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NONPROFIT ORGANIZATION REPORT – WINTER 2013

STATE CHARITIES REGULATORS AND THE GOLDILOCKS PRINCIPLE

You be the bad cop, and I'll be a bad cop, too?

We regularly attend continuing education programs for lawyers to keep current on legal developments. Recently, however, we attended a program designed for state nonprofit regulators, namely state attorneys general and the lawyers on their staffs. "The Future of State Charities Regulation" program was sponsored by Columbia University Law School's Charities Regulation and Oversight Project. While the educational content of the program was outstanding, the most valuable "take away" for us was the insight obtained from poking our nose under the tent of the people to whom nonprofit clients are answerable. We thought we would share the following four observations about the conference.

Observation One: Governance Dissonance

There is a lack of harmony between the states and the IRS on matters of governance.[1] Remember that the IRS is a taxing authority, and that governance principles are creatures of state law. However, as we know, the IRS expanded Form 990 (the nonprofit tax return) in 2008 to ask (in Part VI) a robust set of governance questions that have been giving nonprofits heartburn ever since. Interestingly, the reaction of several regulators at the conference was that the IRS was intruding on their turf, and sowing confusion and anxiety among nonprofits in their states. The state regulators are correct.

We criticized the IRS's governance initiative when it was launched in 2008,[2] and in 2010 likened it to an unguided missile – unguided in the sense that the IRS staff does not have the training or knowledge to undertake this task.[3] At the conference Marcus Owens, the former IRS Exempt Organization Chair (now in private practice), commented on a recent court decision in the District of Columbia *(Loving v. Internal Revenue Service)* that could impact Part VI of the 990 (and perhaps cause the IRS to eliminate it entirely). In the *Loving* decision the Court issued a permanent injunction against the IRS, prohibiting it from enforcing regulations it adopted in

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[1] "Governance" includes a wide range of matters, such as By-law terms, the size of the governing board, conflicts of interest, board committee structure, frequency of meetings, whistleblower policies, compensation setting standards, and many others.

[2] See the Summer 2008 edition of this Report: *The Nonprofit Sector: RIP (the New Form 990 or "SOX Lite).* It and the other past editions of this report referenced in the text are available on our website: www.rrlawpc.com.

[3] To see some specifics about the lack of IRS competence on governance see the Winter 2010 edition of this Report entitled *The IRS is your Big Brother (and your Daddy too!)*

2011 which imposed a host of regulatory requirements on paid tax return preparers.[4] The Court prohibited the enforcement of the regulations because Congress *had not passed a law giving the IRS the legal authority to regulate these people* (the court rejected an IRS assertion that an 1884 federal statute gave it the legal authority it needed).

In the past the IRS has claimed that its authority to regulate governance is based on the principle that better governance means more accurate tax returns, and on its authority to design tax returns. However, there is no statute giving the IRS the specific authority to regulate governance, and in light of the *Loving* decision the IRS justification would seem too slender a reed to withstand scrutiny if challenged in court. If a court ever orders the IRS to remove Part VI of Form 990, nonprofits should send the IRS a bill for all of the accounting, legal and staff expenses they incurred wrestling with it over the years. But in the meantime, we have always urged clients not to get overly agitated over the questions on Part VI as it is likely the IRS personnel reviewing the returns won't know how to interpret the answers anyway.

Observation Two: Too Many Bad Cops

We are all familiar with the "good cop – bad cop" interrogation technique seen frequently on television crime dramas; and unfortunately we sensed more of the "bad cop" attitude among the regulators than we expected. We offer the following thoughts (directed primarily at nonprofit social service providers which rely on governmental funding).

Human service providers (including nonprofit hospitals) see state attorneys general as one arm of the same state government that uses its other arm to provide funding (service contracts and grants) and to regulate programmatically (licensing, inspection, safety and other rules). In the context of the old saw about one arm not knowing what the other is doing, Tim Delaney, President and CEO of the National Council of Nonprofits, spoon fed some striking insights to the attorney regulators at the conference about what the "other arm" is doing.

Mr. Delaney spoke from a draft paper prepared for the conference entitled *Advocacy by Charitable Nonprofits: Flipping the Accountability Lens to Focus on Government Action.* His remarks were both an admonition to the regulators not to forget that nonprofits are the good guys who, by providing essential services, are pulling their oars in the same direction as the state – and an attempt to let the attorney regulators know that the other arm is treating nonprofits very badly these days. He was wonderfully specific in identifying areas of nonprofit "*abuse"* by state governments: oppressive terms in funding contracts, governments directly taking money away from nonprofit missions, governments indirectly taking money away from nonprofit missions, and governments offloading unwanted programs on nonprofits.[5]

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[4] The regulations in question applied to paid return preparers (excluding attorneys, accountants, and others subject to other professional certifications), and imposed annual registration, background check, and continuing education requirements.

[5] We compliment the extensive research behind Mr. Delaney's conclusions about how bad things are for nonprofits. His view of the contracting system as a "cobbled together arrangement in which states fail to pay the full cost of services, frequently change the terms of contracts midstream, routinely pay late, and mandate overcomplicated contracting processes and reporting requirements" is what we have experienced. To extract money from nonprofits, his research found states that have expanded the scope of property and sales taxes to cover nonprofits, and others

Mr. Delaney's observations are compelling and are consistent with what we have seen in our practice. For example: the word "retribution" recently slipped out of the mouth of an officer of a nonprofit client as he discussed possible state reaction to the elimination of a program. Another recent example: a client being harassed by a bad faith Freedom of Information Act request went to a hearing where the Hearing Officer decided the case in a manner which provided the person requesting the information a road map for an alternative way to bring a complaint that will end up costing the client more time and money. The following sentence from Mr. Delaney's draft paper says it all: "***Said another way, traditionally charity regulators look down at the lifeboat's floor to check for water leaking in from the holes in nonprofit governance, yet currently a tidal wave caused by others in government is about to upend the entire lifeboat."***[6]

Observation Three: Regulator Mission Creep and the Goldilocks Principle

"Mission creep" is a cardinal sin in the nonprofit sector, and we fear that some regulators may be guilty of the same transgression. Apropos of the remarks of Mr. Delaney discussed above, some of the panelists suggested that more law and more regulation (such as mandatory educational requirements for nonprofit directors) is necessary to insure, for example, that "*we never have another scandal like Penn State*" (which was mentioned several times during the presentations). The "transparency" word was also voiced reflexively and with almost biblical reverence as an elixir for nonprofit management foibles everywhere – despite evidence that the "transparency" created by Form 990 since 2008 does not seem to have made a positive difference.[7]

Every time we hear arguments that regulators need more law or authority to do their jobs we think of the "60, 30, 10" rule. Sixty percent of people have a personal moral compass that will keep them honest and diligent even if there are no regulators; thirty percent are susceptible to temptation and need regulators to keep them from steering off the straight and narrow path; and ten percent are incorrigible crooks who will do bad things no matter how many laws or regulators we have in place. Our advice to the regulator community is to remember that they are pitching to the thirty percent in the middle, and that if they overreach and try to create a one hundred percent solution only the ten percent will be left standing. In other words, the regulators

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that have tried to skirt state constitutional limits on taxation of nonprofits by imposing things like "sewer usage" fees and "street pole assessments." He reports that some states have been treating nonprofits as an extension of the government itself, by trying to micromanage operations with legislation that would require a certain number of volunteer hours to be eligible for public programs, capping salaries, and treating nonprofit contractors as governmental bodies subject to public records law and reporting requirements.

[6] Readers interested in learning more can access Mr. Delaney's February 14, 2013 testimony before the House Ways and Means Committee Hearing on Tax Reform and Charitable Contributions, available at http://www.councilofnonprofits.org/files/national-council-of-nonprofits-testimony-with-appendix-2-14-2013.pdf.

[7] See our Summer 2012 version of this newsletter entitled *Is Transparency the Best Medicine?* in which we suggest that *translucence* is the better prescription.

should temper their enthusiasm by application of the Goldilocks principle: not too hot, not too cold, but just right!

Observation Four: A Critique of Benefit Corporations – Is There a Better Approach?

The final take away from the conference comes from a panel discussion on hybrid entities – such as benefit corporations (the topic of the Fall 2012 edition of this report). These entities are part of the so-called "social enterprise" movement that envisions enterprises that make a profit while simultaneously providing a social benefit. It was clear that regulators are still trying to get their minds wrapped around these entities – questioning, for example, if the social benefit aspect of their legal DNA creates a "charitable" interest that falls under existing charities law. But we also picked up a feeling from the panel that benefit corporations are over-burdened by their complexity, and, as one panelist noted, if it would be simpler to create a form of revenue sharing. The comment about revenue sharing brought to mind the following remarks of Roberto C. Goizueta, former Chairman and CEO of Coca Cola, and caused us to wonder if more social benefit could be achieved by something as simple as legislation encouraging (perhaps an enhanced corporate tax deduction) publicly traded companies to make gifts of their stock to smaller human service nonprofits which agree to hold the shares as part of a permanent endowment. In other words, give the smaller nonprofits some skin in the economic game:

> "[Given that] billions of shares of publicly-held companies are owned by foundations, universities and the like, one should never forget the multiplier effect in the world of philanthropy, and the benefit to society, that each dollar increase in the value of those shares brings about. If a foundation owns, let's say, 50 million shares of Coca-Cola stock, for each dollar that our stock price increases, that foundation will be required to give out an additional $2.5 million."[8]

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel.

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[8] As quoted in *Business as a Calling (Work and the Examined Life)*. Michael Novak, The Free Press, 1986. Mr. Goizueta's remarks were made in the context of the 5 percent minimum distribution requirement the law imposes on private foundations. While public charities (such as universities) are not subject to a minimum distribution requirement, they typically have annual spending policies at about the 5 percent level.