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Shortcomings in U.S. Federal Tax Regulatory Regime of Private Foundations: Insights for Australia

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ABSTRACT

This Article addresses the need for a more comprehensive regulatory scheme of Australia's nonprofit organizations, particularly its private foundation type structures. By considering the strengths, and more importantly, the weaknesses of the U.S. tax regime of private foundations, Australia can avoid pitfalls that accompany the development of Australia's laws and regulations. The Article begins by exploring the history, nature, and culture of Australia's nonprofit sector. After outlining the structure of the sector, the Article focuses on the potential for abuses if prescribed private funds are not given appropriate attention to avoid such abuses. Then, the Author details the U.S. nonprofit sector by looking briefly at the history and development of U.S. private foundations, as well as actual and perceived improprieties perpetrated throughout the regime by private individuals, nonprofit organizations, and Congress. Finally, the Article applies lessons learned from the U.S. regime to Australia. The Article concludes by discussing the need for effective regulation strategy for Australia's nonprofit sector. Such strategy, according to the Author, is essential to protect the tax base and to guard against major improprieties and scandals.

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TABLE OF CONTENTS

I. INTRODUCTION

A successful innovation is usually the outcome of an evolutionary process that depends on ideas that in large part result from collected and evolved knowledge. During the development of the innovation, missteps may be taken and intermittent failures may occur. Viewing new legislation and regulations as innovations, their final governance successes depend initially on the breadth and depth of the knowledge base brought to their drafting. Ultimately, politics, economics, and enforcement capabilities play a role in their effectiveness and successes. If one focuses on the knowledge base that drafters of legislation and regulations can bring to the table, that knowledge base can be enhanced by an understanding of the strengths and weaknesses of relevant statutes and regulations of other countries. The most effective knowledge base understands those strengths and shortcomings in the contexts of the development and the application of the pertinent comparative laws and regulations, the financial and political environments in which the regulatory regime was developed and operates, and the similarities and differences inherent in the cultures of the countries.

The time is ripe for consideration of a more comprehensive regulatory regime of Australia's nonprofit organizations, and particularly of its private foundation-type structures. For the most part, Australia's nonprofit sector currently enjoys the positive and important societal "halo" perception that its charitable organizations are "providers of good," "trustworthy institutions," "altruistic, compassionate, or caring in nature," "benevolent," and "beyond reproach."[1] This perception helps to engender viable and thriving institutions. Retention of the halo should be a priority of nonprofit organizations and the sector. The halo effect plays an important role in fundraising strategy, as its existence and the concepts on which it is based stimulate donors to financially contribute to nonprofit organizations.[2] The halo effect also increases the demand of beneficiaries for nonprofit institutions perceived as able to provide trusted services.[3] As one Australian scholar has stated:[4]

> The importance of the halo can be appreciated by the consequences of its destruction. Loss of trust means that the ability of the nonprofit entity to attract donors is vastly reduced and may even result in the death of the entity. Examples abound of such charities whose trustworthiness has been questioned resulting in dire financial consequences.[5]

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1. The "halo" perception is a visual depiction of the saintly aura by which society has viewed many charitable organizations. Scholars have written about the "halo" effect for years. *See, e.g.*, Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 605-06 (1990); Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 580-81 (1981).
2. Atkinson, *supra* note 1, at 606.
3. Hansmann, *supra* note 1, at 580-82.
4. Myles McGregor-Lowndes, *Nonprofit Corporations-Reflections on Australia's Largest Nonprofit Insolvency*, 5 AUSTL. J. CORP. L., Dec. 1995, reproduced in 1995 AJCL LEXIS 38, *35-36 [hereinafter "Nonprofit Corporations-Reflections"].
5. *Id.* For example in the United States, the United Way scandal involving its chief executive officer who diverted for his own use money intended for the charity and filed fraudulent tax returns, created years of reduced donations for the organization

Protecting the halo becomes more difficult as Australia's nonprofit sector and its philanthropic vehicles expand in numbers and dimension. Opportunities increase for wrongdoing to occur, such as tax abuse or fiduciary breaches. As nonprofit organizations' decision-makers are well aware, negative publicity of one or more improprieties may taint or even destroy the halo perception enjoyed by the individual nonprofit institutions, or indeed more globally, by the nonprofit sector. To reduce the possibility of a blemished image, decision-makers within the nonprofit sector and the Australian Tax Office (A.T.O.), as well as legislators, should have an effective knowledge base permitting reassessment and perhaps reformation of Australia's tax regulatory regime for the nonprofit sector.

Australia's nonprofit sector dates back to the beginning of the country's colonial settlement,[6] and its tax regulation of the sector dates back to the late-1800s.[7] Nonetheless, its nonprofit sector, its nonprofit institutions, and its tax regulatory regime currently appear to be developmentally in infancy stages. For example, perhaps

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and created a credibility crisis for the nonprofit sector. *See* Kristin A. Goss, *A Crisis of Credibility for America's Non-profits*, CHRON. PHILANTHROPY, June 15, 1993, at 1; Holly Hall, *United Way Donations Up 5.1%*, CHRON. PHILANTHROPY, Aug. 26, 1999, at 25. *See also* Neil Steinberg, *United Way Chief Quits Among Scandal*, CHI. SUN-TIMES, Feb. 28, 1992, at 6 (discussing the United Way scandal and Aramony's resignation); Andrew J. Glass, *Aramony Let Down the Needy*, ATLANTA CONST., Mar. 7, 1992, at A1 (questioning Aramony's tenure of power); William Aramony, *"Voices:" Would You Give to United Way? Or Are There Better Ways to Give?*, USA TODAY, Apr. 5, 1995, at 8A; Elizabeth Greene & Grant Williams, *Asleep on the Watch?: A Spate of Charity Scandals Raises Questions About the Effectiveness of Government Watchdog Agencies*, CHRON. PHILANTHROPY, July 27, 1995, at 1 (discussing the "Ponzi"-type scheme of the Foundation for New Era Philanthropy debacle, the NAACP abuses, and the United Way scandal); W.A. Baker, *The Wider Implications of Covenant House's Troubles*, CHRON. PHILANTHROPY, Apr. 17, 1990, at 30 (discussing a scandal involving Covenant House with officials accused of sexual and financial impropriety); Janet L. Fix, *Wallace-Reader's Digest Funds and N.Y. Attorney General Reach Settlement*, CHRON. PHILANTHROPY, May 17, 2001, at 13 (discussing settlement and its potential effect on Wallace Funds).

In Australia, several nonprofit organizations recently have suffered notoriety for alleged wrongdoings, including Care Australia, Youth Motor Sport Foundation, Wesley Mission, and Brisbane's Royal. *See* Margaret Gibelman & Sheldon R. Gelman, *Very Public Scandals: Nongovernmental Organizations in Trouble*, 12 VOLUNTAS: INT'L J. VOLUNTARY & NONPROFIT ORG. 49 (2001) (analyzing from a cross-national perspective publicized incidents of wrongdoing by nongovernmental organizations and their board members).

6. *See* Mark Lyons et al., *Australia*, *in* GLOBAL CIVIL SOCIETY: DIMENSIONS OF THE NONPROFIT SECTOR 203 (Lester M. Salomon et al. eds., 1999); *see also infra* notes 23-25 and accompanying text (discussing regulations and their potential shortcomings) [hereinafter *Australia, in* GLOBAL CIVIL SOCIETY].

7. The first Act to impose a tax on income—dividends—was Tasmania's Real and Personal Estate Duty Act 1880. *See* Myles McGregor-Lowndes, *Does Charity Begin and End at Home for Tax Exemptions?*, at 1 (paper on file with author); *see also infra* notes 54-55 and accompanying text (explaining that the first comprehensive state income tax legislation dates from 1884).

because the formation of private foundations in Australia has not been tax driven until relatively recently, the number of such institutions is limited. Although Australia provided a tax incentive to support the creation of nonprofit institutions, through state gift and inheritance tax relief for charitable giving, the gift and inheritance tax provisions were abolished in the 1980s. It was not until 1999 that the Australian federal government enacted tax deductions and tax exemptions as incentives that would directly encourage the creation of nonprofit institutions similar to U.S. private foundations.[8]

Prior to July 1, 1999, the Australian structure sanctioned by its federal tax statutes closest to—but not the same as—the U.S. private foundation was the "ancillary fund." Australia's ancillary fund is a public fund[9] that must operate on a nonprofit basis and must seek

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8. Although names of Australian nonprofit organizations may include the term "foundation," the term does not connote or represent the equivalent of a U.S. private foundation. Effective July 1, 1999, the federal Australian government permitted individuals and businesses to create prescribed private funds, which are similar to U.S. private foundations. Income Tax Assessment Act of 1997 (ITAA of 1997), § 995-1 (Austl.). *See infra* notes 9-13 and accompanying text.

Nonetheless, the Australian Tax Office (A.T.O.) has taken the position that unless there are special circumstances, a fund should annually distribute at least a substantial part of its income, generally considered to be at least seventy-five percent. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, Item 2; ITAA of 1997, Division 50, Subdividion 50-A, § 50-5, Item 1.5; A.T.O. Tax Ruling 95/27; A.T.O. IT 340. *See also infra* note 9 (setting forth the A.T.O. ruling in which it defines "public fund").

9. A.T.O. Taxation Ruling 95/27 delineates the attributes of a public fund. In relevant part it provides:

> 5. The word 'public' as applied to a 'fund' refers to the source, constitution and management of the fund rather than to the objects for which it is established.
>
> 6. The term 'public fund' . . . establishes that a fund will be 'public' where: (a) it is the intention of the promoters or founders that the public will contribute to the fund; (b) the public, or a significant part of it, does in fact contribute to the fund; and (c) the public participates in the administration of the fund.
>
> 7. There are two types of funds which are considered to be 'public funds': (a) funds established and controlled by governmental or quasi-governmental authority; and (b) funds to which the public is invited to contribute and in fact does contribute. These funds must be controlled or administered by persons or institutions having a degree of responsibility to the community as a whole.
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> 9. For the ATO to accept a fund as a public fund, the founding documents of the public fund must reflect the following: (a) the objects of the fund must be clearly set out and reflect the purpose of the fund; (b) gifts to the fund must be kept separate from any other funds of the sponsoring organization (if there is one). A separate bank account and clear accounting procedures are required; (c) receipts must be issued in the name of the fund; (d) the public must be invited to contribute to the fund; (e) the fund must operate on a non-profit basis. Moneys must not be distributed to members of the managing committee or trustees of the fund except as reimbursement for out-of-pocket expenses incurred on behalf of the fund or proper remuneration for administrative services; (f) the fund must be managed by members of a Committee, a majority

public donations. It must be established under a will or trust deed solely for the purpose of providing grants to establish or benefit other deductible gift recipients. It must be controlled by persons accountable to the community and not associated with the founder of the ancillary fund. An ancillary fund is a type of investment vehicle that can invest its funds only as permitted under Australian law, but cannot carry on any other activities. The ancillary fund is not statutorily required to disburse a set percentage of income each year.

As of July 1, 1999, individuals, families, and corporations can give an income tax deductible gift of assets to a "prescribed private fund" without seeking broad public financial support.[10] Otherwise, the requirements applicable to public funds must be satisfied.[11] As with public funds, founding documents must provide that the controlling body of the fund must have at least one "responsible person," a person who has general responsibility to the community and not associated with the fund's settlor or donor in any capacity

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> of whom have a degree of responsibility to the general community (this requirement does not apply to funds established and controlled by governmental or quasi-governmental authority); and (g) should the fund be wound-up, any surplus money or other assets must be transferred to some other fund qualifying under subsection 78(4) or 78(5).
>
> *Objects of the Fund*
>
> 10. A fund, authority or institution seeking approval of its public fund under one of the items listed in the tables in subsection 78(4) must ensure that its objects conform with the requirements of that particular item.
>
> *Location of fund*
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> 14. In all cases the public fund itself must be established and operated in Australia. . . . While the moneys in these funds may be used overseas, the actual public fund must be in Australia.

For a public fund to be a deductible gift recipient, it must conform with the requirements applicable to that tax category. *See infra* notes 74-86 and accompanying text.

10. In accordance with ITAA § 995(1), a "prescribed private fund" requires the following in addition to those items discussed in the text accompanying footnotes 10-24:

> 1. Government endorsement if exemption from federal income taxation is desired as an income tax exempt charity. If exemption from federal income taxation is not sought, but deductions for donations to prescribed private funds is desired, government endorsement is unnecessary. *See* ITAA, Division 50-B, item 1.5B of §§ 50-5, 50-52, 50-60.
> 2. Establishment and maintenance of the fund under a will or trust instrument solely for required purpose of funding philanthropic endeavors.
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> * * *
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> 8. Although the original donation can be retained indefinitely, limits apply to subsequent donations, gifts, government grants and accumulation of money within the trust fund.
> 9. An annual information tax return must be filed with the ATO.

See also A.T.O. *Guidelines for Prescribed Private Funds* (describing guidelines and prescribed private funds).

11. *Id.* § 995-1 (1).

other than professional.[12] The documents must prohibit direct or indirect benefit to the settlor or donor or any associate of that person.[13] A trust fund to retain the assets of the prescribed private fund must be established, and a nondistribution constraint is imposed on the trust fund.[14] In other words, there is an absolute prohibition against any part of the trust fund being paid, transferred, or distributed, by bonus, fee, or otherwise, to the trustee, any member, director, or person who would be considered a related party to a transaction. The prescribed private fund is not required to distribute a particular percentage of its assets annually to further its tax-exempt public purpose.

The U.S. nonprofit sector, which dates back to the early 1700s,[15] is composed of many types of nonprofit institutions. The largest group is its § 501(c)(3) organizations, which consist of both public charities and private foundations. A private foundation, as defined in Internal Revenue Code (I.R.C.) § 509, is not financially supported by a broad public—as is a public charity—but rather is supported by one—individual, family, or corporation—or few sources.[16] For donations to be tax deductible to a private foundation and for the private foundation to be tax-exempt from federal income taxes, it must comply with the statutory requirements of I.R.C. § 501(c)(3). It must be organized and operated exclusively for "religious, charitable, scientific . . . or educational purposes. . . ."[17] No part of its earnings can inure to the benefit of a private individual.[18] Substantial lobbying activities and campaign activities to support or oppose a candidate for public office are prohibited.[19] A private foundation also must comport with the judicially developed public policy doctrine.[20] Additionally, special rules attempt to ensure that a private foundation's funds are utilized for charitable-type public purposes rather than merely retained by the foundation. Those rules require a private foundation to distribute annually for its tax-exempt purposes

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12. *Id.*
13. *Id.*
14. *Id.*
15. As early as 1713, almshouses provided shelter to ill poor persons, foundlings, the mentally unbalanced, the physically handicapped, and even criminals. Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures; A Regeneration of Tax Exemption Standards*, 37 B.C. L. REV. 1, 9 n.21 (1995). In the 1700s, hospitals enjoyed the first tax concessions. Pennsylvania Hospital, established in 1751 to care for the mentally and physically ill, was the first hospital in America. *Id.* at 6 n.17. New York Hospital followed. *Id.*
16. I.R.C. § 509 provides several financial formulas to determine whether the organization is publicly supported or privately supported.
17. I.R.C. § 501(c)(3).
18. *Id.*
19. *Id.* *See also* I.R.C. § 4945 (which imposes an excise tax on private foundations that expend funds on political activities).
20. Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983).

at least five percent of the fair market value of its assets—as reduced by debt used to acquire its assets.[21] U.S. private foundations' funding, governance, and management are intimate and private, often controlled by their founders. Nonetheless, the foundations must pursue public benefits.[22] The Internal Revenue Service (I.R.S.) is responsible for monitoring all tax-exempt organizations,[23] including private foundations, to assure they continue to deserve the tax privileges of exemption from income taxation and of recipients of deductible charitable contributions.

For many years, U.S. private foundations were largely self-regulating. Over time, in an effort to curb the perceived and actual abuses permitted by an under-regulated environment,[24] Congress created a federal tax regulatory regime applicable specifically to private foundations.[25] The process was arduous, time-consuming, and often contentious. The process was riddled with various types of problems, some of which might have been more manageable or more easily solved with a broader and deeper understanding of private foundations, and, if available, an appreciation of other countries' experiences and the effectiveness of their regulatory regimes.

This Article is the product of research undertaken during an ATAX Research Fellowship at the University of New South Wales in 2001. The views and opinions stated herein are the Author's, but they are based on legal research and conversations with numerous professors at several universities, employees of the Australian Tax Office, and decision-makers of nonprofit organizations.

The thesis of this Article is that key individuals involved in and responsible for the development of Australia's nonprofit sector, its nonprofit entities—particularly prescribed private funds which are

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21. I.R.C. § 4942(e).

22. Private foundations qualify for tax-exempt status under I.R.C. § 501(c)(3). They are funded to some extent through tax-deductible contributions of monies that likely otherwise would have ended up in government treasuries. Pursuant to I.R.C. § 501(c)(3) and similar state tax provisions, this diversion of assets to private foundations requires their use for charitable, educational, scientific or similarly legitimate purposes for public benefit considered deserving of special tax treatment. The term "public" implies that the benefit cannot be "private" in the senses of the foundation being established for the private advantage of a class of individuals who do not constitute the "public" and of being not conducted for "private" profit. As one author has concisely stated, a private foundation "is a privately organized public institution." *See* JOHN W. NASON, FOUNDATION TRUSTEESHIP: SERVICE IN THE PUBLIC INTEREST 4 (1989) (quoting MILTON KATZ, THE MODERN FOUNDATION: ITS DUAL CHARACTER, PUBLIC AND PRIVATE (1968)).

23. I.R.C. § 501(a).

24. *See infra* notes 178-248 and accompanying text.

25. The development of the federal tax regulatory scheme is discussed *infra* notes 194-257 and accompanying text. The major legislation directed specifically at private foundations began with the Revenue Act of 1950 and proceeded with the Tax Reform Act of 1969, Pub. L. No. 91-172, adding §§ 508(e), 509(a), and 4940-4946 to the I.R.C.

similar to U.S. private foundations—and the innovation of its regulatory federal tax regime should heed U.S. experiences. While Australia's nonprofit sector operates in an environment that is quite different from the nonprofit environment in the United States, Australia's culture, politics, and economic sectors are evolving and are taking on characteristics also found in the United States, such as a broadening of the wealthy class and the ability of corporations to develop private foundation-type philanthropic vehicles. Moreover, Australia's legislators are adopting some U.S. inspired tax measures to boost charitable giving, including tax laws that encourage philanthropy, that permit averaging of tax deductions, and that allow exemptions from capital gains. The insights offered in this Article to the U.S. federal tax regulatory scheme, if considered, might help to thwart pitfalls that accompany the development of Australia's laws and regulations. An appreciation of the troubles faced by U.S. private foundations and of the shortcomings of the relevant U.S. federal tax regulatory regime may enable key persons responsible in Australia for the formation, operation, and regulation of prescribed private funds to be effective in avoiding potential problems. This Article may provide nonprofit sector leaders with an awareness of possible negative consequences of perceived abuses of tax incentives and tax induced arrangements.

This Article will begin in Part II with a brief exploration of the nature and culture of Australia's nonprofit sector. Based on cases and media coverage of Australia's nonprofit sector, the Article will explore why prescribed private funds, without appropriate attention, might face perceived or actual abuses similar to those faced by U.S. private foundations.

Part III will provide a glimpse at the U.S. nonprofit sector, a snapshot into the state and federal regulatory regimes over nonprofit organizations, and a short history of the development of U.S. private foundations. It will indicate some perceived and actual improprieties perpetrated by private foundation decision-makers, as well as briefly sketch the congressional response. Finally, the shortcomings of the tax regulatory regime created to respond to abuses will be discussed.

Part IV will offer some insights as to why effective regulation strategy is essential. To provide some insights for Australia's key decision-makers in the nonprofit sector, the A.T.O., and the legislative branch of government, comments will be made on facets of a regulatory strategy essential to protect the tax base and to guard against major improprieties and scandals.

II. THE AUSTRALIAN EXPERIENCE

A. *Background—Australia's Nonprofit Sector Today*

Australia began as a European settlement in 1788 in Port Jackson—now part of Sydney—and served as a penal colony.[26] The state assumed responsibility for the inhabitants' food, clothing, and shelter until self-sufficiency could be achieved.[27] The government and community attended to communities' social infrastructure and welfare needs.[28] From the mid-1800s to the beginning of World War I, Australia sustained a growth in both nonprofit organizations partnering with and funded by the states and federal governments to deliver needed services, and in those independent from the governments.[29] Numerous factors, including a benign legal environment, a population with a relatively high level of disposable income, a sufficient population size to sustain voluntary organizations, population mobility, needs that a nonprofit sector could meet without competition, a heterogeneous population having diverse religious beliefs and secular ideologies, economic self-interests, a supportive social environment, and government encouragement and finance enabled and enhanced the increase in the nonprofit organizations.[30] After World War I, although nonprofit organizations were closely bound to Australia's state and federal governments as a result of their receipt of governmental funding, there appeared to be some trend toward an increasing number of independent nonprofit organizations.[31]

Through the 1900s, Australia's nonprofit sector evolved to serve new areas of activity, such as battered women refuges, and to look for more financial resources from government, and more recently, from corporations.[32] As part of its evolving regulatory regime applicable to

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26. Myles McGregor-Lowndes, *Australia*, *in* PHILANTHROPY AND LAW IN ASIA 49 (Thomas Silk, ed., 1999) [hereinafter *Australia, in* PHILANTHROPY]; MARK LYONS, THIRD SECTOR: THE CONTRIBUTION OF NONPROFIT AND COOPERATIVE ENTERPRISE IN AUSTRALIA 99 (2001) [hereinafter THIRD SECTOR].

27. Philanthropy in Australia, *at* www.philanthropy.org.au/history.htm.

28. Myles McGregor-Lowndes, *Australia*, *in* STUDIES ON INTERNATIONAL FISCAL LAW, TAXATION OF NONPROFIT ORGANIZATIONS, 233-34 (1999) [hereinafter *Australia, in* STUDIES].

29. *Id;* Mark Lyons, *Government and the Nonprofit Sector in Australia*, *in* THE NONPROFIT SECTOR IN THE GLOBAL COMMUNITY: VOICES FROM MANY NATIONS 254, 266 (1992) [hereinafter *Government and the Nonprofit Sector*, *in* THE NONPROFIT SECTOR].

30. LYONS, THIRD SECTOR, *supra* note 26, at 105-10.

31. Lyons, *Government and the Nonprofit Sector*, *in* THE NONPROFIT SECTOR, *supra* note 29, at 266-69.

32. GINO DAL PONT, CHARITY LAW IN AUSTRALIA AND NEW ZEALAND 55 (2000).

nonprofit organizations, the government adopted laws to control charitable collections and fundraising,[33] as well as non-tax statutes requiring charities to register with the Charity Commission, which would be responsible for modernizing charities and for making them more responsive to needs.[34] The increased legislation along with other governmental actions, for-profit competition, and changes in the popular appeal of nonprofit organizations, however, potentially served to slow and curtail the tremendous growth that the nonprofit sector had sustained in earlier years.[35]

By the early 1990s, more than one-half of all welfare services in Australia were provided by nonprofit organizations.[36] The fields of greatest activity by the nonprofit sector had expanded since the beginning of the century when healthcare was a major activity of nonprofit hospitals and friendly societies.[37] By the mid-1990s, human services, such as education, health, and social services, dominated the activities of nonprofit organizations, although culture, recreation, and housing were significant fields.[38]

By 1995, Australia's nonprofit sector received the bulk of its revenue from fees and charges (62.5%).[39] The fields dominated by fees were culture and recreation (91.5%), professional (90.5%), civic and advocacy (65.7%), development and housing (57.9%), health (52%), and environment (45.2%).[40] Although from 1976 to 1987 direct governmental support of nonprofit organizations doubled in real terms,[41] in 1995 the government provided only 31.1% of all revenues of the nonprofit sector. The governmental sector financing has supported a substantial portion of Australia's education, social services, and research.[42]

By contrast, in 1995 there was considerably less private philanthropic support (6.4%) of nonprofit organizations.[43] A.T.O. statistics indicate that in 1995-1996, individuals claimed AU$528 in deductible gifts to nonprofit organizations, an average of approximately AU$165 per taxpayer.[44] Subsequently, a study concluded that in 1997, eighty-eight percent of all Australians

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33. *Id.* at 55-56 (briefly describing such laws as the War Charities Acts of 1916 and 1940, and the National Assistance Act of 1948).

34. *Id.* at 56.

35. LYONS, THIRD SECTOR, *supra* note 26, at 115-18.

36. Lyons, *Government and the Nonprofit Sector*, *in* THE NONPROFIT SECTOR, *supra* note 29, at 255.

37. Lyons et al., *Australia*, *in* GLOBAL CIVIL SOCIETY, *supra* note 6, at 203.

38. *Id.* at 209.

39. *Id.* at 212.

40. *Id.* at 213.

41. Lyons, *Government and the Nonprofit Sector*, *in* THE NONPROFIT SECTOR, *supra* note 29, at 262.

42. *Id.* at 263.

43. Lyons et al., *Australia*, *in* GLOBAL CIVIL SOCIETY, *supra* note 6, at 212.

44. McGregor-Lowndes, *Australia*, *in* STUDIES, *supra* note 28, at 232-33.

donated approximately AU$210 annually to charity.[45] By 1999, however, another report indicated a decline in cash donations to nonprofit organizations. It found that individuals donated more than AU$1.63 billion, an average of approximately AU$133 per taxpayer.[46] Funds from private philanthropy dominated only international aid organizations and religious organizations.[47]

As to the financial resources of Australia's foundation structures, there currently is no available data. Likewise, there are no figures available on the number of foundations in Australia today. Nonetheless, Philanthropy Australia, a membership organization that functions in part as a resource center, has estimated that charitable trusts and foundations in combination currently number "around several thousand."[48] That estimate stands in stark contrast to numbers of nonprofit organizations, including charitable trusts, reported in 1996 as a result of a project attempting to determine the dimensions of Australia's nonprofit sector.[49] That report counted 34,456 as the total number of organizations in the nonprofit sector, including 110 charitable trusts.[50]

Regardless of the number of organizations composing Australia's nonprofit sector, the sector had operating expenditures of between AU$14.5 billion and AU$19 billion in 1995-1996, which was in the range of 3% to 5.2% of Australia's gross domestic product.[51] The sector is a major employer, accounting for 6.9% of all employed persons as of May 1996.[52] Additionally, the nonprofit sector contributed three percent of Australia's gross domestic product in

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45. Givewell Statistics, *available at* http://www.givewell.com.au/statistics.asp.

46. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 4 (citing GIVING TRENDS IN AUSTRALIA 2000, 12th Annual O'Keefe and Partners Report). Australians perceive that the decline in giving is due to changing demographics and the lack of tax incentives. *Id.*

47. Lyons, *Government and the Nonprofit Sector*, *in* THE NONPROFIT SECTOR, *supra* note 29, at 263.

48. Philanthropy Australia Factsheet, *available at* http://www.philanthropy.org.au/factsheets/7-05-01-ausfound.htm (last visited Nov. 29, 2001).

49. MARK LYONS & SUSAN HOCKING, DIMENSIONS OF AUSTRALIA'S THIRD SECTOR 71-72 (2000) [hereinafter DIMENSIONS].

50. *Id.*

51. *Id.* at 81 (indicating that nonprofit organizations' expenditures were approximately AU$14.5 billion or three percent of Australia's gross domestic product); *cf.* Lyons et al., *Australia*, *in* GLOBAL CIVIL SOCIETY, *supra* note 6, at 204 (stating that the nonprofit sector expended AU$19 billion or 5.2% of the country's gross domestic product, but indicating that the value added to the gross domestic product was 3.9% if accounting only for wages paid to employees and imputed volunteer time). Another study undertaken at the University of Technology in Sydney estimated that the nonprofit sector expends AU$27 billion annually, or approximately six percent of Australia's gross domestic product. Narelle Hooper, *Taxing Times Ahead for Charities*, BUS. REV. WKLY., Sept. 3, 1999.

52. LYONS & HOCKING, DIMENSIONS, *supra* note 49, at 81.

1995-1996.[53] Thus, the nonprofit sector as a whole has a significant role in Australia's economy and in the lives of its residents.

B. *Australia's Income Taxation Laws Applicable to Nonprofit Organizations and Their Donors*

In 1884, the State of South Australia enacted the first comprehensive state income tax legislation.[54] That legislation contained provisions exempting charitable organizations from the State income taxation. As each state adopted income tax legislation exempting charitable organizations from taxation, newly formed charitable trusts blossomed.[55] The federation of states that formed the federal government subsequently enacted the Income Tax Assessment Act of 1936, which exempted broad categories of nonprofit "charitable" institutions[56] from federal income taxation pursuant to section 23.[57] Since that time, the states' income tax

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53. *Id.*

54. South Australia was the first State with the Taxation Act 1884 and the Commonwealth's income tax provisions closely followed the State's exemption provision in section 23 of Income Tax Assessment Act 1936 (Cth). *See* McGregor-Lowndes, *Does Charity Begin and End at Home for Tax Exemptions?*, *supra* note 7.

55. *Id.*; Philanthropy in Australia, *available at* www.philanthropy.org.au/history.htm. England's law of charity was applied as part of Australia's general body of common law and equity. DAL PONT, *supra* note 32, at 57. Although charities providing welfare services were established from the early 1800s, their creation substantially increased during the latter part of the nineteenth century. *Id.*

56. The appropriate meaning of the term "charitable" institution was raised by the Industry Commission—now the Productivity Commission—in its 1995 report. INDUSTRY COMMISSION, CHARITABLE ORGANISATIONS IN AUSTRALIA, Rept. No. 45, AGPS, Melbourne, June 16, 1995. Following release of the 1995 report, the Industry Commission undertook a study in an attempt to ascertain what the appropriate meaning of "charitable" institution should be. The 2001 Sheppard report suggests that the meaning should include, but should not be limited to public benevolent institutions. SHEPPARD, at 258. However, discussion of this term and of the report is beyond the scope of this Article.

57. The categories of exempt organizations under § 23 of the Income Tax Assessment Act of 1936 (ITAA of 1936) included: religious, scientific, charitable, or public educational institutions (§ 23e) that cannot be for the purpose of making a profit and is not formed for the purposes of benefiting a narrow section of community; organizations for the relief of poverty that benefit a class of people; organizations for the advancement of education; organizations for the advancement of religion that has a religious purpose and benefits the community; organizations for community welfare which have purposes analogous to those of Statute of Charitable Uses of 1601 and are for public benefit; public and nonprofit hospitals (§ 23ea); hospital and medical benefits organizations (§ 23eb); Thalidomide Foundation (§ 23ec); trade unions and associations of employees (§ 23f); friendly societies (§ 23gi); societies, associations, or clubs established for musical purposes, or for the encouragement of music, art, science, or literature (§ 23gii); clubs for community purposes (§ 23gv); and funds established by will or trust for public charitable purposes or scientific research through a public university or hospital (§ 23j). Sandra Rodman & Myles McGregor-Lowndes, *Income Tax Exemptions for Non-profit Associations, in* LEGAL ISSUES FOR NON-PROFIT ASSOCIATIONS 121-34 (Myles McGregor-Lowndes et al. eds., 1996).

exemptions and the federal income tax exemption have remained in place for "income tax exempt charities."[58]

In an attempt to philosophically and financially encourage philanthropy and to provide expanded philanthropic vehicles to achieve this goal, the Australian Prime Minister initiated a business-community partnership initiative.[59] In addition to non-pecuniary benefits, the media has reported that the portion of the measure permitting an income tax deduction for inter vivos gifts of property of more than AU$5,000 "could initially increase donations by around AU$45 million per annum and by a larger amount over time."[60]

In an attempt to simplify the federal income tax laws, the Australian government has been rewriting some provisions since 1993. The rewrite project, known as the Tax Law Improvement Project, was intended to rewrite the federal income tax laws in order to institute a new tax system, but the intention has not been fully realized. To date, income tax provisions integral to deductibility of gifts by donors and to excludability affecting income of qualified income tax exempt charities have been revised. The project also has resulted in modest liberalization of these areas.[61]

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58. The current federal income tax exemption was re-enacted as part of the ITTA of 1997, Division 50; §§ 50-1 though 50-70. Pursuant to the federal tax statutes, neither ordinary-type income nor capital gains of nonprofit organizations are subject to taxation. Unlike the United States, where unrelated business income is subject to taxation pursuant to I.R.C. §§ 511-514, there is no unrelated taxable business income under Australia's income tax laws. Scholars have suggested that to tax income earned by a charitable nonprofit organization, regardless of the source of the income, would theoretically be difficult to justify based on the notion that such income contributes to financing the primary purposes of the nonprofit organization. *See* McGregor-Lowndes, *Australia, in* STUDIES, supra note 28, at 235 (citing Ole Gjems-Onstad, *Money Pouring out of its Ears: On the Taxation of Really Profitable Nonprofit Organisations in Australia*, Program on Non-profit Corporations Working Paper No. 28, 1993, Queensland University of Technology, Brisbane, at 2).

Charitable organizations also may be exempt from other direct taxes. For example, fringe benefits provided in respect of employment of employees by public benevolent institutions are exempt from fringe benefits taxes. Fringe Benefits Tax Assessment Act 1986, § 57A(1). Additionally, many of these organizations may be exempt from indirect taxes, such as sales taxes and payroll taxes. DAL PONT, *supra* note 32, at 96-97.

59. *See The Prime Minister's Community Business Partnership*, CCH Announcement, Nov. 30, 1999, *available at* http://www.partnership.zip.com.au/ and http://www.pm.gov.au/news/media_relieases/2001/media_release887.htm (stating that a Community Business Partnership will be established to broker major philanthropic and partnership efforts between business, government and communities). The idea of these partnerships is to encourage the nonpecuniary involvement of business executives in social needs of communities. *Id.*

60. *See id.* (referring to ITAA of 1997, Division 30, § 30-15 (1999)).

61. Givewell Surveys, *New Tax Measures to Encourage Philanthropy*, Apr. 1999, *available at* http://www.givewell.com.au/survey_apr99_2.asp. Additionally, under Australia's Cultural Gifts Program, to encourage philanthropy by private art collectors and others, special statutes exempt capital gain from the gift of property to a qualified cultural institution, and income tax donation deductions are available to

The revised income tax laws do not entitle all nonprofit organizations to federal income tax exemption. Today, the following broad categories of nonprofit organizations are tax exempt under the federal income tax laws:[62] (1) charitable institutions,[63] (2) religious institutions,[64] (3) scientific institutions,[65] (4) public educational institutions,[66] (5) funds established for charitable purposes by will before July 1, 1997,[67] (6) certain testamentary trusts,[68] other funds, including certain public funds and prescribed private funds[69] established in Australia for public charitable purposes by will or instrument of trust,[70] (7) funds established to enable scientific research to be conducted by or in conjunction with a public university or hospital,[71] and (8) societies, associations, and clubs established for the encouragement of science.[72] The sixth category is among the recent statutory changes. It expands the category, which previously was limited to funds that actively sought financial support by the broad public—public funds[73]—to now include "prescribed private funds" as entitled to the federal income tax exemption. The prescribed private fund, a previously non-existent Australian philanthropy vehicle, is functionally similar to U.S. private foundations.

The core provisions of the federal income tax laws affecting excludability of income by endorsed "income tax exempt charities" and deductibility of gifts by donors to qualified "deductible gift recipients"[74] do not provide complete overlap of these nonprofit

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donors unless the gift is testamentary or is an interest in land or a building. ITAA of 1997 § 118-60(2); M2 Presswire, *Australian Government, Tax Incentives a Major Boost for Cultural Sector*, Mar. 29, 1999, *available at* http://www.pm.gov.au/news/media_releases/2001/media_release887.htm.

62. The income tax exemption applies to both "statutory income" and "ordinary income." In some cases, the exempt income is subject to special conditions. ITAA of 1997, Division 50, Subdivision 50-A, § 50-1.

63. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.1; §§ 50-50 and 50-52.

64. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.2; § 50-50.

65. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.3; § 50-55.

66. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.4; § 50-55.

67. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.5; § 50-52 and 50-57.

68. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.5A; § 50-52 and 50-60.

69. *See supra* notes 9-10 (explaining the terms "public fund" and "prescribed private fund").

70. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.5B; § 50-52 and 50-50.

71. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.6; § 50-65.

72. ITAA of 1997, Division 50, Subdivision 50-A, § 50-5, item 1.7; § 50-70.

73. *See supra* note 9 and accompanying text (discussing public funds).

74. In 1995, the Industry Commission had expressed concern that the only donations that could be deducted by donors were those made to charitable organizations that distribute funds to organizations with tax-deductible status. The

organizations. In other words, unlike in the United States and the United Kingdom, tax-exempt status in Australia does not equate with, or even relate to, tax deductibility. Statutorily identified categories of nonprofit organizations entitled to be deductible gift recipients now include funds or institutions involving health, education, research, welfare and rights, defense, industry, trade and design, the family, international affairs, sports and recreation, philanthropic trusts, and cultural and environmental institutions;[75] certain public funds and prescribed private funds;[76] registered political parties;[77] public libraries, museums, and art galleries;[78] specified organizations registered with the National Trust;[79] and the Commonwealth.[80] With the addition of the prescribed private funds, beginning July 1, 1999, individuals, families, and corporations can gift assets to a fund without seeking broad financial support for the fund and can legitimately claim a federal income tax deduction for the gift.[81]

Today, individual donors enjoy an income tax deduction for cash gift donations of at least AU$2 to public funds and prescribed private funds.[82] The amount of this deduction is only subject to the limitation that it cannot create or increase a current year loss because the deduction is limited to the amount of the donor's assessable income less other deductions and any loss carried forward from prior years.[83] Individuals are also entitled to an income tax deduction, spread over five years, for inter vivos donations of property having a fair market value of more than AU$5,000, regardless of when the property was purchased.[84] Nonetheless, if such donated property is capital gain property, the donor is subject to capital gains

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Commission recommended that a wider range of charities receive status as deductible gift recipients. INDUSTRY COMMISSION, *supra* note 56, at 252-53.

Australia does not currently impose a gift tax on intervivos transfers or an estate tax on transfers at death. Therefore, Australians do not benefit from a gift tax or estate tax deduction for gifts.

75. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 1, and Subdivision 30-B, §§ 30-20 to 30-105.

76. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 2. These funds must be endorsed by the A.T.O. under Subdivision 30-BA or must be owned by one or more persons who constitute a government entity that is endorsed by the A.T.O. under Subdivision 30-BA. *Id.* § 30-17. For definitions of public funds and prescribed private funds, *see supra* note 9-10 and accompanying text.

77. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 3.

78. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 4.

79. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 6.

80. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 5.

81. *See supra* note 10 and accompanying text (referring to prescribed private funds).

82. ITAA of 1997, Division 30, Subdivision 30-A, § 30-15, item 2.

83. ITAA of 1997, Division 30, § 26-55 (1999).

84. ITAA of 1997, Division 30, § 30-15 (1999). The amount deductible is the value determined by the Commissioner of the A.T.O. *Id.*

tax on its appreciation if the transfer is inter vivos.[85] By contrast, if capital gain property having a fair market value in excess of AU$5,000 is transferred by testamentary gift to a deductible gift recipient, the capital gains are exempt from income taxation.[86]

In recent years, Australia's federal government has encouraged businesses to engage in philanthropic endeavors.[87] With the exception of the prescribed private funds provisions, however, the federal government has not provided specific and affirmative encouragement to corporations in the form of a federal income tax deduction for donations, whether made in cash or in-kind.[88] As one scholar has stated:

> The law of corporations in both England and Australia does not facilitate corporations making pure philanthropic gifts. A director or senior executive risks breaching his or her duty to act in good faith in the interests of the company if he or she authorizes a donation in circumstances where there is no obvious [potential pecuniary] benefit—direct or indirect—for the company's shareholders.[89]

C. *Legal Forms of Australia's Nonprofit Organizations*

As in the United States,[90] creation of a new nonprofit organization can be accomplished through the choice of one of several

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85. ITAA of 1997, Division 30, § 30-15 (1999).

86. *Id.*

87. *See supra* note 81 and accompanying text.

88. It, however, should be noted that under the ordinary principles of ITAA of 1936, § 51 (now ITAA of 1997, § 8-1), a company, as opposed to an individual, could claim a gift deduction.

89. Myles McGregor-Lowndes, *Regulatory Infrastructure for Nonprofit Organisations*, Working Paper No. 97, Aug. 2000, at 13 (citing Hutton (1883) 23 Ch D 654) [hereinafter *Regulatory Infrastructure*]. This is not something that has lacked legal attention in Australia, a chapter being devoted to it in *Legal Issues for Non-Profit Associations*. The recent report by the Centre for Corporate Law and Securities Regulation at the University of Melbourne also considered the issue. S. Fisher, *Corporations as Donors: A Legal Survey in* LEGAL ISSUES FOR NON-PROFIT ASSOCIATIONS (McGregor-Lowndes, Fletcher & Sievers eds., 1996); J. Vernon, Political Donations by Australian Companies, Centre for Law and Securities Regulation, The University of Melbourne, Melbourne, 2000. In 1999, it was reported that compared to 1998, corporate philanthropy had declined twenty percent. *See* McGregor-Lowndes, *Australia, in* PHILANTHROPY, *supra* note 26, at 5 (citing GIVING TRENDS IN AUSTRALIA 2000, 12th Annual O'Keefe and Partners Rept.). Note, however, that an argument could be made that corporate gifts enhance goodwill and therefore benefit the entity and its shareholders.

90. In the United States, nonprofit organizations are formed under the laws of the states. A charitable nonprofit organization can be formed as a charitable trust or as a nonprofit corporation. For a discussion of the impact that choice of legal form has with respect to fiduciary duties of decision-makers of nonprofit organizations, see Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093 (2001) [hereinafter *Private Foundation's Governance*].

legal forms.[91] An Australian nonprofit organization can be created as an unincorporated association,[92] a corporation by Royal Charter or by private act of Parliament,[93] a corporation under general national corporation laws,[94] an incorporated association,[95] or a charitable

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91. *See generally* McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 50-71.

92. Unincorporated associations had their genesis in the modern laws of England, passed by Parliament in 1799, implicitly recognizing the freedom of association for any lawful purpose. Keith Fletcher, *Developing Appropriate Organisational Structures for Non-profit Associations*, *in* LEGAL ISSUES FOR NON-PROFIT ASSOCIATIONS 4 (McGregor-Lowndes, Fletcher, & Sievers eds., 1996) [hereinafter *Developing*, *in* LEGAL ISSUES]. They are unincorporated groups, which can be small in number or larger more formal groups. Because not incorporated, their creation is not costly and their structures are flexible. An unincorporated association has no separate legal persona from its members. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 54-57. It cannot sue or be sued, but its committees and officers assume primary liability for the association's obligations. *Id.* An unincorporated association is not required to register with a state unless they have more than twenty members and carry on a business in more than one state or territory. *Id.* Therefore, most unincorporated associations are subject to little regulation and have little public accountability. *Id.*

93. Corporations by Royal Charter or by private act of Parliament are limited in number, in part because this status is costly to obtain. These types of corporations generally are not a viable alternative when creating a nonprofit income tax exempt charity. Fletcher, *Developing*, *in* LEGAL ISSUES, *supra* note 92, at 4-5.

94. Most large nonprofit organizations are incorporated under general national corporation laws, usually in the form of a corporation limited by guarantee, by which members guarantee the debts of the organization on its dissolution up to a sum certain. The guarantee terminates on the resignation of a guarantor, but the liability persists for debts of corporation incurred before resignation for one year after the guarantor's resignation. Fletcher, *Developing*, *in* LEGAL ISSUES, *supra* note 92, at 6. Otherwise, the corporation limited by guarantee has attributes and obligations of other public companies under Corporation Laws. *Id.*

Nonprofits incorporated under §§ 150-151 of Corporations Act of 2001 can be formed for charitable purposes. Under the predecessor provision, § 383 of the Corporations law, nonprofit organizations could be incorporated for the purpose of providing "recreation or amusement or promoting commerce, industry, art, science, religion, charity, patriotism, . . . or any object useful to the community; will apply its profits (if any) or other income in promoting its objects; and will prohibit the payment of any dividend to its members." McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 58. The corporation must have a board of directors. Fletcher, *Developing*, *in* LEGAL ISSUES, *supra* note 92, at 6. The nonprofit corporation must register with Australian Securities Commission. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 69. The corporation is subject to more rigorous and comprehensive reporting requirements than for incorporated associations. The corporation must submit financial statements to Australian Securities Commission. *Id.*

There are several reasons that this legal form is not a preferred option: (1) the word "Ltd" must appear after name of organization (although an application can be made for removal of the term); (2) the corporation must keep its registered office open for at least three hours each business day (although this requirement can be circumvented by having another company's office be the registered office); and (3) there are significant direct costs of incorporation and costs in maintaining corporate status. Fletcher, *Developing*, *in* LEGAL ISSUES, *supra* note 92, at 7.

trust.[96] While qualifying "income tax exempt charities" created under one of these legal forms are entitled to income tax exemption under the federal tax statutes, the choice of legal form impacts their registration and reporting requirements, their regulation, the parties responsible for monitoring and enforcing laws and regulations, the

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95. Incorporated associations are organizations that have a separate legal persona. That trait limits the liability of its committee members and governing body. Committee members and governing board members are bound by fiduciary duties under common law or pursuant to the association's constitution, including the duty to act with reasonable care and diligence without personal pecuniary benefit, the duty to disclose any direct or indirect interests in contract with association; and the duty not to vote on matters in which committee member is an interested party. Fletcher, *Developing*, *in* LEGAL ISSUES, *supra* note 92, at 12-13. Each state has separate laws and reporting requirements. The majority of Australia's states require a minimum number of members and a constitution with provisions conforming to established guidelines. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 63. There are three forms of external controls: (1) regulators can conduct inspections in accordance with state statutes; (2) incorporation can be cancelled when the association is inactive or its activities are inconsistent with nonprofit status; and (3) authorities can remove from the state register an incorporated association considered unsuited for continued registration, by reason of size, extent of trading activities, or public dealings. Fletcher, *supra* note 92, at 15. Incorporated associations are often the preferred legal form of choice for nonprofit organizations having religious, charitable, or benevolent purposes.

96. Charitable trusts must have a charitable purpose of the relief of poverty, advancement of education, advancement of religion, or other purpose beneficial to community. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 58. They can carry on commercial activity that benefits the charitable purposes of the trust, but such activity cannot benefit the trustees. *Id.* Trust documents are private and need not be filed for public viewing. *Id.* Charitable trusts are not required to register with the state or territory in which formed, but they may be required to register for tax law purposes. *Id.* Public accountability of charitable trusts is limited; accountability largely rests with the trustees of the trust. *Id.* at 60. Although relator actions may be brought, the states and territories Attorneys General act as the general supervisor of charitable trusts, but they generally only attempt to ensure that charitable trusts are not organized and operated for impossible purposes or have not become inactive. *Id.* The A.T.O. does not require charitable trusts to file informational tax returns. The A.T.O. requires charitable trusts to annually distribute a substantial portion of their income, generally considered at least seventy-five percent. A.T.O. Ruling No. IT 340. This rule is aimed at reducing the use of charitable trusts for tax minimization purposes. But, this position severely limits a trust's ability to accumulate capital for programs and projects, since no more than fifteen percent of the revenues of a charitable trust would be available to be expended for administrative purposes or reinvested in capital for the use of the organization. *Id.*

Charitable trusts have a governing body of trustees whose successors are determined in accordance with the trust deed. McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 60. The trustees hold assets in trust and manage them pursuant to their fiduciary duties under state laws and common law. *Id.* While trustees are personally accountable under these fiduciary duties, historically few cases have been brought by the attorney general or by relators under the supervision of an attorney general. Charitable trusts can exist for fixed period or for indefinite period. Thus, charitable trusts are the only category of trust that have perpetual succession rather than a limited life span. McGregor-Lowndes, *Regulatory Infrastructure*, *supra* note 89.

liability of their officers and key decision-makers, and the fiduciary standards applicable to officers and members of governing bodies.[97]

D. *Australia's Statutory Environment and Culture Account for the Early Developmental Stage of Its Nonprofit Sector*

The environment and culture in which Australia's nonprofit organizations operate is far different from the United States. When viewed in the aggregate, these differences may account for the fact that the developmental stage of Australia's nonprofit sector currently is less regulated than that of the United States.

1. Wealth and Philanthropic Culture

The scope and wealth of Australia's nonprofit sector are not fully known,[98] but their magnitude is significantly less than that of the United States.[99] There are relatively few nonprofit entities in Australia,[100] and the wealth massed in these institutions does not approach that found in U.S. and English nonprofit sectors. There are numerous reasons. Since its inception, Australia has not had a high concentration of wealth. It has had far fewer wealthy individuals and entities than the United States. Additionally, unlike the United States where the federal government provides gift and estate tax deduction incentives for charitable donations to qualifying nonprofit organizations,[101] Australia repealed its federal gift and estate transfer taxes in the 1980s, and thus, currently has no such tax stimulus. Moreover, Australia has a culture of supporting nonprofit projects through volunteerism rather than through pecuniary giving.[102]

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97. *See* INDUSTRY COMMISSION, *supra* note 56, at 203 (table showing different reporting requirements for each state); McGregor-Lowndes, *Australia*, *in* PHILANTHROPY, *supra* note 26, at 51-57.

98. *See supra* notes 47-48 and accompanying text. *See also* McGregor-Lowndes, *Australia, in* PHILANTHROPY, *supra* note 26, at 4.

99. Even when limited to charitable trusts and foundations in Australia, the Industry Commission noted that they are not as significant in Australia as in the United States or the United Kingdom. INDUSTRY COMMISSION, *supra* note 56, at 247.

100. On a relative basis, there are very few large nonprofit entities and many small, rather new, nonprofit organizations. McGregor-Lowndes, *Australia, in* PHILANTHROPY, *supra* note 26, at 60.

Community foundations, funds that derive their resources from multiple donors and that expend those funds with respect to charitable projects in a particular geographic location, were almost nonexistent until the late 1990s. David Cohen, *Community Funds Down Under Tackle Issues Facing Rural Areas*, CHRON. PHILANTHROPY, Oct. 18, 2001, at 7. Today, community foundations are the fastest growing philanthropic recipients in Australia. *Id.*

101. I.R.C. § 2055 (e); § 2522(c)(3).

102. Lyons et al., *Australia, in* GLOBAL CIVIL SOCIETY, *supra* note 6, at 203-12. In 2000, approximately 4.4 million Australians of at least eighteen years of age,

Nonetheless, in recent years, an Australian tradition of wealthy individuals creating and donating funds to private charitable trusts for distribution to, and use for, public benevolent purposes has been developing. Yet, one Australian researcher found that high net worth Australians are not considerably more generous than persons of lesser financial means.[103] This researcher suggested that, although in 1997 Australians' gift donations were estimated to be between AU$2 billion and AU$2.5 billion annually,[104] Australians have not ranked among the most generous philanthropists in the world.[105] What this researcher did not explain is that the Australian culture generally has promoted volunteerism but has frowned upon self-promotion by philanthropists. Therefore, to a large extent, this culture has not engendered philanthropy for the sake of personal gain or personal recognition by others. The relative absence of this attribute, along with the dearth of wealthy residents, may help to elucidate not only why Australians have not ranked among the world's most generous philanthropists but also why there may be relatively little incentive to financially support nonprofit organizations.

2. Complex Tax Statutes and Tightly Controlled Philanthropic Vehicles

As discussed above, Australia's nonprofit sector and potential donors are faced with a maze of complex statutes, both state and

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representing nearly one-third of the civilian population in that age group, volunteered during 2000. AUSTRALIAN BUREAU OF STATISTICS, 4441.0 VOLUNTARY WORK, AUSTRALIA, *available at* http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/NT0001AA0E.htm. They contributed approximately 704.1 million hours of voluntary work. *Id.* The number of volunteers in the same age group had increased since 1995 when just under 3.2 million were volunteers, which represented approximately twenty-four percent of the same population. *Id.* Between 1980 and 1995, the percentage of the Australian adult population that volunteered had declined. LYONS, THIRD SECTOR, *supra* note 26, at 104.

103. *See* Narelle Hooper, *Now That You Have Made It, Perhaps The Time Has Come To Give It Away*, BUS. REV. WKLY., Dec. 22, 1997, at 52 (referring to Mark Lyons, Director of the Centre of Australian Community Organisations and Management, University of Technology, Sydney, Australia).

104. The estimated amounts of these gift donations is substantially less than other estimates of giving for the same year. Mark Lyons, Director of Centre of Australian Community Organisations and Management, University of Technology, reported in 2000 that giving by individuals in 1997 was over AU$3 billion and giving by corporations approximated AU$1.67 billion in that same year. LYONS & HOCKING, DIMENSIONS, *supra* note 49, at 101. The disparity in the numbers may be explainable by the fact that not all individuals are entitled to or do claim the gifts as deductible donations, and until recently, there was no philanthropy vehicle by which corporations could make charitable donations. *See supra* note 10 and accompanying text (discussing prescribed private funds).

105. *See* Hooper, *supra* note 103 and accompanying text.

federal.[106] These provisions are complex in their minutia and detail. The complexity of these provisions alone may have been, and may continue to be, a daunting impediment to the development of the nonprofit sector. The growth potential of the nonprofit sector likely was curbed significantly, however, because prescribed private funds became available as a philanthropic vehicle only two years ago to potential donors, who, until then, could contribute financially only to publicly supported nonprofit organizations.

E. *Fiduciary Improprieties, Tax Abuse, and the Nonprofit Sector*

Three questions were researched and asked of numerous academics, employees of the A.T.O., and decision-makers of nonprofit organizations: (1) whether creators and governing bodies of nonprofit organizations have violated the spirit or letter of the laws conferring special tax status on an organization as an income tax exempt charity or as a deductible gift recipient, (2) whether such persons had violated fiduciary duties owed to the nonprofit organizations, and (3) whether prescribed private funds are susceptible to similar problems. Frequently the response to each question was affirmative.

Australia has an unstated protective culture of institutional silence that prevails among nonprofit organizations when scandals surface. This culture minimizes the knowledge of the public about improprieties, and thereby protects innocent nonprofit institutions from collateral potential harm. Similarly, the A.T.O. has a strictly enforced code of privacy with respect to taxation matters.[107] By law, the A.T.O. is required to settle taxation matters in strict privacy unless it pursues the matters in court.[108] There appears to be a

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106. *See supra* notes 61-85 and accompanying text.

107. The United States Internal Revenue Service also is statutorily prohibited from disclosing information concerning the identity of a § 501(c)(3) organization or findings of questionable or abusive activities uncovered in audit or otherwise. *See* I.R.C. § 6103. Most § 501(c)(3) organizations, however, are required to file an annual information tax return, Form 990 for public charities and Form 990-PF for private foundations. *See* I.R.C. § 6033(a). To encourage accountability of § 501(c)(3) organizations to the public, Congress enacted the disclosure rules of I.R.C. § 6104(e). The statute requires the organizations to make available for public inspection a copy of its application for tax exemption and their Form 990s or Form 990-PFs for three years. The statute exempts from disclosure, however, names of contributors and information that the Treasury Department considers might adversely affect the organization. I.R.C. § 6104(e)(3).

108. ITAA of 1936, § 16. Additionally, the Privacy Act of 1988 and taxation acts protect as confidential personal information collected by the A.T.O. *See* http:/www.austli.edu.au/. But, note that ITAA of 1936, § 14(1) requires the "Commissioner [of the A.T.O. to] . . . prepare and furnish . . . [an annual report] . . . including any breaches or evasions of this Act of which the Commissioner has notice." The A.T.O.'s 1980-81 Annual Report included sixty-four pages listing taxpayers caught offending the Act during the prior year, whereas the Annual Report of more recent years have not. Perhaps the A.T.O. fails to

direct link between decisions by the A.T.O. to initiate prosecutions and privacy considerations. It is unclear whether a combination of the privacy laws and a lack of belief that cases of tax abuse are a real and important threat to the revenue base has contributed to the A.T.O.'s failure to dedicate large amounts of resources to audits and litigation. Nonetheless, information has not flowed from the A.T.O. to persons outside the institution in which infractions of fiduciary duties have been detected, and the A.T.O. has quietly settled all but a few exceptional cases. For the most part, leaks have been contained, and the Australian media has largely refrained from investigative reporting that would uncover and publicize abuses within the nonprofit sector. The silence, however, is a curtain that does veil improprieties, and the curtain has been pierced infrequently for occasions considered particularly egregious.

A number of cases bear out the fact that Australia's nonprofit sector has experienced significant problems associated with breaches of fiduciary behavior and tax abuse concerns of a magnitude that the A.T.O. could not overlook or settle quietly.[109] One infamous illustrative case is *Bray v. Federal Commissioner of Taxation*.[110] In that case, a Brisbane solicitor, Peter William Bray, entered into a series of transactions whereby Bray and three friends—to whom Bray transferred funds for the endeavor—established a trust fund named "The Sportsmens and Businessmens Benevolent Foundation" (Foundation). The recital to the trust deed for the Foundation provided that:

> The founder [Mr. Bray] wishes to establish a [charitable] public fund exclusively for the purposes of providing money, property or benefits to or for funds, authorities and institutions referred to and for purposes referred to in any of the sub-paragraphs of section 78(1)(a) of the Income Tax Assessment Act [that is, charitable public funds qualifying as deductible gift recipients] . . . and for the establishment of any such funds, authorities and institutions.[111]

The trustees were bound by this intent in the use and application of trust assets.[112] Bray also purchased one hundred percent of the

utilize its powers of disclosure and is not as constrained by privacy requirements as some believe.

109. *See* Leary v. Fed. Comm'r of Taxation, 80 ATC 4438 (1980); Mahony v. Fed. Comm'r of Taxation, 10 AITR 463 (1967); Compton v. Fed. Comm'r of Taxation, (1966) 10 AITR 282; Scott v. Fed. Comm'r of Taxation, 10 AITR 290 (1966); Luceria Investments Pty. Ltd. v. Fed. Comm'r of Taxation, (1975) 5 A.T.R. 380. *See* Commonwealth Bank of Austl. v. Friedrich & Ors, 5 ACSR 115 (1991) (a breach of fiduciary case not involving taxation). *See also* Gibelman & Gelman, *supra* note 5 (listing three incidents in 2000 in Australia involving Youth Motor Sport Foundation, Wesley Mission, and Brisbane's Royal Hospital).

110. Bray v. Fed. Comm'r of Taxation, (1978) 140 CLR 560.

111. *Id.* at 569.

112. *Id.*

outstanding shares in a company, M.B.J. Constructions Pty. Ltd. (M.B.J.),[113] the only asset of which was AU$45,240 cash and which had no liabilities. Bray was appointed chairman of the board of trustees and president of the Foundation. Without complete disclosure by Bray of his intended dealings for M.B.J.'s cash, the Foundation's board of trustees approved Bray's donation of his M.B.J. shares to the Foundation in addition to AU$100.[114] Bray claimed the value—AU$44,107—of the shares as a deductible gift for federal income tax purposes. Subsequently, part of the cash in M.B.J.'s bank account was indirectly made available to and used by Trumper Finance Pty. Ltd. (Trumper) to repay its creditors. This facilitated Trumper's lending activities. Bray controlled and beneficially owned Trumper. The remainder of the cash in M.B.J.'s bank account was made available to Bray interest-free and was used by him for personal purposes.[115]

The Federal Court of Australia, General Division—Australia's federal court to which the case had been appealed from the Supreme Court of Victoria—addressed whether Bray's transfer of the M.B.J. shares to the Foundation was a "gift"[116] and whether the transfer was to a "public fund" established and maintained for the purposes that would qualify it as a deductible gift recipient. Chief Judge Bowen and Judge Sweeney found that the transfer constituted a "gift." Although acknowledging that Bray derived advantages from the form of the conveyance—transfer of M.B.J. stock to the Foundation, thereby permitting retention within M.B.J. of cash for subsequent use by Trumper and its controlling shareholder, Bray—Chief Judge Bowen found that the transfer constituted a gift rather than a quid pro quo transaction. Nonetheless, over the dissent of Judge Deane, Chief Judge Bowen and Judge Sweeney determined that the Foundation was not a "public fund," "established and maintained" for benevolent purposes benefiting the public. Chief Judge Bowen and Judge Sweeney made this determination based on a variety of factors: the Foundation's income source was essentially one individual—and not the larger citizenry—its control and management were in the hands of a few private persons; and, in violation of Bray's fiduciary duties as a trustee of the Foundation, the structure permitted conflicts of interest ending in private advantage.

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113. All but one share in the company, M.B.J. Constructions Pty. Ltd., were transferred to Bray. The remaining share was transferred to Trumper Finance Pty. Ltd., a company controlled by Bray and beneficially owned by him. *Id.*

114. Bray had informed that he would make best efforts to see that the company paid dividends on the donated shares. In fact, none of the self-dealing transactions between the company, another company owned by Bray, and by Bray himself were disclosed to the other trustees. *Id.*

115. Bray utilized the money to pay his personal income taxes. *Id.*

116. Entitlement to a deduction for a "gift" to a qualified public fund requires a showing that there was a "gift" within the meaning of ITAA of 1936, § 78(1)(a).

On appeal, the High Court of Australia focused not on whether the transfer was a "gift,"[117] but on whether the Foundation was a public fund properly established and maintained exclusively for benevolent public purposes. Of the five appellate judges, four judges concluded that the Foundation was not a public fund and thus Bray's appeal for the deduction was dismissed. Chief Judge Barwick determined that the Foundation neither originated in a public initiative nor proceeded in an effective endeavor to attract public financial participation. Holding that the Foundation was at no time established and maintained for "public" benefit, he stated that "the only effect" of Bray's transfers to the Foundation was to

> provide the appellant with a deduction from his assessable income. The fund [Foundation] cannot be said to exist as a means of producing assistance for a specified object. The appellant minded to assist any of those objects could have done so directly. . . . The fund existed at material times solely as a vehicle for the justification of the deduction by the appellant.[118]

Chief Judge Barwick also drew upon the policy of the statute to support his conclusion. He wrote:

> The evident purpose of § 78 is to encourage the support by the public of the objects specified in the sub-paragraph of that section by contribution of sums of varying amounts to a fund which, by aggregating them, can significantly assist one or more specified objects. The provision of the deduction is for the implementation of that policy. . . ."[119]

Judge Mason strongly agreed, indicating that "the present case is not a marginal case."[120]

Citing legislative intent, Judge Jacobs repeated the sentiment of Chief Judge Barwick:

> It is not the legislative intention that a private person could establish a fund by making gifts of money or property to trustees for the prescribed [statutory] purposes and thereby claim a deduction. . . . Such private person could if he wished made deductible gifts directly to any of the prescribed authorities or institutions.[121]

Judge Jacobs expanded:

> In my opinion it is not sufficient that the public under the terms of its establishment *may* contribute to the fund. [emphasis added] That being so, it appears to me that it must be the intention of the promoters or of the founder or founders (if any) that the public will contribute so that in the case of a fund established by an initial gift from an individual or a few individuals what is born of the contribution from an

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117. In fact, the judges consistently referred to the transfer as a "gift."
118. *Bray*, 140 CLR 560, at 565.
119. *Id.* at 580.
120. *Id.* at 567.
121. *Id.* at 575.

individual or few individuals will blossom into a fund to which the public in fact subscribe. A fund is a public fund when the purpose of its establishment is the raising of funds from the public or a significant section of the public so that the objects will benefit to an extent greater than the benefit which a founder (if any) confers by his own contribution.[122]

Obviously disturbed by Bray's scheme and bordering on labeling Bray's scheme as tax abuse, Judge Jacobs referred to the private nature of the fund in terms of

the power to retain property in the same form in which it was originally received without being obliged to sell the same or convert it into money. That power, in the manner of its exercise, was the lynchpin of the appellant taxpayer's scheme. For, if the shares were sold, the proceeds would need to be either applied for the benefit of the expressed beneficial object of the trust or to be invested in trustee securities. That would have been fatal to the scheme of having control of the company [M.S.J.] and consequently of the liquid funds which were the only assets of that company whose shares were the subject matter of the gift.[123]

From the lowest court to the highest, most judges noted or implied that Bray's transactions were purely tax motivated.[124] The Foundation appeared to be an alter-ego for Bray, and the financial transactions were structured solely to create personal tax deductions that otherwise could not have been available unless Bray had dedicated his own cash to a true public fund. Bray's actions appeared to demonstrate a lack of intention to benefit the community or public. They also appeared to deceive the tax authorities as well as his hand-picked trustees of the Foundation. Clearly, Australia's tax laws and statutes addressing fiduciary responsibilities are not tolerant of behavior like that of Bray. Moreover, Bray likely utilized his knowledge as a solicitor to undertake aggressive and enterprising tax planning at the expense of the treasury. Such behavior is contrary to a desirable moral climate and not within the spirit of the statutory tax concessions. Cases such as this call out for remedial regulatory mechanisms.[125]

F. *Regulation and Accountability of the Nonprofit Sector*

In Australia's early years, charitable organizations, often supported by influential individuals, staved off regulation of their activities.[126] Today, the regulation of Australia's nonprofit sector is

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122. *Id.* at 576.
123. *Id.* at 578.
124. *See id.*
125. *See infra* notes 249-56 and accompanying text.
126. *See* DAL PONT, *supra* note 32, at 57. Charitable trusts were lightly regulated in the nineteenth century in most states, but the states passed legislation

fractured and vulnerable.[127] Nonprofit organizations are regulated by over seventy different Australian federal statutory provisions and nearly ten federal administrative agencies are involved in overseeing the application of these provisions.[128] As one Australian scholar has stated: "This welter of administrative agencies pales when compared to the number of statutory provisions and agencies in the states. For example, in New South Wales there are over 230 statutory provisions and 15 administrative agencies."[129] Australia's regulatory regime imposes regulatory oversight of entities by bodies based on the legal form of the entity, but no such regulatory body exists with respect to charitable trusts. None of the administrative agencies has the regulation of nonprofit organizations as its core mission.[130]

In addition, regulation by any particular administrative agency may be tentative. The tentativeness in part appears to be a product of the "halo effect" associated with nonprofit organizations by the public. The citizenry purportedly perceives nonprofit organizations as trustworthy, and perhaps even beyond reproach.[131] This halo effect causes administrative agencies to tread rather lightly so as not to be considered as mistreating beloved nonprofit institutions.[132] The agencies' tentativeness may also result from a fear of vulnerability to politically powerful and wealthy individuals whose potential influences on job security may be real or imagined. Focusing particularly on the A.T.O., with respect to business interests, it has been criticized as a federal agency lacking a strong culture of professional independence from the entities over which it has

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during the late 1800s and 1900s that increased the regulation of charitable trusts. *See id.* at 58-78 (explaining the legislation enacted in the states to regulate charitable trusts).

127. Although the regulation of the nonprofit sector in the United States is fractured, it appears that Australia's regulatory structure is more fractured. For a general discussion of the fractured regulatory structure in the United States, see Crimm, *Private Foundation's Governance, supra* note 90.

128. *See* McGregor-Lowndes, *Nonprofit Corporations—Reflections, supra* note 4, at 25. The number of regulatory agencies that have oversight of American nonprofit entities pales when compared to the number in Australia.

129. *Id.* For example, fiduciary duties of directors of incorporated entities are imposed in the states by general law, the Companies Code and Corporations Acts. *See also* DAL PONT, *supra* note 32, at 265-83 (discussing the jurisdiction and roles of the attorneys general of the states.)

130. *See* McGregor-Lowndes, *Nonprofit Corporations—Reflections, supra* note 4, at *19-20.

131. *See supra* notes 1-4 and accompanying text. This halo effect also plays a role in the perception of America's nonprofit organizations. *See generally* Crimm, *Private Foundation's Governance, supra* note 90; Henry B. Hansmann, *supra* note 1, at 580.

132. *See* McGregor-Lowndes, *Nonprofit Corporations—Reflections, supra* note 4, at *37-38 (citing Michael Chesterman, CHARITIES, TRUSTS AND SOCIAL WELFARE 307 (1979)).

statutorily been given regulatory authority.[133] Whether this criticism also applies to nonprofit organizations, the A.T.O.'s tentativeness certainly may be attributable to its perception that the nonprofit sector operates without a threat to the country's revenue, lack of trained staff knowledgeable about nonprofit organization matters, its failure to regularly and extensively audit tax-exempt nonprofit organizations, and its lack of intelligence capability to discern tax evasion with respect to donors and nonprofit organizations. This culture, as well as the criticism of the A.T.O., may also contribute to its tentative positions and actions.

Over the years, the non-availability of senior management who perceive accountability to be a pressing issue, the significant lack of applicable accountability standards, and the failure to impose comprehensive significant accountability requirements on nonprofit entities and their governing bodies may have made administrative agencies' ability to perform their regulatory responsibilities more difficult. Only recently has Australia's nonprofit sector begun to emphasize the need for and value of professional managers within its institutions. The previous inadequacy might have contributed to the lack of accountability by nonprofit entities.

In 1995, the Industry Commission—now known as the Productivity Commission—which had undertaken a major study of charitable organizations in Australia, reported that most nonprofit organizations, those that the report labeled as community social welfare organizations, had little public accountability. The Industry Commission identified as the problems the "lack of consistent data collection processes, the lack of public access to information, and the lack of standardisation of financial reporting and other information."[134] Accountability standards for nonprofit entities and their decision-makers still are virtually nonexistent. Recently, legal accountability standards, AS 3806-1998, were developed for the purpose of assisting for-profit organizations in identifying and remedying deficiencies in their compliance with laws and regulations. Although easily tailored to the nonprofit environment, to date these standards have not been adapted for use by nonprofit organizations.[135]

133. *See, e.g.*, Yuri Grbich, After Bellinz and Ralph: A New Focus for Decision Making in the Australian Tax System (paper on file with author).

134. INDUSTRY COMMISSION, *supra* note 56, at 205.

135. AS 3806-1998 was developed by the Standards Australia Committee QR/14, Compliance Systems at the request of the Australian Competition and Consumer Commission. The standards provide a framework for a compliance program that can be monitored and assessed. The standards "aim to assist an entity to prevent, and where necessary, identify and respond to, breaches of laws, regulations, codes or organizational standards . . .; promote a culture of compliance within the organization; and assist the organization in remaining or becoming a good corporate citizen." STANDARDS AUSTRALIA, AS 3806-1998.

It is also notable that Australia's federal tax disclosure requirements for nonprofit organizations are limited. As of July 1, 2000, to be endorsed as a deductible gift recipient so that an organization can provide donors a gift deduction receipt, it must initially apply for endorsement by the A.T.O.[136] Not all organizations that technically could qualify as a deductible gift recipient have sought endorsement, however, perhaps because they receive so few gifts that it is not worth the effort. Deductible gift recipients must regularly review whether they are entitled to endorsement.[137] An endorsed deductible gift recipient must notify the A.T.O. if it subsequently becomes disqualified for that tax status.[138] By contrast, endorsement is mandatory for a nonprofit organization desiring income tax exempt status, and no annual registration requirement is imposed on those organizations.[139] Instead, a self-assessment regime is in place, and it permits the nonprofit organizations annually to self-assess whether they fall within one of the categories of organizations entitled to the income tax exempt charity status.[140] As part of this self-assessment system, the A.T.O. has attempted to begin to build a culture of compliance with publication of a series of booklets, including the "Charity Pack" and the "Gift Pack," which include self-assessment work sheets.[141]

Australia does not require nonprofit organizations to file annual informational federal tax returns with the A.T.O.[142] The absence of a filing requirement allows nonprofit organizations to be virtually self-regulating for purposes of federal income tax laws. Although the A.T.O. can review and audit a nonprofit organization, it has done so irregularly and only to ensure that an organization deserves its self-assessed income tax exempt charity status.[143] Thus, as a practical matter, with respect to income taxation, currently only minimal audit and review processes are carried out by the A.T.O.[144]

For the most part, at least for federal income tax purposes, Australia's nonprofit organizations, including its prescribed private funds, operate in a permissive and inefficient regulatory

136. ITAA of 1997, Subdivision 30-BA, §§ 30-115 to 30-180. *See also* AUSTRALIAN TAXATION OFFICE, GIFT PACK, May 2000, at 2-9.

137. *Id.* at 12.

138. *Id.*

139. AUSTRALIAN TAXATION OFFICE, CHARITY PACK, Apr. 2000, at 20. There is an income tax exempt charity endorsement form that must be submitted to the A.T.O. *Id.* at v. 16.

140. *Id.* at 18.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

environment.[145] Perhaps the lack of heavy income tax regulation can be rationalized as a credible strategy because the sector is largely volunteer in Australia. As Australia's nonprofit sector grows, developmentally moves ahead, and depends on tax incentives that do not discourage adventurous acts by nonprofit organizations and their decision-makers, such an unregulated environment may support, or at least fail to inhibit, improprieties. This potential result may be particularly true in the newly created subdivision of the nonprofit sector, the prescribed private funds. This segment, which is similar to the U.S. private foundation subdivision of its nonprofit sector, is truly in its infancy developmentally. To protect nonprofit interests, a well-considered regulatory federal tax regime may head off potential improprieties and abuses within this segment. In developing such a regime, note should be taken of and lessons learned from other countries' tax regulatory structures. Thus, Part III of this Article provides an insight into the federal tax regulatory regime of U.S. private foundations and some of its shortcomings.

III. THE U.S. EXPERIENCE

A. *Background—U.S. Nonprofit Sector Today*

Today, the U.S. nonprofit sector is a significant economic force and a major employer; but, perhaps contrary to public perception, it is not the largest nonprofit sector in the world if the size of the nation's economy is taken into account.[146] In fact, as a percentage, the nonprofit sector's contribution to total employment in 1995 in the United States (7.8%) was only marginally higher than Australia's (7.2%).[147] Nonprofit sector employees, paid and voluntary, represented approximately 10.8% of all employees in 1998.[148] In that year, estimates indicate that there were approximately 5.7 million volunteers measured on a full-time equivalency basis—3.7% of the

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145. While numerous state and federal agencies have a part and share in the regulation of Australia's nonprofit entities, which results in a fractured regulatory regime, perhaps the same comment holds true with respect to aspects other than federal tax regulation of these entities. For a brief discussion of the fractured nature of the regulatory regime, see *supra* notes 127-30 and accompanying text.

146. S. Wojciech Sokolowski & Lester M. Salamon, *The United States*, *in* GLOBAL CIVIL SOCIETY: DIMENSIONS OF THE NONPROFIT SECTOR 261, 265 (Lester M. Salamon et al. eds., 1999).

147. *See id.* at 266. The Netherlands, Ireland, Belgium, and Israel rank higher than the United States and Australia as providers of employment.

148. *The Nonprofit World: A Statistical Portrait*, CHRON. PHILANTHROPY, Aug. 9, 2001, at 34.

U.S. workforce—and there were 10.9 million full-time and part-time paid workers—7.1% of the U.S. workforce.[149]

The number of U.S. nonprofit organizations has steadily increased over the past two decades. In 1982, nonprofit tax-exempt organizations numbered 1,180,000.[150] By 1998, the United States had 1,626,000 nonprofit tax-exempt organizations.[151]

Excluding religious worship groups, a large group within the U.S. nonprofit sector, the nonprofit sector in the United States had operating expenditures in 1995 of $502 billion, or 6.9% of the country's gross domestic product.[152] Although a changing environment over the years, as of 1997, the nonprofit sector was composed primarily of health service organizations (53.9%), education and legal services (18.3%), social and legal services (12%), and religious organizations (9.7%).

The United States has a strong individualistic culture, which historically has produced tensions between U.S. individual citizenry and its governments. This tension can be seen in the U.S. nonprofit sector, which is perceived to some extent as an alternative to government as a means of addressing U.S. social and economic problems. Thus, although some nonprofit organizations receive some direct governmental funding, in large part, they are financed from fees and charges (56.6%) and philanthropy (12.9%).[153]

In 2000, total charitable giving grew to $203.5 billion, $6.3 billion more than in 1999 after adjusting for inflation.[154] For 2000, charitable contributions represented two percent of the U.S. gross domestic product, slightly down from the twenty-eight-year high of 2.1% reached in 1998 and 1999.[155]

B. *U.S. Private Foundations*

Like Australia's, the U.S. nonprofit sector dates back to the country's early history; it was an important caretaker of the welfare

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149. *Id.*

150. *Id.*

151. *Id.* This figure represents 5.8% of all United States organizations, and appears to include tax-exempt organizations in addition to those exempt under I.R.C. § 501(c) and registered with the I.R.S., such as § 527 political organizations and some churches. In 2000, 1,354,395 § 501(c) organizations were registered with the I.R.S. *See Tax-Exempt Organizations Registered with the IRS*, CHRON. PHILANTHROPY Nov. 1, 2001, at 83.

152. Sokolowski & Salamon, *supra* note 146, at 262.

153. *Id.* at 273. The government provided 30.5% of the funding of nonprofit organizations in 1995. *Id.*

154. Janet L. Fix & Nicole Lewis, *Growth in Giving Cools Down*, CHRON. PHILANTHROPY, May 31, 2001, at 1.

155. Press Release, American Association of Fundraising Counsel, Total Giving Reaches $203.45 Billion as Charitable Contributions Increase 6.6 Percent in 2000 (May 23, 2001), *available at* http://www.aafrc.org/press3.html.

of U.S. people. The U.S. nonprofit sector and its institutions made significant developmental strides in the 1800s and early 1900s. The late 1800s gave rise to the creation of private foundations in the early 1900s.[156] By 1910, more than sixty private foundations existed,[157] amongst which were the Carnegie Institute of Pittsburgh, the Carnegie Institute for Technology, the Russell Sage Foundation, and the Carnegie Endowment for International Peace.[158] Soon thereafter, in 1913, John D. Rockefeller, Sr. funded the Rockefeller Foundation with $100 million.[159] Private foundations have continued to multiply since that time. The creation of new private foundations in the United States has exceeded 1,300 in each year since 1968, with more than three thousand private foundations created in most of those years and an even larger boom in the two most recent years.[160] Many of these foundations were created by wealthy individuals whose businesses created fortunes for them during the robust economy.[161] U.S. private foundations numbered 46,832 in 1998, 77,287 in 1999, and 80,420 in 2000.[162]

Since their early history, U.S. private foundations have enriched the nation and the world through charitable endeavors. Early on, these institutions contributed to "America's distinctive version of the

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156. *See* Crimm, *Private Foundation's Governance*, *supra* note 90 (recounting the judicial developments that led up to an environment that would support the creation of private foundations). For a definition of U.S. private foundations, see *supra* notes 16-22 and accompanying text.

157. *See* Elizabeth T. Boris, *Creation and Growth: A Survey of Private Foundations*, *in* AMERICA'S WEALTHY AND THE FUTURE OF FOUNDATIONS 65, 70 (Teresa Odendahl ed., 1987) [hereinafter AMERICA'S WEALTHY] (indicating there were 144 foundations in existence before 1910). *But see* JOHN W. NASON, FOUNDATION TRUSTEESHIP: SERVICE IN THE PUBLIC INTEREST 8 (1989) (indicating there were only sixty-two private foundations formed before 1910). The formation of these early private foundations took place even before the 1917 enactment of the first U.S. charitable contribution deduction applicable to individuals.

158. *See* Crimm, *Private Foundation's Governance*, *supra* note 90 (describing the early history of private foundations in the United States).

159. *Id.*

160. *Id.* at 1134 n.243 (providing statistics collected on private foundations and their legal form collected from the Statistics of Income Division of the Internal Revenue Service).

161. For example, Bill Gates of Microsoft Corporation created the Bill and Melinda Gates Foundation, which among its purposes is to finance international vaccination and children's health programs to fight infectious diseases in Third World countries. Press Release, World Health Organization, Bill and Melinda Gates and Ted Turner Donate US $78 Million to Accelerate the Campaign to Eradicate Polio By End of 2000 (Dec. 7, 1999) *available at* http://www.who.int/inf-pr-1999/en/pr99-75.html. Ted Turner, the media magnate, created the Turner Foundation, which, among its activities, supports international children's health programs. *See* http://www.turnerfoundation.org/turner/popul.html.

162. FOUNDATION YEARBOOK (2001), THE FOUNDATION CENTER, *available at* http://www.fdncenter.org/fc_stats/pdf/02_found_growth/04.pdf (reporting for years 1975-1998); *Tax-Exempt Organizations Registered With the IRS*, *supra* note 151 (reporting for the years 1999-2000).

welfare state."[163] Private foundations have enhanced knowledge, have created opportunities for innovation and experimentation, have engaged in or led activist causes, and have propelled social change and many other achievements. Through their varied programs, grants, and projects, among their many accomplishments, U.S. private foundations have been instrumental in eradicating diseases, providing health care to children, educating communities on the value of preventive health services, and reducing world hunger.[164] They have also combated poverty,[165] supported higher education for minority groups,[166] fought racial inequality,[167] promoted the equality of women,[168] combated juvenile crime,[169] improved the quality of

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163. Teresa Odendahl, *Independent Foundations and Wealthy Donors: An Overview*, *in* AMERICA'S WEALTHY, *supra* note 157, at 1 (citing Barry D. Karl & Stanley N. Katz, *The American Private Philanthropic Foundation and the Public Sphere, 1890-1930*, *in* MINERVA 236, 240 (1981) (stating that private foundations in the early 1900s are based on "the relation of such organizations [sic] to national government and politics" and on the "debate over the appropriate role of the federal government in achieving . . . reforms")). The U.S. welfare state was not based entirely on vast centralized government bureaucracies, but instead on a government that, after formulating some national policies, would in some part delegate the implementation of those federal policies to state and local governments and, through tax incentives, to private nonprofit organizations. *See* Peter Dobkin Hall, *Resolving the Dilemmas of Democratic Governance: The Historical Development of Trusteeship in America, 1636-1996*, *in* PHILANTHROPIC FOUNDATIONS: NEW SCHOLARSHIP, NEW POSSIBILITIES 3, 31 (Ellen Condliffe Lagemann ed., 1999) [hereinafter PHILANTHROPIC FOUNDATIONS].

164. For example, the Rockwell Fund has dedicated massive amounts of resources to medical research and public health movements. *See* http://www.rockfound.org/health.htm. The Bill and Melinda Gates Foundation finances international vaccination and children's health programs to fight infectious diseases in Third World countries. Press Release, *supra* note 161. The Turner Foundation supports international children's health programs. *See* http://www.turnerfoundation.org/turner/popul.html. The Susan G. Komen Breast Cancer Foundation has fought breast cancer. *See* http://www.komen.org. The G&P Charitable Foundation supports the development of effective therapies for cancer patients. *See* http://www.gpfoundation.com. The Millbank Memorial Fund and the Commonwealth Fund have promoted public education about health services. *See* Elizabeth Toon, *Selling the Public on Public Health*, *in* PHILANTHROPIC FOUNDATIONS, *supra* note 163, at 119-20.

165. For example, The Charles Stewart Mott Foundation and The Ford Foundation fight poverty through many programs. *See* http://www.mott.org/programs/poverty.asp (last visited Oct. 21, 2001); http://www.fordfound.org.

166. For example, the Exxon Education Foundation, formed in 1955 supported public and private higher education for the sake of diversity. *See* http://www.exxonmobil.com/contributions/education.html. The Slater Fund endowed education for African-Americans. *See* seaftl.org/heritage.htm.

167. For example, the Sloan Foundation contributes scholarship funds to enable African-Americans to enter the professions. *See* http://www.sloan.org/programs/edu_phd.shtml. The Rockefeller Brother Fund has had a tradition of assisting African-Americans through substantial grants to educational institutions traditionally focused on African-Americans and to leading African-American organizations such as the National Urban League. *See* http://www.rbf.org/nycgrant99.html.

168. For example, to promote the equality of women, the Ford Foundation supported the Women's Law Fund, the NAACP Legal Defense and Education Fund, the

children's education,[170] supported environmental causes and conservation,[171] promoted human rights,[172] and supported contemporary arts and culture.[173]

Through the years, U.S. private foundations have made vast sums available to financially support these and other charitable endeavors. Private foundations' grants have increased dramatically over the past decade. U.S. private foundations' grants amounted to $8.7 billion a decade ago but rose to an all-time high of $22.8 billion in 1999.[174]

Nonetheless, these "providers of good" have not been beyond reproach and have suffered blows to their halo effect. It has been popular to attack wealthy individuals as using private foundations to escape taxation and to set broad, but perhaps unwelcome, agendas for society.[175] It also has been popular to challenge foundations as having a disproportionately large impact on the national economy

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Women's Rights Project at the Center for Law and Social Policy, and the Center for Women Policy Studies in their coordinated efforts to compel the government to impose affirmative action quotas on private employers and to force the government to make abortions available to all women and supported by tax dollars. WILLIAM H. MCILHANY II, THE TAX-EXEMPT FOUNDATIONS 176 (1980). The Soros Foundations Network has devoted funds to programs to help women. *See* http://www.soros.org/women/index.htm.

169. For example, the Charles Stewart Mott Foundation projects have supported projects to gain employment for youths in inner cities, to address educational problems of school dropouts, and to reduce juvenile crime. *See* http://mott.org/programs/p-ss.asp. The Astor Foundation has focused on New York City's inner city children. *See* http://www.astor.org. In the late 1950s and early 1960s, the Ford Foundation was a major sponsor of community-based programs to combat juvenile delinquency and deteriorating "gray areas" of U.S. central cities. Alice O'Connor, *The Ford Foundation and Philanthropic Activism in the 1960s*, *in* PHILANTHROPIC FOUNDATIONS, *supra* note 163, at 169.

170. For example, the AT&T Foundation has a history of supporting education of children by providing technology and cash grants to schools and by assisting teachers in the use of technology in class preparation and in the classroom. *See* http://www.att.com/foundation/programs/education.html. Many other foundations have supported education, including, to name a few, The Ford Foundation, *supra* note 165, the Andrew W. Mellon Foundation, http://www.mellon.org/awmpd.html, and the Charles A. Dana Foundation. *See* http://www.dana.org/grants/education.

171. For example, the William and Flora Hewlett Foundation, the Arthur B. Schultz Foundation, the Heinz Endowment, and the Pew Charitable Trusts devote funds to environmental programs. *See e.g.*, http://www.heinz.org; http://www.pewtrusts.com/grants/grants_item.cfm?image=img3&program_area_id3.

172. For example, the Ford Foundation promotes rights of migrants, women, refugees, and minorities. Ford Foundation, *supra* note 165.

173. For example, the Soros Foundations Network has supported children's programs, contemporary arts and cultural programs. Soros Foundation Network, *supra* note 168. The Andrew W. Mellon Foundation supports cultural programs through the nation, as does the Laura Jane Musser Fund. *See* Mellon Foundation, *supra* note 170: *see also* http://www.musserfund.org.

174. Fix & Lewis, *supra* note 154, at 1.

175. *See* WALDEMAR A. NIELSEN, THE BIG FOUNDATIONS 5-9 (1972); *see infra* notes 202-30 and accompanying text.

and as building excessive economic and social power.[176] More substantively, legitimate concerns have concentrated on the narrowness of private foundations' management, the inappropriateness of certain financial dealings and transactions by private foundations and their management, and the unsuitability of certain foundations' activities when they have acted inconsistently with charitable purposes and with tax advantages enjoyed by the foundations and their donors.[177]

C. *U.S. Regulatory Regime and Its Lessons*

1. States' Attorneys General

The regulatory regime of the U.S. nonprofit sector is fractured, largely between states' attorneys general and the I.R.S.[178] Neither has the core mission of exclusively monitoring and regulating nonprofit organizations.[179] Attorneys general are the states' chief enforcement officers and are responsible for enforcing state laws on all individuals and entities within their borders.[180] Their responsibilities are expansive, and, sadly, their workforces are inadequate to carry out the demands of the office.

The number of staff attorneys available in states' attorneys general offices to supervise all nonprofit organizations—inclusive of private foundations—varies. In some states, including those with the most active offices, the number of staff attorneys has declined over the years.[181] The most active attorneys general offices have a separate charitable division manned by several assistant attorneys general. For example, in 1998, Connecticut had four attorneys working in the charities division of the attorney general's office; Massachusetts had six attorneys in its charities division—down from seven in 1994—and New York had fourteen attorneys in its charities division—down from seventeen in 1994.[182]

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176. *See infra* note 210 and accompanying text.

177. *See infra* notes 210-30 and accompanying text.

178. *See generally* Nina J. Crimm, *Why All Is Not Quiet on the "Home Front" for Charitable Organizations*, N.M. L. REV. 1, 6, 24-25 (1999) [hereinafter *Why All Is Not Quiet*] (discussing the dual federal-state regulatory system); Crimm, *Private Foundation's Governance, supra* note 90, at 1190. In addition, federal and state agencies may have regulatory authority over such nonprofit entities as health care organizations.

179. *See id.*

180. *Id.*

181. *See infra* notes 182-84, 189 and accompanying text.

182. *See* Thomas J. Billitteri, *Rethinking Who Can Sue A Charity*, CHRON. PHILANTHROPY, Mar. 12, 1998, at 35 (providing a table of the number of staff lawyers in states' attorney generals offices as determined by the National Association of Attorneys General); HARRIET BOGRAD, THE ROLE OF STATE ATTORNEYS GENERAL 9

Other states, such as Georgia, Hawaii, North Dakota, Rhode Island, and South Carolina, however, had one assistant attorney general to supervise the nonprofit sector as only a portion of his or her responsibilities.[183] In 1998, some states, such as Alabama, Arizona, Colorado, Florida, Louisiana, Michigan, Nevada, New Mexico, Tennessee, Virginia, and the District of Columbia, did not have any attorneys dedicated solely to charitable matters.[184]

In 1994, New York, Connecticut, and Massachusetts charities divisions reported that their states' registration and reporting systems imposed on charities, although useful, were not the source of most of their investigations.[185] Rather, inquiries or complaints from dissenting board members, employees, beneficiaries, or the public, including the media, were more likely to trigger investigations.[186] In determining which cases to pursue, the attorneys general were reported to consider the amount involved, the size of the organization, the impact on the public, and the seriousness or extremity of the abusive conduct, with the worst improprieties—including fiduciary breaches and tax abuses—receiving attention.[187] In New York, Connecticut, and Massachusetts, the attorneys general suggested that only a small fraction of inquiries concerning charities in their states could be investigated.[188] Personnel constraints, the stress of "more important" duties, and the lack of sufficient information to warrant an investigation could partially account for the limited investigations.[189]

Moreover, it appears that political pressures or priorities may cause governmental authorities to shun aggressive pursuit or even to close their eyes to the most egregious and repetitive abuses involving

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(Yale Univ. Program on Non-Profit Organizations, Working Paper No. 206, Aug. 1994) (indicating that in 1994, the state attorneys general offices in Connecticut had four attorneys, in Massachusetts had seven attorneys, and in New York had seventeen attorneys).

183. *See* Billitteri, *supra* note 182, at 35; *Number of Full-Time Equivalent (FTE) Attorney Positions by Selected Practice Areas: "Public Protection"* (Nat'l Ass'n of Attorneys General), 1997, at 18, 20.

184. *See* Billitteri, *supra* note 182, at 35 (table showing additional states in 1998 without attorneys to monitor charities to include Alaska, Iowa, Maine, Mississippi, Missouri, Montana, Nebraska, Oklahoma, South Dakota, Utah, Vermont, Washington, West Virginia, and Wyoming); BOGRAD, *supra* note 182, at 12.

185. BOGRAD, *supra* note 182, at 12.

186. *Id.* at 11-13. The attorneys noted that media involvement, while not determinative in a decision about whether to devote staff time to a case, does add pressure. *Id.* at 16.

187. *Id.* at 15-16 (citing Pamela Mann, the attorney in charge of the New York charities office, as stating that the focus there is to "get the bad guys"). Moreover, there was some sentiment expressed that the attorney general should not be the watchdog for the nonprofit sector. *Id.* at 5.

188. *Id.* at 14-16.

189. Crimm, *Why All Is Not Quiet*, *supra* note 178, at 24-25.

private foundations.[190] Attorneys general are political officers. Some are elected[191] and some are political appointees.[192] Once elected or appointed, attorneys general may set enforcement agendas as a result of powerful politicians and influential citizens. It has been suggested that state attorneys general avoid investigations of nonprofit organizations generally, and not merely of private foundations. Several reasons can be suggested: if investigations were undertaken, the attorneys general would make powerful enemies; if punishments followed, attorneys general would make vindictive enemies of the richest and most influential people and organizations in the state; and if attorneys general were successful in ending abuses, the "wells of charity" would dry up, and it would be the attorneys general who might suffer politically.[193]

2. Internal Revenue Service

Congress has vested authority in the U.S. Department of Treasury to monitor and enforce federal tax statutes. The I.R.S., as a division of the Department of Treasury, therefore functions primarily as a collector of revenues, but it also is responsible for monitoring taxpayers and nonprofit organizations to ensure compliance with the federal tax laws. Nonetheless, Professor Henry Hansmann, a scholar who has provided valuable insights on the U.S. nonprofit sector for years, has argued that the I.R.S. "has at best only an indirect interest in policing the fiduciary behavior in nonprofits."[194] He has argued

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190. *Id.* at 25.

191. The attorneys general of most states are elected. New York and Arizona are but two examples of states in which voters elect the attorney general. By comparison, the attorney general of Maine is determined by joint ballot of a convention of State Senators and Representatives. ME. CONST. art. IX, §11.

192. For states in which the attorney general is appointed, the appointment may be by the governor or by the Chief Justice of the State Supreme Court. For example, the attorneys general of Alaska, Georgia, and Wyoming are appointed by the governor. *See* Alaska Department of Law, *Attorney General Bruce M. Botellio, available at* http://www.law.state.ak.us/ag/index.html; Office of the Attorney General of Georgia, *History of the Office, at* http://www.state.ga.us/ago/history.html; WYO. STAT. ANN. § 9-1-601 (Michie 1977). The attorneys general of each New Jersey and Hawaii are appointed by the governor and confirmed by the state Senate. *See* N.J. Department of Law & Public Safety, *Attorney General John J. Farmer, Jr., available at* http://www.state.nj/us/lps; State of Hawaii Department of the Attorney General, *available at* http://www.state.hi.us/ag. The Attorney General of Tennessee is appointed by the Chief Justice of the Tennessee Supreme Court. *See* TENN. CONST. art. VI, § 5.

193. HOWARD L. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS 233 (5th ed., 1998).

194. Hansmann, *supra* note 1, at 604 (suggesting that policing and enforcement of the nondistribution constraint—the constraint against distribution of assets of § 501(c)(3) organizations to persons other than the intended beneficiaries—is not central to the collection of revenues, which is the main objective of the I.R.S., and therefore burdens, confuses, and threatens the I.R.S. mission).

that because the I.R.S.'s main attention must be dedicated to tax collection, it is only indirectly interested in the fiduciary behavior of nonprofit organizations and their decision-makers.

3. The Development of U.S. Federal Tax Regulatory Regime

The federal tax regulation of its private foundations is steeped in political pressures and reactive legislative measures. Politicians and government officials have been parties to assaults on private foundations and to proffered controls and remedies for perceived and actual wrongdoing by private foundations, their creators, and decision-makers.[195]

The distrust of private foundations and their funders has been evident since the initial development of private foundations in the United States.[196] As early as 1913, President William Howard Taft, established the Commission on Industrial Relations, chaired by Frank P. Walsh, which conducted hearings from 1913 to 1915 on a broad range of issues involving private foundations, among which was the concentration of wealth and influence. In 1916, the Walsh Commission published its final report strongly critical of private foundations. The Walsh Commission accused large foundations of being instruments of wealthy industrialists and robber barons who desired to avoid taxes, to redistribute their "tainted" money to elite institutions that would produce new elite individuals, and to use their funds to influence policy decisions and choices that would strongly impact, if not control, U.S. citizens' social and educational lives.[197] A majority of the Walsh Commission recommended the censure of private foundations. The Commission's report proposed restrictions on the size, functions, powers, and lives of foundations, and proposed limitations on the accumulation of unexpended income of private foundations.[198] The report further suggested strict scrutiny of

195. *See* Crimm, *Private Foundation's Governance*, *supra* note 90, at 1097.

196. During the 1912 presidential race, candidates Theodore Roosevelt and William Howard Taft had opposed federal charters for foundations. When Mr. Rockerfeller applied for a Federal Charter for his General Education Board, Mr. Roosevelt claimed that "no amount of charity in spending such fortunes can compensate in any way for the misconduct of acquiring them." Mr. Taft suggested that the charter would amount to "a bill to incorporate Mr. Rockefeller." PETER DOBKIN HALL, INVENTING THE NONPROFIT SECTOR, 47-48 (1992) (citing PETER COLLIER & DAVID HOROWITZ, THE ROCKEFELLERS: AN AMERICAN DYNASTY 63-64 (1976)).

197. Private foundations were considered ready vehicles for channeling large amounts of money to influence public policy. Although many of the private foundations did not attempt to influence public policy directly, a few, such as the Russell Sage Foundation and the Brookings Institute directly addressed public policy matters. *See* HALL, *supra* note 196, at 48.

198. STAFF OF SENATE COMMITTEE ON INDUSTRIAL RELATIONS, 64TH CONG., INDUSTRIAL RELATIONS: FINAL REPORT AND TESTIMONY SUBMITTED TO CONGRESS (1916).

foundations' investments and open reports to government officials.[199] Congress did not take steps at that time to implement the Walsh Commission's proposals or recommendations.

Private foundations in the 1940s greatly increased in number and diversified their activities.[200] They thus became a more visible part of the United States. This visibility, supported by evidence collected by the Treasury Department from private foundations' annual informational tax returns, which had been required since 1943,[201] triggered Congressional concern about foundations' income-generating activities unrelated to their charitable purposes. Aware that private foundations had been used for private gains, that they had engaged in income-producing activities unrelated to their charitable purposes, that some had accumulated large amounts of income and failed to distribute it, that foundations were being used as a tool to maintain control of family businesses and to protect funds from taxation, and that a judicial conflict existed over whether foundations' unrelated business activities were inconsistent with their tax-exemptions, Congress enacted new tax laws as part of the Revenue Act of 1950.[202] These new federal tax laws did not separately define private foundations, but they reflected the Congressional aim to target foundations for regulation.[203] One new tax provision imposed statutory arms-length standards on transactions between non-publicly supported tax-exempt

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199. *Id.*

200. *See* Crimm, *Private Foundation's Governance, supra* note 90, at 1108.

201. *See* H.R. REP. NO. 78-871 to accompany H.R. 3687, 78th Cong. (1st Sess. 1943), at 24-25. The Revenue Act of 1943 required private foundations to disclose gross income, receipts and disbursements on their annual returns. *Id.* Although private foundations were not separately defined, the Revenue Act of 1943 exempted from the disclosure requirement religious organizations, schools, certain fraternal groups, publicly supported charities, and certain government corporations. *Id.* Although no explanation was given as to the reason for differentiating these nonprofit organizations from private foundations, the information gathered from the disclosures would supply Congress with ample information to determine the need for further regulation. *See id.*

202. Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 947 (1950) (enacting I.R.C. §§ 502, 503, 504, 511-514, re-enacted as part of the I.R.C. of 1954).

203. Congress excluded some tax-exempt organizations from the new regulatory provisions of the Revenue Act of 1950. The Senate Finance Committee report explained:

> The organizations [religious organizations, schools, publicly-supported organizations, governmentally supported organizations, and medical organizations, including hospitals] excluded from the application of these provisions are in general what might be called "public" organizations and because of this characteristic are not believed likely to become involved in any of the prohibited transactions.

SENATE FINANCE COMM. REP. NO. 2375, 81st Cong., 2d Sess., at 38 (1952). *See* JOHN A. EDIE, CONGRESS AND PRIVATE FOUNDATIONS: AN HISTORICAL ANALYSIS 5 (1987) (commenting that "through a process of elimination, private foundations were being targeted even through they were still undefined by the Code.").

organizations and their substantial donors or related persons where the transactions otherwise might result in self-dealing and private gains to the donors or related persons.[204] The Revenue Act of 1950 also established rules to control accumulated investments and financial transactions unrelated to charitable functions and to curtail tax-exempt organizations' unrelated income-generating activities.[205]

During the McCarthy hysteria of the 1950s, private foundations and their donors were targeted. Several Congressional commissions and committees were convened over the course of those years and the 1960s.[206] In the early 1960s, the U.S. Department of Treasury undertook a study of private philanthropy and private foundations. The study resulted in a report to Congress in 1965.[207] While the 1965

204. Revenue Act of 1950, Pub. L. No. 81-814, *supra* note 202. Although the House of Representatives passed a provision absolutely prohibiting self-dealing, the Senate rejected the proposed statute as too strict. *See* EDIE, *supra* note 203.

205. Revenue Act of 1950, Pub. L. No. 81-814, *supra* note 202.

206. The first Commission was the Cox Commission, authorized on April 4, 1952, by Congress to engage in a "full and complete investigation and study of educational and philanthropic foundations and other comparable organizations which are exempt from Federal income taxation to determine which such foundations and organizations are using their resources for purposes other than . . . for which they were established, and especially to determine which . . . are using their resources for un-American and subversive activities . . . ." *Hearings before the House, Select Comm. to Investigate Tax-Exempt Found. and Comparable Org.*, 82nd Cong., 2nd Sess. 1 (1953).

Thereafter, in April 1954, Congress authorized a Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations. EDIE, *supra* note 203. The Reece Committee investigated and held hearings during 1954 that focused on motives for creating foundations and their influences on public life. *Id.* More specifically, the Reece Committee inquired into the use of foundations as vehicles for tax avoidance and the control of wealth, their influence on the social sciences, their power to influence public policy and opinion by selective sponsorship of academic research, their failures and inadequacies in their fiduciary responsibilities, their managers' increasing power, their influence on the media, their promotion of internationalism in foreign policy, and their roles in subversive activities. *Id.*

In 1962, Congressman Wright Patman initiated a study of private foundations and between 1962 and 1972 reported his findings to Congress in eight installments. *Id.* He legitimately concluded that some private foundations were being utilized in self-dealing transactions to the advantage of their donors and related persons, that some foundations sheltered from taxation the wealthy individuals' appreciating assets accumulated from their businesses, that some private foundations were involved in unrelated business activities that disadvantaged for-profit competitors, and that IRS was lax in its oversight. *Id.*

For a more detailed discussion of these commissions and committees, *see* Crimm, *Private Foundation's Governance, supra* note 90, at 1110-14.

207. STAFF OF HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., TREASURY DEPT. REPORT ON PRIVATE FOUNDATIONS (1st Sess., Comm. Print 1965) [hereinafter TREASURY DEPT. REP. ON PRIVATE FOUNDATIONS]. The Treasury Department had based its report on a survey of approximately 1,300 private foundations, which included one hundred percent of all foundations with assets of at least ten million dollars, twenty-five percent of all foundations having one million dollars to ten million dollars in assets, ten percent of those with assets of $100,000 to one million dollars, and five percent of all foundations with assets of $100,000 or less. For purposes of the survey, private foundations were defined as every I.R.C. § 501(c)(3) nonprofit

Treasury report highlighted in positive terms the vital role of private foundations to the nation, it also presented some disturbing information that identified financial abuses spreading among foundations.[208] The Treasury report delineated private foundation problems and attributed many of the problems to the intimate structural ties between the private foundations, their donors, donor families, and affiliated for-profit corporations.[209] Six major problem areas were identified: (1) self-dealing, (2) delay in transfer of benefits to society, (3) foundation involvement in business, (4) family use of foundations to control corporate and other property, (5) financial transactions unrelated to charitable functions, and (6) the lack of breadth of foundation management.[210] The report recommended that Congress consider enacting new statutes to prohibit all acts of self-dealing, to forbid foundations to borrow funds for investments, to limit foundations' investments to safe instruments, to limit private foundation ownership of businesses to twenty percent, to pay out net income to active charitable operations on a current basis, to limit donor influence over a foundation to twenty-five years, and to repeal the charitable donation deduction for transfers of interests in family corporations until the foundation disposes of the interest or devotes it to charitable purposes.[211] Between 1966 and 1968, Treasury released three more reports, and allegations of foundation misconduct continued.[212]

In 1969, the enactment of the Tax Reform Act of 1969 (TRA of 1969),[213] although not altering the underlying laws that permitted

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charitable organization except publicly supported organizations, churches and conventions and associations of churches, schools, and organizations that test for public safety. *See* EDIE, *supra* note 203, at 10.

208. TREASURY DEPT. REP. ON PRIVATE FOUNDATIONS, *supra* note 207, at 5.

209. *See* WALDEMAR A. NIELSON, THE BIG FOUNDATIONS 8 (1972).

210. TREASURY DEPT. REP. ON PRIVATE FOUNDATIONS, *supra* note 207, at 6-8.

211. *Id.*

212. The Treasury Department reports were planned as a means of pressuring Congress to enact reforms. *See* JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 174-75 (1985).

213. Pub. L. No. 91-172, 83 Stat. 487 (1969). Prior to enactment, the Peterson Commission studied roles of foundations and American philanthropy, commented on prevalent abuses by private foundations, and recommended governmental regulation rather than voluntary self-regulation by the foundations in areas in which private foundations previously had been found to have abused their tax-exempt status. FOUNDATIONS, PRIVATE GIVING, AND PUBLIC POLICY: REPORT AND RECOMMENDATIONS OF THE COMMISSION ON FOUNDATIONS AND PRIVATE PHILANTHROPY (1970) [hereinafter PETERSON COMM. REPORT]. The report suggested that the concentration of foundation assets had resulted generally in diminished income for charity, in large part as a result of foundations' poor investment performances. *Id.* at 13, 78-79. The report found that a minority of private foundations owned a controlling interest in a business corporation and that there was no evidence to support claims of wide-spread financial abuses and self-dealing. *See* EDIE, *supra* note 203, at 13. Noting the lack of available data and information about private foundations, the report encouraged foundations to fully and regularly report on their activities to disabuse the public of misconceptions about

the abuses,[214] constructed a sweeping and comprehensive "band-aid" regulatory scheme applicable to private foundations that was intended to rein in financial and other abuses. First, the TRA of 1969 statutorily distinguished private foundations from public charities by providing a definition of the former.[215] It required private foundations to include in their governing instruments provisions that would provide that their acts and transactions and those of their managers and other integral persons would not violate the prohibited activities, transaction, and investment rules of concurrently enacted I.R.C. §§ 4940 through 4945.[216] The TRA of 1969 authorized the I.R.S. to impose excise taxes on prohibited activities—such as self-dealing, lobbying, electioneering, grassroots campaigning—and on certain investments of private foundations.[217]

Many of these excise taxes were two-tiered—the first tier imposed on the problematic transaction and the second tier imposed if the transaction was not corrected. Depending upon the particular type of transaction, the statutes permitted the I.R.S. to impose the excise taxes on a wrongdoer, a complicit foundation manager, or the foundation. For example, the TRA of 1969 imposed a two-tier tax on all self-dealing transactions, effectively prohibiting any self-dealing, even arms-length transactions, between a private foundation and persons with an interest or with control over the foundation.[218] It also established minimum income distribution requirements for all private nonoperating foundations.[219] The primary purpose of this provision was to encourage private foundations to make appropriate grants consistent with their obligations to the public.

Aiming to ensure that private foundations were not merely alter egos of businesses and their controlling shareholders, the TRA of 1969 established rules for private foundations' divestiture of excess

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private foundations' activities and their "monolithic sameness." PETERSON COMM. REPORT, *supra*, at 47. Although the final Peterson Commission report was published in 1970, after passage of the Tax Reform Act of 1969, the Commission contributed to the 1969 legislative deliberations by delivering its findings and recommendations to Congress. For a fuller discussion, *see* Crimm, *Private Foundation's Governance, supra* note 90, at 1118.

Under Wilbur Mills, the House Ways and Means Committee held hearings beginning February 1969. The hearings culminated in the enactment of the TRA of 1969.

214. *See* WITTE, *supra* note 212, at 175.

215. I.R.C. § 509(a) (1988) added by Pub. L. No. 91-273, § 101(a), 84 Stat. 300 (1969).

216. I.R.C. § 508(e) (1988).

217. I.R.C. §§ 4940-46 (2000).

218. I.R.C. § 4941.

219. I.R.C. § 4942. Operating foundations were excluded from the provision because they are created and operated to substantially fund their own charitable activities and not to act as grant-making institutions.

holdings in business enterprises.[220] Absent divestiture within statutorily established time frames, I.R.C. § 4943 subjected a private foundation to an excise tax on excess business holdings in businesses.[221] To ensure conservative investment strategies and to minimize speculation by private foundations with respect to their assets, Congress enacted restrictions that effectively impose a prudent trustee investment standard on private foundations and their managers.[222] With the addition of I.R.C. § 4944, breaches of the duty to invest so as not to jeopardize private foundations' abilities to carry out their exempt purposes became punishable by the imposition of a two-tier excise tax.[223]

Congress confirmed its proscription against substantial lobbying activities and all campaign activities by all § 501(c)(3) organizations, commenting with reference to the ban on campaign activities that "no degree of support for an individual's candidacy for public office" is permitted.[224] Additionally, Congress directed a special provision at private foundations. Pursuant to I.R.C. § 4945, the I.R.S. can impose an excise tax on any amount paid or cost incurred by private foundations to carry on propaganda or to otherwise attempt to influence legislation or to influence the outcome of any specific public election, or to directly or indirectly carry on a voter registration drive unless certain conditions are satisfied.[225] One effect of this provision was to annul the substantiality rule contained in § 501(c)(3) for purposes of applying the excise tax on the costs incurred by private foundations in engaging in such lobbying activities.[226] Moreover, I.R.C. § 4945 imposes an excise tax on costs incurred to influence the outcome of any specific public election.[227] This provision appears to have provided an "intermediate sanction" for such campaign activity by private foundations, which § 501(c)(3) purportedly bans entirely for determining whether an organization deserves tax-exempt status. The TRA of 1969 also imposed restrictions on unorthodox or nontraditional grants, thereby having the potential to effectively paralyze significant innovation and to inhibit progress in dealing with such controversial problems as the urban crisis and race relations.[228] It required private foundations to file and publicly disclose not only annual information tax returns but also, if assets exceeded five thousand dollars, annual reports listing assets at book and market

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220. I.R.C. § 4943.
221. *Id.*
222. I.R.C. § 4944.
223. *Id.*
224. H.R. REP. NO. 413, § 32 (1969); S. REP. NO. 552, § 47 (1969).
225. I.R.C. § 4945(d)(1)-(2), (e).
226. Nonetheless, the substantiality rule governs with respect to a private foundation's deservedness of tax-exempt status under § 501(c)(3).
227. I.R.C. § 4945(a), (d)(2).
228. *See* NIELSON, *supra* note 209, at 18-19.

value, and listing grantees, grants, and purposes, and foundation managers who were substantial contributors.[229] These newly enacted provisions represented dramatic regulatory strictures on a segment of the nonprofit sector that until this time had been largely self-regulating.[230]

Studies, commissions, and congressional hearings on private foundations have continued periodically since 1969. Some of these have led to limited, rather than comprehensive, modifications to the statutory scheme of the TRA of 1969. For example, in response to the 1975 report of the Filer Commission on Private Philanthropy and Public Needs,[231] in which a number of legislative recommendations were presented, in 1976 Congress refined the rules against self-dealing enacted by the TRA of 1969.[232] As liberalized, the rules permitted a private foundation to sell certain property to "disqualified persons" to whom the property had been leased and to sell certain "non-excess" business holdings to "disqualified persons." Other relatively minor liberalizing modifications were made to several excise tax rules.[233] Among those changes, Congress reduced the minimum payout rules applicable to private foundations.[234] Congress

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229. I.R.C. § 6104(d), 83 Stat. 523-24. *See* EDIE, *supra* note 203, at 13.

230. As a means of paying for the monitoring function intended of the I.R.S., Congress imposed a four percent tax on net investment income of private foundations. I.R.C. § 4940 (note of decision).

231. The Commission was chaired by John H. Filer. The Commission made a comprehensive multidisciplinary survey of charitable tax-exempt organizations as employers, as political forces and as sources of varied services. The report considered the tax issues and regulations affecting charitable tax-exempt organizations. It considered charitable organizations to be an organized and unified "voluntary" sector in the United States and recommended the establishment of a permanent quasi-governmental agency to represent it. The Department of Treasury published the Filer Commission's research papers in six volumes in 1977. *See* HALL, *supra* note 196, at 78. Eventually, the diverse interests of the voluntary or independent sector were represented by the Independent Sector, an organization formed to be a common meeting ground for nonprofit organizations. *Id.* at 79.

232. EDIE, *supra* note 203, at 23 (describing the refinement of the self-dealing rules as "minor").

233. For example, the Tax Reform Act of 1976 permitted certain "set asides" to be treated as qualifying distributions for purposes of I.R.C. § 4942(g)(2). Pub. L. No. 94-455, § 1302(a), 90 Stat. 1713-14 (1976).

234. Pub. L. No. 94-455, §§ 1303, 1310, 90 Stat. 1715, 1729 (1976). The modified rule eliminated the fluctuating percentage payout based on a statutory formula with its highest payout rate of 6.75%, and it substituted a payout requirement of the greater of all adjusted net income or five percent of net assets. *Id.*

made further minor revisions to the 1969 tax statutes in 1978.[235] Other minor changes were made in 1980 and 1981.[236]

Under the guiding hand of Representative Rostenkowski (D-Illinois), Chairman of the House Ways and Means Committee, Congress again left intact most of the TRA of 1969 provisions affecting private foundations when it enacted the Deficit Reduction Act of 1984 (DRA of 1984).[237] Importantly, however, the DRA of 1984 made a number of changes that would favorably impact foundations.[238] Provisions reduced the differing treatment of charitable deductions for inter vivos gifts to private foundations and public charities. As a result of the charitable deduction changes, living donors could now deduct up to thirty percent—formerly twenty percent—of their contribution base—similar to adjusted gross income—or cash gifts to private foundations as contrasted to a deduction of up to fifty percent for contributions to public charities and operating foundations.[239] Moreover, gifts to private nonoperating foundations exceeding the allowable deduction for the taxable year could now be carried forward for five years,[240] a privilege previously permitted only for contributions to public charities and operating foundations. Gifts of limited amounts of publicly traded stock could now be deducted based on full fair market value instead of cost.[241] The DRA of 1984 liberalized the definitions of "disqualified person" and "substantial contributor" for purposes of the private foundation excise taxes;[242] authorized the I.R.S. to abate first-tier excise taxes,

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235. Among the modifications enacted as part of the Revenue Act of 1978, the I.R.C. § 4940 excise tax on investment income was reduced from four percent to two percent. Pub. L. No. 95-600, §520(a), 92 Stat. 2884 (1978). The reduction responded to the fact that the collections of the excise tax had exceeded the costs of I.R.S. enforcement efforts.

236. For instance, one change modified the I.R.C. § 4942 distribution requirements imposed on private foundations. Pub. L. No. 97-34, § 823(a), 95 Stat. 351-52 (1981). Additionally the charitable contribution deduction was changed to permit deductions by individuals who did not itemize deductions and to allow corporations to increase contributions from five percent of net income to ten percent of net income. Pub. L. No. 97-34, § 263(a), 95 Stat. 264 (1981).

237. Pub. L. No. 98-369, 98 Stat. 494 (1984).

238. One such provision reduced the I.R.C. § 4940 excise tax on net investment income from two percent to one percent for private foundations able to demonstrate a five year average percentage payout and the use of the one percent savings for additional qualifying distributions. Pub. L. No. 98-369, §§ 302-303, 98 Stat. 779-82 (1984).

239. I.R.C. § 170(b)(1)(A), (B), (E), added by Pub. L. No. 98-369, § 492, 98 Stat. 853-54 (1984). In contrast to the fifty percent cap on deductions to public charities, the lower cap on deductions to private foundations perhaps embodies the sense that donations to private foundations reflect a donor's more personal goals rather than the broader public goals that a donation to a public charity would support.

240. I.R.C. § 170(b)(1)(C)(ii), 98 Stat. 853-54 (1984).

241. I.R.C. § 170(e)(5), 98 Stat. 778 (1984). Gifts to private foundations of other appreciated properties were valued at cost, plus sixty percent.

242. Pub. L. No. 98-369, § 306(a), 98 Stat. 784 (1984).

other than for self-dealing, if violations were due to reasonable cause and were corrected and applied to certain stock transactions;[243] increased the minimum required payout, generally five percent of investment assets, by recapture of prior qualifying distributions and permitted grant administration expenses to be counted as qualified distributions;[244] extended the excess business holding divestiture period in certain circumstances;[245] and, under defined conditions, enabled substantial contributors to cast off the taint associated with that status.[246]

Most recently, as a result of the Tax and Trade Agreement Extension Act of 1998, private foundations became obligated to provide wider and timely access to annual information tax returns, which the I.R.S. has interpreted to require their public availability through disclosure within thirty days upon individual request or by the foundation posting them on the Internet.[247] The federal government's and citizens' interests in oversight of private foundations and in their public accountability had prompted the

243. Pub. L. No. 98-369, § 312, 98 Stat. 786 (1984).

244. Pub. L. No. 98-369, § 304, 98 Stat. 782-83 (1984).

245. Pub. L. No. 98-369, §§ 307-310, 98 Stat. 784-86 (1984).

246. *See* EDIE, *supra* note 203, at 27, 63.

247. I.R.C. § 6104(d). The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(e)(3), 83 Stat. 487 (1969) added I.R.C. § 6104(d) to provide that private foundations must make available for inspection at their principal offices annual reports. In 1980, Congress amended I.R.C. § 6104(d) to instead require that public foundations make available for inspection at their principal offices their annual information tax returns. Pub. L. No. 96-603, § 1(b), 94 Stat. 3503 (1980). More recently, as a result of the Tax and Trade Relief Extension Act of 1998, I.R.C. § 6104(d) was amended to provide wider access to annual information tax returns of private foundations. The 1998 Act deleted the former requirement that private foundations place a notice in a newspaper having general circulation in the county of its principal office to inform the public of the availability of its annual information return. Pub. L. No. 105-277, 112 Stat. 2681-1, 2681-890 (1998). Final Treasury regulations, adopted January 13, 2000, and effective on March 13, 2000, now provide that private foundations must make available their Forms 1023—application for § 501(c)(3) tax-exempt status—along with the I.R.S. determination letter pursuant to I.R.C. § 6110—and Forms 990-PF—annual information tax return. The private foundation must make these documents available for inspection and photocopying upon request, either made in writing or in person, or alternatively, these documents are deemed to be available for inspection if "widely available" by posting on the Internet through the foundation's own web page or as part of a data base of similar documents established by another organization. *See* Treas. Reg. § 301.6104(d)-4(a) (2002). Failure to comply with the request can subject the private foundation's responsible party—the person failing to provide the documents—to penalties under § 6652(c)(1)(C) and (D), and if the failure to permit public inspection is willful, an additional penalty is permitted under § 6685. The party requesting documents from a tax-exempt organization does not have standing to bring an action against the organization to enforce compliance with these § 6104 disclosure rules; only the IRS has standing to bring such an action.

extension of the expanded disclosure provisions to private foundations.[248]

D. *Shortcomings of Federal Tax Regulatory Regime*

Over the course of the last ninety years, Congress periodically and dramatically converted the self-regulatory environment of private foundations to one that increasingly became regulated by federal tax statutes. Even with the heightened and strengthened tax regulatory scheme, however, scandals and abuses involving U.S. private foundations have persisted.[249] In large part, private foundations' intimate and private funding, governance, and management structures are to blame. Serious attention to formal protocols often is lacking, and sight is lost of the foundations' legal and moral obligations to benefit the public. The blame, however, also must be attributed to an under-regulated and permissive environment. Current federal tax laws, as well as monitoring and enforcement activities by the I.R.S., the responsible federal administrative agency, have been inadequate to completely deter abusive behaviors.

The special federal tax rules of I.R.C. §§ 4940 through 4945 applicable to private foundations and the statutes' excise tax structures are intended to curb abuses engendered by the intimate private foundation structure. Under these rules, explicit and implicit fiduciary duties are imposed on persons, such as substantial contributors, directors, trustees, officers, and other insiders who are supposed to act exclusively on behalf of a private foundation. Yet, the statutes are deficient in their deterrent effect on abusive behaviors.

The deficiency has many possible causes. First, wrongdoers may escape the excise taxes because actual breaches of fiduciary responsibilities are difficult to detect and identify. Deliberations and discussions by foundations' governing boards are private and often even exclude foundation staff members. Individual wrongdoing may not be disclosed either within or outside the boardroom. Second, wrongdoers who are risk-takers may not be deterred from abusive behaviors by threat of pecuniary punishment, especially when the potential for being caught is relatively slim. Also, the statutes exclude from punishment managers who do not have actual knowledge that a particular behavior, transaction, or act may violate

248. *See* JOINT COMM. REP., 105TH CONG., 2nd Sess., GENERAL EXPLANATION OF TAX LEGISLATION (1998).

249. *See, e.g.*, Janet L. Fix, *Wallace-Reader's Digest Funds and N.Y. Attorney General Reach Settlement*, CHRON. PHILANTHROPY, May 17, 2001, at 13; Ralph Blumenthal, *13 Institutions Obtain Control of Vast Bequest*, N.Y. TIMES, May 4, 2001, at A1; Crimm, *Private Foundation's Governance*, *supra* note 90.

or violates a statute.[250] This structure unto itself provides no incentive for managers to be informed, and additionally, the nature of the statutory remedies—solely after-the-fact pecuniary tax remedies—likely do not encourage managers to become knowledgeable. Finally, historically, these laws and remedies purportedly have been leniently enforced by the I.R.S.[251] Enforcement leniency or failures by the I.R.S. are enabling, not inhibiting, to individuals, especially to risk-takers.

Although, pursuant to I.R.C. § 6104, private foundations are required to file an annual informational income tax return, Form 990-PF, this return was not initially intended as a public accountability tool. It is all too easy for responses to be crafted so as not to raise probing questions by the I.R.S., by state authorities who also may have access to the form, or by the public who can obtain access to the form.[252] The response format and the data and other information required for completion of a Form 990-PF neither engender adequate transparency nor reflect a sufficiently high standard of accountability.[253]

The I.R.S.'s inadequate budget and its indirect interest in the fiduciary behavior of nonprofit organizations and their decision-makers are weaknesses of the U.S. tax regulatory regime. Larger budgets over the years permitting more audits of nonprofit organizations, including private foundations, could potentially have deterred some of the abuses encountered along the way. The absence of a federal agency, separate and independent from the I.R.S.,[254] whose core mission and responsibilities are the regulation of the nonprofit sector, perhaps has contributed to weaknesses in the federal tax regulatory regime.[255]

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250. *See, e.g.*, I.R.C. § 4941(a)(1)-(2).

251. Current state laws, that authorize the state attorney general to pursue fiduciaries who breach their duties to nonprofit organizations, even if viewed as regulatory tools to complement existing federal tax statutes, do not appear to be adequate roadblocks to abusive behavior. *See* Crimm, *Private Foundation's Governance, supra* note 90, at 1184-86; Crimm, *Why All Is Not Quiet, supra* note 178, at 6, 25.

252. *See* Peter Swords, Address at Norman A. Sugarman Lecture, entitled *Nonprofit Accountability: The Sector's Response to Government Regulation,* (Mar. 6 1999), *available at* http://www.qual990.org/np_account.html (stating that although the Form 990 is a public report that now provides for disclosure of insiders' abusive transactions, "[t]hose who are cagey enough to figure out how to bilk their nonprofit organizations are cagey enough to see to it that their malefaction is not disclosed on their nonprofit's 990s.").

253. For a fuller discussion on possible means of strengthening, see Crimm, *Private Foundation's Governance, supra* note 90, at 1188-90.

254. *See supra* note 194 and accompanying text.

255. For a fuller discussion of the potential responsibilities and structure of such an independent federal agency, see Crimm, *Private Foundation's Governance, supra* note 90, at 1192-94.

These various shortcomings have been augmented by other structures and factors. For example, regulatory responsibility for nonprofit organizations is fractured between the federal and state governments.[256] Private foundations can be created and maintained without independent boards of directors or trustees, thereby increasing their insularity and privacy and providing opportunities for potential abuses.[257] To date, Congress has not chosen to address or remedy these weaknesses.

IV. INSIGHTS FOR AUSTRALIA'S KEY DECISION-MAKERS

If philanthropy is to be encouraged by taxation incentives and deductions, the tax base must be protected from aggressive and unwarranted tax avoidance and evasion. Apart from well-drafted laws, whether in the United States or in Australia, an appropriate regulatory strategy is essential for protection of the tax base.

A. *Effective Regulators*

The strategy requires that for taxation authorities to be effective regulators of the nonprofit sector, they must have adequate financial and workforce resources and must be delegated appropriate powers both to prevent improprieties that lead to tax avoidance and evasion and to monitor for abuses. Among the delegated powers that the taxation authorities should exercise are roles in educating the public, educating the nonprofit sector, and accessing information to detect improprieties. The taxation authorities then must utilize the law and their administrative tools to recover tax revenues through administrative fines, settlements, and litigation penalties.

B. *Remedying Major Improprieties*

Some U.S. private foundations have experienced credibility crises, if not peril to their existence,[258] as a result of their decision-makers' breaches of fiduciary duties, self-dealing activities, investment and tax avoidance tactics, intimate management structures, and their accountability failures. Finding a means of

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256. For a fuller discussion, see Crimm, *Private Foundation's Governance, supra* note 90, at 1184-86, 1190-91 (discussing the roles of state attorneys general and the I.R.S. and their failures to cooperate); Crimm, *Why All Is Not Quiet, supra* note 178, at 26-28 (discussing the distrust of the I.R.S.).

257. For a discussion of the benefit of an governing board composed of independent persons, see Crimm, *Private Foundation's Govenrance, supra* note 90, at 1195.

258. *See supra* note 4-5 and accompanying text.

remedying the major improprieties has been and continues to be no small task. Aside from having effective laws and effective regulators, other mechanisms and vehicles are crucial for an effective regulatory regime.

First, the appropriate persuasive moral climate must exist to influence tax behavior. The moral climate and culture must clearly and publicly label tax and fiduciary improprieties as "anti-social" and must vigorously encourage professional advisors that aggressive and enterprising tax planning through the use of black letter law loopholes is not within the spirit of tax concessions, such as the charitable contribution deduction.

Second, it is imperative that private foundations' staffs and governing board members, such as trustees, be informed of their fiduciary and governance responsibilities. A major educational project targeting these key individuals is essential, and should be a part of a remedy. Successful education would support the notion that nonprofit organizations do indeed deserve their "halo effect."[259]

Third, appropriate public reporting strategies must be in place. To be effective, compliance is required. Any workable reporting strategy will need to balance compliance costs and effectiveness. U.S. and Australia's compliance systems are largely self-assessment regimes that depend on key personnel within the nonprofit sector and their professional advisors. Thus, tied to the disclosure and reporting strategies that will be part of an effective regulatory regime, needs to be a moral climate of cooperation, openness, and honesty.

Fourth, there must be tight accountability standards applied to private foundations—and other nonprofit organizations. They must embrace the highest ethical standards and strict financial standards, as the funds they collect, invest, and ultimately distribute are intended for the benefit of the public.

Finally, a single regulator with the core business mission of nonprofit accountability is needed. This regulator should be an independent, unbiased, and strong federal oversight agency not beholden to politicians and powerful citizens and should be created for the specific purposes of advising and monitoring private foundations, other nonprofit organizations, and their decision-makers.[260] The suggested new regulatory agency might incorporate some of the positive strategies and objectives of the Charity Commission for England and Wales. That Commission has three

259. *See supra* notes 1-5 and accompanying text.

260. *See* Joel Fleishman, *Public Trust in Not-For-Profit Organizations and the Need for Regulatory Reform, in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172 (Charles T. Clotfelter & Thomas Erlich eds., 1999) (envisioning three possible monitoring strategies, amongst which is a new federal regulatory commission). Crimm, *supra* note 90 (envisioning a single regulator with these attributes modeled after the Charity Commission for England and Wales).

main strategic goals: (1) to ensure that charities can operate for their exempt purposes within an effective legal, accounting, and governance framework; (2) to improve charities' governance, accountability, efficiency, and effectiveness; and (3) to identify and address abuse and poor practices.[261] To accomplish these objectives, the Commission is responsible for determining whether an organization qualifies for charitable status, has oversight authority over the registration of charities, is available on request to provide information and legal advice to charities and their trustees,[262] is responsible for supervising the nonprofit sector to ensure compliance with laws and to provide advice to "prevent trouble or put the charity back on a proper footing,"[263] and is charged with investigating alleged wrongdoing.[264] Thus, the Commission's aim is to instill public confidence in the integrity of charities,[265] which supports the important "halo effect" essential to a viable and vibrant nonprofit sector.

V. CONCLUSION

The history and comments in Part II are intended as cautionary notes, of which concerned Australians should be aware as the development of the nonprofit sector and the growth of prescribed private funds evolve. The insights in Part III that evolve from U.S. experiences are intended to provide insights to persons in key positions of responsibility in Australia's nonprofit sector, in the agencies responsible for regulating that sector, and in the legislative branch of government. It is hoped that, through this Article's identification of those shortcomings of the U.S. federal tax regulatory regime that unintentionally permit improprieties and abuses even after ninety years of reformation, Australia may be able to avoid some of the pitfalls as the design and innovation of its tax regulatory scheme progresses.

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261. CHARITY COMMISSION FOR ENGLAND AND WALES, ANNUAL REPORT 2000-2001, at 16 (2001), *available at* http://www.charitycommission.gov.uk./tcc/pdfs/annualreport0001.pdf.

262. Where all relevant information has been provided to the Charity Commission for England and Wales, and trustees follow the Commission's advice, the trustees are legally protected. CHARITY COMMISSION FOR ENGLAND AND WALES, CHARITIES AND THE CHARITY COMMISSION, *available at* http://www.charity-commission.gov. ukpublications/cc2.asp#5, (2000) [hereinafter CCC].

263. *Id.*

264. CHARITY COMMISSION FOR ENGLAND AND WALES, ABOUT THE CHARITY COMMISSION, *available at* http://www.charity-commission.gov.uk/tcc/ccabout.htm (last visited Oct. 18, 2001).

265. The Charity Commission is accountable for its decisions to the courts and for its efficiency to the Home Secretary. CCC, *supra* note 262, at 2.

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