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Written Testimony of Philip Hackney for the Hearing on Oversight of Nonprofit Organizations: A Case Study on the Clinton Foundation (House of Representatives Committee on Oversight, December 13, 2018)

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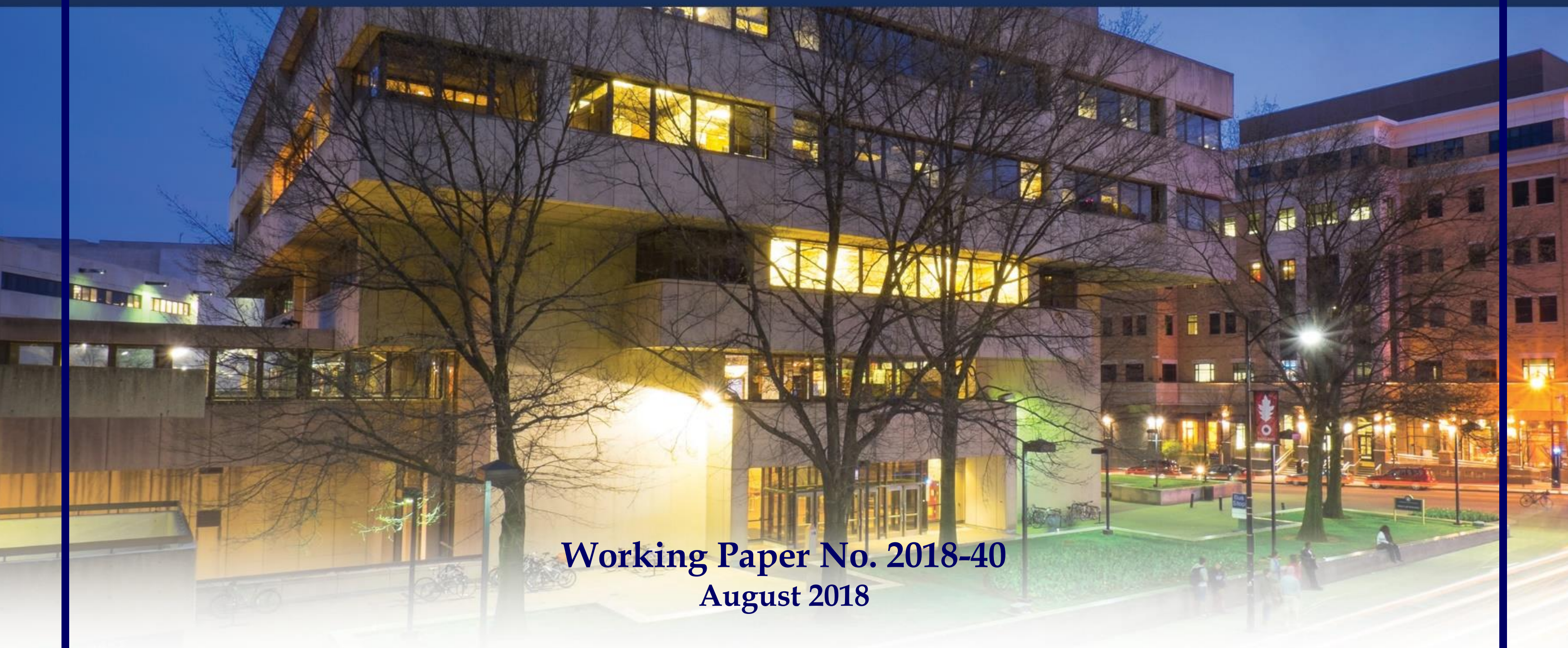

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Committee on Oversight and Government Reform's Subcommittee on Government Operations of the United States House of Representatives

Hearing on Oversight of Nonprofit Organizations: A Case Study on the Clinton Foundation
December 13, 2018

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Chairman Meadows, Ranking Member Connolly and Members of the Subcommittee, thank you for the opportunity to appear before you today to talk with you about oversight of the nonprofit community. I will focus this testimony primarily on organizations exempt from income tax under section 501(a) of the Internal Revenue Code ("Code") because described in section 501(c)(3) (charitable organizations). I will briefly describe the substantive law that applies to these organizations and then describe the enforcement environment in which those rules are applied.

I am an Associate Professor of Law at the University of Pittsburgh School of Law. I write and speak on tax law with a focus on tax exempt organizations. I was an attorney with the Office of the Chief Counsel of the IRS from July 2006 to April 2011 in Tax Exempt Government Entities and I focused on matters in the Exempt Organizations branch. That experience informs my scholarship.

While the IRS is effectively charged by the Internal Revenue Code with regulating the nonprofit sector, the IRS does not have the resources to carry out that charge. If we are going to use the tax laws to regulate non-profits, then we need to fund the regulators adequately to ensure that the nonprofit laws are used as they are intended, and not abused. Real oversight, as this committee well knows, results in better systems.

I am honored to have the opportunity to speak with you today on maintaining a healthy nonprofit sector through governmental oversight. These groups fill vital functions in delivering important services to our local American communities every day. From soup kitchens to schools and from hospitals to churches, these are organizations made up of your friends and neighbors taking up the mantle across this country to solve problems. They are a terrific force for good.

But there is a dark side to the use of these organizations. Some individuals use nonprofits to further their own selfish interest. They take from the organization or direct the organization in ways that further their own interests. This misuse is not necessarily unusual in the sense that the same type of misuse of organizational resources takes place in both the government and for-profit sectors. However, because nonprofits neither have voters nor owners there is no natural constituency to ensure nonprofit leaders use the organization properly. Thus, we need others to look after the sector. Different groups fill this role. Professional organizations try to act as a private regulator. Journalists shine a light on the activities of these organizations. Individuals in our communities become members and directors and work to ensure that nonprofits are run properly. Finally, our government provides regulation at the state level and at the federal level. The regulatory mechanism at the federal level is primarily through the tax law.

The Committee should keep in mind that there are many laws that might apply to problematic acts associated with a nonprofit organization. In fact, I believe it is important that tax exempt laws not be made to fit situations they are demonstrably not designed to fit. For example, if you believe a congressman has accepted bribes through a charity, but the charity leaders appear to have behaved properly and been unaware of the bribe, the government should use laws regarding bribery to attack the problem rather than force the IRS to solve the problem. There could, of course, be tax problems with such a situation but not necessarily the regulation of nonprofits.

Government Oversight of the Nonprofit Community:

State Law

States have traditionally regulated nonprofits through state attorneys general.[1] Some argue that this is where nonprofits should be regulated. State law focuses primarily upon enforcing fiduciary duties on agents of charitable organizations and on ensuring fair charitable solicitation. Thus, a state attorney general typically has the jurisdiction to bring actions to enforce duties of loyalty and duties of care against nonprofit directors who misuse charitable entity resources. However, states tend to provide slim oversight resources to watch over the charitable sector.[2] Outside of a few states like California, Massachusetts, and New York that have invested in the regulation of nonprofits, the vast majority of states are lucky if they have a single person dedicated to regulating charitable organizations.[3] Although some have suggested avenues for increasing oversight at the state level, such as by granting rights to certain individuals to bring actions against charity leaders, no state has made significant improvements on state level charitable regulation.

Federal Tax-Exempt Law

The Internal Revenue Service is in effect a regulator of the nonprofit community because the tax code provides an exemption from the income tax under section 501(a) for organizations described in sections 501(c) of the Code. In order to qualify for exemption, these organizations described in 501(c) must meet a series of requirements. Additionally, certain taxes can apply to these organizations or individuals connected therewith. The following briefly discusses the rules most likely to put a nonprofit at risk for loss of status or to pay taxes whether excise or income. In other words, in any case study the Subcommittee might consider, these would be the primary legal theories a regulator would consider in determining whether the IRS should ideally audit, or bring action against, that organization or its leaders.

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[1] Garry Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128 (2007).

[2] Jenkins *supra* note 1 at 1113.

[3] Jenkins *supra* note 1 at 1113-1114.

Substantial Nonexempt Purpose. Under the Code, a charitable organization is required to be organized and operated exclusively for "charitable" purposes.[4] The regulations sets forth two tests, but for purposes of this testimony I will focus on the operational test. Treasury regulations allow a charitable organization to operate "primarily" for charitable purposes.[5] An organization will fail the test if "more than an insubstantial portion" of its activities is in pursuit of a non-exempt purpose.[6]

If there is going to be a battle over whether a charitable organization is entitled to exempt status, the fight usually concerns whether the operational test is met. The challenge includes determining what activities promote charitable purposes and how much charitable activity an organization must perform. For instance, some health-care related business qualifies while other health-care related business does not. Helping the poor almost always is charitable, though helping the middle class may not be charitable. Education in the context of the classroom is almost always charitable, while educating through a magazine often is not. As far as quantity, while it is not clear when an organization's activities have risen to the substantial level, most would agree that nonexempt activities amounting to more than 50% of revenue or activities that are not charitable should be considered substantial. In some contexts, depending on the nature of the nonexempt activity, over 33% of nonexempt revenue or activity might do it. Realistically, this means that an organization that carries out a lot of charitable activity has significant leeway to carrying out some non-exempt activities (if those activities are not otherwise forbidden by the Code).

Where a nonprofit founder or leader engages in transactions with a for-profit business that the founder or leader owns and controls, the IRS is likely to consider whether the nonprofit furthers a substantial nonexempt purpose. These circumstances can suggest the organization is primarily operated for the benefit of the private interests of the founder or leader rather than for charitable purposes.

If the IRS audits a charity and determines that it engaged in a substantial nonexempt purpose, the IRS will revoke that charity's tax-exempt status. The charity would then have to pay income tax like any other corporation or trust.

Private Benefit. The private benefit limitation prohibits organizations that are operated for private purposes from being considered as charitable or operated for social welfare.[7] In *Ginsberg v. Commissioner*, the court found that an organization operating to dredge a private waterway provided too much private benefit for the owners along the waterway and was thus not a charitable organization.[8] In *American Campaign Academy v. Commissioner*, a section 501(c)(4) case but still instructive, the Tax Court agreed with the IRS that the academy that only trained candidates for office or individuals as campaign workers who all either ran as, or worked for, Republican candidates, was operated for too much private benefit and therefore was not exempt.[9] The evaluation of private benefit is similar to that described in substantial nonexempt purpose. It

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[4] 26 U.S.C. §501(c)(3).
[5] Treas. Reg. 26 U.S.C. 1.501(c)(3)-1(c)(1) (operational test).
[6] Treas. Reg. 26 U.S.C. § 1.501(c)(3)-1(c).
[7] Treas. Reg. 26 U.S.C. § 1.501(c)(3)-1(d)(1)(ii).
[8] 46 T.C. 47 (1966).
[9] Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).

is possible that the organization carries out so much charitable work that the modest amount of private benefit does not outweigh the charitable works and exemption is appropriate. If found, it likely also results in a substantial nonexempt purpose.

Inurement. Under section 501(c)(3), a charitable organization is not permitted to allow any inurement. This means that "no part of the net earnings [may inure] to the benefit of any private shareholder or individual." In simple terms, inurement happens when an individual who has the power to control the charity directs the profits of the charity to themselves. This rule does not prohibit paying salaries, but simply prohibits a nonprofit from acting like a for-profit entity that distributes profit to owners. Technically, no amount of inurement is permitted, though in practice the IRS only uses revocation of exempt status for inurement in extreme circumstances.

Excess Benefit Transaction. Congress passed section 4958 of the Code to impose a tax on someone who takes value from a charity without providing fair market value in return. This is an excise tax that is imposed on disqualified persons (and sometimes knowing approving managers) who receive an excess benefit from a charitable organization. An excess benefit is the amount of value that a person who controls a charity takes from the charity. For instance, if an executive director sells a property worth $100,000 to the nonprofit she controls for a payment of $150,000, there would be an excess benefit transaction. The excess benefit would be $50,000. The tax on the disqualified person is 25% of the excess benefit. Thus, in the above case, the executive director would need to return the $50,000 to the charity and pay a tax of $12,500 to the IRS.

Unrelated Business Income Tax. Section 511 of the Code imposes an unrelated business income tax on the activities of nonprofit organizations. An unrelated trade or business includes "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its" exempt purpose.[10] Practically, this means that some "nonexempt activity" that does not result in an organization losing its exempt status can result in the organization owing a tax at the prevailing corporate or trust rate. There are many more qualifications to the unrelated business income tax.

Political Campaign Prohibition. Section 501(c)(3) states that a charitable organization may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." This is often referred to colloquially as the "Johnson Amendment" because of the provision's connection to Lyndon Johnson. It is an absolute prohibition on a nonprofit working to either help elect a candidate for public office or to work against a candidate for public office. It presents numerous challenges of interpretation.

Too Much Lobbying. Somewhat relatedly, a charitable organization may engage in lobbying that is not substantial. Section 501(c)(3) provides that "no substantial part of the activities of [a charitable organization may be] carrying on propaganda, or otherwise attempting, to influence legislation." Though there is much nuance to parse in this Code section, a charitable organization that engages in using more than 15% of its revenue[11] to lobby legislative bodies or voting bodies

[10] 26 U.S.C. §513.
[11] *See* 26 U.S.C. §501(h).

to pass a certain law will be in danger of violating this provision. Nevertheless, there is no hard and fast rule on what a substantial part means.

Violation of Public Policy. Finally, the IRS might consider whether there is a violation of public policy. The IRS had long recognized that a charitable organization cannot be organized and operated to violate the law of fundamental public policy based on charitable trust law. The United States Supreme Court recognized this provision as a legitimate part of section 501(c)(3) in the Bob Jones case.[12]

Private Foundations. In 1969, inspired by concern that wealthy Americans were abusing the use of nonprofit organizations for their own purposes, Congress imposed expansive new rules on charitable organizations. Under the law, any organization with only a few donors is now classified as a private foundation.[13] Those with broad public support, such as hospitals, and churches, and schools are classified as public charities and spared the rules imposed on private foundations. Private foundations, however, are subjected to a range of excise taxes that work to limit the ability of controlling wealthy donors from taking advantage of these types of charities.[14] Most significantly, Congress imposed a payout requirement on private foundations to ensure a significant amount of money is delivered to charity every year. It also imposes restrictions on what are referred to as self-dealing transactions.[15]

Disclosure. One final part of the regulatory regime that the IRS oversees is the disclosure regime established in section 6033 of the Code. Nonprofit organizations are required annually to file a Form 990 Information Return that serves as a nonprofit's tax return. These documents are public documents. This allows the public to know about the finances and activities of these organizations on an annual basis. This system arms journalists, representatives, and individuals with information so they can hold these organizations accountable. While most of an Information Return is public, the Schedule B, Schedule of Contributors, is not public for most types of exempt organizations, except private foundations and section 527 Political Organizations.

Enforcement Environment

As detailed by some, we have as a nation failed to dedicate the resources needed to meet the need for oversight of the charitable sector.[16] That might have been acceptable when the sector was a smaller part of our economy, but the sector has grown without the IRS resources growing with the sector.

The number of organizations registered with the IRS as tax exempt has grown from around 300,000 in 1980 to almost 1.8 million in 2017.[17] Assets and revenues almost tripled between 1995 and 2014. Assets of the nonprofit sector grew from $1.1 trillion in 1995 to $3.2 Trillion in

[12] Bob Jones Univ. v. United States, 461 U.S. 574 (1983).
[13] 26 U.S.C. §508.
[14] 26 U.S.C. §§ 4941-4945.
[15] 26 U.S.C. §4941.
[16] *See* Lloyd Hitoshi Mayer, *"The Better Part of Valour is Discretion": Should the IRS Change or Surrender Its Oversight of Charitable Organizations*, 7 COL J. TAX L. 80 (2016) (arguing that the deficiencies of IRS oversight are so severe that it is time to consider moving the function out of the IRS).
[17] 2017 IRS Data Book; See Mayer at 84 (cataloging data from the IRS Data Books through the years).

2013.[18] Revenues grew from $660 million in 1995 to $1.7 trillion in 2013. The IRS approved approximately 86,000 applications for charitable status in 2017.[19] That is compared with 56,000 in 1995. Meanwhile, the number of denials plummeted from 1,607 in 2007 to merely 68 in 2017.[20]

The overall IRS budget fell by about 18 percent in inflation-adjusted terms from 2010 to 2017, from $14 billion to roughly $11.5 billion. While the IRS employed a total of approximately 90,000 employees in 2012, in 2017 it employed just shy of 77,000.[21] The Government Accountability Office, a nonpartisan congressional agency, recognized in 2014 that the tax agency's budget and staff were too small to handle its nonprofit oversight responsibilities.[22] The number of its employees dedicated to auditing and vetting the nonprofit sector fell about 5 percent from 2010 to 2013, the GAO found. This long-term trend, which began two decades ago, has eroded the ability of the IRS to conduct the oversight that Congress has tasked it with.

Conclusion

To summarize, our nation has tasked the IRS with the large and complex responsibility for regulating the nonprofit sector, but has failed to provide the IRS with resources commensurate with that task. This is important work. Nonprofits constitute a large and growing part of our economy, and they are granted a highly preferential tax status. An organization that abuses that preferential status will obtain a significant and unfair advantage over the organizations and individuals who play by the rules. If we are to grant such a substantial advantage to nonprofits, and if we are going to rely on the IRS to oversee regulation of these entities, it is essential that the IRS have the resources it needs to ensure that this preferential status is not abused.

Again, thank you for inviting me here today and I welcome your questions.

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[18] Urban Institute: The Nonprofit Sector in Brief http://www.urban.org/research/publication/nonprofit-sector-brief-2015-public-charities-giving-and-volunteering

[19] 2017 IRS Data Book.

[20] See 2007 and 2017 IRS Data Books.

[21] 2017 IRS Data Book. https://www.irs.gov/statistics/irs-budget-and-workforce

[22] GAO, Tax Exempt Organizations: Better Compliance Indicators and Data, and More Collaboration with State Regulators would Strengthen Oversight of Charitable Organizations, (Dec. 2014).