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TAX-EXEMPT PUBLIC CHARITIES: INCREASING ACCOUNTABILITY AND COMPLIANCE

ROBERT C. DEGAUDENZI*

INTRODUCTION

The federal government has long embraced the view that charitable and other public service organizations should be exempt from federal income tax.\(^1\) This policy is codified by section 501(c)(3) of the Internal Revenue Code (the "Code"),\(^2\) which generally permits an exemption for so-called "public charities."\(^3\) The term public charities, a misnomer perhaps, includes not only churches and other traditionally charitable organizations,\(^4\) but also universities, hospitals, research institutions and

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2 I.R.C. § 501(c)(3) (1988); see infra notes 37-76 and accompanying text (discussing requirements of section 501(c)(3)). All section references are with respect to the Internal Revenue Code of 1986, as amended.

3 See PAUL E. TREUSCH, TAX-EXEMPT CHARITABLE ORGANIZATIONS 577 (3d ed. 1988) (noting that term "public charities" is not found in Internal Revenue Code, but refers to organizations exempt under section 501(c)(3) not constituting private foundations); infra notes 84-86 and accompanying text (discussing distinction between public charities and private foundations).

4 See HOPKINS, supra note 1, §§ 6.1−2 (describing historically "charitable" activities).
similar organizations.\(^5\) In recent years, despite their seemingly laudable objectives, tax-exempt public charities have become the focus of critical commentary and increased scrutiny by the federal government,\(^6\) the legal community\(^7\) and the public.\(^8\)

Although no single event can be credited for generating such fervent interest in the tax-exempt sector, numerous media accounts detailing questionable and, at times, abusive dealings by owners and officers of well-known tax-exempt entities were certainly major factors.\(^9\)

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\(^6\) See infra notes 21-36 and accompanying text (discussing recent abuses in tax-exempt field and need for legislative changes). The Internal Revenue Service (the "I.R.S.") has taken steps to curb abuses by tax-exempt organizations by imposing increased disclosure requirements on such organizations. See Marlis L. Carson, New Form 990 Contains Revised Revenue Reporting Requirements, Tax Notes Today, Mar. 7, 1994, available in LEXIS, Fedtax Library, TNT File. In addition, the I.R.S. is stepping up its audit examination procedures of various types of tax-exempt organizations. See, e.g., Marlis L. Carson & Barbara Kirchheimer, Tax Forum Covers Wide Range of EO Issues, 60 Tax Notes 1545, 1545 (1994) (reporting that "examinations of 501(c)(3) health care organizations will be the Services 'number one' focus in ... 1994"); Paul Streckfus, IRS Continues to Turn Up the Heat on Colleges and Universities, 62 Tax Notes 1651, 1652 (1994) (noting that I.R.S. has "new aggressiveness" in audits of colleges and universities).


\(^8\) See infra notes 9-16 and accompanying text (discussing news accounts regarding tax-exempt organizations).

the first, and perhaps most infamous, examples of such an account involved televangelist Jim Bakker whose extravagant lifestyle—largely financed by defrauding members of his PTL ministry—resulted in a fraud and conspiracy conviction carrying a forty-five year prison sentence. More recently, televangelist Pat Robertson made headlines when he sold a division of the tax-exempt Christian Broadcasting Network, of which he is chairman, turning an investment of $183,000 into $90 million.

The list of questionable practices is by no means limited to televangelists. In 1991, the management of Health Net, a California-based health maintenance organization ("HMO"), attempted a buyout of the tax-exempt HMO at a price far below its market value. Although the deal was ultimately approved by state regulators, management was first required to make significant financial and operational concessions including the retention of only a minority interest in the new entity. Similarly, in the United Way of America scandal, United Way's executive director orchestrated the spin-off of several United Way divisions and placed relatives and friends in charge of the newly-formed entities. Perhaps raising even more eyebrows than these self-dealing transactions was the executive director's reported annual compensation of $463,000. Finally, it was reported that the Cystic Fibrosis Foundation plans to transfer some of its key assets, including its mail-order pharmaceutical operations, to a for-profit entity that will be headed by the foundation's president.


13 See James F. Peltz, Health Net Wins For-Profit Status; Medicine: The State Lets the Woodland Hills-Based HMO Convert From a Nonprofit Organization After it Agrees to Cede Majority Ownership to a Foundation, L.A. TIMES, Feb. 8, 1992, at 1.


15 See Barringer, Charity Boards, supra note 14, at A19.

Prompted by such events, the Oversight Subcommittee of the House Ways and Means Committee (the "Subcommittee") conducted hearings in 1993 and 1994 to address the problem of abuses by organizations exempt under section 501(c)(3) of the Code. Based on the testimony presented, the following issues were of primary concern to hearing participants: self-dealing and executive compensation, public disclosure and the inadequacy of sanctions for abuses.

Under section 501(c)(3), the activities of a public charity must benefit public, rather than private, interests. Moreover, a public charity's net earnings may not inure to the benefit of insiders such as officers, in violation of the Code.

17 See supra notes 10-16 and accompanying text.


19 See supra note 5; Hearings II, supra note 18; Hearings III, supra note 18. Initially, it was noted that tax-exempt organizations are the fastest growing sector of the United States economy, numbering more than 1.2 million with 30,000 new organizations created annually. See supra note 5. In addition, exempt organizations in the aggregate account for approximately $1 trillion in assets and have annual revenues of $500 billion. Id.

In preparation for these hearings, Subcommittee members reviewed the tax returns of 250 of the largest exempt organizations. See supra note 5. Additionally, in a closed-session hearing, the Subcommittee questioned I.R.S. field agents regarding specific cases in which tax-exempt organizations had engaged in abusive dealings or activities. See supra note 18. Although the I.R.S. was prohibited from publicly disclosing the names and identities of the taxpayers discussed during the closed session, the types of abuses involved were nevertheless described in general terms. Id.; I.R.C. § 6103 (1988) (prohibiting disclosure of taxpayer identities unless within specific statutory exception).

20 An ancillary concern raised during the meetings was the potential abuse of tax-exempt bond financing. See supra note 18; see also Gaul & Borowski, Cheap Money, supra note 17, at 1.

21 I.R.C. § 501(c)(3) (1988); see infra notes 54-62 and accompanying text (discussing private benefit).
Tax-Exempt Public Charities

Thus, Subcommittee members were troubled by the occurrence of self-dealing transactions that often appeared to confer a prohibited benefit on organization insiders. In particular, the payment of executive compensation and benefits was perhaps the most often-cited area of abuse by public charities. In addition to arguably excessive salaries, the Subcommittee was disturbed by the many indirect forms of compensation provided to executives including interest-free loans and the payment of executives' living and recreational expenses.

22 I.R.C. § 501(c)(3); see infra notes 63-76 and accompanying text (discussing private inurement).

23 See Hearings I, supra note 5, at 29-30; Hearings II, supra note 18 (testimony of Hon. Dan Morales, Attorney General of Texas, describing acts of self-dealing by exempt organizations). Based on testimony of I.R.S. field agents, Subcommittee members learned of various examples of abusive self-dealing transactions including: (1) the leasing of buildings, land, and other properties to an insider without charging rent; (2) the sale of a hospital to a profit corporation controlled by the hospital's board at a price below its fair market value. See Hearings II, supra note 18; see also supra notes 10-16 and accompanying text (describing news accounts of self-dealing transactions by exempt organizations).

24 See Hearings I, supra note 5, at 12 (testimony of I.R.S. Commissioner); see also Gaul & Borowski, Charity Really Pays, supra note 17, at A1 (discussing high compensation of executives at tax-exempt organizations).

25 See Hearings I, supra note 5. Initially, the Subcommittee observed, with apparent dismay, that 15% of the executives from the largest 250 exempt organizations earned more than $200,000 annually, and that 38 individuals of the same organizations were earning more than $400,000. Id. In the hearings conducted on August 2, 1993, the Director of the I.R.S.'s Exempt Organizations Division presented examples, based on actual audits, of high, and arguably excessive, compensation packages of officers of exempt organizations. See Hearings II, supra note 18. One instance involved the chief executive officer of a health care organization who earned over $1 million in base salary, executive compensation, and other benefits. But see Hearings I, supra note 5 (testimony of Bennett Weiner, Vice-President of Philanthropic Advisory Service, stating that executive compensation in tax-exempt sector is generally not excessive but in line with demands of market).

26 See Hearings I, supra note 5. The Subcommittee learned of one case in which the president of a school received a $1 million loan to purchase and renovate his home; the loan had a term of 50 years and was interest free. Id.

27 See Hearings II, supra note 18. In one case, for example, an executive of an exempt organization paid for his "child's college tuition, leased a luxury car for his wife, had his kitchen remodeled, and rented a vacation house" using organization assets. Id. In the same case, the charity allowed the executive to charge almost $60,000 on the organization's credit card. Id. In another case, the CEO of an exempt organization used organization assets to pay for "such personal items as liquor, china, crystal, perfume, airplane, and theater tickets." Id.

Although the Subcommittee acknowledged that these types of abuses were clearly exceptions to general practice, it nevertheless noted that "charities are not immune from abuse by executives more interested in lining their own pockets than in serving the public." Id.
Although section 501(c)(3) exempt organizations do not generally pay federal income tax,\(^\text{28}\) in most cases, they are required to file an annual informational tax return on I.R.S. Form 990.\(^\text{29}\) Form 990, which is available for public inspection,\(^\text{30}\) requires disclosure of organization revenues and expenses.\(^\text{31}\) Internal Revenue Service officials testified that the current Form 990 permits public charities to hide the payment of executives' personal expenses and misrepresent the amount of charitable activities they perform.\(^\text{32}\) In addition, these officials were concerned with the lack of diligence used by exempt organizations in filling out these forms, which are often incorrectly or only partially completed when filed.\(^\text{33}\)

Perhaps a unifying theme of the hearings was the concern that current law does not provide the I.R.S. with appropriate administrative remedies to respond to abuses by public charities.\(^\text{34}\) Currently, if a public charity is found in violation of one or more statutory or regulatory requirements, the primary course of action available to the I.R.S. is revocation of the organization's tax-exempt status.\(^\text{35}\) Although this response appears equitable, in many cases revocation fails to punish the culpable


\(^{29}\) \textit{Id.} § 6033(a) (1988). The filing requirement does apply, \textit{inter alia}, with respect to churches and other religious organizations as well as organizations whose gross receipts do not normally exceed $5,000. See \textit{HOPKINS, supra} note 1, § 34.3, at 643-44. The I.R.S., using its discretion under section 6033(a), has indicated that churches and other organizations whose gross receipts do not normally exceed $25,000 will not have to file. Rev. Proc. 83-23, 1983-1 C.B. 687.

\(^{30}\) I.R.C. § 6104(e)(2) (1988); \textit{see infra} notes 142-45 and accompanying text (discussing public's access to Forms 990).

\(^{31}\) \textit{See generally} \textit{HOPKINS, supra} note 1, § 34.3 (discussing reporting requirements). In particular, certain items must be provided such as public contributions and similar revenues as well as various expenses including compensation, fundraising, and management expenses. \textit{Id.}

\(^{32}\) \textit{See Hearings II, supra} note 18.

\(^{33}\) \textit{See Hearings I, supra} note 5; \textit{Hearings II, supra} note 18.

The Subcommittee was also interested in determining whether the I.R.S. had sufficient resources and personnel to effectively monitor exempt organization compliance. See \textit{Hearings I, supra} note 5. It was noted that the I.R.S. has fewer employees today monitoring exempt organization than in 1980. \textit{Id.} In response, the I.R.S. contended that, although more resources would be helpful, their current focus on the larger organizations does not necessarily require additional staff or other resources. \textit{Id.} See \textit{generally} Gaul & Borowski, \textit{IRS Can't Keep Up, supra} note 17, at A1.

\(^{34}\) \textit{See Hearings I, supra} note 5.

\(^{35}\) \textit{See Hearings I, supra} note 5. The I.R.S. can also respond to exempt organization violations by entering into a "closing agreement" with the organization. \textit{Id.} A closing agreement is essentially a contract between the I.R.S. and the organization whereby the organization promises to take certain corrective action, or pay taxes, or both, in order to maintain its tax-exempt status. \textit{Id.} Although this type of action is generally less harmful than revocation, it is administratively cumbersome since each closing agreement must be individu-
parties and, in effect, may penalize the intended beneficiaries of the charity or organization.\textsuperscript{36}

It is submitted that, due to the abusive activities occurring at public charities, statutory reform is necessary to prevent future incidents and restore the public's confidence in these institutions. Recently, members of the federal government as well as private institutions have suggested certain legislative revisions. In particular, so-called "intermediate sanctions" legislation has been proposed, which essentially imposes an excise tax on certain proscribed activities. In addition, suggestions have been made for increasing the amount and quality of disclosure by public charities.

This Article will review and analyze the significant proposals made and suggest how accountability to the general public and compliance with governing laws can be increased. Part I briefly outlines the relevant requirements for exemption under section 501(c)(3). Part II analyzes the various approaches to intermediate sanctions legislation and concludes that a narrowly-focused approach should be implemented. Finally, Part III evaluates the recent proposals for increasing and improving disclosure. This Part asserts that, while the recent proposals are helpful, other alternatives explored in this Part may prove more effective.

I. BACKGROUND: THE REQUIREMENTS OF SECTION 501(c)(3)

Section 501(a) provides an exemption from federal income tax for organizations that satisfy the requirements described in sections 501(c) and 501(d).\textsuperscript{37} Although these provisions cover different types of organizations,\textsuperscript{38} section 501(c)(3) describes the most commonly-known and sig-

\textsuperscript{36} See \textit{Hearings I}, supra note 5. For example, if the officers of an exempt organization self-deal, thereby causing the I.R.S. to revoke the organization's tax-exemption, the harm resulting from a subsequent termination of the organization would fall primarily on the individuals relying on the organization's services, and not on the responsible officers. \textit{See Hearings III, supra} note 18 (illustrating by example inadequacies of existing sanctions). Because revocation has such severe consequences, the I.R.S. revoked only approximately 500 exemptions in 1992, as compared to approving over 30,000 new applications. \textit{See Hearings I, supra} note 5.

\textsuperscript{37} I.R.C. § 501(a) (1988); Treas. Reg. § 1.501(a)-1 (as amended in 1982).

\textsuperscript{38} See, e.g., I.R.C. § 501(c)(2) (1988) (title holding companies); Id. § 501(c)(4) (civic leagues and social welfare organizations); Id. § 501(c)(5) (labor and agricultural organizations); Id. § 501(c)(6) (business leagues); Id. § 501(c)(7) (social clubs); I.R.C. § 501(c)(9) (employee associations); Id. § 501(c)(10) (fraternal associations); Id. § 501(c)(11) (teachers' retirement fund associations); Id. § 501(c)(12) (1988 & Supp. 1994) (life insurance associations); Id. § 501(c)(13) (1988) (cemetery companies); I.R.C. § 501(d) (religious and apostolic organiza-
nificant category which exempts organizations that are "organized and operated exclusively for religious, charitable, scientific . . . or educational purposes." To qualify for tax exempt status under section 501(c)(3), an organization must satisfy four requirements: (1) it must be "organized and operated exclusively" for exempt purposes; (2) no part of its net earnings may inure to the benefit of a private shareholder or individual; (3) no part of its activities may constitute intervention or participation in any political campaign for public office; and (4) no substantial part of its activities may consist of political or lobbying activities. This Part will discuss the first two requirements since they are relevant to analyzing recent abuses by public charities.

A. "Organized and Operated Exclusively" for Exempt Purposes

According to the Treasury regulations, the requirement that an organization be "organized and operated exclusively for religious, charitable, scientific . . . or educational purposes" represents two separate and distinct inquiries: an "organizational test" and an "operational test." The organizational test requires that the articles of organization limit the organization's purposes to one or more of those listed in the statute. Similarly, the operational test requires that the organization's activities actually seek to accomplish one or more exempt purposes. Although section 501(c)(3) requires that an organization be "organized and operated exclusively" for exempt purposes, the term "exclusively" has not been accorded its literal meaning. Rather, it has been inter-
preted to mean "primarily" or "substantially," and not "solely." Thus, an organization can still qualify for tax exempt status despite having some nonexempt purposes, such as ancillary business activities. Case law and I.R.S. rulings permit such nonexempt activities to the extent they are not "substantial," but rather are "only incidental" to the organization's pursuit of valid exempt purposes. The determination of whether an organization's nonexempt activities are "insubstantial" is a question of fact, requiring analysis of all relevant facts and circumstances. Various factors considered include the profitability of the nonexempt activities and the extent of the organization's participation in such activities.

To determine whether an organization qualifies under section 501(c)(3), courts and the I.R.S. also apply the "private benefit" doctrine.

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48 See Treas. Reg. § 1.501(c)(3)-1(b) (as amended in 1990) (allowing articles of organization to authorize "insubstantial" portion of exempt organization's activities to be nonexempt); Id. § 1.501(c)(3)-1(c) (stating that organization operates exclusively for exempt purposes so long as it "engages primarily in [such] activities") (emphasis added); HOPEKINS, supra note 1, at 225.


Congress has expressly acknowledged that an exempt organization can conduct a trade or business unrelated to its exempt purpose by enacting the unrelated business income tax (the "UBIT"). I.R.C. §§ 501(b), 511-514 (1988). See generally Donald C. Haley, The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem to be Headed?, 7 AKRON TAX J. 61 (1990) (discussing administrative and judicial application of UBIT provisions).

50 See Better Business Bureau, 326 U.S. at 283 ("The presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."); Trinidad, 263 U.S. at 578 (allowing "incidental" commercial activity of exempt organization); supra note 49; see also TREUSCH, supra note 3, at 111-17 (citing cases and I.R.S. authority).

51 See Orange County Agric. Soc'y, 55 T.C.M. (CCH) at 1604; Church of Scientology v. Commissioner, 83 T.C. 381, 474 (1984), aff'd, 823 F.2d 1310 (9th Cir. 1987); Kentucky Bar Found. v. Commissioner, 78 T.C. 921 (1982); B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978). In general, this analysis should focus on the purposes of the nonexempt activities, and not merely their nature. See Lawrence Zelanek, Serving Two Masters: Commercial Hues and Tax Exempt Organizations, 8 U. PUGET SOUND L. REV. 1 (1984).


53 See Greater United Navajo Dev. Enters., Inc. v. Commissioner, 74 T.C. 69 (1980), aff'd mem. 672 F.2d 922 (9th Cir. 1981); see also TREUSCH, supra note 3, at 111-13 (listing additional factors and authority).
This doctrine, which is derived from the operational test, prohibits an organization from benefitting private interests by more than an insubstantial amount. For example, in *American Campaign Academy v. Commissioner*, the Tax Court found that a school organized and operated to train students for political campaign positions substantially benefitted the private interests of the Republican party and, thus, did not qualify under section 501(c)(3). Conversely, in *Aid to Artisans, Inc. v. Commissioner*, the Tax Court found that an organization which bought handicrafts from artisans located in impoverished communities for sale to museums provided substantial public benefit, despite the incidental private benefits to artisans who were not themselves disadvantaged.

The I.R.S., in applying this doctrine, requires that any private benefit be both "quantitatively" and "qualitatively" incidental. Private benefit is quantitatively incidental if the "overall public benefit conferred by the [organization's] activity(ies)" is incidental. On the other hand, private benefit is qualitatively incidental if such benefit is considered a "necessary concomitant of the activity which benefits the public at large."

**B. No Private Inurement of Net Earnings**

An organization exempt under section 501(c)(3) may not allow any "part of . . . [its] net earnings . . . inure to the benefit of any private shareholder or individual." This requirement, which prohibits the distribution of earnings to shareholders, represents the critical, substantive distinction between profit and not-for-profit organizations. Generally, the private inurement doctrine is aimed at preventing the "insiders"

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54 See HOPKINS, supra note 1, § 12.6.
57 Id. at 1079.
59 Id.
62 Id.
64 See Hansmann, supra note 7, at 838 (terming private inurement doctrine "nondistribution constraint").
65 See HOPKINS, supra note 1, § 12.1, at 240.
of an exempt organization from obtaining private benefits. In this context, an “insider” includes the creator of the organization, a shareholder, or any other individual or group that can influence or control the actions of the organization. Private inurement may take many forms; most notably, “self-dealing” transactions often offend this doctrine. Excessive compensation paid to officers or employees is one instance of private inurement. Similarly, transactions between insiders and the organization on below-market terms will constitute private inurement. Private inurement may also occur in less obvious ways such as when an organization undertakes a joint venture with an entity controlled or owned by an insider or when an insider enjoys unreasonable fringe benefits.

From an analytical perspective, the private inurement doctrine seems to overlap with the private benefit doctrine of the operational test. Although both prohibit public charities from benefitting private interests, the two doctrines clearly differ in that the private benefit doctrine applies not only to insiders but also to “disinterested” parties. Thus, while excessive compensation could violate both the private inurement and private benefit doctrines, non-arm’s length transactions between exempt organizations and third parties could violate only the private benefit doctrine.

67 See, e.g., International Postgraduate Medical Found. v. Commissioner, 56 T.C.M. (CCH) 1140 (1989); Gondia Corp. v. Commissioner, 44 T.C.M. (CCH) 590 (1982).
68 See, e.g., Orange County Agric. Soc’y v. United States, 893 F.2d 647 (2d Cir. 1990); Birmingham Business College v. Commissioner, 276 F.2d 476 (5th Cir. 1960).
70 See supra notes 22-27 and accompanying text.
71 See Hopkins, supra note 1, at 250 n.70 (citing cases in which inurement found based on excessive compensation). But see Gen. Couns. Mem. 39,674 (June 17, 1987) (allowing organization to provide profit-sharing plan).
72 See, e.g., Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980) (funds borrowed at below-market interest rate), aff’d per curiam, 647 F.2d 163 (2d Cir. 1981); Texas Trade Sch., 30 T.C. at 642 (excessive rental payments).
73 See Hopkins, supra note 1, at 260.
74 Compare supra notes 54-62 and accompanying text (discussing private benefit doctrine) with supra notes 63-75 and accompanying text (discussing private inurement doctrine).
II. INTERMEDIATE SANCTIONS: HOW SHOULD THEY BE IMPLEMENTED?

Currently, if the officers, directors, or shareholders of an organization exempt under section 501(c)(3) engage in acts resulting in substantial private benefit or private inurement, the I.R.S. may revoke the organization's tax exemption.\textsuperscript{77} As noted above, however, this remedy can have harsh consequences that may neither punish the wrongdoers, nor ensure that the charity's beneficiaries will be protected.\textsuperscript{78} Accordingly, several legislative proposals have been suggested that provide an "intermediate sanction" in the form of an excise tax on certain prohibited acts of private benefit and private inurement.\textsuperscript{79} Although the amount and application of the excise tax vary among the proposals, they are all based on the two-tier excise tax mechanism applicable to private foundations, a subset of section 501(c)(3) organizations.

It is asserted that a broad application of the private foundation rules to public charities is inappropriate given the magnitude and type of abuses occurring in the tax-exempt sector. Further, even proposals adopting only the self-dealing restrictions applicable to private foundations are not necessarily appropriate. Finally, it is suggested that a tightly-focused approach to imposing intermediate sanctions is justified. Before analyzing the proposals, an overview of the relevant restrictions governing private foundations is necessary.

A. The Private Foundation Regime

Broadly stated, private foundations are distinguishable from other section 501(c)(3) tax-exempt charitable organizations in that private foundations derive their principal financial support from one source, such as an individual or family, rather than from public contributions.\textsuperscript{80} Traditionally, private foundations were the subject of pointed debate,\textsuperscript{81} with critics asserting that private foundations served primarily private interests, rather than public good.\textsuperscript{82} In response, Congress aimed to cur-

\textsuperscript{78} See supra note 36.
\textsuperscript{79} See, e.g., infra notes 114-20, 125-29 and accompanying text (discussing various proposals).
\textsuperscript{80} See Hopkins, supra note 1, at 437. "The 'private' aspect of a private foundation, then, principally looks to the nature of its financial support, rather than to the nature of its governance." Id.
\textsuperscript{82} See Hopkins, supra note 1, § 20.1, at 429-32; Nielsen, supra note 81, at 5-16; Treusch, supra note 3, at 429-30.
tail abuses within such organizations through the Tax Reform Act of 1969.\textsuperscript{83}

As a preliminary matter, Congress established two categories of charitable organizations: "private foundations," which would be subject to the new restrictions, and "public charities," which would not.\textsuperscript{84} As codified under section 509(a) of the Code, a "private foundation" is implicitly defined as an organization described under section 501(c)(3) that, \textit{inter alia}, does not: (1) derive a substantial portion of its support from the government or public contributions,\textsuperscript{85} or (2) receive more than one-third of its support from contributions, sales, or services revenues, and does not receive more than one-third of its gross support from gross investment income.\textsuperscript{86}

As a result of the Tax Reform Act of 1969, private foundations are now subject to an elaborate regulatory regime which imposes an excise tax on certain prohibited activities.\textsuperscript{87} Of particular relevance is the excise tax imposed on self-dealing transactions.\textsuperscript{88}

"Self-dealing," as defined in the Code, includes sales, leases, loans, or other transfers of benefit between a private foundation and a "disqualified person."\textsuperscript{89} "Disqualified persons" generally include substantial contributors or owners of the foundation, foundation managers,\textsuperscript{90} entities in which disqualified persons have more than a thirty-five percent interest,\textsuperscript{91} and family members of certain disqualified persons.\textsuperscript{92} The Code provides, however, certain exceptions to the definition of self-dealing

\textsuperscript{84} I.R.C. § 509(a) (1988).
\textsuperscript{85} Id. § 509(a)(1). This provision specifically excludes "organization[s] described in section 170(b)(1)(A)." Id. Organizations described under section 170(b)(1)(a), I.R.C. § 170(b)(1)(a) (1988), include most traditional public charities such as museums, hospitals, churches, schools, and research institutions. See Treas. Reg. § 1.170(a)-9(e)(1)(ii); \textsc{Treusch}, supra note 3, at 435.
\textsuperscript{86} I.R.C. § 509(a)(2) (1988). Two other categories are also not considered private foundations: so-called "support organizations," id. § 509(a)(3), and organizations "organized and operated for testing for public safety," id. § 509(a)(4). See generally \textsc{Treusch}, supra note 3, at 436.
\textsuperscript{87} See \textsc{Treusch}, supra note 3, at 548-55.
\textsuperscript{88} I.R.C. § 4941 (1988).
\textsuperscript{89} Id. § 4941(d); Treas. Reg. § 53.4941(d)-2 (as amended in 1984); see, e.g., Rev. Rul. 78-395, 1978-2 C.B. 270 (transfer of property); Rev. Rul. 76-18, 1976-1 C.B. 355 (sale of goods).
\textsuperscript{90} I.R.C. § 4946(a)(1)(A), (C) (1988).
\textsuperscript{91} Id. § 4946(a)(1)(B); see id. § 4946(b)(1) (defining "foundation manager" to include "officer, director, or trustee of [the] foundation").
\textsuperscript{92} Id. § 4946(a)(1)(E)-(G).
\textsuperscript{93} Id. § 4946(a)(1)(D).
which, for example, permit the payment of reasonable compensation to certain disqualified persons.94

The excise tax on self-dealing adopts a two-tiered approach. Initially, a disqualified person who engages in an act of self-dealing will be liable for 5% of the "amount involved" 95—the greater of the amount of money and property given or the amount of money and property received.96 As part of this first level of tax, a foundation manager who knowingly participates in such act will similarly be subject to a tax of 2.5% of the amount involved.97 If the act of self-dealing resulting in the initial excise is not "corrected" within the taxable period,98 the second tier of the tax will be triggered, and the disqualified person and foundation manager will be liable for an additional tax equal to 200% and 50%, respectively, of the amount involved.99 To avoid this second level of tax, curative steps must be taken to either "undo" the transaction, if possible, or provide restitution to the foundation.100

In addition to self-dealing transactions, a similar two-level excise tax is imposed on certain other activities engaged in by private foundations. These activities include: maintaining excessive business holdings,101 incurring certain taxable expenditures,102 making unreasonable or so-called "jeopardizing" investments103 and accumulating assets.104 In yet other instances, a private foundation may be subject to a single excise tax. For example, if a private foundation terminates without first

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94 Id. § 4941(d)(2)(E); Kermit Fischer Found. v. Commissioner, 59 T.C.M. (CCH) 898, 901 (1990).
96 Id. § 4941(e)(2).
97 Id. § 4941(a)(2).
98 Id. § 4941(e)(1) (defining "taxable period").
99 Id. § 4941(b)(1)-(2). The foundation manager's liability with respect to each level of tax shall not exceed $10,000. I.R.C. § 4941(c)(2).
100 Id. § 4941(e)(3) (1988).
101 Id. § 4943. Private foundations in combination with certain related parties may not hold more than a 20% interest in any business enterprise. Id. § 4943(c)(2)(A). This percentage is increased to 35% if it can be shown that the private foundation does not have effective control of the business. Id. § 4943(c)(2)(B).
102 I.R.C. § 4945. Private foundations may not pay or incur expenses related to certain nonexempt activities such as influencing legislation or a specific election. Id. § 4945(d)(1)-(2).
103 Id. § 4944. Private foundations are prohibited from making investments that would "jeopardize" their ability to carry out their tax-exempt purposes. Id. § 4944(a)(1). The Treasury regulations interpret this requirement to mean that a private foundation manager must exercise ordinary business care and prudence in managing and investing foundation assets, considering all facts and circumstances. Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973).
104 I.R.C. § 4942 (1988). In order to avoid imposition of an excise tax, private foundations must distribute annually at least five percent of the value of their nonexempt net assets. Id.
transferring its assets to another public charity, it will be subject to an excise tax.\footnote{Id. § 507. Private foundations are also subject to an excise tax on certain investment income earned. Id. § 4940.}

\subsection*{B. Applying Private Foundation Restrictions to All Section 501(c)(3) Organizations}

One approach to implementing an intermediate sanction regime with respect to public charities is to adopt all or most of the restrictions and rules applicable to private foundations.\footnote{See Independent Sector Supports "Most" Proposals on Public Charities' Accountability, Tax Notes Today, Dec. 16, 1993, available in LEXIS, Fedtax Library, TNT File (suggesting one alternative to public charity reform is adoption of some or all of private foundation restrictions) [hereinafter Independent Sector].} This method might appear attractive since the regulations imposed on private foundations have successfully curbed abusive activities. Thus, similar results could be achieved if the same restrictions were imposed on public charities. While this approach has superficial appeal, the price exacted would be neither justifiable nor beneficial to the long-term interests of the government and general public.

In 1969, after extensive hearings,\footnote{Hearings on the Tax Reform Act of 1969 Before the Comm. on House Ways and Means, 91st Cong., 1st Sess. (1969), reprinted in Tax Reform, 1969: Hearings Before the Committee on Ways and Means, House of Representatives, Ninety-First Congress, First Session, on the Subject of Tax Reform (1969).} Congress decided that the two-tiered excise taxes were necessary only with respect to certain section 501(c)(3) organizations—private foundations.\footnote{See supra notes 83-86 and accompanying text.} Congress' decision to allow public charities substantially greater regulatory freedom was primarily based on the belief that public charities, unlike private foundations, were not generally vehicles of abuse.\footnote{See Independent Sector, supra note 106.} Since public charities relied mainly on the general public for their continued financial support, they were accountable to the public for their actions; in this respect, public charities differed markedly from private foundations which were usually financially independent. Today, public charities still generally rely on public donations. Thus, because they remain accountable to the public, the application of the private foundation rules still appears inappropriate.\footnote{See Independent Sector, supra note 106. But cf infra notes 135-83 and accompanying text (discussing need and alternatives to improve public charity disclosure).}

Perhaps a more fundamental reason for not adopting all or most of the private foundation rules is that they would be unnecessary in light of the actual and alleged abuses of public charities. As noted above, an excise tax is imposed on private foundations for activities such as excess
business holdings, taxable expenditures and unreasonable or jeopardizing investments. There is little evidence of such activities within public charities to substantiate prohibitions of this nature. Moreover, these prohibitions would impose major operational and managerial constraints on public charities that would significantly, and inappropriately, hinder the pursuit of organizations' exempt purposes.

Recently, Representative Fortney Pete Stark introduced a bill that proposed a limited application of the private foundation rules. In particular, the bill proposed self-dealing restrictions for public charities that were very similar to the provisions applicable to private foundations. As with private foundations, the bill imposed an absolute prohibition on "self-dealing" between "disqualified persons" and the exempt organization. Under the bill, if a disqualified person engaged in an act of self-dealing, an initial excise tax would be imposed; if the act was not subsequently "corrected," the second level of tax would be imposed. While this approach is certainly superior to the wholesale application of the private foundation rules, the absolute prohibition on self-dealing is inap-

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\item[111] See supra notes 101-104.
\item[112] See supra notes 21-36 and accompanying text (summarizing findings from congressional hearings on public charities).
\item[115] Id. In addition the bill proposed that a similar two-level excise tax be imposed with respect to acts of "private inurement." Id.; see supra notes 63-76 and accompanying text (discussing private inurement). Further, the bill's provisions would apply not only to section 501(c)(3) organizations but also to section 501(c)(4) organizations, which generally include social and civic welfare organizations. See Stark Bill, supra note 114; I.R.C. § 501(c)(4) (1988). See generally Michael W. Peregrine & Bernadette M. Broccolo, Stark Introduces Exempt Organizations "Intermediate Sanctions" Legislation, 9 Exempt Organization Tax. Rev. 131 (1994) (summarizing and analyzing Stark bill).
\item[116] See Stark Bill, supra note 114. "Self-Dealing" is defined as the "direct or indirect transfer, lease, or license of property between an applicable tax-exempt organization and a disqualified person," and "lending of money or other extension of credit between an applicable tax-exempt organization and a disqualified person." Id. The term "disqualified person" includes "any person who was an organization manager at any time during the five year period ending on the date of [the self-dealing] transaction," "any member of a family" of an organization manager, or a corporation, partnership, trust, or estate in which organization managers or their families have more than a 35% interest. Id.
\item[117] Id. Under the Stark bill, for each act of "self-dealing," an initial excise tax would be imposed on the "disqualified person" and the "organization manager" in the amount of 5% and 2.5%, respectively.
\item[118] See Stark Bill, supra note 114. Under the bill, "correction" of a prohibited transaction means preventing any future inurement and either "undoing" the transaction or, if that is not possible, taking such curative steps as would be prescribed in Treasury regulations. Id.
\end{itemize}
propriate with respect to public charities. Very often, public charities rely heavily on contributions by, or favorable transactions with, organization insiders who, under the proposed bill, would be disqualified persons. Particularly in small communities, it is quite common for organization insiders to provide needed services or goods that otherwise would be unaffordable or unavailable to the organization. Thus, an absolute ban on self-dealing is an exaggerated response with harmful effects that outweigh the actual abuses it prevents.

C. A Focused Approach to Intermediate Sanctions

The types of abuses occurring within public charities generally involve self-dealing transactions such as excessive compensation, interest-free loans and other non-arm's length transfers of assets to insiders. However, as noted above, considering that beneficial self-dealing transactions frequently take place, an absolute ban would not be an appropriate solution. Thus, an approach which imposes an intermediate sanction only to the extent the self-dealing transaction inappropriately favors an insider, would discourage abusive self-dealing, while permitting self-dealing that confers a benefit on the public charity. Specifically, an intermediate sanction should be imposed if the transaction between the insider and the organization does not reflect an arm's length transaction, and the party favored in the deal is the insider.

This approach was recently adopted in a Treasury Department proposal which suggested that an excise tax be imposed on any "excess benefit" conferred on "insiders." An excess benefit "is the excess of the

120 See Administration, supra note 119; Independent Sector, supra note 106; Practitioners Criticize, supra note 119 (noting Stark bill may have "chilling effect on some transactions that are not abusive").
121 See Independent Sector, supra note 106.
122 See supra notes 21-27 and accompanying text.
123 See supra notes 23-27.
124 See supra notes 119-21.
125 See Hearings III, supra note 18; see also Independent Sector, supra note 106. The Independent Sector, an association of over 850 philanthropic organizations, previously submitted a proposal that adopted the same approach—albeit with different terminology—as that of the Treasury. Id. Under the Independent Sector's proposal, a two-tiered excise tax would be imposed with respect to "non-fair market value use of income or assets" on the organization, certain beneficiaries, and the organization manager involved. Id. Slightly more narrow than the Treasury's approach, the Independent Sector's excise tax would apply only with respect to two types of transactions: (1) the "payment of unreasonable com-
value of any benefit provided by the organization over the consideration received by the organization in return for the benefit." \(^{126}\) Insiders would include: (1) "the officers, directors, and trustees of the organization;" (2) "those otherwise in a position to exercise substantial influence over the organization's affairs;" (3) family members of insiders; and (4) "entities in which an insider or family members have significant direct or indirect beneficial interests." \(^{127}\) Under this proposal, an excise tax of 25% would initially be imposed on the amount of excess benefit provided to an insider. \(^{128}\) If the excess benefit was not subsequently repaid to the organization, then an additional tax equal to 200% of the excess benefit would be imposed. \(^{129}\)

In practice, this regime would generally apply to unreasonable compensation and non-fair market value transfers of organization assets to insiders. \(^{130}\) Thus, while the Treasury's proposal is admittedly limited, it would nevertheless address the large majority of abuses occurring at public charities. In addition, for certain flagrant or continuous abuses by a public charity, the I.R.S. would still retain the authority to revoke the organization's tax exemption if circumstances otherwise warranted. \(^{131}\)

Arguably, a shortcoming of the Treasury's proposal is that it does not impose an excise tax on all forms of private inurement and private benefit. This limitation does not appear significant, however, since most recent abuses involving private inurement and private benefit would be subject to the proposed excise tax mechanism. \(^{132}\) In any case, however, an intermediate sanction based on the private inurement and private benefit standards might not be effective in light of the very fact-oriented and imprecise nature of these legal concepts. \(^{133}\) An administrative remedy based on these abstract standards would likely be inefficient and
could promote inconsistent treatment of similarly-situated organizations.\textsuperscript{134}

III. \textbf{INCREASED DISCLOSURE AND COMPLIANCE REQUIREMENTS}

An essential element of improving public charities' compliance with relevant laws and regulations is to increase the amount and quality of information available to the general public. Public charities traditionally have been accorded considerable operational flexibility and freedom from governmental regulation.\textsuperscript{135} However, these benefits are justifiable only to the extent that public charities are held accountable to their primary financial contributors—the general public.\textsuperscript{136} The primary means of ensuring this accountability has been through permitting the general public to inspect public charities' annual informational return on I.R.S. Form 990. At recent congressional hearings, however, it was noted that Form 990 is not serving its intended purpose since public charities often misrepresent information or even fail to provide it at all.\textsuperscript{137} As a result, debate has arisen regarding the manner in which Form 990 should be revised to resolve these issues.

The Treasury recently proposed several changes to the content and administration of Form 990. It is asserted, however, that these proposals, while helpful, may not provide the needed stimulus to encourage public accountability by public charities. Specifically, special attention should be paid to increasing the quality of existing disclosure,\textsuperscript{138} rather than creating new categories of disclosure. Accordingly, with this focus, several additional alternatives are outlined that seek this objective.

A. \textit{Current Law and Recent Proposals}

Under current law, the only penalty imposed for failure to file a timely or complete Form 990 is $10 for each day the failure continues, up to the lesser of $5,000 or five percent of the gross receipts of the organization for the year.\textsuperscript{139} If the failure is willful, an additional penalty of

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\textsuperscript{134} See \textit{Independent Sector}, supra note 106. It should be noted that once a limited intermediate sanction mechanism is in place, subsequent amendments could be implemented that would target specific elements of private inurement or private benefit. In this manner, the restrictions placed on public charities would be implemented only for specific and problematic abusive activities.
\textsuperscript{135} See supra notes 107-10 and accompanying text.
\textsuperscript{136} Id.
\textsuperscript{137} See supra notes 32-33 and accompanying text; \textit{Hearings III}, supra note 18.
\textsuperscript{138} See \textit{Hearings II}, supra note 18 (noting that major problem with Forms 990 is that portions are frequently left blank) (testimony of Ormstedt, Assistant Attorney General, State of Connecticut).
\textsuperscript{139} I.R.C. § 6652(c)(1) (1988). \textit{But see id.} § 6652(c)(3) (providing exception from penalty for "reasonable cause").
\end{footnotesize}
$1,000 applies. The Treasury recently proposed to increase these penalties from $10 to $100 a day, with a cap of $50,000, for organizations with gross receipts exceeding $1 million per year.\textsuperscript{140} A smaller increase from $10 to $20 would apply to companies with gross receipts below $1 million, with a cap of the lesser of $10,000 or five percent of the gross receipts.\textsuperscript{141}

As noted above, any person may review a public charity's Form 990.\textsuperscript{142} In addition, an organization's application for exemption, supporting documentation, and letters sent by the I.R.S. in response to the application are available for public inspection.\textsuperscript{143} Under existing law, however, a person interested in examining this information must go to the organization's place of business to view the documents.\textsuperscript{144} Further, in these cases, the organization is not required to provide the interested person with copies of the requested information.\textsuperscript{145} To improve access to this data, the Treasury has proposed that an organization be required to copy and mail the Form 990 or other information upon any person's request, provided that the person making the request pays a reasonable fee for copying and mailing the information.\textsuperscript{146} A penalty equal to the amount proposed for the failure to file Form 990 would apply to organizations that do not comply with requests for copies of their Form 990.\textsuperscript{147}

In its current form, Form 990 includes an itemization of organization revenues and expenses, a current balance sheet, and various other items including a statement of program accomplishments, a list of officers, directors, and trustees and information regarding taxable subsidiaries.\textsuperscript{148} The Treasury has proposed that additional information be dis-

\textsuperscript{140} See Hearings III, supra note 18.
\textsuperscript{141} Id.
\textsuperscript{142} Public charities are not required, however, to disclose the names of contributors. I.R.C. § 6104(e)(1)(C) (1988).
\textsuperscript{143} Id. § 6104(e)(2).
\textsuperscript{144} Id. Section 6104(e)(2) provides, in relevant part, that an organization exempt under section 501 must make available for public inspection:

\begin{quote}
A copy of . . . [its exemption] application (together with a copy of any papers submitted in support of such application and any letter or other document issued by the Internal Revenue Service with respect to such application) . . . during regular business hours by any individual at the principal office of the organization and, if the organization regularly maintains 1 or more regional or district offices having 3 or more employees, at each such regional or district office.
\end{quote}

\textsuperscript{Id.}
\textsuperscript{145} See id.
\textsuperscript{146} Hearings III, supra note 18.
\textsuperscript{147} Hearings III, supra note 18.
\textsuperscript{148} See generally Hopkins, supra note 1, § 34.3 (detailing items to be included in Form 990).
closed on Form 990, such as any excise taxes imposed based on excess benefits or similar sanctions. In addition, the Treasury expressed support for modifying Form 990 to prevent misrepresentations and increase the accuracy of disclosure by public charities.

B. Other Proposals to Increase Public Accountability

1. Penalty on Certifying Directors or Trustees

Although, if implemented, the Treasury’s proposal to increase the filing penalties should have some impact on increasing disclosure by public charities, the overall focus of this approach appears misguided. When organization insiders have the unbridled power to engage in abusive self-dealing transactions, it is probable that they would be equally capable of coercing non-disclosure or inaccurate disclosure of these transactions on the Form 990. Since under current law, as well as under the Treasury’s proposal, nondisclosure penalties are primarily imposed on the organization itself, insiders would probably prefer incurring such penalties to disclosing information indicating abusive transactions. This preference against disclosure will be even greater if intermediate sanctions are imposed with respect to abusive self-dealing transactions. Of course, persistent nondisclosure resulting in the accumulation of penalties will eventually become known to contributors, at which point they may either demand accountability or refuse to make further donations. Unfortunately, it may take years before such accountability is ultimately demanded, providing nefarious insiders the opportunity to become unjustly enriched.

In order to increase the amount and quality of disclosure on Form 990, it is submitted that the chairman, on behalf of the charity’s board of directors or trustees, and the controller or responsible officer should be

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150 Hearings III, supra note 18. In addition, the Treasury proposed that additional information be requested on Form 990, such as significant changes in the management of an organization, changes in the membership of its governing board, and any change of the certified public accounting firm examining the organization’s books and records. Id.

151 Id.

152 Indeed, the officer responsible for overseeing the preparation of the Form 990 could conceivably be the party engaging in such abusive activities.


154 Similar to the unfair consequences resulting from exemption revocation, see supra note 36 and accompanying text, this scenario presents the ironic situation in which the culpable parties are not held responsible while innocent parties—beneficiaries of the organization—are harmed.
required to certify the form. This requirement would presumably increase the board's involvement with and supervision of organization activities, consequently improving the quality of disclosure and making it more difficult for officers to act appropriately. Further, outside directors, who may not otherwise be involved in the operations of the charity, would be prompted to scrutinize the decisions and activities of fellow board members and officers.

As an enforcement incentive, a penalty similar in amount and operation to that proposed by the Treasury would be imposed directly on each board member for an incomplete or inaccurate Form 990. In this way, board members would be motivated to ensure compliance with all disclosure requirements. In fairness, however, certain de minimis exceptions should be implemented so that penalties will only be levied on board members for material or substantial failures to complete the form.155

Under this proposal, disclosure on Form 990 would be greatly enhanced. Equally important perhaps, it would place the penalty burden on the parties ultimately responsible for any misconduct occurring within the organization, sparing needless and unfair waste of organizations' assets.

2. Penalty on Tax Return Preparer

Tax return preparers are generally liable for negligent or willful conduct that results in the understatement of liability reported on a tax return.156 A penalty in the amount of $250 and $1,000 is imposed on the tax return preparer with respect to negligent or willful conduct, respec-

155 In addition, the penalty should not be imposed if “reasonable cause” can be shown for failure to properly complete or file the Form 990. Cf. I.R.C. § 6652(c)(3) (1988) (providing “reasonable cause” exception for penalty imposed with respect to organization's failure to file Form 990).
156 I.R.C. § 6694(a)-(b) (1988 & Supp. 1994). Section 6694(a), the so-called negligence penalty, provides in relevant part that if:

1. any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on the merits, [and]
2. any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, . . . such person shall pay a penalty of $250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

Id.

With respect to willful or reckless conduct, I.R.C. section 6694(b) provides, in relevant part, that if the understatement is due:

1. to a willful attempt in any manner to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or
This penalty, however, only applies with respect to the preparation of a "tax return." As defined in the Treasury regulations, a tax return does not include Form 990; thus, a Form 990 preparer, while not necessarily aiding or abetting any abusive nondisclosure, is certainly not motivated to promote accurate and complete disclosure.

It is therefore submitted that, to further encourage full disclosure on I.R.S. Form 990, a modified understatement penalty be imposed with respect to the Form 990 preparer. Because abusive insiders of public charities can likely control the degree of disclosure on Form 990, a third-party return preparer could serve as an independent reviewer. As under current law, to avoid a negligence penalty with respect to preparation of Form 990, the preparer must act reasonably in light of all circumstances. To avoid a penalty based on willful or fraudulent conduct, the preparer must undertake a due diligence review of the tax return. This due diligence requirement would not require the preparer to undertake an audit of the public charity's Form 990, or investigate the organization's books, records, and activities. However, the preparer would ensure that all information is appropriately supplied on the return, and that the data is reasonable in light of any information provided to or known by the preparer.

An underlying assumption of this proposal is that a public charity will engage an independent tax return preparer to complete its Form 990. However, abusive insiders may simply decline the use of an independent tax return preparer if they believe that the preparer would

(2) to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of $1,000 with respect to such return or claim.

Id.

The term "income tax return preparer" means any person who prepares for compensation any return for or claim for refund of income tax. Id. § 7701(a)(36)(A). Thus, organization officers or the controller would not be subject to this penalty since they are not completing the Form 990 for compensation. See generally Ira L. Shafiroff, Liability of Tax Return Preparers (1989).

158 See supra note 155.
160 See supra note 152 and accompanying text.
163 Treas. Reg. § 1.6694-2, -3 (as amended in 1992); see also Shafiroff, supra note 156, at 159-61 (providing examples and discussing willful conduct penalties).
increase disclosure, and perhaps expose their illicit activities. Despite the initial appeal of this preventive measure, a charity's sudden decision to refuse retention of an independent preparer may have significant negative consequences. For example, contributors reviewing the Form 990 may question this conduct and withhold their contributions, particularly if they are familiar with the implicit quality control aspects associated with the use of independent tax return preparers. Moreover, once the contributing public becomes fully aware of disclosure safeguards identified with independent tax return preparers, public charities that use such preparers may be greatly favored over those that do not.

Several modifications would be needed to adapt the existing preparer understatement penalty to the Form 990 context. Since public charities do not generally pay tax, a penalty triggered by an "understatement" is meaningless; thus, the preparer penalty should be imposed with respect to any material omission or misrepresentation that should reasonably have been known to the preparer.

In addition, the amount of the penalty imposed should be modified. As noted above, flat penalties of $250 and $1,000 are imposed on return preparers for negligent or willful conduct, respectively. However, since the goal of the tax return preparer penalty in the public charity context would be to improve disclosure, rather than to punish the return preparer, a lower penalty is warranted. Thus, penalties in the amount of $100 and $250 for negligent or willful conduct should apply, respectively. Nevertheless, in order to discourage any complacency on the part of tax return preparers, these penalty amounts should rise with each successive violation by the preparer. From a policy perspective, a graduated penalty mechanism is inherently more equitable since it seeks to impose stiffer penalties only on those preparers who flagrantly and repeatedly refuse to follow the standards of conduct imposed by law. Moreover, in such situations, higher penalties are additionally justified on the grounds that continued refusals to adequately prepare a Form 990 may indicate collusion with, or at least blind acquiescence to, abusive insiders.

Finally, the application of the return preparer penalty should prompt an examination regarding whether any of the other disclosure penalties discussed above apply, and vice versa. For example, the imposition of the proposed penalty on board directors may indicate that the return preparer did not meet the standards of practice required by law.


\[165\] See supra note 157 and accompanying text.

\[166\] See, e.g., supra notes 139-41 and accompanying text (failure to file Form 990); supra subpart III(B)(1) (proposed penalty on organization board of directors or trustees).
and thus is subject to penalty. However, it should be noted that the assessment of one type of disclosure penalty should not result in the automatic assessment of other disclosure penalties since the standards of liability would differ among the various types of penalties.167

3. Amendment of Section 6103

Although increasing the amount and quality of disclosure on Form 990 will significantly improve public charity accountability, it must be acknowledged that many contributors will not seek this information or otherwise investigate their recipient public charities.168 Apart from Form 990,169 the I.R.S. is prohibited from disclosing any other information concerning a public charity's identity or findings of abusive or questionable activities.170 Thus, while a close examination of a Form 990 may indicate questionable activities, thereby prompting certain contributors to forego making donations, it would likely not reveal detailed or transactional information sufficient to attract the media's attention.171 Accordingly, those contributors who are not diligent in seeking and examining Forms 990, or do not obtain privately-conducted public charity evaluations,172 will likely be oblivious to any abuses occurring at recipient charities. On occasions when newspaper headlines described abusive activities at public charities, these accounts were often the result of

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167 For example, compare supra note 139 and accompanying text (noting "reasonable cause" exception to penalty imposed on organizations for failure to file Form 990) with supra subpart III(B)(2) (imposing liability on return preparers only with respect to negligent or willful conduct).
168 See Boisture & Cerny, supra note 113, at 1390. Indeed, it seems unlikely that the average contributor would discover the recent revocation of a public charity's tax exemption since notice of revocation is only indirectly disclosed by the I.R.S., which provides such notice by merely "de-listing" disqualified organizations from periodic enumerations of tax-exempt entities. See Hearings I, supra note 5, at 40-41; Hearings II, supra note 18.
169 Under the Treasury's proposal, public charities would be required to disclose the imposition of intermediate or similar sanctions. See supra note 150 and accompanying text. Thus, while examination of Form 990 may indicate some type of wrongdoing, as evidenced by the imposition of intermediate sanctions, the details surrounding such misconduct may not be apparent on the face of the Form 990.
170 See infra notes 174-77 and accompanying text (discussing I.R.C. §§ 6103, 6104). It should be noted, however, that the I.R.S. does provide notice as to the revocation of a public charity's tax exemption, see supra note 168, but the circumstances surrounding and reasons for the revocation are not provided. See Hearings II, supra note 18.
171 See supra note 164 and accompanying text. But see supra note 17 (describing the Philadelphia Inquirer's 18-month study of 6000 tax-exempt organizations' Forms 990). Although the Philadelphia Inquirer's investigation yielded significant findings of abuse by public charities, these discoveries only resulted from a unique and extensive research project. See id.
172 See, e.g., Hearings II, supra note 18 (testimony of various public charity "watch dog" groups describing their review and evaluation procedures).
voluntary disclosure. When such disclosure is not made, confidentiality laws prohibit the I.R.S. from publicly disclosing the nature and circumstances surrounding abusive conduct. It is thus submitted that these laws be amended to permit public disclosure of information concerning abusive conduct obtained through I.R.S. investigations. In particular, the public charity's identity should be disclosed along with a description of the misconduct.

Under current law, section 6103 of the Code provides that tax returns and "return information" are confidential and thus may not be publicly disclosed, except as otherwise permitted in the Code. "Return information" includes a "taxpayer's identity, the nature, source, or amount of his income, . . . whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary . . . ." To enforce these provisions, certain civil and criminal fines and penalties are imposed on parties who improperly disclose confidential information.

Thus, section 6103 should be amended to permit disclosure by the I.R.S. of information regarding certain abusive or questionable activities by public charities that would not likely appear on Form 990 or otherwise be publicized. The types of abuses that should be disclosed are those that would likely have a material impact on a reasonable donor's decision to contribute to a particular organization. Thus, insignificant or inadvertent abuses would not be grounds for disclosure. However, if an organization consistently engages in abuses that, individually, do not appear material, but when viewed collectively indicate a plan to circumvent the law, then disclosure would be appropriate.

Upon discovery of such abusive conduct, the I.R.S. would be authorized to publicly disclose, either upon request or voluntarily, the identity of the public charity and any other party materially involved in the

173 See Hearings I, supra note 5. In addition, the I.R.S. has required disclosure as a condition to a closing agreement. Id.
175 See id. § 6104(a)(1)(A), (e) (1988 & Supp. 1994) (permitting disclosure of annual returns and exemption application information of section 501(c)(3) organizations); see also id. § 6103(c) (designee of taxpayer); Id. § 6103(d) (1988) (designated representative of state agency, body or commission charged with administration of state tax laws); Id. § 6103(e) (1988 & Supp. 1994) (persons having material interest in tax return); I.R.C. § 6103(f) (1988) (congressional committees); Id. § 6103(g) (President and certain other persons); Id. § 6103(h) (officers or employees of Treasury and Justice Department); Id. §§ 6103(i)-(o) (1988 & Supp. 1994) (listing other exceptions).
176 Id. § 6103(b)(2)(A) (1988).
177 I.R.C. § 7213 (criminal penalty requiring imprisonment up to five years or fine up to $5,000, or both); Id. § 7431 (civil remedy for willful or negligent disclosure).
wrongdoing. In this way, the public would at least be apprised of certain significant abuses. Further, it is likely that if such information were made available, private organizations that now monitor public charities using Forms 990, among other sources, would be able to greatly enhance their quality control efforts. Finally, this increased disclosure would also provide state and local governments with much needed information with which to bolster their own efforts at regulating public charities.

The proposed amendment to section 6103 does not appear to greatly conflict with the underlying intent of the statute. Section 6103 was significantly broadened in the the Tax Reform Act of 1976 to reduce then widespread and abusive use of tax returns and return information by various government agencies and certain individuals. For example, Justice Department attorneys commonly used tax return information to impeach or cross-examine witnesses in both tax and non-tax matters. The purpose and use of tax return information in the context of abusive public charities clearly differs from the questionable practices of government officials that led to the 1976 amendments to section 6103.

To implement this proposal, certain definitional items and procedural safeguards would need to be established. For example, disclosable information concerning a public charity should be limited to those items that would indicate abusive activities. In terms of defining “abusive activities,” the legal restrictions with respect to private inurement, the organizational and operational tests, and private benefit should serve as primary components. In addition, certain procedural safeguards should be implemented to prevent harassment of public charities or unjustified invasion of privacy.

See Hearings II, supra note 18 (describing method and materials used by public charity “watch dog” groups in reviewing public charities).

Id. (implying that confidentiality laws should be amended so that I.R.S. could disclose information regarding public charity).


See S. Rep. No. 94-938, 94th Cong., 2d Sess. 323-24 (1976). Other alleged abuses involved use by White House officials, including the President, of tax return information for non-tax matters. Id. at 321-23; see Karnes & Lirely, supra note 181, at 925-26 (discussing history and abuses prompting revision of section 6103).

Admittedly, the proposed amendment will draw criticism, particularly from the tax-exempt sector. However, any actual or perceived inequity resulting from increased public access to such return information is more than compensated by the substantial economic subsidy—embodied in the grant of federal tax exemption—that is provided to these organizations. Moreover, the public, serving the dual role of financial contributor and taxpayer, deserves at least this degree of accountability. Viewed in this light, the proposed disclosure amendment seems more than reasonable.

**Conclusion**

Heightened media and governmental scrutiny of tax-exempt public charities has painted a disconcerting picture of these traditionally benevolent institutions. The frequent occurrence of abusive dealings by organization insiders validates the widely-held belief that legislative reform is necessary and, indeed, inevitable. To this end, this Article has considered solutions regarding the two major components of public charity reform: implementing intermediate sanctions and increasing the quality of public charity disclosure.

Although the I.R.S. is generally reluctant to revoke an abusive charity’s tax exemption, the alternative recourse—inaction—has proven equally inappropriate. Thus, the general consensus that some form of intermediate sanction is necessary cannot be reasonably disputed. This Article suggests that the partial or total adoption of the stringent regulatory rules applicable to private foundations is unnecessary and potentially injurious to the public good. Instead, the Treasury’s proposal that intermediate sanctions be assessed only to the extent “excess benefit” inures to certain disqualified individuals strikes an appropriate balance, providing the I.R.S. with an effective enforcement tool without unduly burdening public charities’ operational freedom.

The traditional view that public charities do not require rigorous regulation rests largely on the assumption that the general public, as contributors and financial supporters, will demand accountability from these organizations. The efficacy of this self-regulating approach, however, depends on the quality of the organization’s disclosure to the public, which is generally achieved by permitting public access to the organization’s Form 990. Recent evidence that Form 990 disclosure is not serving this intended purpose has prompted several proposals that seek to improve such disclosure. While these proposals will likely improve public accountability, further measures, as proposed herein, are needed.

Members of the tax-exempt sector may, or more likely will, oppose part or all of the aforementioned proposals. It is asserted, however, that this type of response is misguided. Although the suggested proposals
may impose some additional burdens on certain public charities, the organizations that have traditionally followed the letter and spirit of the law will not experience any negative effects. Indeed, measures aimed at increasing accountability and compliance will benefit the long-term interests of all public charities by restoring the public's confidence in, and desire to support, charitable organizations. Thus, the small price paid now, if at all, in the form of increased compliance and disclosure costs will result in substantial benefits for public charities of the future.