

11-2014

## Is Federalization of Charity Law All Bad? What States Can Learn from the Internal Revenue Code

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### Recommended Citation

Melanie B. Leslie, *Is Federalization of Charity Law All Bad? What States Can Learn from the Internal Revenue Code*, 67 *Vanderbilt Law Review* 1621 (2014)

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# Is Federalization of Charity Law All Bad? What States Can Learn from the Internal Revenue Code

Melanie B. Leslie\*

Commentary on Mark L. Ascher, *Federalization of the Law of Charity*<sup>1</sup>

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## I. INTRODUCTION

Professor Ascher makes a compelling case that federal law, and especially the Internal Revenue Code (the “Code”), has eclipsed state law as the predominate regulating force of the charitable sector. Professor Ascher views this trend with trepidation—he criticizes the Code for imposing a “frightening and bewildering array of often draconian penalties” and for its failure to track preexisting state-law concepts.

I agree that the combination of state and federal law creates an impenetrable maze that charitable fiduciaries find overly difficult to negotiate. Yet I am reluctant to finger the Code as the primary culprit.

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1. Mark L. Ascher, *Federalization of the Law of Charity*, 67 VAND. L. REV. 1581 (2014).

In my view, state law deserves much of the blame for its own demise. For when it comes to legal issues at the core of charity law—the non-distribution constraint and the charitable purpose requirement—state law is a largely useless tool for guiding or disciplining charitable boards. This failure is not solely attributable to attorneys’ general lack of resources or interest. The larger problem lies with the law itself. A compilation of the fuzziest of standards, state law gives no guidance to charitable fiduciaries. And charitable fiduciaries—volunteers with good intentions but little time and few resources—are uniquely in need of clear guidance.

Now, before you laugh, I want to assure you that I am not holding up the Code as a model of clarity and simplicity. In many respects, the Code suffers from the same failures as state law. But on a few key issues, the Code has shifted away from fuzzy standards toward bright-line rules. These rules explain both the line between what is allowed and what is proscribed and the procedure that a charity should follow to ensure compliance. For added reinforcement, the Code imposes a series of tax penalties for noncompliance to ensure that charities pay attention. This approach is superior to state law’s embrace of ineffectual, fuzzy standards that have no bite and may be a contributing factor to federal law’s recent ascent.

This Comment will focus on state and federal law’s approaches to two key issues. The first concerns the non-distribution constraint—the charity’s promise that charitable assets will be directed entirely towards accomplishing the charity’s mission and not distributed to insiders. I will compare the state-law duty of loyalty to the Code’s excess benefit transaction regime, and show that the Code and accompanying regulations do a better job of preventing self-dealing and conflict-of-interest transactions that are not in the charity’s best interests.

The second issue concerns state and federal law limitations on political activity. Although state courts have long agreed that a purely political organization has no “charitable purpose,” they have been ineffective at describing exactly how much political activity a charity can engage in while remaining eligible for state tax exemptions. On the federal front, the Code contains a fairly clear prohibition on campaign activity and gives charities that wish to lobby a road map for avoiding penalties or revocation of tax-exempt status.<sup>2</sup>

Finally, I will briefly consider two states—California and New York—that recently amended some nonprofit code provisions to replace standards with rules. If this is the beginning of a trend, as I

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2. I.R.C. § 501(h) (2012).

hope it is, state law may once again become relevant.

## II. SELF-DEALING AND CONFLICTS OF INTEREST

The defining characteristic of the nonprofit corporation is the “non-distribution constraint”—the prohibition of the distribution of profits to owners.<sup>3</sup> The non-distribution constraint reassures donors that donations will be directed toward advancing the charity’s mission and not into charitable fiduciaries’ pockets.<sup>4</sup> This promise compensates for donors’ inability to monitor the effectiveness of the charity’s performance.<sup>5</sup> Any transaction between a charity and a charitable fiduciary that is (1) not in the charity’s best interest, or (2) not on terms that are equal or superior to those the charity could obtain in an arm’s-length transaction, represents an inappropriate diversion of assets to the charitable fiduciary in violation of the non-distribution constraint. Understanding this, many charities effectively manage conflicts of interest and would do so regardless of what legal rules require. In these organizations, key directors and/or the Executive Director (“ED”) have internalized social norms against self-dealing.

But when adherence to social norms is weak or nonexistent, the environmental factors can combine to create an environment that leads to poor decisionmaking. First, few market forces deter opportunistic behavior.<sup>6</sup> Second, nonprofit boards are uniquely

3. See Henry Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (“A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.”). Among other criteria, an organization can qualify for tax-exempt status under section 501(c)(3) of the Code if “no part of the net earnings . . . inures to the benefit of any private shareholder or individual.” § 501(c)(3).

4. See Hansmann, *supra* note 3, at 838 (noting that, for tax-exempt status, all net earnings must be retained and devoted entirely to financing future services and projects).

5. See *id.* at 846–47 (explaining that the non-distribution constraint provides “additional protection” for donors that are unable to ascertain whether “the service they paid for was in fact ever performed, much less performed adequately”).

6. Fiduciaries of for-profit corporate enterprises face a fair amount of market monitoring that increases the pressure to comply with fiduciary duties; shareholders, share price, and the market for corporate control all play powerful roles. Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179, 1202–03 (2010). By contrast, nonprofits are not legally accountable to stakeholders directly—charitable beneficiaries are by definition an indefinite class and have no standing to sue the fiduciaries. See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 616 (1999) (“Any person served by the entity has an interest in seeing that it is run properly, but no one person is likely to have the incentive, the ability, or the information necessary to monitor the charity. Further, beneficiaries are unlikely to have standing to enforce their rights as beneficiaries.”). It follows that the only significant market pressure that a charity may face comes from the need to attract capital. Sources of capital include donations from

vulnerable to groupthink—a decisionmaking process that occurs when the desire to be an accepted member of a group becomes more important than raising questions or challenging the status quo.<sup>7</sup> Because board members are volunteers, they may be disinclined to risk angering other directors or the ED by challenging consensus.<sup>8</sup> This is especially true when boards are comprised of people from similar social, professional, or economic backgrounds. And many boards are, in fact, fairly homogenous.<sup>9</sup>

In addition, charitable board members do not often view themselves as responsible for monitoring the ED.<sup>10</sup> Unlike the members of the for-profit board, who understand that the CEO operates from self-interest, members of a nonprofit board may (justifiably) attribute altruistic motivations to the ED. Nonprofit directors are more likely to view the board as performing a supportive function, with the goal of assisting the ED in accomplishing the nonprofit's goals. This view might be encouraged by the ED, who may

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members of the public, corporate and foundation grants, and government support. See CHARITY NAVIGATOR, [www.charitynavigator.org](http://www.charitynavigator.org) (last visited Oct. 24, 2014), *archived at* <http://perma.cc/8CLE-JPCH> (showing sources of support for a wide variety of charities). But funders do not have standing to sue for breach of fiduciary duty. See Gary, *supra*, at 616. Although the Uniform Trust Code purports to grant standing to settlors of charitable trusts, it is unclear whether this provision will have much impact on nonprofit governance, since most donors fail to make donations in charitable trust form, and charitable trust settlors are likely to be more focused on whether the trustees advance the trust's charitable mission. UNIF. TRUST CODE § 409 (amended 2010).

Foundations and government agencies require various degrees of disclosure or accountability as a condition for repeat giving, which may exert some pressure on the nonprofit to refrain from self-dealing that does not advance the charity's best interests. See, e.g., *Grants*, FORD FOUND., <http://www.fordfoundation.org/grants> (last visited Sept. 14, 2014) (explaining that “[w]hen we make grants . . . [w]e set benchmarks to measure success and monitor progress to ensure that goals are being met”). It follows that the greater the percentage of government and large-foundation grants, the more effective the monitoring. A study commissioned by the Urban Institute shows that the level of a nonprofit's reliance on government funding is positively associated with having an outside audit, a separate audit committee, a conflict-of-interest policy, and a whistleblower policy. FRANCIE OSTROWER, THE URBAN INST., *NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY 4–6* (2007), *available at* [http://www.urban.org/UploadedPDF/411479\\_Nonprofit\\_Governance.pdf](http://www.urban.org/UploadedPDF/411479_Nonprofit_Governance.pdf), *archived at* <http://perma.cc/9Y72-GB7A>.

7. Leslie, *supra* note 6, at 1183.

8. *Id.* at 1199.

9. Kathleen Fletcher, *Building Diverse Boards*, in PERSPECTIVES ON NONPROFIT BOARD DIVERSITY, 15, 15 (1999), *available at* [http://networks.seepnetwork.org/ppp-design2/doc/Perspectives\\_on\\_nonprofit\\_board\\_Diversity.pdf](http://networks.seepnetwork.org/ppp-design2/doc/Perspectives_on_nonprofit_board_Diversity.pdf), *archived at* <http://perma.cc/GJ42-SEE9> (“First, new board members are typically recruited from among the friends, acquaintances, and business associates of those already on the board. This system, of course, tends to make boards homogeneous.”).

10. The Urban Institute's study indicates that boards that focus board recruiting efforts on friends and acquaintances of current board members did less well with every aspect of governing except fundraising, on which recruiting strategy had no impact. OSTROWER, *supra* note 6, at 16.

view the role of board members as to fundraise or to lend their names to a cause but may resent “meddling” by the board in substantive decisions.

Information deficits are more pronounced in the nonprofit setting. Volunteer directors have careers, families, other professional commitments, hobbies, and social lives. Even the most well-intentioned board members may find that conflicting demands result in inadequate preparation for, or sporadic attendance at, board meetings.<sup>11</sup> The need to prioritize among conflicting demands can also cause directors to adopt the least time-consuming approach to problem solving.<sup>12</sup> There may be fewer stigmas attached to this behavior when board members are volunteers.<sup>13</sup>

Therefore, the law governing conflicted transactions in the nonprofit context should compensate for the lack of monitoring and board members’ lack of time to devote to governing. It should seek to implement (where absent) and support (where existing) the social norm of subordination of self-interest in favor of the nonprofit’s best interests.

Rules are superior to standards for generating and supporting social norms that counter the pull of self-interest.<sup>14</sup> Because standards do not prescribe clear limits of legal behavior, people who are self-serving will interpret fuzzy information in ways that benefit them.<sup>15</sup>

11. Brody writes, “Nonprofit directors devote even less time and attention to their positions. Such affirmative board duties as selecting the chief officer, preparing the budget, and reviewing operations are likely to be carried out haphazardly or by only a few of the board members.” Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1445–46 (1998). One writer stresses that, “[U]nlike for-profits, the board of many nonprofits consists of uncompensated volunteers. These volunteer directors are usually very busy people who hold other full-time jobs and simply do not have as much time to devote to their duties as most inside directors of for-profits.” David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 967 (1996); see also Harvey Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 J. CORP. L. 631, 633 (1998) (emphasizing that board members who fail to become involved are “corrosive” to nonprofit corporations).

12. Of those charities responding to the Urban Institute’s study, fewer than half were able to state that their boards were “very active” at financial oversight and monitoring the boards’ own behavior. OSTROWER, *supra* note 6, at 13.

13. Leslie, *supra* note 6, at 1201.

14. See, e.g., Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 55 (2000) (“[R]ules, because of their ex ante clarity, are more likely to affect social norms than are more ambiguous standards.”); Cass R. Sunstein, *On the Expressive Function of the Law*, 144 U. PA. L. REV. 2021, 2025–26 (1996) (discussing the diminished influence of the law in the presence of established social norms).

15. See Linda Babcock et al., *Biased Judgments of Fairness in Bargaining*, 85 AM. ECON. REV. 1337, 1340 (1995) (“The self-serving bias is less problematic in a rules regime where there is, by definition, little or no ex ante ambiguity about legal boundaries.”); Korobkin, *supra* note 14, at 46 (citing Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of*

In other words, they will determine that their behavior fits within the standards of allowable conduct even if an objective observer might disagree.<sup>16</sup>

In addition, rules are superior tools for combating the groupthink and ingroup bias that cause directors to subordinate the best interests of the corporation to the self-interest of board members.<sup>17</sup> Besides clarifying the limits of permissible behavior,<sup>18</sup> rules can provide “cover” for directors who wish to fulfill their fiduciary obligations but are afraid of sanctions that might attach as a result of confrontation. Rules that prescribe a particular procedure also benefit the corporation in a second important way: questioning by directors is less likely to disrupt group cohesion—rather than a sign of uncooperative behavior, questioning becomes part of the decisionmaking process. Thus, by reducing the “costs of confrontation,”<sup>19</sup> clear procedural rules can replace norms of self-interest with norms of questioning and debating.

#### A. State Law: The Fiduciary Duty of Loyalty

Most state-law formulations of the duty of loyalty are fashioned as fuzzy standards. Cut and pasted from corporate law, these statutes authorize conflicted transactions and shield fiduciaries from liability as long as transactions are “fair.”<sup>20</sup> The Revised Model Nonprofit

*Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2101–02 (1979)); George Lowenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 150–51 (1993).

16. A standard requiring drivers to drive at a “reasonable” speed may lead a driver to conclude that driving 90 miles per hour on a highway meets the legal standard, given his driving prowess and his assessment of road and traffic conditions. Korobkin, *supra* note 14, at 46. Rules, on the other hand, tend to minimize the effect of self-serving bias because they communicate more direct information about the limits of allowed behavior and leave less to the discretion of the individual actor. *Id.* If faced with a rule limiting the speed to 70 miles per hour, the same driver would be unlikely to convince himself that driving 90 miles per hour was within the law.

17. See, e.g., JAMES T. TEDESCHI & SVENN LINDSKOLD, SOCIAL PSYCHOLOGY 561–73 (1976); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 612 (1982) (citing MARVIN E. SHAW, GROUP DYNAMICS 267–79 (1971)); Stanley Foster Reed, *On the Dynamics of Group Decisionmaking in High Places*, DIRECTORS & BOARDS, Winter 1978, at 40, 51–53 (detailing the pressure independent directors feel to conform to the viewpoint of boardroom leaders and management).

18. As Professor James Fishman states, “If nothing else, explicit standards of care will provide a clearer guide for conduct and will sensitize board members not only to their responsibilities but to potential liabilities as well.” James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 413 (1987).

19. Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 688–89 (2002).

20. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 215, 221–22 (2004). Thirty-five states have adopted this standard. *Id.* at 220; see, e.g., FLA. STAT. § 617.0832

Corporation Act is a fairly typical formulation: it sanitizes a self-dealing or conflict-of-interest transaction and shields directors from liability for breach of duty<sup>21</sup> if a majority of disinterested board members, acting in good faith, authorize the deal, *or* if the board ratifies a “fair” transaction after the fact.<sup>22</sup> Even if the deal is determined to be unfair, a director will not face personal liability except in the most egregious circumstances.<sup>23</sup> The fuzzy “fairness”

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(2014) (providing that a transaction may not be void or voidable if it is fair and reasonable). Of the thirty-five states, seven further require that the disinterested directors “reasonably believe that the transaction is fair to the corporation.” FREMONT-SMITH, *supra*, at 220–21. Still others require that the disinterested board members approve the self-dealing transaction “in good faith.” *See, e.g.*, COLO. REV. STAT. § 7-128-501 (2013) (providing for the validation of self-dealing transaction ratified in good faith by disinterested board members).

21. MODEL NONPROFIT CORP. ACT § 8.31(a)(1)(ii) (2008).

22. *Id.* § 8.60(a)(1)-(3).

23. *Id.* § 8.31:

§ 8.31 STANDARDS OF LIABILITY FOR DIRECTORS

- (a) A director is not liable to the nonprofit corporation or its members for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:
- (1) none of the following, if interposed as a bar to the proceeding by the director, precludes liability:
    - (i) subsection (d) or a provision in the articles of incorporation authorized by Section 2.02(c);
    - (ii) satisfaction of the requirements in Section 8.60 for validating a conflicting interest transaction; or
    - (iii) satisfaction of the requirements in Section 8.70 for disclaiming a business opportunity; and
  - (2) the challenged conduct consisted or was the result of:
    - (i) action not in good faith; or
    - (ii) a decision:
      - (A) which the director did not reasonably believe to be in the best interests of the corporation, or
      - (B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or
    - (iii) a lack of objectivity due to the director’s familial, financial or business relationship with, or a lack of independence due to the director’s domination or control by, another person having a material interest in the challenged conduct:
      - (A) which relationship or which domination or control could reasonably be expected to have affected the director’s judgment respecting the challenged conduct in a manner adverse to the corporation, and
      - (B) after a reasonable expectation to such effect has been established, the director has not established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or



defense has no bite—it provides little guidance and creates no significant disincentive to engage in problematic transactions.

The corporate approach to the duty of loyalty may be tolerable in the for-profit corporate context. Even if legal boundaries of permissible behavior are less than clear, market pressures create an incentive to put the shareholder's interests first. Institutional investors can be vigilant monitors. A board that regularly engages in transactions that undermine, rather than advance, the corporation's best interest is likely to attract attention, which will negatively affect share price. The market for corporate control creates additional pressure. Fuzzy fiduciary duty standards give management room to take risks, and the market provides a backstop. But the charitable board faces relatively few, if any, market pressures that create disincentives to self-dealing.

In sum, the corporate "fairness" standard gives little guidance to charitable boards. Advance approval is recommended but not required, and a board convinced of the "fairness" of a particular deal may see no reason to jump through procedural hoops. Even if the board does engage in an approval process, the law seems perversely designed to allow boards to rubber stamp transactions.

### *B. The Internal Revenue Code: Excess Benefit Transactions*

The Internal Revenue Code presents a more satisfactory, though not ideal, approach to the problem of self-dealing and conflicts of interest. The Code differentiates between private foundations and public charities and sets forth different rules for each. Because private foundations are subject to even less monitoring than public charities, self-dealing rules are unusually strict—self-dealing and most conflict-

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- (iv) a sustained failure of the director to devote attention to ongoing oversight of the activities and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor; or
  - (v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its members that is actionable under applicable law.
- (b) The party seeking to hold the director liable:
- (1) for money damages, also has the burden of establishing that:
    - (i) harm to the nonprofit corporation or its members has been suffered, and
    - (ii) the harm suffered was proximately caused by the director's challenged conduct . . . .

of-interest transactions are flatly prohibited.

The rules applicable to public charities are more complicated. Historically, the Code provisions addressing self-dealing and conflicts of interest were just as muddy as state-based fiduciary duty law standards. As a condition of 501(c)(3) status, and the variety of tax benefits that come with it, the Code directs that the nonprofit shall be run for public, as opposed to private, benefit.<sup>24</sup> The Code also prohibits private inurement.<sup>25</sup> These standards were as problematic as state-law fiduciary duty rules; they give little guidance and create few incentives to comply. Because the only remedy for violating the prohibitions was recession of tax-exempt status, the IRS invoked these provisions only rarely and in extremely egregious circumstances.

In response to these difficulties, Congress amended the Code in the 1980s to give the Service a more targeted tool for getting at self-dealing. I.R.C. § 4958(c)(1)(A) imposes tax penalties on directors who engage in or approve of “excess benefit” transactions—transactions on terms greater than the charity could obtain through an arm’s-length transaction.<sup>26</sup> It sets forth a schedule of excise taxes that will be levied against directors who participate in or approve of an excess benefit transaction, and levies an even harsher penalty if those individuals fail to correct the transaction.

Expanding on this Code provision, the treasury regulations set forth a clear procedure by which the charity can obtain a presumption that the transaction was at or below market value.<sup>27</sup> The presumption

24. The private benefit doctrine requires charities to abstain from conferring more than an incidental private benefit on individuals other than insiders. I.R.C. § 501(c)(3) (2012); Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008).

25. Section 501(c)(3) prohibits charities from engaging in transactions that result in inurement of charitable funds to insiders. See I.R.C. § 501(c)(3) (2012) (providing tax exemption only for companies “no part of the net earnings of which inures to the benefit of any private shareholder or individual”); Treas. Reg. § 1.501(c)(3)-1(c)(2).

26. I.R.C. § 4958(c)(1)(A) (2012) (imposing penalties on “disqualified persons” who engage in “excess benefit” transactions and on the manager who approves them and defining “excess benefit transaction” as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit”).

27. Treas. Reg. § 53.4958-6 (as amended in 2011):

26 C.F.R. § 53.4958-6 Rebuttable presumption that a transaction is not an excess benefit transaction

(a) *In general.* Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied—

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt

attaches if the deal (1) was approved in advance by a majority of independent directors, (2) who gathered and considered comparability data, such as research, expert opinions, and actual competing offers, and (3) the board adequately documented the basis for its determination that the deal was a good one for the charity.<sup>28</sup>

The excess benefit–transaction regime is a superior approach to state-law duty of loyalty standards. In forthrightly requiring that the board prove that a transaction is at market value or below, it gives more guidance than the “fairness” standard. It sets forth a schedule of tax penalties that will be levied if the board fails to meet the standard, with more severe penalties if the harm to the charity is not remedied. It provides guidance in the form of a road map that, if followed, will enable the board to have confidence that it will not suffer penalties.

A charitable board that can satisfy the excess-benefit test will also be in compliance with most state-law fiduciary duty of loyalty standards. It is perhaps for this reason that the Code, instead of state fiduciary duty law, has more of an impact on board performance.

### III. POLITICAL ACTIVITY

Both state law and the Code cast a suspicious eye on charities that engage in political activity and withhold certain tax benefits from organizations that seek to achieve overtly political ends. Here again, state law is so murky as to be worthless, while the Code contains much clearer rules that are backed up with tax penalties to create an incentive for compliance.

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organization (or an entity controlled by the organization within the meaning of § 53.4958-4(a)(2)(ii)(B)) composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;

- (2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, as described in paragraph (c)(2) of this section; and
  - (3) The authorized body adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.
- (b) *Rebutting the presumption.* If the three requirements of paragraph (a) of this section are satisfied, then the Internal Revenue Service may rebut the presumption that arises under paragraph (a) of this section only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. . . .

28. *Id.*

### A. State Law

Although many states have no explicit prohibition or limits on political activity,<sup>29</sup> state courts have, from time to time, denied tax benefits to organizations that go too far. These cases, however, fail to provide even minimal guidance to charities.

Consider, for example, *Michigan United Conservation Clubs v. Township of Lansing*.<sup>30</sup> In that case, the Michigan Supreme Court affirmed the Tax Tribunal's denial of the Michigan United Conservation Clubs' ("MUCC") petition for a property tax exemption.<sup>31</sup> The MUCC's principle purposes were to advance environmental causes with an emphasis on conservation, to promote the sustainable use of natural resources, and to provide educational programs on natural resource conservation and environmental protection.<sup>32</sup> To that end, the group engaged in a number of significant activities that fit the definition of "charitable"—distributing, at low or no cost, publications explaining the value of conservation and the development of natural resources; giving free public lectures on these subjects; and conducting hunter safety programs in youth camps that were open to the public.<sup>33</sup>

The Court of Appeals affirmed the Tax Tribunal's denial.<sup>34</sup> The court recognized that most of MUCC's activities qualified as "charitable," and recognized that "[i]f this was the limit of petitioner's activities, we would not hesitate to conclude that it is entitled to a charitable exemption."<sup>35</sup> But because the Court also found that MUCC "engages in a considerable amount of lobbying" and "clearly and forcefully advances a specific viewpoint," it was not entitled to a charitable exemption.<sup>36</sup>

The Michigan Supreme Court affirmed but modified the appellate court's ruling on the ground that the court had erred in using MUCC's lobbying activity as "the sole distinguishing factor" in denying the tax exemption. According to the Supreme Court, "political activity alone is not a valid reason for denying a property tax

29. See, e.g., N.Y. LEGIS. LAW § 1-A (McKinney 2013); CAL. GOV'T CODE §§ 86100–86118 (West 2014).

30. 378 N.W.2d 737 (Mich. 1985).

31. *Id.* at 738.

32. *Id.* at 739.

33. *Id.* at 742.

34. *Mich. United Conservation Clubs v. Lansing Twp.*, 342 N.W.2d 290, 297 (Mich. Ct. App. 1983).

35. *Id.* at 296.

36. *Id.*

exemption.”<sup>37</sup> Yet the Court failed to give any guidance concerning the level of political activity in which a tax-exempt nonprofit could engage. In a footnote, the court ineffectively grappled with the issue:

This does not mean that evidence of lobbying or political activity can never be relevant. Evidence of political activity may or may not be relevant depending upon the facts of the case and the type of exemption sought. Although the question is not before us today, we surmise that certain forms of lobbying may preclude a tax exemption. For example, we doubt that an organization whose sole purpose is lobbying would be entitled to an educational or charitable exemption. Thus, we cannot say that political activity has no relevance to a claimed tax exemption.<sup>38</sup>

Other courts have taken a similar perspective. In determining whether charitable organizations that engage politically can obtain real estate tax or income tax exemptions, state courts consistently decline to articulate a standard. Instead, they insist on a “case-by-case” approach that considers political activity as an amorphous “factor” to be considered.<sup>39</sup>

### *B. The Code: Lobbying and Campaigning*

In some respects, the Code has always been more straightforward. First, it classifies political activity into two categories—lobbying and campaigning—and includes fairly thorough definitions of each term. The Code treats private foundations differently than public charities and prohibits private foundations from both campaigning and lobbying. Public charities may not campaign but may engage in minimal amounts of lobbying.

Historically, the lobbying limitations applicable to public charities were fairly murky and no better than analogous state-law standards. Since 1934, 501(c)(3) has granted tax-exempt status to an organization if “no substantial part” of its activities consist of “attempting to influence legislation.” This formulation presented two puzzles for courts: first, what activities constitute “lobbying,” and second, where is the line between insubstantial and substantial lobbying? Courts developed no real consensus in their approaches to these questions. In 1976, in response to criticism of the Code’s lack of

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37. 378 N.W.2d at 743.

38. *Id.* at 743 n.6.

39. *See, e.g.*, Fairbanks N. Star Borough v. Dena’ Nena’ Henash, 88 P.3d 124, 141 (Alaska 2004) (affirming the lower court’s denial of partial property tax exemption because the lower court committed no error in considering lobbying activities and other factors to apportion the property tax exemption); Minn. State Bar Ass’n v. Comm’r of Taxation, 240 N.W.2d 321, 325–26 (Minn. 1976) (upholding denial of state sales tax exemption to bar association whose activities included lobbying, but not explaining how much weight it gave to lobbying activities in upholding the denial).

guidance, Congress enacted the 501(h) expenditure test, which sets forth very clear spending limitations, keyed to the size of the organization's operating budget.<sup>40</sup> Charities must opt into the regime in advance by filing a one-page form with the Internal Revenue Service. Organizations that exceed the limitations are subject to tax penalties. Organizations that regularly exceed spending limitations may have their exempt status revoked.

Subsection (h) gives charities that want to lobby the ability to plan and to protect their tax-exempt status. To date, no state court has weighed in on whether compliance with 501(h) is sufficient to allow the organization to keep its state sales tax exemption. It seems reasonable to assume that at least some state courts will find that compliance with 501(h) does not turn a charitable organization into a political one.

#### IV. A TREND TOWARDS "RULENESS"? CALIFORNIA AND NEW YORK

If state law is to be more relevant, it must be retooled to articulate clear procedural rules. Recent amendments to the California and New York nonprofit codes indicate that the legislatures of these states are cognizant of this fact. Both state codes have made meaningful reforms to their fiduciary duty of loyalty rules, which are steps in the right direction.

The most significant and most important change is that both statutes eliminate the "fairness" defense to self-dealing. They require the conflicted parties to fully disclose the conflict and the board to approve the transaction in advance. New York requires the board to determine that the transaction is fair, reasonable, and in the corporation's best interest.<sup>41</sup> With respect to transactions involving only a conflict of interest (as opposed to direct self-dealing), New York law now requires the board to consider alternative transactions before voting and to document its reasons for entering the transaction in writing.

California goes one step further and requires the board to establish that, prior to authorizing the transaction, "the board considered and in good faith determined after reasonable investigation . . . that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the

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40. Section 501(h) limits a public charity's lobbying budget as follows: 20% of the first \$500,000, 15% of the next \$500,000, 10% of the next \$500,000, and 5% of the excess over \$1.5 million. The statute caps lobbying expenditures at \$1,000,000 per year, which is reached when a charity's operating budget is \$17 million or greater. *See* U.S.C. §§ 501(h), 4911(c) (2012).

41. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 2013).

circumstances.”<sup>42</sup> This statute essentially imposes strict liability for self-dealing and conflict-of-interest transactions entered into without the approval of the Attorney General or a majority of the disinterested board members with full knowledge of the material facts about the conflict of interest.<sup>43</sup> This standard is quite stringent and appropriately tailored to give guidance to charitable fiduciaries, counter problems of groupthink, and create incentives for compliance.

## V. CONCLUSION

If, as a matter of policy, it is important to ensure that tax-exempt organizations devote charitable assets exclusively towards the accomplishment of charitable purposes, state law must be retooled to accomplish that objective. State-law rules should be formulated with the charitable context in mind. They should be designed to clearly communicate to boards the limits of permissible behavior, and offer a procedure that, if followed, will ensure compliance with the legal rules. Finally, penalties for departing from recommended procedures should be clearly stated.

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42. CAL. CORP. CODE § 5233(d)(2)(D)(i) (West 2014). In the alternative, subsection (d)(3) provides the same safe harbor for transactions approved in compliance with subsection (d)(2)(D) by a committee or agent of the board, if it was not reasonably practicable to obtain approval of the board prior to entering into the transaction and if the board both determines that the committee followed correct procedures and ratifies the transaction at the next meeting. *Id.* § 5233(d)(3).

43. *Id.* § 5233(d). Subsection (h) of § 5233 provides:

If a self-dealing transaction has taken place, the interested director or directors shall do such things and pay such damages as in the discretion of the court will provide an equitable and fair remedy to the corporation, taking into account any benefit received by the corporation and whether the interested director or directors acted in good faith and with intent to further the best interest of the corporation. Without limiting the generality of the foregoing, the court may order the director to do any or all of the following:

- (1) Account for any profits made from such transaction . . . ;
- (2) Pay the corporation the value of the use of any of its property used in such transaction; and
- (3) Return or replace any property lost to the corporation as a result of such transaction . . . or account for any proceeds of sale of such property, and pay the proceeds to the corporation together with interest at the legal rate. The court may award prejudgment interest to the extent allowed in Section 3287 or 3288 of the Civil Code. In addition, the Court may, in its discretion, grant exemplary damages for a fraudulent or malicious violation of this section.