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Federal Regulation of Nonprofit Board Independence: Focus on Independent Stakeholders as a "Middle Way"

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INTRODUCTION

There has always been some controversy about how oversight of charities is or should be divided between the states, the federal government, and charities themselves. Since the beginning of their existence, states have expressed a right and obligation under common law and statute to oversee the operation of charities to ensure that they (and those who control them) act consistently with their charitable missions. On the other hand, the federal government, to the degree that it gives favorable tax treatment to charities, has an interest in reserving such treatment only for charities that are "worthy" of such treatment, and federal law limits the charities that qualify for tax exemption. The federal government ensures compliance with federal law through the Internal Revenue Service (IRS). Finally, charities themselves take the biggest role in providing mechanisms to ensure that their charitable goals are met. This autonomy of charities' self-governance is also important.

1 Benjamin M. Leff is an assistant professor at American University—Washington College of Law. I would like to thank Lilian Faulhaber, James Fishman, Adam Hirsch, Heather Hughes, David Snyder, the participants at the AALS Section on Non-Profit Law and Philanthropy annual meeting, the participants at the Florida State University College of Law Visiting Faculty Series, and the participants at the Washington College of Law Business Law Workshop for their comments and criticisms.

2 The term "charity" will hereinafter be used generically to refer to organizations exempt from federal income tax under section 501(c)(3) of the Code. Many of the observations contained in this Article may apply equally to non-profit organizations that are exempt from tax under provisions other than section 501(c)(3), but will be constrained in this discussion to 501(c)(3) organizations.


4 Evelyn Brody & John Tyler, Respecting Foundation and Charity Autonomy: How Public Is
Recently, the IRS has increased its focus on "governance"—a series of practices adopted by charities that have previously been perceived to be largely the province of charities themselves or of state regulation. The IRS's "governance initiative" is a series of programs implemented by the IRS to identify "best practices" that are followed by the boards of directors of well-managed charities and to "encourage" charities to adopt such practices. The IRS's governance initiative has been criticized as an instance of the IRS overstepping its proper authority and interfering in an area that either should be the province of the states, or of the charities themselves. For example, James Fishman has argued that the IRS's governance initiative is "a kind of stealth preemption, which undermines the principles of our federal system."\(^7\)

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\(^5\) See discussion infra Section II.

\(^6\) See James J. Fishman, Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative, 29 VA. TAX REV. 545, 548 (2010) (describing the IRS's recent initiatives in the area of corporate governance as "a kind of stealth preemption, which undermines the principles of our federal system"); see also ADVISORY COMM. ON TAX EXEMPT & GOV’T ENTITIES (ACT), THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES 6 (2008) [hereinafter ACT REPORT], available at http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf; Grace Allison, The Exempt Organization Division Reports on Tax Compliance, TAX’N EXEMPTS, May-June 2009, at 12, 14 (recognizing that some observers have cited an “absence of studies showing any correlation between governance on the one hand and compliance on the other”); Brody & Tyler, supra note 4, at 578 (decrying the IRS’s recent governance initiatives, not because they infringe on the states’ authority to regulate, but because they infringe on the charities’ own autonomy); Thomas Silk, Good Governance Practices for 501(c)(3) Organizations: Should the IRS Become Further Involved?, 107 J. TAX’N 45, 45 (2007) (“I have heard many practitioners argue that governance is the sole purview of state law, and that the IRS should stay away from the issue.”); John R. Washlick, The Form 990 Preparedness Assessment—Miserly Loves Company, TAX’N EXEMPTS, Jan.-Feb. 2009, at 26, 27 (“Form 990 now essentially imposes on exempt organizations compliance with policies that the IRS perceives as best practices, and that it acknowledges are not required by the Code.”); Bruce Hopkins, Presentation to the Georgetown University Law Center 27th Annual Representing & Managing Tax-Exempt Organizations Conference 8 (April 22, 2010) [hereinafter Hopkins Outline] (copy on file with author) (The purposes of new Form 990 are, among other things, to “[c]reate new law, such as in the realms of governance.”). But see Sarah Hall Ingram, Comm’r, Tax Exempt and Gov’t Entities, IRS, Remarks at Georgetown University Continuing Legal Education: Nonprofit Governance—The View from the IRS 11 (June 23, 2009) [hereinafter Ingram 2009 Speech], available at http://www.irs.gov/pub/irs-tege/ingram_grown_governance_062309.pdf (“While both state regulation and sector self-regulation are important, and I welcome and respect them, they do not get the IRS off the hook. Congress gave us a job to do, and we cannot delegate to others our obligation to enforce conditions of federal tax exemption. The federal tax law must be applied consistently across the country, and we will use both our education and outreach programs and a meaningful enforcement presence to accomplish this.”).

\(^7\) Fishman, supra note 6, at 548.
One prominent example of a governance issue on which the IRS has focused is "board independence." An "independent" board member is generally a person on the governing board of an organization who has no financial interest in the organization or its activities. The IRS claims that it has encouraged organizations to have independent boards, but has never required them to do so. Critics of the governance initiatives have focused on board independence as well, arguing that "[d]espite what the Form 1023 and its instructions suggest, the Service has denied exemptions because of the lack of an independent board, some independent members, or a conflict of interest policy." Specifically, critics argue that practitioners' reports and some published cases and rulings suggest that the IRS has recently required organizations to include "independent" board members, even though independent boards are not currently required under federal law. In other words, the critics claim that the IRS is requiring charities to have independent boards, and this requirement not only infringes on charities' autonomy or the states' prerogatives but is actually illegal under federal law.

If the IRS were denying tax exemption to any organization that had a non-independent board, it would indeed be beyond its authority under current law. The IRS would need Congress to change the law to permit it to make such a sweeping change in the requirements for tax exemption under section 501(c)(3) of the Code. In fact, some commentators argue that Congress should amend the law to require that substantially all charities have at least some independent members on their governing board. These

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8 This Article borrows the definition of an “independent” director from a recent report by a prestigious panel: independent directors are those

1. who have not been compensated by the organization within the past twelve months . . . except for reasonable compensation for board service;
2. whose own compensation, except for board service, is not determined by individuals who are compensated by the organization;
3. who do not receive, directly or indirectly, material financial benefits (i.e., service contracts, grants, or other payments) from the organization except as a member of the charitable class served by the organization; and
4. who are not related to (as a spouse, sibling, parent, or child) any individual described above.

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9 Fishman, supra note 6, at 562. See also ACT REPORT, supra note 6, at 31 ("In various contexts, . . . [the IRS] has created a per se requirement for exemption that requires the organization be governed by an independent body. The IRS’s position, however, has not always been sustained by the courts and we are concerned about per se requirements."); Brody & Tyler, supra note 4, at 578 ("It is understood that the Service demands a minimum of three unrelated board members—although, because such a requirement does not appear in the statute or regulations, the Service cannot deny exemption on this basis alone.").
commentators include a very prestigious panel convened by Independent Sector, and composed of numerous leaders from the tax-exempt sector.10

This Article surveys the IRS's actions, as expressed in its speeches, training manuals, and adverse determination letters. I find that the IRS does appear to be requiring some organizations to have independent boards, but that it is doing so in a sharply constrained way. It appears that the IRS is generally only denying tax exemption when an organization (i) has a governing board dominated by its founders; (ii) intends to engage in ongoing financial transactions with those founders; (iii) is not a private foundation; and (iv) has very few meaningful "independent stakeholders," such as donors, who might monitor the organization. It appears that organizations that meet all four of these criteria may be denied tax exemption if they refuse to broaden their governing board to include independent directors. This approach is a "middle way" between the IRS completely leaving board independence to the charity itself or to state regulators and Congress changing the law to require board independence in substantially all section 501(c)(3) charities.

The problem is that the IRS appears to be only stumbling toward this approach. It has nowhere expressly described these limitations on its own discretion and is not applying them in an entirely consistent manner. This Article argues that the IRS could more effectively represent the "middle way" if it would expressly embrace the relevance of board independence to tax exemption and the limitations on its discretion described herein. This middle way recognizes that the federal government has a legitimate interest in charity board independence, but only under certain circumstances. This Article supports the middle way because it appears to reflect current law in representing a plausible balance of the federal interest in preventing the diversion of tax-deductible contributions to private purposes, the states' interests in protecting the interests of various stakeholders, and charities' interests in their own autonomy.

In Part I, this Article reviews the IRS's "governance initiatives," as they pertain to the issue of board independence. In Part II, it reviews some recent adverse determination letters in which the IRS denied applications for tax-exempt status to organizations without independent boards. I find that these adverse determination letters do suggest that the IRS considers board composition relevant to an initial exemption ruling, and that there is a plausible argument that board composition is at least sometimes relevant to a determination of tax-exempt status. In Part III, I argue that it appears that the IRS only denies exemption to organizations that are characterized by three constraining factors: first, these organizations

10 The Independent Sector Panel recommended that federal law be changed to require at least one-third of a public charity's governing board be composed of "independent" directors or trustees. The requirement would not apply to private foundations, churches, and government instrumentalities. See INDEPENDENT SECTOR, supra note 8.
INDEPENDENT STAKEHOLDERS

have governing boards that are completely dominated by their founders; second these organizations have founders who plan to engage in significant financial transactions with the organization; and third, these organizations are generally not private foundations.

In Part IV, I address another factor that the IRS appears to be considering in deciding which organizations should be urged (or required) to have independent boards. Attention to this factor has the potential to cabin the IRS's discretion still further in selecting which organizations may need an independent board. This factor is whether the organization has any "independent stakeholders," such as donors. None of the organizations that were denied exemption had significant numbers of independent donors, and the rulings exhibited an acute interest on the part of the IRS in the lack of independent donors or other potential independent stakeholders. The IRS is likely acting on a theory that the existence of independent stakeholders may serve to protect against abuse by non-independent, founder-dominated governing boards. I argue that a more explicit focus on third-party stakeholders would more effectively cabin IRS discretion in this area and permit the IRS to do a better job of identifying organizations that would likely benefit from independent board members, and which could be required to have them.

The IRS's recognition of the relevance of independent stakeholders other than board members has implications for the "federalism" question as well. Section V of this Article provides some tentative thoughts about why a more rigorous focus on independent stakeholders by the federal government might enhance the proper balance between federal and state regulation of charities.

When viewed in this way, the limitations that the IRS has imposed on its approach to requiring independent governing boards—especially its attention to independent stakeholders—potentially provides a warrant for federal regulation of the composition of charity boards of directors, a limit on the extent of federal discretion, and a (highly tentative) explanation for state lapses of regulation. The IRS must not overstep its congressionally-created authority just because it fears that states are not doing enough to regulate charities. On the other hand, it cannot be lax in protecting the interests of the federal government to the degree that protection is permitted or mandated under federal law. The limited approach described in this Article reflects the nuanced balance of federal interests, state regulatory authority, and charity autonomy that has long been a cornerstone of the federal regulation of charities. In the context of calls from critics for the IRS to stay out of a charity's boardroom and calls by reformers to change federal law to mandate a minimum level of "independence" in the composition of all charity boards, the cautious approach described and advocated in this Article represents a "middle way."
I. THE IRS'S GOVERNANCE INITIATIVE: FOCUS ON BOARD INDEPENDENCE

The IRS's so-called governance initiative refers to a collection of actions taken by the IRS in the past half-decade focusing on the way exempt organizations are governed. The projects involve gathering information about organizations' governance practices and communicating "best practices" to organizations. Such governance practices have included conflict of interest policies, compensation policies, governing board review of agents' actions, independent review of financial statements, investment policies, governing board minutes, and records retention policies. But the governance issue that the IRS has stressed the most, and the one that is perhaps most fundamental to a charity's autonomy, is the issue of board composition. The IRS has stated that it believes that in most circumstances the governing board of a charity should include at least some members who have no financial interest in the organization—members who are "independent." For the last several years, the IRS Commissioner for Tax-Exempt and Government Entities has given public speeches emphasizing the IRS's interest in governance issues. In her 2009 comments, the Commissioner explained that governance—including the "principle that the organization's board should be . . . independent"—was a central concern of the IRS. She explained that the concern with governance reflects a principle that "seems intuitively true" to her and many people that "there is a link between good governance and tax compliance."

While Commissioner Ingram made clear in her comments that she believed that an independent board is relevant to an organization's tax compliance, and therefore the IRS has a legitimate interest in board composition, she also took pains to define the nature of the IRS's interest. Specifically, she emphasized that the IRS does not require boards to be independent as a prerequisite for exemption. When an organization seeks

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12 Id.
13 Id. at para. 3. ("Irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships.").
15 Ingram 2009 Speech, supra note 6, at 4.
16 Id. at 5.
INDEPENDENT STAKEHOLDERS

tax-exempt status, it sends a form to the IRS. This form is reviewed by the IRS Exempt Organizations Division's "determinations" agents. Ingram stated that the IRS determinations agents "encourage applicants for determination letters to consider incorporating some principles of good governance into their organizing documents." But she clarified by stating:

[In talking about the determination stage, I have been using the word "consider" deliberately. We may encourage applicants to incorporate principles of good governance into their organizational structures, and thereby reduce their risk of something going wrong later, but we are not requiring adherence to a particular set of rules.]

She noted that she had heard reports of determinations agents sometimes requiring certain specific governance policies as a condition of exemption. In response, she announced a training program to make sure that agents understood the IRS's position—there are no "universal and mandatory governance principles"; but the IRS has "no intention of walking away from governance." In short, the IRS has staked out a position in its public statements that is potentially ambiguous. On the one hand, it views governance practices, like an independent board, to be intricately connected with an exempt organization's compliance with federal law, and so it views its role as promoting their adoption. On the other hand, it recognizes that federal law does not require any particular organization to have an independent board, and so it claims that it does not require an organization to have an independent board as a prerequisite for exemption. This uneasy position is reflected not only in public pronouncements made by IRS personnel, but also in the various governance initiative actions undertaken by the IRS.

A. Form 1023

Possibly the first IRS action to be associated with the contemporary governance initiative was the re-design of the Form 1023 that was completed for tax year 2004. Form 1023 is the application that a section 501(c)(3) organization files in order for the IRS to recognize its exempt status. While the Form asked no direct questions about board independence, it did contain several "governance" questions. For example, Part V of the new Form has several new questions, including question 5a, which asks if

17 IRS Form 1023 (2009) [hereinafter Form 1023].
19 Ingram 2009 Speech, supra note 6, at 6.
20 Id.
21 Id. at 14 (specifically mentioning the ACT REPORT, supra note 6).
22 Id. at 15.
the organization has "adopted a conflict of interest policy consistent with the sample conflict of interest policy in Appendix A to the instructions."23 If a "consistent" conflict of interest policy has been adopted, then the organization is asked to provide a copy of it.24 If none is provided, then further questions are asked about the "procedures" the organization follows to assure that persons with conflicts of interest will not be involved in setting their own compensation or approving business deals with themselves.25

Both the model conflict-of-interest policy and the question for organizations that have no conflict-of-interest policy necessitate the existence of at least some board members who have no conflict of interest with regard to any specific transaction. Under the model conflict-of-interest policy, board members with a financial interest in a transaction must abstain from the discussion of, and the vote on, whether to approve the transaction.26 If the board contains only members with an interest in any specific transaction, then no committee of disinterested board members can be formed, and the policy cannot be followed.27 For example, a board made up solely of a husband, wife, and child cannot approve a compensation arrangement with the wife consistent with the model conflict-of-interest policy because there are no unrelated (and therefore disinterested) board members to compose an independent committee to approve the compensation arrangement. If interested directors abstain from the decision to approve the compensation arrangement, the room would be empty. Likewise, an organization with no conflict-of-interest policy presumably cannot explain how an interested director will not be involved in approving transactions between her and the organization if there are not other—disinterested—directors who can make those decisions. Nonetheless, the Form has a disclaimer following these questions that explains: "Note: A conflict of interest policy is recommended though it is not required to obtain exemption."28 Presumably, that means that however this question is answered, the answer should not provide grounds by itself to disqualify the organization from exemption.

23 FORM 1023, supra note 17, at pt. V, Question 5a.
24 Id.
25 Id.
27 See Dana Brakman Reiser, Director Independence in the Independent Sector, 76 FORDHAM L. REV. 795, 808 (2007) ("Maintaining a group of directors able to [review and approve transactions with conflicted directors] is another benefit of requiring a majority, or at least some critical mass, of independent directors.").
28 FORM 1023, supra note 17, at pt. V, Question 5a.
In 2008, the IRS completed a substantial re-design of its Form 990—the annual information return filed by exempt organizations. The re-designed Form 990 contained an unambiguous focus on governance, including a new section, Part VI, called “Governance, Management and Disclosure.” While some of the questions in this section appeared on prior Forms 990 in other sections, some were truly new. For the first time, the Form addressed “board independence” explicitly, asking the organization to identify the number of voting members of the organization’s governing body who are “independent.” An “independent” board member, for the purposes of the question, is defined as one who: (1) “was not compensated at any time during the year as an officer or employee of the organization or of a related organization”; (2) “did not receive total compensation or other payments exceeding $10,000 . . . as an independent contractor, other than reasonable compensation for services provided in the capacity as a member of the governing body”; and (3) “[n]either the member, nor any family member of the member, was involved in [an ‘excess benefit transaction’] with the organization . . . for the organization’s tax year.”

An excess benefit transaction is one in which an organization provides an improper or excessive benefit to a related person and thereby subjects the organization to punitive excise taxes. Thus, the IRS explicitly asked about the independence of an organization’s governing body for the first time, notwithstanding the fact that no federal law requires that an organization have even a single “independent” member of its governing body. The definition of “independence” adopted in the Form was apparently crafted entirely by the IRS and is not drawn from any source of federal law.

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29 IRS Form 990 (2009) [hereinafter Form 990].
30 Id. at pt. VI.
31 Id. at pt. VI, Question 1b.
32 IRS, INSTRUCTIONS FOR FORM 990 pt. VI, at 17 (2009) [hereinafter FORM 990 INSTRUCTIONS]; see also Fishman, supra note 6, at 570. The definition of an “independent” board member adopted in Form 990 is relatively permissive. For example, the definition is more permissive than the definition contained in the Independent Sector’s proposal regarding board independence in that Form 990 considers an independent contractor who is paid less than $10,000 per year “independent,” while the Independent Sector definition does not. See INDEPENDENT SECTOR, supra note 8, at 75. Likewise, Form 990 considers a person who engages in a financial transaction with the organization in which the benefit received by the person is not excessive “independent,” while the Independent Sector definition does not. Id. Both definitions consider a board member who receives reasonable compensation for her service on the board to be “independent.” The working definition used in this Article follows the Independent Sector definition rather than the more permissive Form 990 definition.
34 See generally FORM 990 INSTRUCTIONS, supra note 32.
In the Instructions to Form 990, the IRS expressly addresses this lack of legal mandate for an independent governing board, acknowledging that "federal tax law generally does not mandate particular management structures, operational policies, or administrative practices." Nevertheless, the Form requires an organization to answer the questions and thereby disclose how many "independent" directors it has. The Instructions explain that "the IRS considers such policies and procedures to generally improve tax compliance" by helping to prevent organizations from engaging in "excess benefit transactions, inurement, operation for non-exempt purposes, or other activities inconsistent with exempt status." But every organization is different, and so "it is important that each organization consider the governance policies and practices that are most appropriate for that organization in assuring sound operations and compliance with tax law."

Thus, the new Instructions to Form 990 are also ambiguous as to the IRS's intentions. On the one hand, they express an interest in governance issues, like board independence. They state a preference for certain governance practices in general, although they concede that such practices may not be appropriate for all organizations. And they imply that certain governance practices, like an independent board, may protect an organization against drift from its charitable mission or abuse by insiders. On the other hand, the Instructions inform the reader that board independence is not a requirement of federal law.

C. Determinations Training

In addition to asking about governance issues—specifically board independence—in Form 990, the IRS instituted special training programs for its agents regarding exempt organizations governance issues, which also focused on board independence. The IRS has provided materials on its website related to two distinct training programs. One is directed at "determinations" specialists, and the other is directed at "examinations" specialists. The IRS's "determinations" specialists review Forms 1023,
and determine whether to approve an organization’s initial application for recognition of exemption. The “exam” function reviews existing organizations to determine whether they are, or are still, in compliance with federal tax law. In “exam,” the IRS may determine that an organization no longer warrants exemption, or it may determine that an excise tax, such as the punitive excise taxes imposed on “excess benefit transactions,” should be imposed on it. Thus, the “determinations” training should reflect the IRS’s views about whether and to what degree governance issues like board independence may be relevant to an organization’s initial qualification for tax-exempt status. The “exam” training should present the IRS’s views about the relevance of governance issues, like board independence, to continued qualification for tax-exempt status.

This Article focuses on the determinations training materials. The determinations training materials—directed at agents who review Form 1023 and are in a position to decide whether the IRS recognizes an organization’s exempt status or not—presumably tell us more about whether the IRS thinks that an independent board is a precondition of exemption than the “exam” training materials. If the IRS determines that the organization is not exempt, then the organization’s only recourse is to petition for a review of the determination in court. Therefore, the IRS determinations specialists wield significant power over an organization seeking exempt status. The determinations training materials consist of two documents, a Determinations Outline and Determinations Slides.

When it comes to the issue of board independence, the Determinations Outline expresses an acute interest in board independence. For example, the core training part of the Outline, under the heading “IRS Areas of Interest,” includes the subheading “Composed primarily of independent members.” There, the Outline states that “[i]rrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships.” It goes on to state that “[t]he Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets.”

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42 See Internal Revenue Manual, supra note 18.
43 Id. § 4.75.
45 See Determinations Outline, supra note 40, at 12.
46 Id. at 12-13 (emphasis in original).
47 Id. at 13; see also id. at 18 ("The Service believes that it is very important to the long-
The Determinations Outline also emphasizes the limitations on possible actions by determinations personnel. It repeatedly states “[e]ach organization needs to decide for itself how best to govern—one size does not fit all,” or language to that effect. Thus, in the determinations training materials, the IRS has staked out basically the same uneasy position it expressed in the Forms 1023 and 990 and in speeches: it believes that board independence is potentially extremely important to compliance with tax law—specifically with advancing a tax-exempt purpose, avoiding substantially advancing private purposes, and avoiding excess benefit transactions. However, the IRS also acknowledges that it is inappropriate to deny an organization exempt status merely because it does not have independent board members.

The apparent culmination of the determinations training is a section of the Outline called “Possible Approaches to Problem Boards.” The section assumes that an organization without an independent board is a “problem.” It concedes that facts and circumstances may excuse an organization from having an independent board and suggests that...
sometimes IRS "governance concerns" can be alleviated by adoption of a conflict of interest policy. But, as was discussed above, a conflict-of-interest policy only makes sense if the organization has at least some members of the governing board that are not financially implicated in the transaction, which may not be the case if all the directors are related to each other, either familially or financially. The Determinations Outline also recommends "Audit Referral or other possible follow-up," stating that "[g]enerally, we cannot require that an organization expand its board nor adopt a conflict of interest statement as a condition of exemption. If an organization refuses to expand its board and inurement is likely, but cannot be proven, [a referral to examinations follow-up] should be considered." In other words, the lack of independent board members should prompt a referral to the examinations function when inurement is likely. This is a perfectly reasonable suggestion, but does not answer the question of whether a lack of an independent board itself is evidence that "inurement is likely" or whether the evidence of likely inurement comes from other facts or circumstances.

Finally, the Determinations Outline proposes that lack of an independent board may be a "Contributing Factor to an Adverse Position." The Outline says very little, but it does say that "a 'non-community' board cannot be the sole factor in an adverse case," and it goes on to state that "[t]ypically, bad governance practices can be shown to highlight the control of an organization by individuals who are receiving an undue private benefit from the organization."

II. IS THE IRS CREATING "NEW LAW" ABOUT BOARD INDEPENDENCE?

As discussed above, there is some room for dispute about what exactly the IRS is doing in its governance initiatives. On the one hand, it has emphasized that board independence is an important governance practice and that organizations should at least consider having independent board members. On the other hand, it recognizes that "one size does not fit all" and that it is not authorized under federal law to require organizations to have an independent board as a precondition to obtaining exemption. What is the nature of this "middle way" that the IRS is seeking to occupy? Is it possible to maintain this uneasy balance between the organizational autonomy over board composition permitted under federal law, and the IRS's attempts to "encourage" organizations to maintain independent boards?

51 Id. at 27.
52 See discussion supra Part I.A.
53 See Determinations Outline, supra note 40, at 27.
54 Id. at 27-28.
55 Id. at 28.
Critics of the IRS argue that the IRS is not faithfully occupying the middle way it describes. Rather, it is stepping over the line and coercing organizations to adopt governance policies like an independent board. For example, some critics have noted that the mere identification of “best practices” by the IRS is coercive. In discussing the IRS’s “suggestions” about governance practices, one critic notes that “it would be a reckless charity to ignore the Service’s suggestions.” But observers of the tax-exempt sector not only claim that the mere existence of the questions pressures exempt organizations to adopt specific policies or procedures, they also claim that—notwithstanding the IRS’s protestations to the contrary—the IRS actually requires the adoption of these policies as a precondition of exemption. There is anecdotal evidence from practitioners who report that IRS determinations specialists have told their clients that they must have some independent board members before their exemption can be granted. Better evidence than anecdotes are rulings published by the IRS, and several commentators have argued that “recommended” governance policies appear to have factored prominently in several recent denials of exemption, especially when those recommendations involved board independence. In effect, these critics are arguing that the IRS

56 See Fishman, supra note 6, at 560; see also id. at 562 (“There is also the implication that when the exemption application is reviewed, the Service will take a negative view of the [conflict of interest] policy’s absence.”).

57 See, e.g., ACT REPORT, supra note 6, at 4.

58 See id. at 33 (“Our personal experience and research for this report suggests, however, that specific governance practices may be required on an ad hoc and inconsistent basis.”); see also id. at 35 (“We are concerned about the IRS having this level of discretion in cajoling or requiring specific governance process, particularly in the determination phase, where there usually is no track record evidencing operational failures.”); Allison, supra note 6, at 14 (noting that some have cited the “absence of studies showing any correlation between governance on the one hand and compliance on the other”); see, e.g., ACT REPORT, supra note 6, at 2-3; Evelyn Brody, Charity Governance: What’s Trust Law Got To Do With It?, 80 CHI.-KENT L. REV. 641, 648 n.17 (2005) (“The Service also reportedly looks for a certain percentage of independent directors to balance the directors who are financially interested or related.”); Silk, supra note 6, at 45 (“I have heard many practitioners argue that governance is the sole purview of state law, and that the IRS should stay away from the issue.”); Washlick, supra note 6, at 27 (“Form 990 now essentially imposes on exempt organizations compliance with policies that the IRS perceives as best practices, and that it acknowledges are not required by the Code.”); Hopkins Outline, supra note 6, at 8.

59 See ACT REPORT, supra note 6, at 4 (The authors of the Report attribute these claims to “[o]ur personal experience and research for this report . . .”).

is creating a "new law" with respect to board independence through its determinations process. The next Section examines these rulings.

The IRS has argued in speeches and in its governance initiative materials that it is not forcing any organization to adopt any specific governance practice—that one size does not fit all. The critics, on the other hand, have pointed to a number of recent rulings and cases to argue that the IRS has strongly urged organizations without any independent board members to expand their board to include some, and that the IRS has then denied exempt status to organizations that refused. The critics argue that the IRS practice, as represented in the adverse rulings and cases, is the real IRS policy, notwithstanding the IRS's express message of restraint. Therefore, we turn to those rulings and cases to discern the IRS's policy.


61 See supra note 60.

62 Federal law does require board independence in one very specific circumstance—for credit counseling organizations. See Pension Protection Act of 2006, Pub. L. No. 109-280, §1220(a), 120 Stat. 780, 1086; I.R.C. § 501(q)(1)(D) (West Supp. 2010); see also Determinations Outline, supra note 40, at 25-26 ("[A] majority (at least 51%) of the board members [of credit counseling organizations] must represent the broad interests of the public."). In addition, the IRS has for quite some time required the boards of non-profit hospitals to have some independent board members. See ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, IMPROVING THE EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM: A ROADMAP FOR GREATER COMPLIANCE 4 (2008), available at www.irs.gov/pub/irs-tege/tege_act_9177.pdf; Determinations Outline, supra note 40, at 26 ("The Service will not allow a tax-exempt hospital's board of directors to be dominated by the medical staff physicians."). These few specific situations are quite narrow, and are not not addressed in this Article.

63 See supra note 60.

64 It is very clear that attempting to draw conclusions from a small number of adverse rulings is a problematic method for many reasons. First, of course, the rulings may represent an outdated stage in the IRS's evolving policy. Second, the IRS may simply be applying its policy inconsistently, as the ACT REPORT suggests, since the IRS has determined that they may have to deal with governance practices ad hoc. ACT REPORT, supra note 6, at 3. Finally, and most importantly, without looking at favorable rulings as well, it is impossible to have any clear sense of the universe of fact patterns from which the IRS has drawn its denials. Without being able to compare organizations that have been approved, there is no way to know whether board independence was a determinative factor or not in any case. All we know is that there have been denials in which the IRS thought it relevant to discuss the board's lack
A. The IRS is Apparently Requiring Some Organizations to Have Independent Board Members

A review of the rulings and cases identified by the IRS's critics suggests that the IRS is—at least sometimes—urging some organizations to expand their governing boards. For example, in PLR 2008-28-029, the IRS expressed concern that the organization, whose purpose was to develop low-income housing, had a board of directors that had financial interests in the organization's activities. It said, "[w]e asked whether you were willing to expand your board so that it is more representative of the community that it serves . . . . You responded that you would add additional board members with no financial interest in your affairs within the first 12 months of closing your first acquisition." Likewise, in PLR 2005-35-029, a ruling about an organization that intended to run a faith-based addiction rehabilitation center, the IRS stated, "In Response [number one] of the above letter, you advise us that your governing board has been expanded with two new members." Presumably, this action was taken in response to requests by the IRS. In Exploratory Research, Inc. v. Commissioner, the court notes that the IRS "requested petitioner to alter its board of directors to include members unrelated to [the founder] 'to insure that . . . [the] organization will serve public interests.'" After the petitioner refused to alter its board, arguing that the law did not require it, the IRS "renewed his request that petitioner add members to its board of directors." Similarly, in Ohio Disability Ass'n. v. Commissioner, the court described a letter from the IRS to the organization asking "[w]hether petitioner would modify the board of directors to include unrelated individuals selected from the community the corporation will serve."

The rulings do not uniformly provide a legal justification for the IRS's request that an organization expand its governing board, but the IRS has provided a legal argument that an independent board is a pre-requisite for exemption—at least sometimes. For example, in a letter to a religious organization seeking exemption, the IRS stated its position plainly:

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations states that an organization which serves private interests rather than public purposes does not qualify for exempt status. To insure that your organization will serve public interests changes should be made to the bylaws whereby control is
INDEPENDENT STAKEHOLDERS

vested in a Board of Directors consisting of a majority of unrelated persons. Please provide the name, title, address and compensation of each newly appointed governing body member when responding to this letter.70

The IRS appears to be saying that it interprets Section 1.501(c)(3)-1(d)(1)(ii) of the Treasury Regulations to require that an organization—or at least this organization—have an independent board to ensure that the organization serve a public purpose rather than private interests. That is, the IRS is requiring the organization to have an independent board as a prophylactic against excessive private benefits.

I argue that the IRS’s argument is not plainly without merit. In fact, if the IRS acts within certain constraints, it may be within its authority to require certain organizations to have independent boards. The key is to identify sufficiently robust constraints to ensure that the IRS will only push for adoption of an independent board in appropriate situations.

B. The Argument that Board Composition is Legally Relevant

In order to understand the IRS’s policy regarding board independence, it is necessary to understand the basic legal argument about the relevance of an independent board. The existence or not of an independent board is relevant to an exemption determination because of the requirement under section 501(c)(3) that an exempt organization be “organized and operated” for certain purposes71 (so-called exempt purposes).72 This provision has been interpreted to mean that an organization is not exempt “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”73 That is, it is not exempt if it either does not primarily serve any exempt purpose or if it serves a non-exempt purpose in a substantial way. The fact that an organization must not only advance an exempt purpose, but cannot advance any other purpose too much is best expressed in Treasury Regulation §1.501(c)(3)-1(d)(ii):

An organization is [not exempt] unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.74

73 Id.
74 Id. § 1.501(c)(3)-1(d)(1)(ii) (emphasis added).
Thus, under the Regulations, an organization must establish not only that it affirmatively is organized and operated for a "public" purpose, but also that it is \textit{not} organized or operated substantially for a "private" purpose, or for the purpose of advancing "private" interests. In reviewing the organization's structure and operations, the ways in which "private interests" benefit or are likely to benefit from the organization is expressly relevant. Specifically, the interests of "the creator or his family" or "persons controlled" by the creator or his family are relevant.

The Regulations appear to require that the IRS make a difficult, fact-intensive determination—is the organization formed for a public purpose or is there a substantial private purpose? The determination is even more difficult because it presumably requires the IRS to \textit{predict} future behavior. The idea that the IRS is making a determination about the purpose of the organization implies that it is seeing into the organization's (founder's?) heart to determine what it plans to do in the future.

It is not a wholly unreasonable inference that an organization entirely controlled by "the creator or his family . . . or persons controlled . . . by such private interests" would be more easily used by those persons to advance their private interests than an organization \textit{not} controlled by such private interests. There are numerous cases denying or revoking tax exemption that have \textit{discussed} the fact that the board of directors of the organization entirely consisted of or was largely dominated by a single person or family.\textsuperscript{75} In the recent adverse determination letters cited by critics of the IRS governance initiative, the IRS has been citing these cases repeatedly.\textsuperscript{76} Thus, it is established law that the lack of an independent board may be \textit{relevant} to an IRS determination of whether an organization is organized for a substantial private purpose.\textsuperscript{77} Specifically, the dominance of the board by the organization's creator or his family may be evidence that the organization was created to advance a private purpose. Or, if the creator is inclined to use the organization for his private purposes, his dominance of the organization's governing board may make the advancement of such private purposes more likely or more easily accomplished.

On the other hand, many organizations engage in transactions with their founders. These transactions may be the best way for an organization to advance its charitable purposes (as when founders provide goods, services,
or capital to organizations at below-market rates). Congress expressly chose to permit such transactions when it drafted the prohibitions on excess benefit transactions (for public charities) and self-dealing (for private foundations), which prohibit certain transactions between organizations and their founders and permit others. 78 Obviously, the IRS's task—to predict which organizations will further a substantial private purpose and deny those organizations exemption—could not swallow up all organizations who engage in transactions with their founders. The IRS could not impose a per se rule that all organizations must have an independent board in order to be exempt under section 501(c)(3).

If it is true that the IRS may not have a per se rule against non-independent boards nor must it completely turn a blind eye to the composition of an organization's governing board, what can the IRS do under federal law? The IRS can do the following: If the IRS concludes that an organization has been formed for a substantial private purpose because of the likelihood of substantial financial dealings with the organization's founder, it could offer to the organization a way to have its exemption approved anyway by incorporating some independent board members. In other words, the IRS could offer the organization a means of assuring the IRS that the already identified substantial private interests will not dominate the organization. This proposed prophylactic measure could be the expansion of the board to include a sufficient number of independent directors to mitigate the founder's dominance. If the organization agrees, then the IRS's fears of excessive private purpose are allayed.

It appears from the rulings that—at least sometimes—this is in fact the IRS's position. 79 If the organization should be denied exempt status because of evidence that it has substantial private purposes, then it is not improper for the IRS to offer it a means to protect against that improper private purpose and to condition its tax exempt status on instituting some effective mechanism. In that sense, the IRS is fully within its authority if

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79 For example, in PLR 2008-43-032 (small church), the IRS states, "control has, and continues to be, an issue since application was initially filed. Despite repeated requests to expand control, any efforts made in responding to such requests have been superficial and ineffectual." I.R.S. Priv. Ltr. Rul. 2008-43-032 (Oct. 24, 2008). The same ruling continues: "your organization is under the control of a single individual, the Pastor and President. This issue has been raised repeatedly in information requests, to no avail." Id. In PLR 2008-28-029 (affordable housing organization), the IRS asked the organization to expand its board; the organization stated that it would in the near future, and the ruling stated, "no change in the composition of your board has been made to date." I.R.S. Priv. Ltr. Rul. 2008-28-029 (July 11, 2008). In PLR 2005-35-029 (spiritual rehabilitation organization), the organization expanded its board by two members, apparently in response to the IRS's request, and the IRS issued the organization an adverse determination ruling anyway. I.R.S. Priv. Ltr. Rul. 2005-35-029 (Sept. 2, 2005). Thus, it appears that the IRS is offering to organizations the opportunity to correct substantial private-purpose problems by expanding their boards.
it offers an organization that otherwise would fail to qualify as exempt a prophylactic measure that will save its exemption.\footnote{The Fishing Charity, discussed infra at Part III.B, should provide important counter-examples. In that case, the public purpose of the organization is clear and there is no evidence of a substantial private purpose. Thus, it would be improper for the IRS to attempt to require this organization to incorporate independent board members as a prophylactic against private benefit. The mere opportunity to advance a private benefit that is shared by all organizations is not sufficient to warrant IRS intervention into board governance matters. Congress has specifically chosen not to require any independent board members in general.}

It would be improper for the IRS to refuse to accept other effective prophylactic measures that the organization itself proposes. But it is not improper to suggest diversifying the board of directors. To the degree that the IRS is offering charities this option, they are within their proper authority.

However, if this approach is within the IRS’s authority, the question remains what means the IRS should use to identify those organizations that pose a sufficient threat of a substantial private purpose that it justifies denying exemption—absent the prophylactic adoption of an independent board—on account of that threat. It appears from the recent adverse determination letters that the IRS considers mere dominance of the board by non-independent directors an insufficient reason to be concerned about private benefit. Instead, it appears to consider four factors relevant.\footnote{This Article discusses the first three factors in Part III, infra, and the final factor in Part IV, infra.}

III. EVIDENCE OF THE IRS’S APPROACH FROM RECENT ADVERSE RULINGS: A PROPHYLACTIC APPROACH WHEN RISK OF SUBSTANTIAL PRIVATE INTERESTS SEEMS HIGH

While board composition may be relevant to the IRS’s determination that an organization is formed for a proper purpose, it is also well-accepted that under federal law there is no per se rule that a board may not be dominated by (or even consist exclusively of) an organization’s creator or his family.\footnote{See, e.g., Ohio Disability Ass’n v. Comm’r, 98 T.C.M. (CCH) 462, at *8 (2009) (“The Commissioner has ruled that an organization will not be denied tax-exempt status merely because the organization is controlled by one individual.”).} Both the IRS and the critics of the IRS’s governance initiatives have been very clear that no federal law requires organizations to have even one “independent” board member.\footnote{Some states require some number of “independent” board members. See Reiser, supra note 27, at 798 nn.12-13 (listing statutes requiring some board independence in Maine, New Hampshire, North Dakota, Vermont, and California).} So, how has the IRS been\footnote{See Brody & Tyler, supra note 4, at 577-78; see also Fishman, supra note 6, at 562-63, 570-72. There are certain limited exceptions. For example, under the Pension Protection Act of 2006, Congress mandated that an organization that provides “credit counseling services” and is exempt under section 501 of the Code must have a governing body that both}
determining which organizations create enough risk that they have been formed for a substantial private purpose to warrant a requirement that they expand their board to include independent directors?

A. Control by Creator or Founder

First, it appears from the adverse determination letters that the IRS is concerned with domination by the board of the creator or founder of the organization, not merely by directors who could be considered non-independent. Of the adverse determination letters reviewed, the vast majority involved organizations in which the governing board was composed exclusively of the founders or creators of the organization. No adverse determination letters involved control of the board by mere employees or other "non-independent" directors otherwise unconnected to the creation of the organization.

To understand the implications of this limitation, it is important to review the multiplicity of the operative definitions of an "independent" board member. For the purposes of this Article, an "independent" director is defined as anyone who has no financial interest in the charitable organization. But it was pointed out that the definition that the IRS has adopted for the purposes of its Form 990 was significantly narrower. In the for-profit sector, definitions of "independent" directors have commonly emphasized that these directors are not employees of the organization.

It appears that the IRS's definition for the purposes of its determinations function is narrower still. The IRS is really concerned with organizations that are completely dominated by their founders or creators. This interest

"is controlled by persons who represent the broad interests of the public," and which is not dominated by persons "who will benefit financially, directly or indirectly, from the organization's activities." Pension Protection Act of 2006, Pub. L. No. 109-280, § 1220, 120 Stat. 780, 1086 (2006) (codified at I.R.C. § 501(q)(1)(D)).


86 In other words, in its determinations rulings, the IRS is not concerned with the separation of oversight (in a board) and management (in employees). See Brody, supra note 58, at 669-70.

87 See supra note 8 and accompanying text.

88 See supra note 22 and accompanying text.

makes sense, given the explicit focus on “the creator or his family” in the
Regulations.90 They are not concerned with organizations that merely have
employees or other professionals as directors.

B. Substantial Ongoing Financial Transactions
   Between Founder and Organization

The adverse determination letters do not show an interest by the IRS
in all organizations in which the governing board is dominated by the
founders or creators, however. Rather, the letters generally concern only
organizations in which the founders/directors intend to engage in substantial
ongoing financial transactions with the organization. It makes perfect sense
that the IRS would not be overly concerned about organizations in which
a founder who dominated the governing board has no financial dealings
with the organization since a director who does not engage in financial
transactions with an organization is “independent” under all the operative
definitions. The quintessential trait of a “non-independent” director is
that she engages in financial transactions with, or has a financial interest in,
the organization.

To illustrate this issue, imagine a hypothetical organization called the
“Fishing Charity.” The founder of the Fishing Charity has an idiosyncratic—
perhaps even misguided—vision of the public good. He has taken the old
adage—teach a man to fish, and you feed him for life—and has decided that the
best way to eradicate poverty is to give the poor fishing rods. The founder
plans to distribute fishing rods in poor neighborhoods free of charge and
hold free basic classes teaching fishing techniques. He has never found
anyone other than himself who believes that literally teaching the poor to
fish will eradicate poverty, and so he has trouble finding people to serve
on his board, but his vision is unshaken. He chooses to create a charitable
organization entirely controlled by him. Perhaps he is required under state
law to have more than one director,91 so he persuades his wife, or even his
wife and son, to join him on the board, which they do out of love for him.
He and his other family members do not gain anything material from the
distribution of fishing rods. He is not in the business of selling them or
of selling anything else connected with fishing. He holds no copyright
in his fishing training materials and does not have any commercial tie to
the fishing classes his organization provides. Under the Fishing Charity’s
organizational documents, he and his family are prohibited outright from
engaging in any financial transactions with the Charity, and the evidence
suggests that they never have done so.

The Fishing Charity should easily satisfy the “organizational” and the “operational” tests. It has a substantial exempt or public purpose: the eradication of poverty. It also does not have any substantial private purpose, or at least none has been identified. While the Regulations caution against organizations created to advance the “private interests” of “the creator or his family,” it is clear that an idiosyncratic vision of how to advance the public good is not a “private interest.” Rather, “private interests” of concern are likely to be financial. Thus, under the facts provided, it seems clear that the Fishing Charity should be tax-exempt under section 501(c)(3) of the Code.

But now imagine an organization in which the governing board was financially interested in the organization and therefore not “independent.” For example, imagine a permutation of the Fishing Charity in which the founder was in the fishing rod fabrication business. For a hundred years, his family has owned a company that makes and sells fishing rods and tackle. His plan is for his Charity to seek contributions from the general public, and then use the money to purchase fishing equipment at market price (or slightly discounted price) from his company, which the Charity would then provide free of charge to the poor. Let’s call this organization the Corporate Fishing Charity because it has a tie-in to his family business. Because the organization plans to purchase fishing equipment from the founder’s business, he is an “interested” director under our broad definition.

It seems clear that the IRS’s concern—whether the organization is truly formed for a public purpose or instead formed for the benefit of private interests—is more clearly implicated in the case of the Corporate Fishing Charity than in the Fishing Charity. The plan to engage regularly in transactions with a company owned by board members intuitively seems to create a risk of advancing private interests in a way that mere control by founders does not. But it is not immediately clear whether or when—if ever—this apparent risk should translate into a denial of exemption or other action by the IRS.

92 There are cases in which courts have held that a substantial private interest may be non-financial and still disqualify the organization for exemption. See, e.g., Am. Campaign Acad. v. Comm’r, 92 T.C. 1053, 1072 (1989) (organization training political operatives provides a substantial private benefit to the Republican Party); see also Founding Church of Scientology v. United States, 412 F.2d 1197, 1201 (Ct. Cl. 1969) (organization provides both financial and other benefits to its founder). But I know of no case that has held that a merely personal or idiosyncratic (or misguided) vision of the means to attain a clearly public purpose constitutes a “private interest.”

93 Of course, in order to qualify as exempt under section 501(c)(3), the Charity must also meet the other requirements of that section. For example, it must ensure that “no substantial part of its activities (consist of) carrying on propaganda, or otherwise attempting, to influence legislation” and that it “does not participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office.” I.R.C. § 501(c)(3) (2006).
It is worth pointing out that there are two potential concerns of the IRS when reviewing an exemption application from an organization like the Corporate Fishing Charity. First, it may be concerned that the organization will engage in excess benefit transactions. Since we know that the organization is going to buy fishing rods to supply to the poor and the founder of the Charity is in the business of selling fishing rods, we may be concerned that he will cause the charity to purchase fishing rods at inflated prices, providing him with a direct financial benefit. This may happen even if the fishing rods are sold at their list price, if, for example, the Charity purchases fishing rods at full price that would otherwise have to be sold at sale or discounted prices. Presumably, demand for a specific type of fishing rod will not perfectly match supply all the time, and it may be in a business's commercial interest to have a ready market for its over-produced models. But the concern here is not just that the organization will purchase products from the founder's company. The concern here is that the organization will pay too much for the fishing equipment and thereby waste the Charity's assets.

Second, the IRS may be concerned not (only) with excess benefit transactions but with the fact that the organization is serving a substantial private interest, even if all of the transactions are completely reasonable. Imagine that the Corporate Fishing Charity acquires all of its rods from the founder's company at the true fair market value, not just the "list price." Or, perhaps it even acquires them at below the true fair market value. So long as the company provides them at more than cost, one could argue that there is a commercial benefit in that a profit is made on the sale of each rod, and that commercial benefit may be the real motivation for creating the Charity. Even if the company provides the fishing rods at below cost, there may be a commercial benefit. For example, the company may be creating a new market for the future purchase of more expensive rods by providing them for free to people previously uninterested in fishing. Companies often give products away hoping to build interest in their products in this way. Or, they may be providing themselves with good publicity, building goodwill, or free advertising for their products. Thus, the private interest may theoretically dominate even if no excess benefit transactions will occur.

This second potential concern of the IRS is more controversial.

As discussed above, dominance of an organization by the creator(s) or founder(s) of an organization are of potential concern to the IRS, but only if there is some significant opportunity for them to advance private financial interests. Thus, the broad definition of independence—not having any financial interest in the organization—is relevant to IRS determinations since dominance by independent directors raises few questions regarding

95 See, e.g., Am. Campaign Acad., 92 T.C. at 1068-69, 1072.
INDEPENDENT STAKEHOLDERS

the public purpose of the organization, even if the organization is dominated by its creator(s) or founder(s). On the other hand, when an organization is dominated by founders who are simultaneously “non-independent” (in the sense that they engage in financial transactions with the organization), the IRS may have some cause for concern.

The only example of an adverse determination issued to an organization that was dominated by a founder with no financial interest in the organization is PLR 2007-37-044. That ruling dealt with an organization created by a man primarily to distribute his own sperm free of charge to women seeking to use it to become impregnated. The IRS determined that eighty-eight percent of the sperm had been donated by the founder, and that the remaining twelve percent was donated by only two other donors. Furthermore, the organization screened and selected recipients of the donated sperm but did not apparently make the case that it did so on any charitable criteria. In addition, the ruling notes that all of the organization’s funding came from donations by the founder. Finally, the organization’s governing body consisted solely of the founder and his father, who were both the only “trustees” and the only officers. The IRS held that the organization did not meet the requirements for an exempt organization under section 501(c)(3) of the Code.

It is worth noting that the IRS did not identify any financial transactions between the organization and its founder/directors (except cash contributions). There was no evidence that the directors intended to compensate themselves either as employees, private contractors, or directors. Nor did the ruling mention any evidence that the creators of the organization planned to engage in any other financial transactions with the organization. In other words, the directors of the organization would qualify as “independent” under either the Form 990 definition or our broader definition. Nonetheless, the IRS expressly noted the small number of directors and their relationship to each other, to the sperm donors, and to the financial donors several times. The IRS clearly noted that the dominance of the board by the founder and his father were material facts in the denial of exemption for the organization.

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96 I.R.S. Priv. Ltr. Rul. 2007-37-044 (Sept. 14, 2007); see also I.R.S. Priv. Ltr. Rul. 2007-36-037 (Sept. 7, 2007) (operating under the exact same facts). These rulings were affirmed in Free Fertility Found. v. Comm’r, 135 T.C. 2, at *3-4 (2010), although the court did not mention the governance issues discussed herein.


98 Id.

99 Id.

100 Id.

101 Id.
The ruling separated its “rationale” into two subheadings: “Serving a Public Interest” and “Private Benefit.”\textsuperscript{102} It held that providing sperm for free is not inherently a public purpose and distinguished the sperm donation activities from a 1966 revenue ruling holding that blood donation services were a proper public purpose.\textsuperscript{103} It listed three facts that distinguished the sperm donation activities from the blood donation ruling: (1) the composition of the respective organizations’ boards;\textsuperscript{104} (2) the number of donors of sperm (three) as opposed to the number of donors of blood (presumably many);\textsuperscript{105} and (3) the fact that the women who received the sperm for free were not “needy” in any economic sense, while some of the women who received blood were.\textsuperscript{106} Without explaining which distinguishing characteristics were material, the IRS argued that the sperm donation organization did not advance a proper “public” purpose.\textsuperscript{107}

The second subheading, “Private Benefit,” included only one claim supporting the argument that the organization was created for a substantial private purpose. It relied entirely on the domination of the board by “your founder, your sole financial donor, your principal sperm donor, one of two related trustees and one of two related officers.”\textsuperscript{108} In the next section, the ruling concluded that the organization is not exempt because it advances a private interest.\textsuperscript{109}

This ruling seems at first reading to support the claim that the IRS will deny tax-exempt status to organizations dominated by the founder even if there is no evidence that the founder intends to benefit financially from the organization. It appears more likely, however, that despite the explanation in the ruling, the IRS is not taking the position that the mere dominance of the organization by its founder disqualifies the organization for exemption. Rather, it is probable that the fact that the organization was (arguably) created for a substantial private purpose, even if not a financial

\textsuperscript{102} Id.
\textsuperscript{103} Id.
\textsuperscript{104} Id. The IRS distinguished between the sperm donation organization at issue and a blood donation organization held to be exempt by commenting that “your Board of Directors consists of only two individuals,... who are father and son, respectively.” Id. The IRS further commented that “[i]t is . . . significant that [a single person] is your founder, your sole financial donor, and your principal sperm donor.” Id.
\textsuperscript{105} Id.
\textsuperscript{106} Id. If this is indeed the IRS’s argument, it is not completely clear that it is right as a matter of law. Providing sperm to women who need it to have a baby does seem to further the recognized charitable goal of “advancing health” and should be a sufficient public purpose. Similarly, if the sperm is provided for free to all recipients, it is by definition provided for free to those who are economically needy. There is no requirement that a product necessary for health be provided for a charge to those who can afford it.
\textsuperscript{107} Id.
\textsuperscript{108} Id.
\textsuperscript{109} Id.
one, is what disqualified the organization for exemption. It would be easy enough to fill in an explanation for why a sperm-donation organization like the one described was created to advance the private purposes of its founder. It is generally accepted that a person has a “private” interest in his offspring, and even in producing offspring. It is plausible that the organization was formed to advance the private interest of increasing the quantity (or quality) of the donor’s offspring who carry his genetic material. If that is the real purpose of the organization, then the IRS is well within the current law to deny such an organization exempt status—even though the founder/controlling director was “independent” in the sense of free from any financial interest in the organization—notwithstanding the fact that it did not plainly explain the likely private purpose in the ruling. But this private purpose—disseminating genetic material—is unusual. Most often the private interest that causes concern is a financial interest, and thus, most often the IRS will be interested only in domination by founders with a financial interest in the organization.

Generally, the organizations that were denied exemption intended to engage in significant ongoing financial transactions with their founders. For example, PLR 2009-16-035 involved an organization formed by a group of cousins to promote the legacy of a historical person who was their aunt. The organization described potential activities, like constructing and operating a museum and giving scholarships, which would constitute a public purpose if performed. But the IRS expressed concern that the primary activity of the organization would be to operate a “family website” that would sell memorabilia related to the aunt, and which was operated as a for-profit LLC. There is no information about whether the for-profit LLC was wholly owned by the organization, or whether it was a joint-venture with other private owners. In addition, the organization reported that a significant activity would be for the organization to purchase, from members of the organization [all of whom were cousins], at fair market value, items such as ‘designs, artwork, logos, poetry, [and] sheet music.’

If the organization actually did the things it proposed to do to promote the legacy of the founders’ aunt, those things would likely be evidence of a proper exempt purpose. But the operation of the website created a

110 See, e.g., Richard Dawkins, The Selfish Gene II (30th Anniversary ed. 2006) arguing, generally, that organisms act to advance the interests of their genes, not themselves personally, and therefore are “selfish” when they act to advance the interests of their offspring, even to their own personal detriment).
111 See supra note 85.
113 Id.
114 Id.
115 Id.
financial interest in the directors of the organization. Here, the IRS could be concerned that the organization would pay the cousins too much for their artwork and poetry. Overpaying insiders—engaging in excess benefit transactions—would clearly constitute a “private purpose” substantial enough to negate the public purposes of the organization. The problem, from the government’s point of view, is whether the evidence supports an inference that the organization is likely to overpay in the transactions it will conduct.

In addition, there is an argument that the organization was created to advance a private interest even if the artists and poets were paid only fair market value for their works. The argument would be that if the true dominant purpose (or a true substantial purpose) of the organization is to provide a market for the artistic output of the founder/directors or their relatives, then this private purpose negates the organization’s public purpose even if the transactions are all at fair market value.

In either case, the IRS may pay special attention to potential insider transactions and the safeguards that the organization takes to prevent them from being abused. In fact, the majority of the ruling was devoted to a discussion of the dominance of the board by the founder. The IRS found substantial proposed financial transactions between the directors and the organization. The organization failed to provide information about how it would protect against domination of these financial purposes, and how it would protect against excess benefit transactions when conducting business with board members.

Finally, one ruling that should not be controversial is PLR 2008-45-053. In that case, an organization seeking to “promote and finance research, prototype design and commercialization of Pollution Free Energy” was created as a “stock corporation,” with the founders individually owning the stock. Here, the ruling discussed the commerciality of the organization as well as the lack of an independent board. The ruling should have been a single sentence denying exemption because the organization was neither organized as a nonprofit organization nor as a business corporation prohibited from paying dividends to its owners and whose assets are

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116 Id. In this example, it should be pointed out that the evidence of regular financial transactions between the organization and its board members would disqualify those board members for “independent” status under the broad definition; but because none of the board members were likely to be paid as employees or independent contractors, they probably would qualify as “independent” under the definition provided in Form 990. See discussion supra Part I.B.


118 Id.


120 Id.

121 Id.
distributed to charity upon dissolution. Organizing a charity as a business corporation with private shareholders under state law is generally a per se violation of the prohibition on private inurement. Nonetheless, in addition to its discussion of private inurement arising out of potential dividends, the IRS discussed the fact that the board is controlled by three persons, and therefore could be operated for their private benefit. This organization was dominated by its founders, and its founders were empowered to have an ongoing financial relationship with the organization since they could presumably receive dividends or distributed profits from it. It obviously fit the profile for an organization that would arouse the IRS’s concern.

In each of the cases discussed, the IRS identified organizations in which the governing board was dominated by the organization’s founders and in which those founders intended to engage in ongoing financial transactions with the organization. In these situations, the IRS may require some assurance that the organizations will not provide excessive private benefits to their founders. It can accept an independent board—or some independent board members—as a sufficient form of assurance. If the organization refuses to take any prophylactic measures, the IRS is presumably within its authority to deny the organization tax exemption.

C. IRS “Hands-Off” Policy Toward Private Foundations

The third factor that the IRS appears to be applying to determine whether an organization should be required to have an independent board is whether the organization is a “public charity” or a “private foundation.” The IRS has expressed a clear policy of refraining from encouraging or requiring so-called private foundations to have independent governing boards.

Section 501(c)(3) organizations are classified under section 509 of the Code as either private foundations or not (hereinafter, “public charities”). While private foundations are treated differently from public charities in several ways, one notable difference is how transactions between the organization and its directors or other insiders are regulated. Public charities are subject to a penalty regime that applies to transactions between the organization and its directors (and certain other insiders), but this regime generally permits transactions unless they are unfair to the organization. Transactions between private foundations and certain insiders are subject

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122 See Treas. Reg. § 1.501(c)(3)-1(b)(4) (2008) (“[A]n organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.”).


to a more restrictive penalty regime. This regime completely prohibits certain insider transactions and requires additional reporting of other transactions.

Under federal law, private foundation status can be avoided in several ways. Section 509 of the Code provides that a 501(c)(3) organization is a private foundation unless it meets one of the statutory exceptions: (1) that the organization is a church, (2) that the organization is a school, (3) that the organization is a hospital, (4) that the organization is a governmental unit, (5) that the organization is a so-called supporting organization, or (6) that the organization meets one of several "public support" tests.

The most basic way to avoid being classified as a private foundation is to meet one of the public support tests. In general, to qualify for public charity status under the public support tests, an organization needs to receive a significant portion of its financial support from donations from multiple donors, the government, or proceeds from the operation of its charitable activities. In other words, it needs to have a relatively broad base of donors or purchasers of services. This broad base of donors constitutes a class of quintessential independent stakeholders. The existence of these donors/ stakeholders is believed to provide a check on the organization's ability to advance merely private interests. The theory is that the organization could not raise money from multiple independent donors unless it served a public interest and did not serve a substantial private interest.

To illustrate the distinction between private foundations and public charities, imagine the Fishing Charity described previously. Recall that we initially created the hypothetical on the assumption that the idea of a charity to distribute fishing equipment to the poor was so idiosyncratic that its founder could not find any volunteers to serve on the Charity's board of directors. If it also could not find a sufficient number of unrelated

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125 See id. §§ 4940-4945.
126 See id. § 4941.
128 Id.
129 See, e.g., Johnny Rex Buckles, Should the Private Foundation Excise Tax on Failure to Distribute Income Generally Apply to "Private Foundation Substitutes"? Evaluating the Taxation of Various Models of Charitable Entities, 44 NEW ENG. L. REV. 493, 511-12 (2010) (The assumptions that plausibly underlie the minimal regulation of public charities include “that the members of the governing board can be trusted to exercise their fiduciary duties in such a way that further regulation ... through tax law is unnecessary. ... The most plausible basis for the assumption is the predicate assumption that the charity's reliance on support from the general public obviates the need for the tax system to restrict or otherwise regulate distributions beyond the most basic requirements for tax exemption. ... The premise also implies that the entity's reliance on support from the general public obviates the need for the tax system to regulate the composition of the [charity's] governing board.”); see also JOHN D. COLOMBO & MARK A. HALL, THE CHARITABLE TAX EXEMPTION 163-64 (1995) (discussing the logic in more detail).
130 See supra Part III.B.
131 See supra Part III.B.
donors to support the activities of the organization with contributions, it would likely fail the various public support tests and would therefore be classified as a private foundation rather than a public charity. In that case, we could call the organization the Fishing Foundation instead of the Fishing Charity. Likewise, if the so-called Corporate Fishing Charity (which used donated funds to purchase fishing equipment from the founder’s company) could not find sufficient unrelated donors, it too would be classified as a private foundation, and so we would call it the Corporate Fishing Foundation. On the other hand, if either of these organizations could convince other unrelated persons to donate a substantial portion of the funds necessary to operate the organization, it would be classified as a public charity.

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In its determinations training materials, the IRS expressly recognized that private foundations often have governing boards dominated by their founder or the founder’s family. The existence of stricter rules against self-dealing means that “the composition of a private foundation governing board is not a concern during the determinations process.”

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132 See supra note 127 and accompanying text (discussing that companies that fail to meet the various “public support tests” will be deemed private foundations under section 509 of the Code).

133 The Fishing Charity could also avoid private foundation status if it were a school, church, a hospital, a governmental unit, or a supporting organization, but we are assuming it would not meet the criteria of any of those types of organizations.

134 See Determinations Outline supra note 40, at 24 (“Due to its nature, it is typical for a private foundation to have a related board. ... Due to [the existence of more stringent rules on self-dealing by foundations, among others] the composition of a private foundation governing board is not a concern during the determination process.”).

135 Id.; see INDEPENDENT SECTOR, supra note 8, at 75 (explaining that private foundation
The IRS explains its position on private foundations as follows:

The federal law governing the operations of private foundations is a composite of rules pertaining to self-dealing, mandatory payout requirements, business holdings, investment practices, various types of expenditures, and more. Due to these rules, the composition of a private foundation governing board is not a concern during the determination process.136

In other words, private foundations by their very nature lack independent stakeholders. Because of their lack of independent stakeholders, they also present a natural opportunity for excessive private benefits. Nevertheless, Congress has made a decision to permit them to be tax-exempt. Special statutory requirements have been used, instead, to control foundations more closely and prevent them from being used too extensively for private ends.

Thus, according to the IRS determinations training materials at least, the fact that the board of the Corporate Fishing Foundation, for example, is completely dominated by its founder should not be an impediment to its tax-exempt status, and determinations agents should not flag that dominance as a problem or urge the Foundation to add independent members to its governing board.

There's a certain irony to this, of course. We discussed above that the IRS may well be concerned about the board of the Corporate Fishing Foundation: it provides an opportunity for the founders who completely control the board to enrich themselves. But, according to the IRS determinations materials, the IRS should not be concerned about a private foundation that has a "related" board. The presumption is that the stricter self-dealing rules for private foundations should deal with the situation sufficiently. In the case of the Corporate Fishing Foundation—at least as we’ve described the hypothetical facts—this presumption appears to be accurate. Under section 4941(d)(1)(c) of the Code, disqualified persons (including “substantial contributors”) are prohibited from providing goods and services to a private foundation for a charge, even if that charge is commercially reasonable.137 In other words, the Code would prevent the founder of the Corporate Fishing Foundation from selling fishing equipment to the Foundation even at reasonable prices. Thus, the excise tax regime that applies to private foundations prohibits the type of transaction

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136 Determinations Outline, supra note 40, at 24.
137 See I.R.C. § 4941(d)(2)(C) (West Supp. 2010) If the goods were provided “without charge” the transaction would be permitted, but not if any charge is made, even if it is a below market charge.
INDEPENDENT STAKEHOLDERS

The IRS's claim that board independence is not required in the case of a private foundation because of the stricter excise tax that applies to foundations seems to be borne out in this case. If the Corporate Fishing Foundation, in effect, is prohibited outright from operating as described, then there is presumably no need for such an organization to have an independent board.

However, changing the facts only slightly significantly undermines the argument that the private foundation excise tax regime is adequate to protect against excess private benefit by the founders of the organization. Imagine that instead of purchasing fishing equipment from the founder's company, the Corporate Fishing Foundation hired the founder as an advisor—on fishing, for example, or the benefits of fishing for the poor—paying him substantial compensation in that role. Nothing in the law would prevent the organization from paying the founder reasonable compensation whether the organization was a private foundation or a public charity. Thus, in the case of compensation, an independent board may be as necessary for a private foundation as for a public charity.

The adverse determination letters tell a somewhat mixed story. On the one hand, there are several adverse determination letters in which the IRS has focused on board independence issues and denied tax exempt status to organizations that apparently should have been classified as private foundations. But these adverse determination letters by no means suggest that the IRS is predominantly disregarding its own policy of ignoring board independence issues in private foundations. None of them involve normal private foundations in which a family creates a charity.

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138 If the facts were slightly different, however, and instead of buying fishing equipment from the founder's company, the Corporate Fishing Foundation paid the founder a salary for providing expert consulting services about the link between fishing and prosperity, the self-dealing rules under section 4941 of the Code would permit the transaction so long as the services provided were "reasonable and necessary to carrying out the exempt purpose of the private foundation" and "the compensation . . . [was] not excessive." § 4941(d)(2)(E).

139 See id.

140 For example, the sperm donor organization described in PLR 2007-37-044 should have been classified as a private foundation since it received all its financial support from one source. See I.R.S. Priv. Ltr. Rul. 2007-37-044 (Sept. 14, 2007). The "churches" in PLR 2008-43-032 and PLR 2008-30-028 should have been classified as private foundations if they failed to meet the criteria for church status. See I.R.S. Priv. Ltr. Rul. 2008-43-032 (Oct. 24, 2008); I.R.S. Priv. Ltr. Rul. 2008-30-028 (July 25, 2008). The most poignant example is the Ohio Disability Association, which apparently responded to a request from the IRS to modify its "board of directors to include unrelated individuals selected from the community the corporation will serve" by replying that it would not do so, and "provid[ing] an amended application designating [the organization] as a nonoperating private foundation." Ohio Disability Ass'n v. Comm'r, 98 T.C.M. (CCH) 462, at *2 (2009). In other words, the organization asked to be classified as a private foundation, presumably to avoid the IRS's requirement that it expand its board to include independent members. The court's opinion does not include any information about whether the IRS responded to the request, but it upheld the IRS's adverse determination.
that will receive family contributions and distribute them to charitable beneficiaries over time.

The adverse determination letters on the whole suggest that the IRS is indeed leaving private foundations alone. In general, it appears that they are not encouraging or requiring private foundations to have any independent board members. There is not one adverse determination letter in which the IRS recognized that the organization under scrutiny should be classified as a private foundation but denied it exempt status on account of having no independent board members.

The discussion above has suggested that the rulings can tell us a few things about the IRS's view of the relationship between the domination of boards by "inside directors" and exemption. First, no organization was denied exemption merely because it included paid employees on its board of directors, or even because its board was dominated or controlled by employees. That is, the IRS is not attempting to implement a rule that exempt organizations must have "independent" boards of directors, in the sense that term is given in Form 990 and in most of the discussion of board independence in the for-profit context—directors who are not part of the professional management of the company. The IRS appears to be concerned only with the domination of the governing board by the organization's founders or creators. Second, the IRS is suspicious of organizations with boards of directors entirely dominated by their founders, but only when those founders have a strong private interest that might be advanced by the organization. That private interest may be non-financial, but that is unusual—the only case in the rulings is the sperm donation organization in which the private interest was arguably the propagation of a single man's genetic material. More common are situations in which the organization is premised on ongoing financial relationships with the founder(s)/controlling director(s) of the organization. In these cases, the IRS has held (at least at times) that these private purposes are substantial enough to call into question whether they are the real purposes of the organization, thus negating the purported public purpose and properly calling the organization's tax exempt status into question under Treasury Regulation 1.501(c)(3)-1(d)(ii). Third, in general, the IRS has been taking a "hands-off" approach to private foundations. While there are a few

141 It is worth reiterating that our method—reviewing adverse determination letters—means that we have no information about whether and how often the IRS "persuaded" organizations to expand their boards of directors in situations in which a favorable determination was eventually obtained. Thus, it is possible that the IRS has been regularly (or occasionally) urging organizations with "insider" boards to expand their boards even in the absence of substantial private purpose problems. We just do not see the evidence of that in the adverse determination rulings we have reviewed.

142 See, e.g., Reiser, supra note 27.

possible exceptions to the rule, the IRS’s approach has generally been to permit private foundations to have boards of directors that are entirely dominated by the founders and that intend to continue to engage in financial transactions with the boards, so long as those financial transactions are permitted under the self-dealing rules that apply to private foundations.

These three restrictions significantly narrow the field of organizations that are subject to the IRS’s rule about independent directors. But, the adverse determination letters suggest that another factor may also be important. The IRS appears to be targeting only organizations that meet the three criteria described above and that do not have any meaningful “independent stakeholders.”

IV. LACK OF INDEPENDENT STAKEHOLDERS

While the adverse rulings discussed herein suggest that the IRS does not require charities to have an independent board unless they meet the three criteria described above, it is not clear that these three criteria are robust enough to provide an effective check on IRS discretion in this area. Once the IRS has identified organizations that (i) have governing boards dominated by their founders, (ii) intend to engage in ongoing financial transactions with those founders, and (iii) are not private foundations, how does it identify those in which the risk of substantial private purpose is so high that exemption should be denied unless the organization adopts procedural safeguards, of which an “independent” board of directors may be the most obvious?

While the IRS rulings do not provide a completely satisfactory answer to this question, they do suggest another factor that appears to be extremely important to the IRS in identifying those organizations in which the risk of substantial private purpose is highest. Namely, each organization discussed in the adverse rulings had no identifiable independent stakeholders that were in a position to monitor the activities of the organization and influence its public purpose. None of the rulings expressly identify this characteristic as important, but it appears that it may be important to the IRS’s evaluation of whether it should press the organization to have an independent board. Thus, an evaluation of independent stakeholders may already be providing a check on the IRS’s discretion in this area; but it could serve as a more effective check if the IRS explicitly stated that independent boards (or other checks on the risk of dominance by private interests) are only necessary when an organization lacks any meaningful independent stakeholders.

First, an explanation: I use the term “independent stakeholders” as a way of identifying people who have an interest in an organization’s
activities other than the organization itself or the government. Possible independent stakeholders include donors, members, beneficiaries, volunteers, purchasers of goods or services, and others. In an unpublished work-in-progress, I explore the importance of independent stakeholders to the government's evaluation of whether an organization is worthy of tax-exempt status; or more specifically, whether it should qualify to receive tax-deductible contributions. That piece explores the so-called agency-cost literature about nonprofit organizations. It argues that one of the purposes of the federal law of charities is to enable the federal government to minimize its own "agency costs" by identifying meaningful independent stakeholders who can help monitor charitable organizations, in effect, on the government's behalf. The key for the government in identifying meaningful independent stakeholders is identifying those persons whose interest in the charity are the most aligned with the government's interest. The simplest (although obviously imperfect) way to identify aligned interests is to exclude persons who have a financial interest in the charity. The government acts rationally if it only permits tax-deductible contributions to go to organizations that have meaningful independent stakeholders. Thus, to the degree they exert influence over an organization, independent stakeholders advance the government's interests when they advance their own interests. Viewed in this way, "independent" board members are just one category of potential independent stakeholders.

A. Relevance of Independent Stakeholders Under Federal Law

Despite the fact that it would be rational for the government to restrict tax-deductible contributions to only those organizations that have independent stakeholders, that is not the way federal law generally works. The qualifications for exemption under federal law do not require an organization to have any identifiable independent stakeholders. Although independent stakeholders are not generally required as a precondition of exemption, the concept of independent stakeholders is deeply embedded in federal law, specifically in the distinction between private foundations and public charities.

144 A more systematic analysis of the relationship between third-party stakeholders and charitable organizations under federal law is attempted in Benjamin M. Leff, The Case Against For-Profit Charity: An Agency Cost Analysis (July 21, 2010) (unpublished manuscript) (preliminary draft on file with the author).

145 Id.


147 Leff, supra note 144.

148 See I.R.C. § 509(a) (West Supp. 2010).
Thus, the existence of independent stakeholders, especially donors, is relevant to a determination of whether an organization is a private foundation or a public charity under federal law. But it is not generally relevant to the initial determination of whether an organization is tax-exempt.\footnote{In general, the determination of whether the organization is a private foundation or a public charity has nothing to do with the composition of its governing board. There is one limited exception to this rule. Under the so-called facts and circumstances test, which is only applied if an organization cannot meet the other public support tests, one relevant fact is whether the organization has a “representative governing body” or not. Treas. Reg. § 1.170A-9(e)(3)(v) (2008). If the organization’s governing body is composed of various types of persons, including “public officials; . . . persons having special knowledge or expertise in the particular field or discipline in which the organization is operating; . . . clergymen, educators, civic leaders, [and others]” then that weighs in favor of granting the organization public charity status. \textit{Id.}}

How, then, is the IRS using the existence of independent stakeholders in its analysis of an organization’s initial qualifications for exempt status?

\subsection*{B. IRS Treatment of Organizations Without Meaningful Independent Stakeholders}

The rulings seem to suggest that the IRS is taking an acute interest in the determinations phase in the existence of independent stakeholders when organizations are dominated by their founders and when those founders have the potential to profit financially from the operation of the organization. The absence of meaningful independent stakeholders—especially donors—appears to be significant to the IRS’s evaluation of whether an organization qualifies for exemption or not. Specifically, none of the adverse rulings appear to describe organizations that have multiple donors of money, such that the organization would avoid private foundation status on account of voluntary contributions alone. In general, then, it appears that organizations that successfully raise money from multiple donors are not denied exemption on account of being dominated by founders or insiders.\footnote{It is worth reiterating here the weaknesses in our method and the impossibility of making any confident claims about the IRS’s intentions from adverse determination letters alone. \textit{See supra} note 64.} This observation is extremely important. If the field of organization subject to the IRS’s “independent-board” requirement excludes both organizations that are private foundations and organizations that avoid private foundation status because of multiple donors, then it is a much narrower category than it might initially appear to be.

The rulings not only exclude organizations with multiple independent donors, they also discuss at length the importance of the absent independent stakeholders, even when that factor should not technically be relevant to an initial determination of tax-exempt status. For example, the lack of independent stakeholders was material to the IRS’s determination in
PLR 2007-37-044, the sperm donation case discussed above. There, the IRS pointed out that all of the organization's funds were provided by a single donor. Therefore, the organization had no independent donors of funds to serve as independent stakeholders. While the recipients of the sperm could conceivably count as independent stakeholders, they are unlikely to be in a position to monitor the organization very effectively or cause change. After all, their only connection to the organization may be receiving something of value from it for free. Thus, their interest in the proper functioning of the organization may be narrow.

The IRS was also very interested in the existence of independent stakeholders in several of the rulings that involved organizations that purported to be "churches." An organization is tax exempt under section 501(c)(3) if it advances religious purposes. If it is a "church" (really a house of worship in any faith), it can avoid private foundation status on that account. Thus, an exempt religious organization avoids private foundation status by being a church, but whether it is a church or not should not be relevant to whether it qualifies as tax-exempt in the first place.

What constitutes a church is somewhat contested, but it is clear that one foundational attribute of a church is that it has members who meet together regularly to worship—a congregation. A church whose congregation consists solely of a single family is unlikely to be considered a church by the IRS. The existence of a congregation is another form of independent

152 Id. ("[Y]ou are controlled by one individual, M, who is your founder, your sole financial donor, your principal sperm donor, one of two related trustees, and one of two related officers. Thus, taking into account your structure, governance and operations, your activities result in the provision of more than an incidental level of private benefit to M and his family. Therefore, you violate the prohibition in section 1.501(c)(3)-1(d)(1)(ii) of the regulations against impermissible private benefit.").
154 See I.R.C. § 170(b)(1)(A)(i) (West Supp. 2010). One recent example of an organization that the IRS refused to classify as a church, but was exempt nonetheless as a religious organization, is the Foundation of Human Understanding whose negative determination of church status was recently upheld by the Court of Appeals for the Federal Circuit. See Found. of Human Understanding v. United States, 614 F.3d 1383 (Fed. Cir. 2010).
155 See Found. Human Understanding, 614 F.3d at 1390; see also Am. Guidance Found., Inc. v. United States, 490 F. Supp. 304, 306 (D.D.C. 1980) ("At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship.").
156 Found. of Human Understanding v. United States, 88 Fed. Cl. 203, 221-22 (2009), aff'd, 614 F.3d 1383 (Fed. Cir. 2010); see Am. Guidance, 490 F. Supp. at 307 (A family worshiping together is "engaged in a quintessentially private religious enterprise" and therefore is not a church.); Richardson v. Comm't, 70 T.C.M. (CCH) 14, at *4 (1995) ("A church cannot, for federal income tax purposes, consist of just one individual."); Church of Eternal Life and Liberty, Inc. v. Comm't, 86 T.C. 916, 927-28 (1986) (holding that a two-person congregation that makes no effort to expand its size is too small); Church of the Visible Intelligence that Governs the Universe v. United States (Church of the Visible Intelligence), 4 Cl. Ct. 55, 65 (1983) ("If membership does not extend beyond [the founder's] immediate family, it would appear
stakeholders that can take the place of multiple donors in providing some protection against excessive private benefit by organizational insiders.\textsuperscript{157} 

PLR 2008-30-028\textsuperscript{158} and PLR 2008-43-032\textsuperscript{159} involve denials of exempt status for organizations describing themselves as churches.\textsuperscript{160} In PLR 2008-30-028, the IRS determined that an organization that described itself as "operate[d] for the advancement of Christianity and for other charitable purposes" was not exempt under section 501(c)(3) of the Code and was not a "church" under section 170(b)(1)(A)(i) of the Code.\textsuperscript{161} In holding that the organization was not a church, the IRS stated, 

[y]ou lack all of the significant elements used to determine whether an organization is a church for tax purposes. You do not have a group of people who come together on a regular basis and you do not hold regular religious services. Your organization consists only of four members of a single family and you do not even hold regular services for those individuals.\textsuperscript{162}

The IRS did not discuss the funding of the organization, but it seems like a fair inference that all the organization's funding came from its four members. Thus, the organization lacked any meaningful independent stakeholders such as congregants or donors.

In that context, the IRS held that the organization had a substantial private purpose. The only facts discussed related to private purpose were that all the members of the governing board were family members and the organization had not eschewed the possibility of paying its members compensation or engaging in other financial transactions with them.\textsuperscript{163}

In PLR 2008-43-032, the IRS similarly determined that an organization that described its mission as "to carry the whole Gospel of Jesus Christ to the whole world" was not exempt under section 501(c)(3) and was not

\begin{footnotesize}
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\item \textsuperscript{157} Similarly, a school avoids private foundation status even if it fails all of the public support tests, but non-school educational organizations do not. I.R.C. § 509 (West Supp. 2010). That is because schools are required to have regular faculty and a regular student body, both of which are third-party stakeholders with the potential to keep the school from advancing impermissible private benefits.
\item \textsuperscript{158} I.R.S. Priv. Ltr. Rul. 2008-30-028 (July 25, 2008).
\item \textsuperscript{160} See also I.R.S. Priv. Ltr. Rul. 2008-46-040 (Nov. 14, 2008) (church or church affiliate with no identifiable congregation).
\item \textsuperscript{161} I.R.S. Priv. Ltr. Rul. 2008-30-028 (July 25, 2008).
\item \textsuperscript{162} \textit{Id.}
\item \textsuperscript{163} \textit{Id.} at 3, 7. The analysis is somewhat complicated by the fact that the organization had apparently given very little information to the IRS. For example, the organization had not adopted any bylaws or a conflict-of-interest policy. Similarly, the organization apparently provided no financial information, as is required in FORM 1023, and when asked, explained: "No financial data to report at this time, but in . . . moving forward the church is expecting to buy equipment . . . and all the things for operating the church." \textit{Id.} at 4.
\end{itemize}
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a church under section 170(b)(1)(A)(i) of the Code.\textsuperscript{164} In this case, the
organization reported that it had ten to twelve participants who regularly
attended worship services and meetings of the organization.\textsuperscript{165} Assuming
that the majority of those participants are not related to the founder, this
arguably should constitute a body of independent stakeholders who would
exert some degree of monitoring and control over the founder of the
organization, even if such body is relatively small. The ruling rejected this
reasoning, explaining that even though the organization

has some of the characteristics of a church [presumably that it has
'congregants' who regularly worship together,] no evidence has been
submitted to demonstrate that anyone has achieved the status of becoming
a member with voting rights. . . . Since there is no membership with voting
rights other than the Pastor and his spouse, it has not been established that
there is a regular congregation of individuals who consider this as their
church.\textsuperscript{166}

There is no requirement under federal law that members of a church
have any specific sort of "voting rights," and so the IRS's holding on that
score is almost certainly wrong as matter of law. But the IRS's concern with
independent stakeholders such as congregants is notable.

The IRS's discussion of the organization's finances is somewhat
confusing, but it appears that seventy percent of the organization's
funding comes from the Pastor, and it is all paid back to him as a "housing
allowance."\textsuperscript{167} The remaining thirty percent came from "certain individuals
and churches."\textsuperscript{168} Thus, the fact that seventy percent of the organization's
income is received from one source—and is spent specifically to provide tax-
free income to that same source—is at least some evidence of a substantial
private purpose. On the other hand, the fact that the remaining thirty percent
of the organization's income is from unrelated charities and persons (if they
are actually unrelated) should be a good sign. That means that almost one-
third of the organization's funding is supplied by independent donors, a
well-recognized category of independent stakeholder. Here, the IRS has
correctly identified relevant information but has not placed it in a context
in which the IRS could evaluate whether the existence of independent
stakeholders was sufficient to allay concerns of excessive private benefit.

\textsuperscript{165} Id.
\textsuperscript{166} Id.
\textsuperscript{167} Id. The housing allowance is especially troubling, of course, because under federal
law, "ministers of the gospel," but no one else, may be provided with compensation in the
form of a "housing allowance" which does not constitute income to the recipient. I.R.C. § 107
(2006). Therefore, if a pastor donates money to a church, which then pays it back to him in
the form of a housing allowance, he has a deduction (for his charitable contribution) without
corresponding income (since the housing allowance is tax-free).
Thus, the adverse rulings involve situations in which there is some evidence that the organization is set up to provide private benefits to its founders, and in which, there are limited independent stakeholders to monitor the organization. While the IRS has not necessarily evaluated the evidence in the most compelling way in each case, each ruling suggests that both of these concerns are central.

Once the concept of independent stakeholders is introduced, it becomes clear that an independent board is just one more example of independent stakeholders who can be expected to monitor the organization to prevent it from excessively advancing the founder’s private purposes. Just as independent donors have an interest in the charity pursuing its public purpose, and independent congregants have an interest in a church pursuing its public purpose, so do independent board members have an interest in any charity pursuing its public purpose. When an organization lacks other effective checks on impermissibly advancing private interests, the IRS is within its authority to insist that the organization adopt some check, of which board independence of some sort is at least one logical possibility.

C. Independent Stakeholders and “Quasi-Commercial” Charities

One significant category of organizations without meaningful independent stakeholders consists of organizations that get their income from the performance of their exempt purpose. These organizations do not have meaningful independent stakeholders but also avoid private foundation status on account of their “program-related” revenue.

Under section 509(a)(2) of the Internal Revenue Code, an organization can include gross receipts from the performance of its exempt purpose as part of its “public support.” In other words, an organization that receives more than one-third of its support from fees for performance of its exempt purpose can avoid private foundation status so long as the organization meets the other requirements. To illustrate this principle, imagine that the Fishing Charity did not provide its fishing equipment to poor people for free but instead sold it to them for a below-market price. The Fishing Charity would meet the “exempt purpose” test by subsidising the acquisition of fishing equipment by the poor, and thereby seeking to eradicate poverty. Under section 509(a)(2) of the Internal Revenue Code, the Fishing Charity could count the gross receipts from the sale of fishing equipment as its “public support.” Thus, even if the founder provided all the other financial support for the organization (either in cash or in-kind in fishing equipment),

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170 Id. § 509(a)(2)(A)(i)-(ii) (defining other requirements to include (1) that it otherwise qualifies for exemption under 501(c)(3) and (2) that it not receive more than one-third of its support from gross investment income or unrelated business income).
the organization could potentially avoid private foundation status. Let's call this organization the Low-Cost Fishing Equipment Charity (see table below).

The Low-Cost Fishing Equipment Charity avoids private foundation status because it meets the public-support test on account of the fees generated from the performance of its tax-exempt purpose. But there is an argument that the existence of *purchasers* of low-cost goods—really beneficiaries of the charity—does not provide the same potential check on the actions of the charity as would be provided by *donors* to the organization.¹⁷¹ Likewise, one could argue that the other independent beneficiaries required to avoid private foundation status—like congregants, students, regular faculty, patients, doctors, etc.—are more likely to monitor adequately their organizations than are purchasers of low-cost fishing equipment.¹⁷² If the sale of goods or services can produce “public support” without involving meaningful independent beneficiaries, this is a potential loophole in the private foundation scheme. The IRS could use its analysis of independent beneficiaries to identify these organizations and limit itself to requiring *them* to expand their boards of directors (or take other prophylactic action) to lessen the risk of the dominance of a substantial private purpose.

<table>
<thead>
<tr>
<th>Private Foundation Rules Apply</th>
<th>Public Charity With Independent Stakeholders</th>
<th>No Independent Stakeholders, but also Avoids Private Foundation Status</th>
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<tbody>
<tr>
<td>No Ongoing Financial Transactions</td>
<td>Fishing Foundation</td>
<td>Fishing Charity</td>
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<tr>
<td>Ongoing Financial Transactions</td>
<td>Corporate Fishing Foundation</td>
<td>Corporate Fishing Charity</td>
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¹⁷¹ See Leff, supra note 144.
¹⁷² See id.
In fact, several of the organizations described in the following rulings followed this pattern, and arguably could have avoided private foundation status without having any meaningful independent stakeholders, such as donors. I generally call these organizations “quasi-commercial” both because they generate revenue primarily from selling their (arguably charitable) services and because the IRS identifies “commerciality” as an impediment to tax-exempt status in the adverse rulings addressing some of these organizations.\footnote{See I.R.S. Priv. Ltr. Rul. 2008-28-029 (July 11, 2008) (discussing the “commerciality” impediment).}

For example, in PLR 2008-28-029, the IRS rejected an exemption application from an organization that intended to purchase mobile home parks and rent space to needy persons at low rent.\footnote{Id.} The provision of affordable housing for needy persons has been recognized as a legitimate tax-exempt purpose under certain circumstances.\footnote{See Rev. Rul. 70-585, 1970-2 C.B. 115; Rev. Rul. 72-124, 1972-1 C.B. 145; Rev. Rul. 79-18, 1979-1 C.B. 194, all of which are cited in I.R.S. Priv. Ltr. Rul. 2008-28-029 (July 11, 2008). See also Rev. Proc. 96-32, 1996-1 C.B. 717 (describing a safe-harbor and facts and circumstances test to determine whether the provision of housing to the poor qualifies as a charitable purpose) (cited in I.R.S. Priv. Ltr. Rul. 2008-28-029 (July 11, 2008)).} The IRS was concerned that the organization failed to qualify as charitable because it could not guarantee that the cost to residents would be less than thirty percent of their income, the measure of “affordability” under the safe-harbor presented in IRS Revenue Procedure 96-32.\footnote{Id.} The organization argued that it was impossible to guarantee that total costs would be a fixed percentage of residents’ income since the “pad rental” was only a portion of the residents’ overall cost.\footnote{Id.}

We do not know how the IRS would have handled this argument if the organization had a truly independent board because the ruling discusses both a “charitable purpose” problem (no guarantee that housing is “affordable”) and a “private interest” problem (created by the composition of the organization’s board and its relationships with interested persons).\footnote{Id.} The ruling does not identify which issue is material or how the issues are weighted. Instead, the ruling simply states, “[w]e do not believe in this case that you have significant interests that can be distinguished from those of [the founder] so as to establish that you are not being operated for the non-exempt purpose of benefiting him.”\footnote{Id.} The ruling then goes on to discuss the institutional ways that the founder exerts special control over the organization. For example, while the board consists of three persons, the founder was designated as “Founding Director,” a special director

\footnote{See Rev. Proc. 96-32, 1996-1 C.B. 717.}
who serves a longer term than other directors and can be removed only for cause. Furthermore, the founder is the president of the organization and appears to be the only person involved in managing the organization. The founder also receives compensation from the organization. The way that the PLR is redacted makes it difficult to follow the description of the various financial relationships, but it appears that the founder may stand to gain financially from the organization’s activities in ways other than through his compensation. In other words, the PLR describes a situation in which the governing board is dominated by the founder, there is the potential for the organization to benefit the founder financially, and the organization is not a private foundation.

Under Part III of this Article, this organization would meet the criteria for the IRS prophylactically requiring a more independent board as a prerequisite of exemption. But, as this section has discussed, the IRS has not only been evaluating the criteria described in Part III, but has also been interested in whether the organization has any meaningful independent stakeholders. This organization is a classic example of an organization that will avoid private foundation status, arguably without having any meaningful independent beneficiaries. The organization expects to fund its operations through “tax-exempt bonds; space rental income, utility pass-through income, and, other miscellaneous income from residents; and, asset management fees.” Under section 509(a)(2) of the Code, the space rental income, utility pass-through income, miscellaneous income from residents, and asset management fees all constitute public support since they are presumably “gross receipts from performance of services, or furnishing of facilities, in an activity which is not an unrelated trade

180 Id.

181 Id. For example, the ruling points out that the founder/president is authorized to make operational decisions and that bylaws specify that the board is only required to meet once a year at the annual meeting, thus, calling into question its ability to adequately oversee the founder/president’s actions. Id.

182 Id. There is also evidence that the organization intends to pay the founder in his role as president, which would presumably be an employee. Id. (“Your proposed budget includes compensation of . . . your president.”).

183 See id.

184 The control issue illustrates the difficulty in making a rule about “independent” directors since the majority of the board is composed of “independent” directors. Even the founder may be independent under the IRS Form 990 definition if his compensation is less than $10,000 per year and paid to him as a contractor rather than as an employee or if his financial interest is not in the nature of compensation at all (for example, if it comes from being an owner of an entity that is engaged in co-ventures with the organization) and it is not excessive. See Form 990 Instructions pt. VI-A, supra note 31, at 6.

185 I.R.S. Priv. Ltr. Rul. 2008-28-029 (July 11, 2008). The ruling also states that the founder “has financed your activities.” Id. It is not clear whether the founder intended to continue to make contributions to the organization, or whether the financing of activities referred only to startup costs.
or business.” So, the organization would not be classified as a private foundation.

But the organization also would not have meaningful independent stakeholders in the form of donors, congregants, students, or faculty. What the organization will have are customers. The residents of the mobile home parks that are owned by the organization will pay the organization’s rent, utilities, miscellaneous fees, and management fees. The structure of section 509(a)(2) of the Code suggests that an organization with multiple independent customers does not need to be subjected to the special restrictive rules that apply to private foundations. It is beyond the scope of this Article to address what makes an independent stakeholder a potentially meaningful check on the operations of an organization, but it is plausible that customers do not function in this way. Presumably, customers are interested only, or primarily, in whether they are receiving the provided goods or services at a fair price.

Thus, so long as the organization provides the customers with goods or services at a market (or below market) rate, they are not interested in whether the directors or managers of the organization enrich themselves. The customers are especially uninterested in whether the organization’s directors or managers enrich themselves at the expense of the federal fisc. In fact, so long as the customers receive a portion of any benefit derived from tax-exemption, they should be perfectly happy to split potential gains with the organization, its directors, or managers.

Thus, it is plausible that the organization that provides mobile home spaces for needy persons is exactly the kind of organization that the IRS should be most worried about: (i) it does not meet the safe-harbor for providing low-income housing, (ii) the founder has extensive control over the organization’s governing board, (iii) the organization is structured to potentially engage in multiple transactions with the founder that could benefit the founder financially, (iv) the organization will avoid private foundation status, and (v) the organization arguably has no meaningful independent stakeholders.

186 I.R.C. § 509(a)(2)(A)(ii) (2006). There is the further requirement that the sums received from any one person cannot exceed the greater of $5,000 or one percent of the organization’s support in any year. Id. As long as there are at least 100 residents, paying roughly equal amounts, this should not be a problem.

187 Admittedly, if it issues tax-exempt bonds, it may have some degree of oversight on account of the issuance. While it is beyond the scope of this Article to evaluate what kind of oversight comes with the issuance of tax-exempt bonds, presumably that would be an issue of great interest to the IRS if the existence of third-party stakeholders was relevant to its determinations of tax-exempt status, and it would be worthwhile for a determinations officer to investigate that issue.

188 See Leff, supra note 144.

189 See id.
PLR 2008-28-029 is not the only example of an organization that would simultaneously avoid private foundation status and fail to have any meaningful independent stakeholders. For example, PLR 2005-14-021\textsuperscript{190} and PLR 2005-10-031\textsuperscript{191} both involve organizations that provide some sort of consumer credit counseling to low-income people. It is worth pointing out that credit counseling organizations have been the object of intense scrutiny by the IRS and by Congress, who enacted special rules for credit counseling organizations in the Pension Protection Act of 2006.\textsuperscript{192} These organizations fit the profile described here perfectly: they avoid private foundation status and make their money from fees from their customers. Thus, they are subject to abuse if they do not have any check on the actions of their governing boards, like the kind of safeguard an "independent" board could potentially provide. PLR 2008-24-025 and PLR 2008-06-021 are other examples of organizations that would presumably avoid private foundation status because of fees paid by "customers."\textsuperscript{193}

At least one of the IRS Rulings rejected an application for tax-exempt status on "commerciality" grounds when it seemed likely that the organization would get the bulk of its "support" from donations from the general public under somewhat unusual circumstances. PLR 2007-33-027 involved an organization that planned to solicit donations of used ski boats from the general public, which it would then repair (if necessary), and sell at discounted prices to 501(c)(3) camps.\textsuperscript{194} The IRS held that

\begin{quote}
[s]elling boats to non-profit camps is similar to providing adoption services for a fee and managerial services for a fee, in the sense that they are all commercial activities usually carried on by for-profit businesses. You will compete with other commercial boat dealers for the camps' business and, therefore, there is a distinctive "commercial hue" to the way you propose to carry out your business.\textsuperscript{195}
\end{quote}

The ruling also notes that the majority (three) of the organization's governing board was from the same family (although there were also two independent members), and the chairman received compensation that was fixed without the benefit of a conflict-of-interest policy.\textsuperscript{196}

One way of viewing the ruling is that it is just wrong. But it is also possible that the ruling could fit within the framework described here. If the receipt

\begin{flushleft}
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195 Id. (internal citations omitted).
196 Id.
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of in-kind contributions, like the boats donated to this organization, do not generate the same kind of monitoring by donors as cash contributions, then the organization would fit the "suspect" class of organizations without meaningful independent stakeholders that also avoid private foundation status. The argument is plausible as there has been significant anecdotal evidence over the last decade or so that taxpayers make in-kind donations, especially of vehicles and other items, the value of which is easily inflated, without much concern about the operations of the recipient charities.197 If the IRS explicitly included a discussion of independent stakeholders in its analysis of the dangers associated with non-independent boards, it could address whether an organization like this one should be subject to heightened scrutiny.

The speedboat organization illustrates that the rubric suggested in this Article could produce disputes. However, the heart of the rubric is as follows: in cases in which (i) an organization's board is dominated by its founder, (ii) the founder intends to have ongoing substantial financial dealings with the organization, (iii) the organization is not a private foundation, and (iv) the organization has no substantial independent stakeholders, the IRS is most within its proper sphere to require that the organization provide some assurance that the organization will not be advanced for a private purpose and is within its discretion to accept the existence of an independent board as a minimum qualification for making that assurance. This situation appears to apply most clearly to organizations that avoid private foundation status on account of receiving the bulk of their support from fees generated by their exempt activities—so-called quasi-commercial organizations. While the IRS appears from the rulings to be already focusing on this type of organization, the IRS could more clearly guide (and limit) its own actions by explicitly adopting an approach that took this rubric into account.

V. FEDERALISM CONCERNS IN THE REGULATION OF CHARITABLE ORGANIZATIONS

The absence of independent stakeholders is not only a general problem from a regulatory perspective. I believe that it also has implications for federalism concerns that arise from the concurrent jurisdiction of states and the federal government over the regulation of charities. This Part of the Article discusses a few very tentative implications that the orientation toward independent stakeholders may have on thinking about the proper regulatory reach of the federal government over tax-exempt organizations. While this section is highly speculative, it appears that the federal government's emphasis on organizations without meaningful independent

stakeholders may serve to focus the federal regulatory gaze on those organizations least likely to be adequately regulated by state charity regulators.

On the one hand, the difference between the state’s regulatory authority over charities and the federal government’s can be described as the difference between a general mandate arising initially out of the common law and one tied specifically to the tax code, and therefore with a wholly statutory origin. The state mandate is broader; the federal mandate is more specific. On the other hand, one can describe the state’s mandate and the federal government’s as serving somewhat different interests. In general, it is possible to see that the state’s interest in charities is in protecting various interested citizens from abuse by charities. These interested citizens include the charitable beneficiaries of a charity and, broadly, the general public. Also included in the group are other third-parties, such as donors, congregants, members, and others. The federal government, while it may legitimately share the general interest in protecting stakeholders, is more fundamentally interested in protecting the federal fisc against abuses of tax exemption and the deductibility of charitable contributions. These interests often align, but not always.

State attorneys general are tasked with protecting the interests of the general public. The public’s interests are advanced by ensuring that the charity serves its charitable purposes faithfully and without waste. State attorneys general are also tasked with protecting various interests associated with independent stakeholders. For example, they may protect the interests of donors by “correcting abuses involving fraudulent charitable solicitation” and fraud. Even when the state is protecting the interests of

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198 The federal government’s specific mandate reproduces the state’s regime, since every feature of the [federal] excise tax regime ... assumes that regulating fiduciary behavior through the enforcement of state law fiduciary duties exclusively by state attorneys general is insufficient to encourage fiduciaries of charitable entities to behave responsibly. Otherwise, the federal excise tax system governing compensation paid by each type of charitable entity would be unnecessary.


199 The state’s interest in protecting interests of stakeholders is reflected in the range of areas that are the traditional areas of state regulatory concern. See Fishman, supra note 6, at 553 (“Of particular state concern have been the areas of charitable solicitation, fraud, and breach of fiduciary duties.”). In some states, like Texas, the Attorney General’s charity regulators are a subsection of the general consumer protection division.

200 See, e.g., Ingram 2009 Speech, supra note 6, at 2 (“[T]he IRS does have the very clear obligation to see that the tax subsidy that the tax-exempt community enjoys—estimated by the Office of Management and Budget to be billions of dollars per year—is used properly, for the purposes and within the parameters the Congress has laid down.

201 Fishman, supra note 6, at 556.
the general public by monitoring the charitable objectives of the charity, the state may be connected to a mission of protecting donors against fraud or waste of their charitable donations. Even when state charity regulators are acting proactively and conscientiously, they may focus their attention on those charities that deceive donors or waste donated assets. Thus, the state charity regulators may be focused on those organizations that have numerous independent stakeholders (like donors). Organizations that do not have independent stakeholders, like quasi-commercial organizations, or private foundations, may not be the most important focus of state charity regulators.

Federal interests, however, may be somewhat different. Because the federal government provides a tax exemption and a tax deduction for donations to charitable organizations, it has a financial interest in charitable organizations.\textsuperscript{202} Presumably, the government provides the exemption and deduction to assist organizations in pursuing their charitable missions. But when an organization has no independent stakeholders, the federal government has no allies that can assist in protecting the organization against abusive insider transactions. Meaningful independent stakeholders who have no financial interest in a charitable organization are potentially very useful to the federal government because they share the federal government’s interest in monitoring the organization and keeping it true to its charitable mission.\textsuperscript{203} So, the federal government may best serve its own interests by focusing its regulatory gaze on organizations without independent stakeholders because independent stakeholders can monitor organizations with which they are associated.

Thus, the existence or lack of independent stakeholders highlights the times when the federal government’s interest may be stark, while the state’s interest may be minimal. That is, when there are no independent stakeholders, the federal government may be most worried because the lack of disinterested donors or others willing to devote time to a cause may be evidence that the cause is not truly charitable or that private purposes dominate. On the other hand, when there are no independent stakeholders, the state may be least worried because the potential victims of the charity’s abusive behavior are fewer or less visible. No donors are being defrauded; no volunteers are being abused; no members’ interests are being ignored; no minority directors are being bullied. Of course, the fiduciary duties enforceable by the state attorneys general are arguably duties owed to

\textsuperscript{202} The federal government’s interest in 501(c)(3) organizations is higher than its general interest in the activities of other exempt organizations, because (c)(3) organizations are generally permitted tax-deductible contributions under section 170 of the Internal Revenue Code. As Fishman points out, the argument that exempt organizations receive a “subsidy” from the federal government is strongest in the case of organizations that receive tax-deductible contributions. See Fishman, supra note 6, at 557.

\textsuperscript{203} See Leff, supra note 144, at 26-30.
charitable beneficiaries or the general public. But a charity with no meaningful independent stakeholders may not even have well-defined beneficiaries, thereby decreasing the state's interest in expending resources to regulate it more. When the only identifiable beneficiaries are the general public, the duty may be attenuated and undefined enough that states may lack a will or an operative theory of how or when to regulate it. The point is that organizations with no meaningful independent stakeholders are low on the state's priority list but high on the federal government's priority list in both cases because of the lack of independent stakeholders. Thus, a federal policy of explicitly theorizing the effect of turning independent stakeholders into regulatory priorities should simultaneously serve the interest of rational regulation and addressing federalism concerns.

CONCLUSION

In this Article, I have attempted to argue that the IRS may be justified in requiring exempt organizations to have an independent board, or some independent board members, but only under very narrow circumstances. First, the IRS must find that an organization has the potential to advance a substantial private purpose. It does this at least partially by identifying organizations (i) whose governing boards are dominated by their founders, and (ii) who intend to engage in ongoing financial transactions with those founders/directors. Under its own policies, the IRS then should (iii) exclude any organization that is a private foundation. But this initial identification is arguably not sufficient to require that an organization expand its board to include independent members.

Once the IRS has identified organizations that it thinks pose a potential danger of being operated to advance a substantial private purpose, an analysis of meaningful independent stakeholders can assist an evaluation of whether conditioning exemption on the existence of some sort of “independent” board is warranted. When an organization has donors, volunteers, or congregants who have no financial interest in the organization, they can ensure that the organization serves a public purpose, and therefore that it does not serve a substantial private purpose. Indeed, Congress has seen fit to recognize expressly the importance of independent stakeholders and make them a part of the very structure of the Code. Independent board members are just another potential independent stakeholder. Therefore, while the IRS may reasonably use the existence of independent board members as the pivotal check on excessive private purposes under certain limited circumstances, it should do so only when other independent stakeholders are absent.

204 See Marion R. Fremont-Smith, Governing Nonprofit Organizations 301 (2004).
Finally, if the IRS incorporates an analysis of independent stakeholders into its regulatory decision-making, it should have salutary effects on federalism concerns. It is exactly those organizations without independent stakeholders that are likely to avoid state regulation and that are central to the federal government’s interest in regulating charities, namely protection of the federal fisc.

In the final analysis, whether the IRS is authorized to require any organizations to change the composition of their boards of directors is a question of federal law. Because of that, Congress could act to clarify the IRS's mandate. This Article has argued that the cautious approach that the IRS appears to be taking currently—the "middle way"—has benefits. If Congress were to act, it would have to choose whether to support the current approach or replace that approach with a new approach. If it acted to further the current approach, Congress could potentially improve the enforcement of restrictions on private benefits by clarifying the relationship between independent stakeholders and the private foundation excise tax regime. It could also enhance the restrictions on transactions between private foundations and disqualified persons. Either of these areas of reform could continue the balance between federal interests, state interests, and charity autonomy that is reflected in the "middle way."

On the other hand, Congress could instead accept recommendations to add broadly applicable minimum requirements for board independence that would apply to all (or substantially all) charities. This latter approach would be more invasive to charity autonomy, more transgressive of state regulatory authority, and less consistent with the current balance of interests expressed under current law. The IRS's "middle way" is better.

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205 See, e.g., INDEPENDENT SECTOR, supra note 8, at 4.