Testimony of Professor Roger Colinvaux[1]
Before the House Committee on Ways & Means,
Subcommittee on Oversight
Hearing on Tax Exempt Organizations
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Mr. Chairman, Mr. Ranking Member, Members of the Committee, thank you for inviting me to testify today, and for holding this hearing. I believe that the laws regulating the section 501(c)(3) sector are in need of a critical look, and welcome the opportunity to provide my observations about the current state of the law.[2]

In sum, I offer a descriptive account, in an effort to better understand the development of the law, and to explain its increasing complexity. The central tenets of my account are that recent legislation has established new legislative precedents that run counter to the traditional regulatory approach: precedents for distinct exemption standards based on the type of organization, a weakening of the basis for distinguishing among charities as "public" or "private," and a related preference for brighter enforcement lines and frustration with the status quo. These trends make for growing complexity, but are in large part a reasonable response to the historic legacy of defining a sector based on broadly conceived purposes and the inherent difficulties of oversight that follow. Going forward, it is critical to assess the federal role in support of the section 501(c)(3) sector, and at a minimum, take steps to further the integrity of the sector by minimizing opportunities for abuse. More broadly, if the federal approach is to be reconceived, the tax policy focus should shift to greater promotion of activities rather than purposes, and require more from the sector than avoiding bad outcomes.

A. Background

Under federal tax law, an organization that is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes" is tax preferred. This single legislative phrase provides a standard not just for tax exemption for over a million organizations (which are diverse in purpose, size, function, complexity, and effectiveness)[3] but also is a gateway to several tax and nontax preferences, including eligibility to receive tax deductible contributions (for income, estate, and gift tax purposes), access to tax-exempt financing, State property tax exemptions, and regulatory relief, among other benefits.[4] The section 501(c)(3) designation includes large national organizations with many millions of dollars of revenue, and small local organizations with gross receipts under $5,000.[5] The result is invariably referred to as the "nonprofit sector," the "charitable sector," the

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[2] Portions of this testimony are based on my article: *Charity in the 21st Century: Trending Towards Decay*, 11 FLA. TAX REV. 1 (2011), and available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809171

[3] The National Center for Charitable Statistics at the Urban Institute maintains an informative coding scheme for charitable organizations, available at http://nccsdataweb.urban.org/PubApps/nonprofit-overview-sumRpt.php?v=ntee&t=pc&f=0.

[4] See Staff of Joint Committee on Taxation, 109th Cong., Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations, at Appendix (Joint Comm. Print 2005); Evelyn Brody, All Charities are Property Tax-Exempt, But Some are More Exempt Than Others, 44 New Eng. L. Rev. 621 (2010).

[5] One recent estimate provides that the section 501(c)(3) designation covers over 1.1 million organizations, with revenues in one year of approximately $1.4 trillion, and asset holdings of approximately $2.6 trillion. Molly F.

"independent sector" – but for purposes of my testimony, I will use the phrase "section 501(c)(3) sector." This is because the identity of the sector stems not exclusively from its nonprofit status, charitable nature, nor independence, but rather from its relationship to this iconic section of the tax code.

B. Historical and Current Legal Characteristics of the Section 501(c)(3) Sector

The initial exemption was passed in 1913 and had several notable characteristics: (1) The exemption was self-enforcing – there was no requirement that the organization apply for the exemption or report regularly. (2) No explicit limits were placed on activities.[6] (3) The exemption was a complete or blanket exemption, that is, it covered all of an organization's income. (4) The exemption applied equally to all organizations meeting its terms. (5) The exemption was all or nothing: either the organization met the requirements and was free from income tax or it did not meet the requirements and was subject to income tax. (6) The exemption was conditioned on a "good" purpose and no effort was made to define purpose in concrete terms, based on outcome, content, or other quantifiable measure. (7) The exemption was conditioned on the private inurement restriction; that is the profits of the organization were required to go to the good purposes of the organization, and not be paid out to private persons or private interests. (8) The standard for tax exemption was used as a basis for other, distinct tax benefits; for example, as of 1917, the language of the exemption provided a basis for the charitable contribution deduction.

It is not surprising that 100 years later, the law has changed. Section 501(c)(3) status is not self-enforcing, but is conditioned upon an explicit determination by the Internal Revenue Service ("IRS") and subject to ongoing oversight through the filing of annual information returns. Congress also decided that certain activities were inconsistent with tax exemption: for example, section 501(c)(3) organizations may not participate in political campaigns or engage in substantial lobbying. Further, the exemption is not a blanket exemption. All charitable organizations are subject to tax on income from business activities that are not related to the organization's section 501(c)(3) purpose; and some section 501(c)(3) organizations (i.e., private foundations) are subject to tax on their investment income. Finally, the exemption no longer applies equally to all. Section 501(c)(3) organizations are divided into broad categories: public charities and private foundations; with the former being preferred to the latter for purposes of the charitable deduction, tax exemption, and permissible activities and surveillance.

These changes are all significant legal responses to experience with section 501(c)(3) organizations over the course of a century. Yet much of the foundational statutory laws and historical approaches to section 501(c)(3) status and enforcement have remained the same. The two core statutory requirements of the 1913 exemption are unchanged: section 501(c)(3) exemption still (importantly) requires a generically "good" purpose;[7] and the exemption still is conditioned on the private inurement restriction. In addition, the requirements for the charitable deduction remain linked to the requirements for section 501(c)(3) exemption, i.e., the law does not require separate tests for two rather different tax benefits. Further, section 501(c)(3) status remains, for all intents and purposes, an either/or proposition.

Sherlock & Jane G. Gravelle, Cong. Research Serv., R40919, An Overview of the Nonprofit and Charitable Sector 3, 9-12 (2009) (reporting as of July 2009 and not including organizations that do not report to the IRS on the annual information return (Form 990 series) such as churches and small organizations).

[6] In 1919, however, the Treasury adopted a regulation for purposes of the charitable contribution deduction of 1917 stating "associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute." Reg. 45, art. 517 (1919), in T.D. 2831, 21 Treas. Dec. Int. Rev. 285 (1920).

[7] Of course, a century's worth of experience provides considerable precedent as to what qualifies as a section 501(c)(3) organization as determined over time by the IRS and the courts.

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Revocation of exemption, which is based on an inquiry into all the facts and circumstances, remains the primary sanction for failure to meet a condition of section 501(c)(3) status.[8]

C. Observations Regarding Historical Changes

Thinking, broadly, about what has changed and what has stayed the same, a number of observations can be made. First, the historical trend is toward more restrictions on the section 501(c)(3) designation. What began in 1913 as a fairly straightforward and sweeping tax exemption, has been incrementally pared back and subjected to more rules and requirements. Section 501(c)(3) organizations must apply for their status (with churches a principal exception), may not engage in certain activities, must pay tax with respect to some income, and some organizations will be treated better than others.

Second, these restrictions generally have taken the form of negative rather than positive requirements. Positive requirements are the things a section 501(c)(3) organization must do to secure and keep its status. By contrast, negative requirements are the things a section 501(c)(3) organization must refrain from doing. In other words, section 501(c)(3) organizations have been asked to refrain from doing certain things, such as politicking or lobbying, or engaging in (untaxed) business activity. But section 501(c)(3) organizations have not, in general, been asked to do anything affirmative, apart from file forms.[9] Thus, the century's narrowing of the 501(c)(3) designation has occurred not through an effort to limit eligibility for the preference or to demand something quantifiable in return for tax benefits, but through rules that constrain the scope of the preference once eligibility has been established.

A third observation relates to a consequence of a century of retreat from the scope of the original tax preference in the form of negative and not positive restrictions: the facilitation of a large and growing section 501(c)(3) sector. Without positive requirements, becoming and remaining a charity is relatively easy. And although a charity in 2012 faces a lot more rules and restrictions than a charity of 1913, apart from a vague entreaty to remain "operated" for its purpose, the exemption, once granted, is unlikely to be withdrawn. Further, the pluralistic approach toward defining section 501(c)(3) organizations means that the definition evolves to accommodate societal change and as it does so, the activities encompassed by section 501(c)(3) grow. In addition, because the requirements for the charitable deduction are linked to requirements for section 501(c)(3) exemption (and other benefits), the amount of support provided by the federal government to the sector via the section 501(c)(3) designation also naturally increases along with the scope of the exemption standard.

A fourth observation relates to enforcement. Overall, the risk of audit for a section 501(c)(3) organization is low. But to a certain extent, the examination rate as such is beside the point. Even if there were a dramatic increase in resources and a corresponding uptick in audits and examinations, there likely would be little meaningful change in growth or in the nature of organizations qualifying for section 501(c)(3) status. This is because, at least with respect to public charities, there is very little "hard" law for the IRS to enforce. In general, the IRS is limited to an inquiry into "purpose," with the thrust of the inquiry being not on the substance of the purpose, or the direct accomplishments of the organization, but on the more ethereal inquiry into whether the organization really is benefiting private interests more than public ones. Importantly, this existential question is the heart of the matter primarily because of the absence of anything positive to measure and the all-or-nothing, facts and circumstances nature of enforcement. An organization either qualifies as a 501(c)(3) organization or it does not, there is no middle ground. Further, because the sanction is severe, an already delicate query is to a certain extent

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[8] There are exceptions. Excise taxes, or intermediate sanctions, may be imposed on self-dealing transactions and excess lobbying. IRC § 4941, 4958, 4911.

[9] The principal exception to this is imposition of a pay out requirement on private foundations. IRC § 4942.

tilted in favor of the organization. Revocation of the 501(c)(3) designation is a serious step, and, as a practical matter, is not (and should not be) undertaken lightly. This leaves the IRS with very little other than the somewhat limited tool of intermediate sanctions to try to deter and punish bad behavior, which in any event has very little to do with overseeing the accomplishments of the organization.

A final related observation is that the consequences of regulation by negative restriction and the relative absence of bright enforcement lines are beginning to stress the viability of the regulatory system and the section 501(c)(3) designation. The all-or-nothing nature of the tax preference combined with the vague positive requirement to be operated for section 501(c)(3) purposes and no other positive measure, has limited the ability of the IRS, for better or for worse, effectively to police abuse or to check the growth of the section 501(c)(3) sector in any meaningful way, or even to provide any strong degree of confidence that the organizations receiving the section 501(c)(3) moniker, typically at the outset of their existence, meet their promises or are actually serving a public benefit. The outcome is a large and growing section 501(c)(3) sector and legal standards that accommodate growth.

D. Trends Exemplified by Recent Legislation

Growth without measureable standards is conducive to problems. Although the section 501(c)(3) form is vital, it is also relatively easy to abuse and hard to enforce. And so in recent years, scandals have too often been associated with section 501(c)(3) organizations, at some considerable cost to the "halo" effect of the sector as a whole. Scandals have involved certain iconic institutions, contributions of noncash property, participation in tax shelter transactions, spending and management abuses at private foundations, concerns about grant-making public charities such as donor-advised funds and supporting organizations, scandals in the hospital and credit counseling industries, and excess compensation to name some of the more prominent.

Scandals led to significant section 501(c)(3) reform legislation over the past several years. These legislative responses are telling, quite apart from the substance, in that the legislation highlights growing tensions within the current tax policy framework. For one, through the legislation Congress in effect has said that the breadth and amorphous nature of the section 501(c)(3) standard is too generous. For another, Congress has expressed disaffection with the current basis for distinguishing among charities as "public" or "private." And for a third, Congress has begun to approve brighter lines over facts and circumstances approaches to enforcement. It is important to see how these trends are being articulated through legal changes because they provide the best sense of the current direction of the law.

(i) Frustration with the breadth and amorphous quality of the section 501(c)(3) exemption standard

Although the open-ended standard for exemption yields the benefits of a diverse sector, it also comes with costs. As noted, the lack of affirmative standards makes measurement and enforcement difficult, a problem magnified by the size of the sector. Alternatives might be to require that some threshold of activity be met, to narrow the scope of the section 501(c)(3) standard, or even to impose guidelines on how money is to be spent and for whose benefit. Another, less divisive, response is to focus on process. Positive but process-oriented requirements do not mandate that a specific type or amount of a public good be provided, but nonetheless require action by the 501(c)(3) organization, action intended to facilitate production of the public good. The reform legislation took significant steps toward a more process-oriented approach.

Credit counseling organizations are an example. In response to abuses, Congress took credit-counseling organizations out of the generic framework of section 501(c)(3), and provided a series of distinct bright-line standards for section 501(c)(3) status. Accordingly, credit counseling organizations

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must satisfy several extensive requirements, including rules about the composition of the governing body, rules requiring a reasonable fee policy (one that requires provision of services even if the consumer does not have the ability to pay), categorical rules about permissible practices, rules about ownership of related entities, and rules limiting the amount of allowable revenue from certain sources.

Such statutory precision regarding the conditions of section 501(c)(3) status for a particular type of organization was unprecedented. It represented a significant conceptual shift, considering that the general operating principle of section 501(c)(3) has been that all public charities are created equally; that is, if you have a "good" purpose, the law will not adversely discriminate because of such purpose.[10] Even when Congress created second-class citizenship for private foundations, foundations generally were disfavored because the foundation form could lead to abuse, and not because of the substance of foundation activity. By contrast, credit-counseling organizations now are singled out by their purpose, and special rules are applied on this basis.

Hospitals are another example. As a class, hospitals are perhaps the most prominent part of the section 501(c)(3) sector, and have long raised questions about the meaning of the section 501(c)(3) exemption standard. This is because many section 501(c)(3) hospitals may seem indistinguishable from taxable for-profit hospitals. Both, after all, perform similar functions. In general, the legal difference is that a section 501(c)(3) hospital must provide a "community benefit." But this standard has been widely criticized for its lack of a positive measure. Accordingly, a policy question has been whether section 501(c)(3) hospitals should be subject to affirmative positive requirements, such as mandating some free or charity care as a condition of section 501(c)(3) status.

In response, in 2010 Congress adopted new exemption standards for section 501(c)(3) hospitals. To maintain 501(c)(3) status, hospitals must, among other things, and in addition to generally applicable standards, conduct a "community health needs assessment" at least once every three years, establish a written financial assistance policy and a written policy relating to the provision of emergency medical care, limit the amount of charges to certain patients for emergency or other medically necessary care, and refrain from engaging in "extraordinary collection actions" without first making reasonable efforts to discover whether a patient is eligible for financial assistance. New reporting requirements and excise taxes also apply.

It is noteworthy that these new standards do not impose a substantive positive requirement on section 501(c)(3) hospitals; rather, the legislation settles for process-oriented rules that are designed to promote a more charitable outcome. For example, the financial assistance and emergency care policies, and requirements to stop overcharging the indigent and performing unreasonable collections are anti-abuse oriented: i.e., focusing on stopping manifestly uncharitable behavior. Although important, this of course is different from affirmatively requiring charitable activity. The community health needs assessment comes closer to imposing an affirmative charity standard. By requiring section 501(c)(3) hospitals formally to seek input from and assess the needs of their communities, the legislation aims to force hospitals to consider how they are integrated within and accountable to the communities they serve, and, therefore, to take active steps to foster a community (and charitable) benefit. Notably, however, the legislation stays well on the side of process, providing no hint as to what a community benefit might be substantively.

The credit counseling and hospital-specific legislation not only highlight the difficulty of imposing substantive positive requirements, but also show that Congress continues to wrestle with the all-

[10] There is some affirmative discrimination based on purpose: churches, hospitals, and colleges and universities are generally considered to be "public charities" (and not private foundations) by definition—that is, based on their purpose. IRC § 509(a)(1).

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or-nothing nature of section 501(c)(3) status. For example, most of the new hospital requirements are conditions of section 501(c)(3) status. In theory at least, this means that if a charitable hospital violates a requirement, for example by engaging once in an unreasonable collection activity, the hospital's 501(c)(3) status is revoked. This outcome is highly unlikely, however, making these new requirements (and others like them) aspirational in nature—i.e., a sanction is plausible only in the most egregious of cases. Thus, these efforts to tighten the standards for section 501(c)(3) status show how difficult it is to regulate behavior when there are no positive obligations to enforce and the principal sanction is revocation of 501(c)(3) status. This difficulty is evidenced by the fact that the Treasury Department and the IRS have not yet issued administrative guidance that describes the consequences of or penalties for noncompliance with the additional exemption requirements.

(ii) Erosion of the public charity-private foundation distinction

Initially, the law made no distinction among section 501(c)(3) organizations: all in effect were treated equally. Yet, as time passed, the "private" foundation was singled out for adverse treatment. The private foundation is defined in the negative, as something other than a "public" charity. Some organizations are deemed public because of their function and role in the community: hospitals, colleges and universities, and churches. Most other organizations must satisfy a public support test. The theory is that all such "public" organizations will be overseen effectively by their donor or service-based community. Such oversight, lacking for a private foundation, means in theory that the public charity is less susceptible to abuse, and so should escape additional regulation. In effect, by distinguishing public charity from private foundation in this way, Congress assumed that public charities did not raise the same concerns, either as a matter of form or substance.

The consequences of being public or private are stark. Operationally, a comprehensive anti-abuse regime – a series of negative restrictions – applies to private foundations, and is enforced by stiff excise taxes. The anti-abuse rules target four areas: self-dealing between the foundation and foundation insiders, excessive ownership of a for-profit business, the making of risky investments, and spending for non-exempt purposes. In addition, private foundations are subject to a key positive requirement – they must pay out a percentage of investment assets each year for exempt purposes. Private foundations also are disfavored for purposes of the charitable deduction rules; and most private foundations must pay a tax on investment income. Public charities face far fewer restrictions.

The existence of the public-private distinction is important because it demonstrates in law and policy a preference for certain categories of 501(c)(3) organization over others. It also presents alternative regulatory approaches, giving policymakers a base from which to regulate abuse generally. Thus, the recent wide array of reported scandals at public charities tested the underlying theory of the public-private distinction, raising the question whether additional anti-abuse rules were necessary for public charities. For example, if self-dealing at public charities is not sufficiently addressed by current law, should the less forgiving private-foundation self-dealing rules be applied? Similar questions could be asked of all the private foundation anti-abuse rules.

Although the ongoing efficacy of the public-private distinction was not directly addressed in the reform legislation, Congress made liberal use of the private foundation rules in reforming two types of public charity: donor advised funds and supporting organizations. Here, Congress applied private foundation-like rules in the areas of the charitable deduction, self-dealing, payouts for exempt purposes, excess holdings of a business, and nonexempt purpose expenditures.

While utilizing private foundation rules for these types of public charities may be a natural and appropriate response, the more the private foundation rules are applied to public charities, the less distinct public charities and private foundations become. Indeed, it is likely that with each new scandal at a

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public charity, the pressure will increase to extend the private foundation anti-abuse rules to cover the new scandal.

The trouble with such a selective incorporation approach, however, is that it neglects to address the underlying issues. Granted that our current system treats some 501(c)(3) organizations better than others, does the current basis for doing so make sense? Should we assume that some 501(c)(3) organizations are inherently deserving of "better" treatment because of their function, or sources of support? Or can we draw different lines? Rather than selectively incorporating aspects of the private foundation regime to public charities, a more sensible approach might be to reexamine the basis for the distinction altogether and analyze each abuse currently regulated and decide the extent to which the abuse remains a concern, and if so, with respect to what types of 501(c)(3) organizations. Should all section 501(c)(3) organizations be subject to an excise tax for non-exempt purpose spending? Should there be tax consequences to imprudent investing for any type of section 501(c)(3) organization? Should we distinguish 501(c)(3) organizations for purposes of the charitable deduction, not just on the basis of whether the organization actively conducts a program (as opposed to primarily making grants), but also on the type of program or public good provided?

(iii) Toward brighter enforcement lines

One response to abuse of section 501(c)(3) organizations is for more and better enforcement of the laws. But one of the difficulties with a "more enforcement" argument, apart from the political question of resources, is the question of standards for enforcement. For public charities, there are no measurable affirmative obligations and few anti-abuse rules. Enforcement is largely of broad purpose requirements or of negative restrictions that depend intensively on facts and circumstances determinations: for example, no private inurement, no private benefit, no intervention in a political campaign, and no substantial lobbying.[11] Further, because of the all-or-nothing nature of 501(c)(3) tax exemption, enforcement for public charities generally means the drastic step of revocation of charitable status. The chief exception to revocation is the intermediate sanctions or excess benefit transaction rules, but these are fairly generous as compared to the private foundation rules on self-dealing, are process-oriented, and fairly limited in scope.

More effective enforcement might depend on a new legislative approach: brighter lines and, perhaps, positive requirements. There is evidence that the legislative policy is beginning to shift in this direction. Precise standards imposed on credit counseling organizations and the private foundation-like rules that apply to donor advised funds and supporting organizations are each modest confessions that additional enforcement tools are needed to police certain abuses. In addition, these provisions show a preference for brighter lines in enforcement over the prevailing facts and circumstances or value-based standards for imposition of sanctions.

Even stronger evidence of a shift is found in the rule enacted in 2006 designed to stop participation by tax-exempt organizations in tax shelter transactions. The provision imposes a 100 percent excise tax on proceeds attributable to knowing participation by a tax-exempt organization in a "prohibited tax shelter transaction." Notably, the tax applies even absent knowing conduct, though the rate is reduced in such cases to 35 percent.

In enacting this provision, more than any of the other reform provisions, Congress changed the ground rules for tax-exempt status. As a policy matter, the provision stands for the proposition that it is

[11] With respect to lobbying, section 501(c)(3) organizations that make an election under section 501(h) of the Code are subject to an extensive set of regulatory rules, and so are not subject to the default facts and circumstances "no substantial part" test.

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fundamentally inconsistent with tax-exempt status to engage in conduct that enables tax evasion. True to form, it is a negative restriction, but unlike some of the other broad negative restrictions (no substantial lobbying, no political intervention), it was written with a strong deterrent that does not require revocation of tax-exempt status. And consistent with the anti-abuse approaches taken with respect to donor advised funds and supporting organizations (following the private foundation approach), the rule in effect stops the transaction, without allowance for much in the way of facts and circumstances ambivalence. In short, the rule provides the IRS with a strong, previously lacking, enforcement tool.

Going forward, the question is the extent to which this trend will continue. Although bright lines can have inequitable outcomes, their administrative appeal is manifest. As the public charity-private foundation distinction breaks down and the section 501(c)(3) sector continues to grow, there will be increasing pressure for more certainty in tax enforcement through imposition of bright-line rules.

E. Concluding Observations: Tax Policy and Section 501(c)(3)

In general, over the course of a century, notwithstanding dramatic change in the scope and diversity of the section 501(c)(3) sector, and so of the aggregate value of the tax benefits, most legal change has been in the form of negative requirements or process-oriented positive requirements and not in the imposition of substantive positive obligations. Although the initial exemption of 1913 has been significantly restricted in many ways, key fundamental traits have remained relatively untouched: the broad purpose-based approach to qualification as a section 501(c)(3) organization, the all-or-nothing approach to enforcement for public charities, and the policy of linking multiple tax benefits to a determination under section 501(c)(3). The result has been a large, growing, and diverse section 501(c)(3) sector, but also a sector, especially with respect to public charities, that is proving increasingly difficult to oversee.

Recent reform legislation shows that the law is wrestling with the remaining legacies of the initial approach to section 501(c)(3) exemption. Clear trends that emerge are frustration with the breadth of the standard under section 501(c)(3) and with the all-or-nothing, facts and circumstances-based means of enforcement. The result has been piecemeal reform: a fragmentation of the section 501(c)(3) sector based on purpose (but an unwillingness or inability to measure the purpose), and a gradual but selective blending of the public charity-private foundation distinction. This piecemeal reform approach has some predictive capacity. As new scandals are reported, the law will likely continue to shift in the direction now cast – following the lead of credit counseling organizations and hospitals, and further disaggregating the sector. And the law likely will continue to borrow anti-abuse measures from the private foundation regime and selectively apply them to public charities on a case-by-case basis.

Such piecemeal reform, certain to have detractors, nevertheless should be viewed as a consequence of the reluctance to impose substantive positive obligations on section 501(c)(3) organizations. In the absence of a positive standard for exemption and the presence of a growing sector, when it comes to oversight, there may be little choice but to draw additional lines based on form and not substance. This may result in formal compliance, with greater emphasis placed on functional categories and process: such as through governance initiatives, greater disclosure and transparency, community-based input and accountability, and brighter (if harsh) enforcement lines to police abuses.

Key questions going forward are whether additional reform is necessary along the lines established, whether the status quo is acceptable, and whether the current system has become too complex. My suggestion is to start from first principles – and to debate anew the relationship of the federal tax law and private, "good purpose" organizations. My overarching concern is that our law is developing without a clear understanding of the federal legal role. To what extent does tax exemption warrant regulation? What types of entities does the government seek to promote? Should the government

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care how an exempt organization spends its money? Is there a federal tax policy with respect to "charities"? The answers to these questions are not easy – but attempting to answer them is important.

At a minimum, protecting the integrity of the sector (the "halo"), and easing its administration, should be a top priority. In my view, Congress could advance this goal by focusing on ways to keep section 501(c)(3) organizations from abusive arrangements. One way would be to reconsider the current tax incentives for noncash charitable contributions. Many of the scandals of the past decade involved such contributions, which encourage donors and section 501(c)(3) organizations alike to engage in transactions that often yield questionable public benefits. The cost is not just to the Treasury, but to tax administration and to the reputation of the sector. Another is to ensure that the rules enacted to prevent tax-exempt organizations from participating in tax shelter-like arrangements are working. A third is, as a general principle, to tighten or maintain current borders, such as the rules against campaign activity, substantial lobbying, the unrelated business income tax, and private inurement (through tougher intermediate sanctions). Although some would argue that some borders should be expanded, to allow campaign activity for example, I think it important to recognize that further dilution of section 501(c)(3) purposes could lead to even more abuse and a less "charitable" sector.[12]

More broadly, my testimony is intended to emphasize that the current regulatory approach is largely ineffective – in part because there is no clear goal for oversight. Is the goal just to minimize abuse, or to promote a public good (other than the presence of a large and diverse section 501(c)(3) sector)? The purpose-based approach is increasingly complex, yet by focusing on purposes not activities, the system's added complexity does little to promote or reward positive "charitable" output, and continues to facilitate unchecked growth in an environment of dwindling tax administration resources. This may not be sustainable.

If the present approach to the section 501(c)(3) sector is to be reconceived, it is important to recognize that much of the federal interest in section 501(c)(3) organizations stems from the charitable deduction and other tax benefits, and less from tax exemption. Accordingly, the tax policy focus could, and in my judgment should, be on whether the eligibility standards for other tax benefits, especially the charitable deduction, should be tightened, including by changing from a deduction to a credit. Focusing on the tax policy in support of charitable donations would lead, appropriately in my view, to greater emphasis on promoting activities, such as certain types or levels of output of public goods, rather than merely curbing abuses. Ultimately, this is the precise role of Congress to decide the types and quantum of charitable outcomes and activities that should be encouraged and rewarded by the federal tax system, and the tax benefits to be used for such purposes.

The section 501(c)(3) sector is widely praised and admired for its contributions to society and as representing much of what is best in our nation: a dynamic civil society that fosters volunteerism, altruism, and community. But the section 501(c)(3) sector also is a "sector," replete with business elements, inefficiencies, bad actors, and vested interests. The federal tax system's support for the section 501(c)(3) sector is longstanding, but also to a certain extent adrift. There is no simple remedy – but this hearing is an important step toward more effective oversight.

Thank you for inviting me to testify, and I welcome any questions.

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[12] My forthcoming article, *The Political Speech of Charities in the Face of Citizens United: A Defense of Prohibition*, addresses this issue (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1726407).