprofit groups into their proper classifications, better to guard the government's revenue base against unnecessary or improper deductions; detecting improper accounting practices; and imposing taxes on unrelated business income.[39]

The modern extension of federal authority to the areas indicated in Chart 2, below, began late in the 1960s, particularly through new lobbying regulations and the set of provisions contained in the Tax Reform Act of 1969, which levied excise taxes upon misgoverned private charitable foundations.[40] With respect to the private foundation rules, the IRS acquired statutory and case law approval to police board governance and to enforce other federal statutes.[41] It acquired authority to prevent loans to disqualified persons, to prevent jeopardizing investments, excessive compensation, and other powers.[42] Within a decade, the Treasury Department had gone further and requested that the Internal Revenue Service be able to seek remedial decrees in equity in federal district courts to correct violations uncovered while acting to enforce its excise tax assessment authority. Congress did not enact these 1977 proposals, but to many professionals in nonprofit law enforcement, the traditional division between regulating the "mission" and

38. *See* Internal Revenue Service, *Tax Exempt & Government Entities Division at a Glance*, *at* http://www.irs.gov/irs/article/0,,id=100971,00.html (last visited Mar. 2, 2005).

39. *See* Fishman, *supra* note 22, at 223, 265–67 (citing U.S. GEN. ACCOUNTING OFFICE, GAO-02-526, TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES (2002)).

40. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat 487 (codified as amended in scattered sections of 26 U.S.C.).

41. *See* Fishman, *supra* note 22, at 265–67.

42. *See* I.R.C. § 4940 *et seq.* (West 2004).

regulating the "money" was breaking down and no longer appeared necessary or sound.[43]

In 1996, through the enactment of § 4958, public charities—which are not covered by the private foundation rules—were subjected to IRS sanctions for certain excess benefit transactions.[44] The "intermediate sanctions" rules applied principles similar to those earlier invoked for private foundations and added to the extreme and mostly impractical remedy of revocation of exemption the less catastrophic sanction of financial penalties potentially imposed on directors, disqualified persons, and managers.[45]

Chart 2 describes the current federal reach. Although private foundation excise taxes were designed in part to encourage state supervision of private foundations, the state role with respect to private foundations was not so much enhanced as supplanted, except in the most exotic case where a nonprofit private foundation neither had nor wanted a federal tax exemption.[46] Professor Nina Crimm has noted that the enactment of the private foundation provisions of the Tax Reform Act of 1969 "in one sense represented a federal preemption of the [responsibility for establishing] acceptable means of operation by private foundations."[47]

CHART 2 IRS Jurisdictional Authority to Address Misconduct in Nonprofit Organizations

Violation/breach of duty	**IRS/federal enforcement action**
Improper or inadequate ***a***ccounting or reporting practices.	Excise taxes upon excess business holdings; failure to distribute income; excessive compensation; federal antiperjury statutes and case law; penalties for inaccurately filing federal tax returns, etc.
Negligent supervision of operations; poor ***b***usiness judgment.	Excise taxes on jeopardizing investments (pf); excess business holdings (pf); excess benefits transactions.
Unlawful political ***c***ampaigning.	§ 501(c)(3) ban on political activity.
Excessive ***c***ompensation or benefits.	§ 4958 intermediate sanctions; excessive compensation rules.
Unfair ***c***ompetition.	Department of Justice antitrust division enforcement; UBIT rules.

43. Brody, *supra* note 23, at 568–70 (citing *Treasury Proposals to Improve Private Philanthropy* (Treas. Dept. News Release Jan. 18, 1977), [1977] 9 STANDARD FED. TAX REP. (CCH) ¶6156, at 70,850–57 (Jan. 26, 1977)).

44. I.R.C. § 4958 (West 2004).

45. GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at 98–100.

46. *See* SILBER, *supra* note 23, at 127–59 (regarding migration of review of many substantive performance aspects of nonprofits from state to federal levels).

47. Nina J. Crimm, *Why All Is Not Quiet on the "Home Front" for Charitable Organizations*, 29 N.M. L. REV. 1, 6 (1999).

Conflicts of interest; usurpation of business opportunities.	Excess business holdings (§ 4943 pf); self-dealing (§ 4951 pf); excess benefits—includes public charities (§ 4958).[48]
Improper ***c***onversion from nonprofit to a for-profit business form.	Excise tax on excess benefit transactions, § 4958 pf (§ 501(c)(3), (4) orgs.).
Discrimination against or harassment of personnel.	Federal nondiscrimination rules pertaining to grants; federal civil rights statutes as basis for revocation of exemption.
Discriminatory programmatic activities.	Excise taxes rules regarding nonqualifying expenditures; constitutional claims.
Dissipation of nonprofit assets or investments.	Excise taxes on jeopardizing investments (§ 4944 pf).
Improper ***d***issolution or termination of nonprofit entity.	Medicare/Medicaid statutes and regulations; proposed conversion rules; IRS dissolution requirements per statutes and regulations.
Excessive or improper ***l***obbying activities.	§ 501(c)(3) ban on substantial lobbying; § 501(h) election; § 4911; § 4912.
Violation of client, volunteer, employee, or ***m***embership rights.	Volunteer Protection Act; federal employment law; enforcement of constitutional guarantees, e.g., freedom of association.
Failure diligently to pursue a charitable ***m***ission.	Revocation of exemption; minimum payout rules; excess business holdings (§ 4943 pf); § 4940 (pf tax on investment income); failure to distribute income (§ 4942 pf).
Deviations from lawful ***m***ission.	UBIT rules.
Underpayment or nonpayment of ***t***axes.	UBIT; accurate filing requirements.
Unlawful invasions of ***p***rivacy.	Federal topical statutes and IRS nondisclosure rules; violation of UBIT rules regarding income from list sales.
Deceptive charitable ***s***olicitations.	FTC jurisdiction[49]; nondeductible contributions (§ 6710); disclosure of nondeductibility (§ 6113).
Terrorist and subversive activities and support.	USA PATRIOT Act.

On the other hand, it was argued at passage that these excise tax and lobbying rules were not outside the traditional role of state regulation of charitable uses, because they fundamentally dealt with the imposition of penalty taxes for the failure to make qualifying expenditures. Even when intermediate sanctions were adopted, Alvin D. Lurie, an Assistant Commissioner of the IRS, assured readers that the state role continued to be paramount:

> [T]he ability to invoke the jurisdiction of an equity court, with its broad and adaptable powers, is uniquely the province of the states. Only in certain limited circumstances can the Service take all of the steps necessary fully to protect the public. . . . [t]he state's role . . . where correction re-

48. "pf" indicates that the statute is confined in reach to private foundations; "pc" means public charity.

49. *See, e.g.*, Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act of 2003, Pub. L. No. 108-187, 117 Stat. 2699; Notice of Proposed Rulemaking (Project No. R411008), 69 Fed. Reg. 50091–101 (Aug. 13, 2004).

> mains outstanding, is to bring about "correction." The state alone can do this through the exercise of state equity powers.[50]

Lurie's comments understated the actual power of the IRS to bring about corrections through the threat of revocation of exemption and monetary penalties and the extent to which the Service could, if it wanted to, find a way to pursue most of the violations of nonprofit wrongdoing that the states could pursue. Notwithstanding the absence of federal power to obtain equitable decrees, the Service had excise tax power and the power to revoke exemptions in order to conform subpar behavior to IRS standards.

In 2004, further expansions of the authority were suggested.[51] If some or all of the proposals currently being debated are adopted, the legal landscape will advance dramatically in the direction of greater IRS and greater federal oversight. It is a general direction supported by a number of regulators and experts in the field, including Professor Fremont-Smith, who writes that:

> [e]xempt organizations are no longer the stepchildren of the Service . . . [which] is staffed by specialists at the national level . . . who view their role as assuring that exempt charitable organizations continue to make contributions to our society that are the rationale for the special status they are afforded in the tax system.[52]

IV. RECENT PROPOSALS TO EXPAND STATE AND FEDERAL NONPROFIT AUTHORITY

Proposals to address nonprofit abuse have circulated around Washington for several years, growing out of interest principally shown in the House by its Ways and Means Committee (Thomas, Chair) and in the Senate by the Senate Finance Committee (Grassley, Chair). During June 2004, the staff of the Senate Finance Committee floated proposals which contemplate dramatic changes to existing federal statutes concerned with nonprofit law enforcement. As related to the concerns being discussed here, the thrust of the proposals is (a) to grant additional power to the IRS to further patrol the conduct of nonprofit fiduciaries, (b) to vest additional power in the States to prosecute violations of federal tax law, and (c) to relax constraints

50. Crimm, *supra* note 47, at 7 (citing Alvin D. Lurie, Assistant Commissioner of the IRS for Employee Plans and Exempt Organizations, Speech Before the Third Annual Conference of the National Association of Attorneys General Special Committee on Charitable Trusts and Solicitations (Apr. 1975), *in Lurie Calls for Cooperation with States in Regulating Charitable Organizations*, 43 J. TAX'N 58 (1975)).

51. *See infra* Part IV; Staff Discussion Draft, *supra* note 24, at 7.

52. GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26, at xiii.

imposed on the IRS which discourage it from sharing income tax information with state authorities.[53]

A. Proposed Expansion of Federal Authority

Senator Grassley's committee staff proposes that the self-dealing rules which currently apply principally to private foundations should be broadened to apply to public charities generally. With the exception of the payment of unreasonable compensation, the self-dealing rules that were first adopted in 1969 would be extended to public charities (and social welfare organizations) so that, in general, self-dealing transactions between a public charity (or social welfare organization) and a disqualified person would result in excise taxes.[54]

The staff also proposes a five-year review of the tax-exempt status of charitable organizations, foundations, and all other tax-exempt groups by the IRS.[55] Every tax-exempt, essentially, would be required to file governing instruments, financial information, and narratives in order to enable the IRS to determine whether the original determination letter should remain in

53. At least some of the proposals in the Senate Finance Committee's draft appeared to have a chance of becoming law as this Article went to press. With support from the Senate Finance Committee, the leading coalition of nonprofits, Independent Sector, formed the "Panel on the Nonprofit Sector," which in turn established an elaborate set of study panels and a process "to ensure that the nonprofit community remains a vibrant and healthy part of American society." Press Release, Panel on the Nonprofit Sector, Nonprofit Panel Proposes Actions to Strengthen Accountability of Charities, Foundations, *at* http://www.nonprofitpanel.org/press/interim (last visited Apr. 1, 2005). On March 1, 2005, the Panel released an Interim Report, which embraced some of the Committee's recommendations, but declined or postponed endorsing a conclusion with respect to others.

Among proposals endorsed in some form by the Interim Report are the incorporation of federal standards for charitable organizations into state law; more information sharing between state and federal enforcement officers; stricter regulation of donor-advised funds; coordination of state and federal filing requirements; and some federal review, through new questions in federal nonprofit returns, of conflicts of interest. Among those topics postponed were federally established periodic reviews of exemption, auditing standards, and rules regarding board size and composition. *See* PANEL ON THE NONPROFIT SECTOR, INTERIM REPORT PRESENTED TO THE SENATE FINANCE COMMITTEE § III (Mar. 1, 2005), *at* http://www.nonprofitpanel.org/interim/PanelReport.pdf.

54. The Senate Finance Committee discussion draft explains that:

> Under present law, excise taxes apply if private foundations engage in acts of self-dealing with disqualified persons. Self-dealing transactions generally include the sale, exchange, or leasing of property; the lending of money or other extension of credit; the furnishing of goods, services, or facilities; payment of unreasonable compensation by a private foundation; transfer to or use by a disqualified person of a private foundation's income or assets; and certain payments to government officials. . . . In general, the definition of disqualified person for purposes of the private foundation rules would be adopted for public charities, except that adjustments would be made to include persons with substantial influence over the organization, and the rules would be modified as necessary to take into account relationships with affiliated or supporting entities. With respect to compensation, the regulations that apply to the compensation arrangements of public charities generally would be modified with respect to the rebuttable presumption of reasonableness.

Staff Discussion Draft, *supra* note 24, at 3–4.

55. *Id.* at 1.

effect. Failure to file the five-year review would result in loss of tax-exempt status.[56] As Professor Brody observed in a communication to the Senate Committee, such a requirement effectively "import[s] additional substantive fiduciary law into the Internal Revenue Code."[57]

Another proposal would see the federal government play a greater role in the conversion of nonprofit corporations into for-profit entities. Because of concern that conversions of tax-exempt organizations to for-profit organizations have not been sufficiently protective of charitable interests and assets, the proposal would impose public reporting requirements on exempt organizations in advance of a conversion, and it would apply taxes similar to the current IRS self-dealing or excess benefit transactions excise taxes to all parties, including successor entities.[58] This proposal, too, appears to expand the role of the federal government, particularly the IRS, into policing the substantive fairness, the procedural regularity, and the charitable benefit of board decisions. An additional proposal would extend Sarbanes-Oxley accounting reforms to nonprofits. Such rules would establish federal standards of care for the work of directors and officers, especially the work of nonprofit financial officers and board audit committees.[59]

B. Proposed Expansions of State Authority

The Senate Committee staff also proposed to expand the authority of state charities officials to bring claims based on statements in federal returns as provided in existing § 508(e). The authority now enables states' charity regulators directly to enforce several private foundation excise tax rules, by placing a requirement that the rules be contained in state governing instruments. It was suggested that the IRS intermediate sanctions rules (§ 4958) also ought to be made applicable to interested director transactions as a matter of state law because, although the states already have authority to enforce § 4941, "those cases are difficult to bring because of its slippery standards."[60]

56. *Id.*

57. Brody, *supra* note 33; *see also Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before Sen. Comm. on Finance*, 108th Cong. (2004) (statement of Derek Bok) (objecting to automatic reviews as burdensome on nonprofit entities and a drain on agency resources), *at* http://finance.senate.gov/hearings/testimony/2004test/062204dbtest.pdf.

58. Staff Discussion Draft, *supra* note 24, at 6.

59. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745; Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829 (2003); BOARDSOURCE & INDEP. SECTOR, THE SARBANES OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS (2003), *at* http://www.independentsector.org/PDFs/sarbanesoxley.pdf.

60. Statement of William Josephson, *supra* note 24. Josephson testified:

C. Proposed Facilitation of Information Sharing

For law enforcement purposes, state and federal officials have called for greater information sharing between the IRS and state attorneys general, the Federal Trade Commission, and the U.S. Postal Service.[61]

Privacy concerns underpin Internal Revenue Code § 6103 and, to some extent, § 6104, which sharply restrict the ability of the IRS to disclose to the states any information concerning pending applications for tax exemption, investigations, or litigation. While the impact in terms of privacy and defensive litigation might be great, proponents argue that amendment of §§ 6103 and 6104 to allow such disclosure would alert state regulators "to applications by organizations that have violated state law and, accordingly, [through feedback from the Attorney General] could alert the IRS to issues that might impact its decision whether or not to grant tax exempt status," make joint investigations feasible, reducing duplicate prosecutions, and eliminating "the possibility of inconsistent results."[62]

Chart 3 synthesizes Charts 1 and 2. It indicates that upon adopting the proposals in the draft, federal power to address violations of nonprofit law would become nearly coextensive with state law.

CHART 3 Jurisdictional Overlap (proposals for expansion in **bold**)

Violation/breach of duty	**Attorney General/ Available state enforcement action**	**IRS/Federal enforcement action**
Improper or inadequate ***a***ccounting or reporting practices.	Statutory penalties for false state charities statements or for filing untimely or inaccurate reports; state tort law; state consumer protection law; state tax law; whistleblower protections; violation of nonprofit accounting principles.	Excise taxes upon excess business holdings; failure to distribute income; excessive compensation; federal antiperjury statutes and case law; **applications of Sarbanes-Oxley federal audit committee standards**; penalties for inaccurately filing federal tax returns, etc; **five-year review of determination letter**.

> In particular cases, there would be some overlap between sections 4941 and 4958. But they are not congruent. "Disqualified person" is much more broadly defined in section 4958(f)(1). Section 4958 separately taxes disqualified persons and organization managers. . . . Section 4958 covers compensation and benefits from affiliated entities. As a consequence of Code section 508(e), the states have authority to enforce section 4941, but in fact those cases are difficult to bring because of its slippery standards.

Id.

61. Staff Discussion Draft, *supra* note 24, at 16.
62. Josephson, *supra* note 32.

Negligent supervision of operations; poor ***b***usiness judgment.	Violation of governance and management principles derived from case law, statute, and professional standards, including transgression of prudent person and business judgment rules; duty of care violations; breach by trustees of fiduciary standard of care; charter and bylaw violations, etc.	Excise taxes on jeopardizing investments (pf **pc**); excess business holdings (pf **pc**); excess benefits transactions; **action on periodic review of determination letter**.
Unlawful political ***c***ampaigning.	State election campaign laws; state anticorruption statutes	§ 501(c)(3) ban on political activity; **action on periodic review of determination letter**
Excessive ***c***ompensation or benefits.	Breach of noninurement and nondistributional constraints established in charters and bylaws pursuant to state law; breach of statutes imposing reasonable compensation and reimbursement limitations, etc.; **state authority to pursue federal intermediate sanctions**.	§ 4958 intermediate sanctions; excessive compensation rules; **action on periodic review of determination letter**.
Unfair ***c***ompetition.	State incorporation requirements; state antitrust regulations.	Department of Justice antitrust division enforcement; UBIT rules.
Conflicts of interest; usurpation of business opportunities.	Common law duty of loyalty violations; state corporate governance requirements, including disclosure statutes; common law and statutory procedural standards; state contract bid rules; common law contractual and equitable claims; breach of bylaw and charter obligations; contract and indemnification claims by Attorney General based on subordination and subrogation powers, etc.	Excess business holdings (§ 4943 pf **pc**); self-dealing (§ 4951 pf **pc**); excess benefits—including public charities (§ 4958); **action on periodic review of determination letter**.[63]
Improper ***c***onversion from nonprofit to a for-profit business form.	Attorney General's consent authority; state nonprofit conversion laws (principally healthcare).	Excise tax on excess benefit transactions, § 4958 pf (§ 501(c)(3), (4) orgs.); **Federal/state approval of conversion**.
Discrimination against or harassment of personnel.	Claims of violation of state constitutional rights; violation of state employment and	Federal nondiscrimination rules pertaining to

63. Staff Discussion Draft, *supra* note 24, at 1. The Discussion Draft says:

> On every fifth anniversary of the IRS's determination of the tax-exempt status of an organization that is required to apply for such status, the organization would be required to file with the IRS such information as would enable the IRS to determine whether the organization continues to be organized and operated exclusively for an exempt purposes (i.e. whether the original determination letter should remain in effect). Information to be filed would include current articles of incorporation and by-laws, conflicts of interest policies, evidence of accreditation, management policies regarding best practices, a detailed narrative about the organization's practices, and financial statements. Such information would be made publicly available. The IRS would not be required to issue a new determination letter (or to review all organizations), but would be permitted to revoke tax-exempt status if a review undertaken by the IRS concluded that the organization no longer was entitled to exemption. Failure to file the five year review would result in loss of tax-exempt status.

Id.

	human rights statutes, civil rights, or criminal laws; whistleblower provisions.	grants; federal civil rights statutes as basis for revocation of exemption; **five-year review of determination letter**.
Discriminatory programmatic activities.	State civil rights laws; public accommodation law.	Excise taxes rules regarding nonqualifying expenditures; constitutional claims; **action on periodic review of determination letter**.
Dissipation of nonprofit assets or investments.	Common law and statutory violations of trust and corporate investment management rules; assertion of *parens patriae* power; trustee fiduciary malfeasance; prosecution of federal jeopardizing investment statutes under § 508(e) authority; violation of charter and bylaw constraints; claims based on subrogation powers, etc.	Excise taxes on jeopardizing investments (§ 4944 pf **pc**); **action on periodic review of determination letter**.
Improper ***d***issolution or termination of nonprofit entity.	Attorney General's authority to judicial consent requirements; state statutory dissolution requirements; conversion laws.	Medicare/Medicaid statutes and regulations; proposed conversion rules; IRS dissolution requirements per statutes and regulations.
Excessive or improper ***l***obbying activities.	State and municipal lobbying restrictions; common law *ultra vires* actions.	§ 501(c)(3) ban on substantial lobbying; § 501(h) election; § 4911; § 4912; **action on periodic review of determination letter**.
Violation of client, volunteer, employee, or ***m***embership rights.	Private actions under state nonprofit membership rights provisions; claim of state constitutional violations; common law contractual claims; common law and statutory employment law violations; voting rights and membership rights; derivative actions, etc.	Volunteer Protection Act; federal employment law; enforcement of constitutional guarantees, e.g., freedom of association; **action on periodic review of determination letter**.
Failure diligently to pursue a charitable ***m***ission.	Action, *parens patriae*, or on behalf of members or officers or directors, to revoke a charter; action to reclassify the status of an organization; action to revoke specific tax benefits, including property tax benefits, for failure to qualify therefore; action to revoke an administrative consent or state license to operate; to compel a name change or impose a bond pursuant to statutory authority, etc.	Revocation of exemption; minimum payout rules; excess business holdings (§ 4943pf **pc**); § 4940 (pf tax on investment income); failure to distribute income (§ 4942 pf **pc**); **action on periodic review of determination letter**.
Deviation from lawful ***m***ission.	Statutory and common law actions claiming *ultra vires* conduct and breach of duty of obedience; breach of charter and bylaw	UBIT rules; **action on periodic review of determination letter**.

	restrictions; breach of state judicial and bureaucratic approval and consent requirements, etc.	
Underpayment or ***n***onpayment of taxes.	State and local tax law violations, especially state real property tax exemption law; employment tax violations; municipal tax requirements, service fees, etc.	UBIT; accurate filing requirements.
Unlawful invasions of ***p***rivacy.	State tort law claims; legislative consumer privacy statutes; statutory and common law membership list protections, etc.	Federal topical statutes and IRS nondisclosure rules; violation of UBIT rules regarding income from list sales; **action on periodic review of determination letter**.
Deceptive charitable ***s***olicitations.	Violations of state charitable solicitation statutes; common law misrepresentation claims; statutory consumer protection actions based upon topical regulation of business practices, marketing techniques, and similar statutes; deceptive acts and practices statutes; contract, tort, and fraud law; violations of state payment system regulations.	FTC jurisdiction; nondeductible contributions (§ 6710); disclosure of nondeductibility (§ 6113); **action on periodic review of determination letter**.
Terrorist and subversive activities and support.	State antiterrorist legislation prohibiting financial support for terrorist activity (in some states); criminal statutes.	USA PATRIOT Act; **action on periodic review of determination letter**.

V. WEIGHING CONSEQUENCES OF OVERLAPPING JURISDICTION

The proposals that have been made recently have less to say, maybe than they should, about the problems associated with fostering a legal regime in which almost all the misconduct committed by nonprofit organizations—and most persons connected with them—can be characterized as violative of legal rules that constitute the core responsibilities of two different agencies at the two different levels of "sovereignty." The inability to diagnose improper action by nonprofits is not where the majority of problems connected with overlap arise; rather, problems arise because of the mechanisms of enforcement. Within both agencies, furthermore, enforcement activity is only a small part of a larger set of responsibilities. Both operate with different institutional incentives for taking legal action or for refraining from enforcement activity, and each is led by political appointees and by delegates who sometimes have ambitions of their own.

There is some theoretical support for my suggestion that, in the nonprofit sector, inadequate attention to poor performance results from coextensive supervision and enforcement responsibility. Building on the welldeveloped literature about the "tragedy of the commons";[64] on some of the "new institutional" scholarship;[65] and on an emerging concept of a "regulatory commons," which exists when multiple regulators have coextensive power to address substantially similar ills,[66] the environmental law scholar William Buzbee theorizes that "the more complex, multilayered, or fragmented the legal and political setting, the more likely it is that [negative] dynamics [leading to unsatisfactory regulation] will arise."[67] In such a setting, status quo preservation incentives are a predictable outgrowth of placing important monitoring and enforcement responsibilities into a regulatory commons.[68] In a regulatory commons, there arise "predictable incentives for legislators and regulators to fail to address even broadly perceived social ills."[69]

Such incentives are not wanting in the context of nonprofit supervision and enforcement. The IRS is led by a Commissioner who is a political appointee[70] and who is part of an administration that, like most recent administrations, is ambivalent and sometimes internally divided about vigorous enforcement. The IRS is concerned about shedding a reputation for unfriendliness to its customers, but it is aware that cracking down on nonprofit abuse not only promotes social welfare, it is part of the IRS's mission and can be "good press."

State attorneys general are elected in many states.[71] They, too, have found that devoting resources to an investigation of nonprofit corporations builds public appreciation for their work, but at other times they have found that it has an opposite effect.

I am not deeply concerned about whether the state level of nonprofit regulation will atrophy as a result of federal expansion—in part because of what Professor Herbert Wechsler referred to long ago as the "political safe-

64. Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

65. *See* Robert H. Bates, *Contra Contractarianism: Some Reflections on the New Institutionalism*, 16 J. POL. & SOC'Y 387, 394 (1988).

66. *See* David A. Dana, *Overcoming the Political Tragedy of the Commons: Lessons Learned from the Reauthorization of the Magnuson Act*, 24 ECOLOGY L.Q. 833 (1997) (exploring how the "government apparatus" itself can be captured by powerful interests and thereby frustrate derivation of a cure for commons overuse).

67. William W. Buzbee, *Recognizing the Regulatory Commons: A Theory of Regulatory Gaps*, 89 IOWA L. REV. 1, 22 (2003).

68. *Id.* at 33–36.

69. *Id.* at 1.

70. The Commissioner of the IRS is appointed to a five-year term and reports to the Secretary of the Treasury; "his sole mission is the administration of the tax collection system." WILLIAM H. WEBSTER, REVIEW OF THE INTERNAL REVENUE SERVICE'S CRIMINAL INVESTIGATION DIVISION (I.R.S., Pub. No. 3388 (Apr. 1999)), *available at* http://www.irs.gov/irs/article/0,,id=120418,00.html.

71. *E.g.*, Florida, Tennessee, Wyoming, and many more.

guards of federalism."[72] States, he asserted in that classic article, were politically protected from the encroachment of federal legislation that would diminish their power, because of the way in which the Constitution gave states the central role in national politics. Half a century later, Professor Larry Kramer has drawn attention to the weakness of several of Wechsler's claims, but has revived the safeguards argument with the claim that political linkages between state and federal actors preserve core federalist principles. He also reminds us that if centralized authority is unavoidable in cases such as this, it is probably because it is desirable. He points to James Madison's observation in The Federalist No. 46:

> If therefore, as has been elsewhere remarked, the people should in future become more partial to the federal than to the State governments, the change can only result, from such manifest and irresistible proofs of a better administration, as will overcome all their antecedent propensities. And in that case, the people ought not surely to be precluded from giving most of their confidence where they may discover it to be most due.[73]

It is of course much too early to tell, but the proposals which have been advanced in Congress appear to support Professor Kramer's perspective—they seem to widen state authority even as they would probably diminish its relative importance.

* * *

Even if none of the current proposals are adopted, however, the problems connected with the existing amount of overlap do concern me and I think are worth addressing. Up to this point, I have only suggested their significance by providing the concrete examples at the start of this exploration and by indicating the extent of the overlap through the charts above.

There are claims to be made in favor of undifferentiated general responsibility by multiple agencies for the enforcement of the law. A practitioner in the area told me that he finds it quite effective to counsel a client using words something like these: "Your board is proposing to pay your chief executive too much. You know it's too high and I know it's too high, and the Attorney General will know it's too high, and the IRS will, too. You'll be violating state laws under which you have a duty of care, and you'll be violating federal laws under which you may wind up personally responsible for paying an excise tax. SO DON'T DO IT."

72. Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543 (1954); Larry D. Kramer, *Putting the Politics Back into the Political Safeguards of Federalism*, 100 COLUM. L. REV. 215 (2000).

73. Kramer, *supra* note 72, at 286 (quoting THE FEDERALIST NO. 46, at 315, 318 (James Madison) (Jacob E. Cooke ed., 1961)).

State and federal officials, as indicated above, tend to think that there is little to be lost by overlapping authority. Many believe that the overlap increases the probability of prosecution by one or the other agency and that the ability to "pass the ball" serves a valuable function—allowing the official to avoid matters that are problematic. Of course, if they both want to pass the ball rather than receive it, the ball may be dropped.

Until now, there has been a public charity/private foundation division of labor, established implicitly by the statutes, which ameliorates the overlap problem at the present time. The Texas Attorney General in the Enron example above could observe, with solid support, that state attorneys general do not generally take the lead role in supervising private foundations despite having a statutory basis for acting to investigate them "in appropriate cases."[74] The Service could observe in the Citizen's Education Fund case that the Service does not take a lead in evaluating the substantive performance of operating nonprofit organizations, even if it might have a statutory basis for investigation.[75]

There are, furthermore, working relationships which have sometimes operated to establish priorities for enforcement.[76] State and federal authorities devote their resources in a consistent manner to some enforcement activities rather than others, depending on current events and political philosophies.[77] Such consistency reduces concerns about double jeopardy, over-prosecution, and the like. Regardless of the pressure state authorities may feel to go after a nonprofit for its failure to pay state tax on unrelated business income, such cases will virtually always be an IRS priority. Conversely, no matter how forcefully the Service is urged to take up a conflict over the interpretation of a bylaw (unless, perhaps, the bylaw involved discrimination subject to federal civil rights laws or depended for its interpretation on the language of a federal tax provision), state action would probably occur first.

It can be anticipated that adoption of the new rules will only serve to exacerbate overlap concerns and raise issues of practice and law. Under the new proposals, the amount of overlap would be much more substantial than ever before,[78] and problems that are attributable largely to the administrative discretion that exists in the present system would be greater than at

74. *See supra* Introduction.

75. *See generally supra* Part II and accompanying charts (examining the traditional role of state attorneys general); *see also* GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26.

76. *See generally supra* Part III and accompanying charts (detailing the tradition role of the IRS and the statutory underpinnings); *see also* GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 26.

77. *See supra* Part II & III.

78. *See supra* Part IV.

present.[79] The questions that are attributable to overlap today would seemingly be multiplied: if an IRS proceeding to assess an excise tax against self-dealing is brought against a disqualified person, does a prior state proceeding resolving the identical substantive question have a binding effect? In most cases this would not appear to be the case.[80] In the interests of fairness, it makes sense to bind the Service to the determinations made in prior state court proceedings, whether adverse or favorable to the Service, when the Service has intervened or declined the opportunity to intervene.[81] Would a state court action involving a breach of duty preclude an IRS action contesting the same question in the form of an excise tax assessment, particularly if the state had declined to exercise ancillary federal authority? More sharing of information between state and federal charities officials may lead to some actions being consolidated. In the absence of consolidation, federal rules allow for the abatement of excise taxes to reduce the amount of a federally imposed penalty if a judgment has been paid in a prior action;[82] but these provisions contemplate, rather than work to diminish, the likelihood of dual proceedings over breaches of fiduciary duty.

To what extent would the Service defer to the states in actions involving fiduciary duties? Professor Brody has taken the view that "[i]n any case when both Federal and State investigations are proceeding, principles of

79. *Id.* These problems include discretion as to whether state or federal actors, in no particular order, choose whether to investigate or prosecute, choose whether to share information among themselves, and sometimes choose to do nothing at all.

80. *See* Comm'r v. Estate of Bosch, 387 U.S. 456 (1967) (state court decisions do not bind the IRS to decisions to which the IRS is not a party). *But see* United States v. White, 853 F.2d 107 (1988) (IRS is not precluded from contesting a surrogate court's conclusion about the reasonableness of a fee). *See generally* Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 EMORY L.J. 871 (1999).

81. *See generally supra* note 80. In the interest of fairness to nonprofits, their officers, and directors, it is possible to modify the rule that there is to be no res judicata or collateral estoppel effect to be given to state court decisions favorable to a nonprofit party in which the IRS was not a party to a proceeding. The rule in *Bosch* and its progeny currently imposes a "one way street" down which the IRS is not bound by state court decisions favorable to defendants, and yet up which losing parties can be bound to their disadvantage in further IRS proceedings. The proposed changes that allow the IRS to share information with State Attorneys General are welcome in many respects, but taken together with the wider jurisdictional overlap, they elevate the problem of repetitive litigations. A preferable approach to address unfairness might be to bind the IRS to a state court's prior resolution of identical issues when the IRS had the opportunity to participate in a proceeding and declined. Such a rule would add predictability to law and promote substantive fairness.

82. I.R.C. § 507(g), for example, provides that a termination tax imposed by the Service can be abated, at the discretion of the Service, if an appropriate state official certifies that the assets of the private foundation in question are:

> preserved for such charitable or other purposes specified in section 501(c)(3) as may be ordered or approved by a court of competent jurisdiction, and upon completion of the corrective action, the Secretary receives certification from the appropriate State officer that such action has resulted in such preservation of assets.

I.R.C. § 507 (West 2004). Other provisions for abatement include IRC §§ 6701, 4961, and 4962.

federalism suggest that the IRS should have to defer to the State, or at least stay its hand until the proceedings conclude, to protect the charity from inconsistent mandated governance changes."[83] Federalism principles may suggest such a result, but thus far they have not compelled such a result. And even if the problem of duplicate actions is minimized by procedural rules and the convergence of jurisprudence, concern about protracted duplication litigation would persist. Brody explained her concern about the sheer exhaustion of a defendant's resources in the context of a private-inurement prosecution:

> A charity that violates the private-inurement (and excess-benefits) proscription also violates the duty-of-loyalty requirements of State nonprofit law. Depending on the resources and inclinations of the State attorney general's office, the charity might be facing investigations on two fronts. Under current privacy law applying to exempt organizations, the State can share information with the IRS, but the IRS cannot share information about its investigation short of notifying the State of revocation of exemption. However, because this final determination might not be made for a number of years, a tax-exempt organization may have exhausted its assets through illicit transactions or disposed of its assets or changed its operations in a way which can no longer be corrected by the time the IRS is permitted to inform the State.[84]

CONCLUSION

I am left considering whether a supplemental set of proposals would help to alleviate these concerns. Overlap might be less objectionable if the two principal agencies had formally assigned principal responsibilities; that is, if priorities were to some extent established by statute along with enforcement authorization.

It is probable that the under-resourced nature of charities enforcement results, at least in part, from overlap and from the failure to establish such priorities. For example, knowledge that the Service polices the same jurisdiction, with respect to a jeopardizing investment, as the Attorney General, may reduce the imperative for enforcement resources by the states. And it can work the other way. Knowledge that the states will police, for example, reasonable compensation questions, may affect the Service's decision not to be the "first responder" to such incidents.

Especially in light of the proposed changes being considered, it is time to consider more formal assignments of primary enforcement responsibili-

83. *See* Brody, *supra* note 33; Brody, *supra* note 23, at 543–45; I.R.C. § 507 (establishing that the Service is already empowered to consider the findings of state charities enforcement officials and judges in certain situations).

84. Brody, *supra* note 33 (internal quotation marks and citation omitted).

ties in the nonprofit legal regime—assignments which would reduce the discretion of the principal agents involved to pursue wrongdoing and increase the predictability of enforcement. Understanding who should assume these roles would minimize confusion about whether responsibility for action rests with the state or federal actors. It should not be necessary to return entirely to the historical divisions of responsibility, nor to be indifferent to the variations among the states in terms of resources and effectiveness of enforcement. Nonetheless, it would be useful to give organizations advance notice of which agency in the first instance should take responsibility for an investigation of wrongdoing, and under what circumstances.